A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa

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Director: Jan Joost Teunissen

A Regional Approach to Financial Crisis Prevention

Lessons from Europe and Initiatives in Asia, Latin America and Africa

Edited by
Jan Joost Teunissen

FONDAD
The Hague

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The views expressed in this book do not necessarily represent those of the Forum on Debt and Development or any of the co-sponsors. The summaries of the floor discussions, following the papers, attempt to convey the sense and substance of what was discussed. They have not been reviewed by all of the participants.

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Abbreviations

ACEP	Asia-Europe parliamentary meeting
ADB	Asian Development Bank
AFDM	ASEAN Finance and Central Bank Deputies Meeting
AMF	Asian Monetary Fund
APEC	Asia Pacific Economic Cooperation
ASA	ASEAN Swap Arrangement
ASEAN	Association of South-East Asian Nations
ASEM	Asia-Europe Meetings
AU	African Union
BBC	basket, band, and crawl
BIS	Bank for International Settlements
BOP	balance of payments
BS	Balassa-Samuelson effect
BSA	Bilateral Swap Arrangement
CAP	Common Agricultural Policy (of the EU)
CCL	Contingency Credit Line (of the IMF)
CEMLA	Centro de Estudios Monetarios Latinoamericanos
CEPAL	see ECLAC
CEPR	Centre for Economic Policy Research
CGFS	Committee on the Global Financial System
CMI	Chiang Mai Initiative
CNB	Czech National Bank
COMESA	Common Market for Eastern and Southern Africa
CPI	Consumer price index
CZ	Czech Republic
DCs	developed countries
DM	Deutsche mark
EAEC	East African Economic Community
ECB	European Central Bank
ECLAC	Economic Commission for Latin America and the Caribbean (of the UN); (in Spanish CEPAL)
EMEs	emerging market economies
EMS	European Monetary System
EMU	Economic and Monetary Union
EPU	European Payments Union
ERM	Exchange Rate Mechanism (European)
ESCB	European System of Central Banks
EU	European Union

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EWS	early warning system
FDI	foreign direct investment
FSAP	Financial Sector Assessment Program
FSSAs	Financial System Stability Assessments
FTA	free trade area
FTAA	Free Trade Area of the Americas
GDP	gross domestic product
IMF	International Monetary Fund
LIBOR	London Interbank Offered Rate
Mercosur	Southern Cone Common Market (in Latin America)
MFG	Manila Framework Group
NAFTA	North American Free Trade Agreement
NBH	National Bank of Hungary
OAU	Organisation of African Unity
ODA	official development aid
OECD	Organisation for Economic Cooperation and Development
PIBOR	Paris Interbank Offered Rate
PPP	purchasing power parity
RTA	regional trading arrangement
SACU	Southern African Custom Union
SADC	Southern African Development Community
SDR	special drawing right
SEACEN	South East Asian Central Banks
SEANZA	Central Banking Group of South East Asia
TEs	Transition Economies in Eastern Europe
USD	US dollar
WTO	World Trade Organization

Introduction

Can regional financial arrangements help prevent the outbreak of financial crises in emerging and developing economies? Should the governments of these countries follow the example of Western Europe and stabilise the exchange rates in their region by fixing them to each other rather than to the dollar, the yen or the euro? Should international organisations like the IMF and the World Bank become much more open and supportive to regional monetary arrangements? These are the questions discussed in this book. In light of the recurring financial crises of the last eight years – Mexico (1994), East Asia (1997), Russia (1998), Argentina (2001) – these questions are highly relevant for policymakers as well as the public at large.

The book starts with a chapter by Charles Wyplosz on Europe's experience with exchange rate arrangements. Wyplosz analyses why Western Europe has been so successful, and whether its experience holds lessons for other regions of the world. He focuses in particular on the choice of exchange rate and capital mobility regimes and argues that Europe's story contradicts the one suggested by the current conventional wisdom that fixed exchange rate regimes are doomed to fail in a world of unfettered capital flows. Commitment to fixed exchange rates was considered far more important than establishing full capital mobility. Capital mobility was restrained for decades, both internally and externally, and was only fully implemented after achieving a high degree of trade integration and establishing powerful regional institutions.

"Put differently," concludes Wyplosz, "regional trade integration, exchange rate stability and institution building came first, capital mobility and monetary union came last."

Wyplosz suggests that countries that aim to deepen trade integration may opt, like Western Europe did before, for a mutually fixed exchange rate regime. He stresses that policymakers should realise that applying financial restrictions is not as sinful as generally is believed nowadays.

Wyplosz' analysis incited an interesting debate. For example, Leslie Lipschitz, of the IMF, said that he could not imagine a country successfully imposing any kind of capital account restriction when it had already l iberalised capital flows. "You cannot get the genie back into the bottle," Lipschitz observed. Lipschitz' view was shared by those who argue that financial markets have been liberalised and linked to each other through sophisticated computer technology to such a degree that it would be foolish to think that one could return to the former days of financial

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restrictions. Wyplosz viewed this as nonsense. "I don't agree with the view that you can't put the genie back in the bottle because the genie has become so sophisticated. I think the bottle too has become much more sophisticated. If we wanted to restrict capital movements we could use all this wonderful technology for that."

Bill White, of the Bank for International Settlements, did not believe there is any evidence that fixed exchange rates would encourage trade. In fact, he argued, it is the other way around. "What happened after the collapse of Bretton Woods? Trade exploded when currencies started to float. And what has happened in recent years since many smaller countries have chosen to float their currencies? Again, the growth of trade volumes has been dramatic."

However, Zdeněk Drábek, of the WTO, observed that Bill White dismissed the fact that East Asian countries had been growing rapidly for 20 to 30 years because they had stable exchange rates. "The conventional wisdom and prevailing argument of the time was that one reason why the countries have been growing so fast was precisely the fact that they had a clear notion of the advantages of stable exchange rates."

Brian Kahn, of the Central Bank of South Africa, compared the lessons of Wyplosz' analysis for the African experience. One of the critical challenges policymakers in Africa are facing, said Kahn, is the will to engage in regional integration (which requires partially giving up sovereignty) and deal with the problem of "centre country". "Many of the debates in Southern Africa about regional integration, particularly monetary integration, focus on the 'problem' of South Africa being the dominant country," observed Kahn.

In the second part of the book, which deals with economic convergence and financial stability in Central and Eastern Europe, Oldřich Dědek examines one of the key economic policy issues for countries aspiring to become members of the European Union: real versus nominal convergence, or in other words, "Copenhagen" versus "Maastricht" criteria. The so-called Copenhagen criteria aim at establishing a market economy and closing the economic gap between the candidate countries and the member states of the European Union. The Maastricht criteria, on the other hand, set a number of nominal economic parameters for inflation, long-term interest rates, public budgets and the exchange rate.

Dědek observes that many economists believe that the real convergence criteria of Copenhagen and the nominal convergence criteria of Maastricht compete with each other and that "exaggerated" ambitions to meet nominal convergence criteria (such as low inflation and low public debt) will harm real convergence and result in slower growth. According to this critical view, more time is needed to close the economic gap between the accession countries and the EU member states. However, there is also an alternative view, which stresses the complementarity between real and nominal convergence.

Dědek discusses the trade-offs between real and nominal convergence and suggests that each candidate country will have to choose its own path, taking into account its own historical experience and social preferences.

In his chapter in the second part of the book, János Vincze argues that not all financial crises seem to be equally destructive, and he distinguishes between "bad" and "good" crises. He defines those that amplify real disturbances as "bad", and those where fluctuations have risk-sharing features and do not aggravate real shocks as "good". In Central and Eastern Europe, it is widely believed that full membership of the EU will reduce the vulnerability to financial crises, says Vincze. This may be true with respect to "bad" crises, but being "locked in" by a regional arrangement will not prevent financial crises from happening, as Mexico's crisis after its accession to NAFTA illustrates. Vincze observes that the accession countries may become vulnerable to financial crises in particular during the intermediate stage before fully joining the EU and recommends bold liberalisation of the financial sector to shorten the intermediate stage.

In her comments on Dědek and Vincze, Stephany Griffith-Jones stressed that countries like the Czech Republic and Hungary should not engage too ambitiously in disinflation policy, because this might hinder growth of the economy and of productivity. Griffith-Jones disagreed with Vincze's distinction between good and bad crises. She suggested that a more interesting distinction would be between crises in developed and emerging market countries. Since most emerging market crises are extremely costly, she thought it would be better to try and prevent such crises. She also thought that too hasty liberalisation of the financial sector in Central and Eastern Europe could make these countries more vulnerable.

In the third part of the book, which deals with regional economic integration in East Asia and South America, Yung Chul Park examines the rationale and need for a regional monetary arrangement in East Asia. After the financial crisis broke in Asia in 1997, Japan proposed the creation of an Asian monetary fund as a framework for promoting financial cooperation and policy coordination in the region. The idea was that this would help Asian economies prevent and/or better manage future financial crises. The proposal received a positive response from a number of East Asian countries, but it was shelved on the objection of the US, the EU and the IMF. The idea was revived again in 2000 when the ASEAN countries plus China, Japan and South Korea agreed to establish a system of swap arrangements which became known as the Chiang Mai Initiative. The aim of the initiative is to provide liquidity support to countries experiencing

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balance of payment difficulties in order to prevent the financial turmoil and regional contagion that struck East Asia at the end of the 1990s.

Park deals extensively with the question of whether regional financial arrangements are needed in East Asia, and whether they would be effective in safeguarding the region from future financial crises. He discusses arguments opposing the creation of regional financial arrangements and contrasts them with views that suggest that regional financial mechanisms could complement multilateral trade and financial liberalisation while helping to promote global financial stability.

Commenting on Park, Leslie Lipschitz of the IMF reported that the Fund was now "wholly positive" about the Chiang Mai Initiative and other regional financing initiatives in Asia, but warned that they should not provide "unconditional" finance. In other words, the IMF should maintain its role of setting the conditions under which international financial support is given to a country. While Park favours the establishment of a common peg system, Lipschitz argued that the recent experience of fixed exchange rate regimes in Asia, Russia, Brazil and Turkey has been "less than comforting". He therefore opposed the idea of a common currency or peg.

In the chapter on Mercosur, Daniel Heymann observes that macroeconomic turbulence is not a novelty for Argentina, Brazil and their partners. However, there has been little movement in establishing concrete forms of macroeconomic cooperation to deal with such turbulence. On the contrary, recent macroeconomic disturbances, particularly the Brazilian currency crisis of 1999 and the deep recession and financing difficulties of Argentina of 2001-02, have raised scepticism in the Mercosur countries about the benefits of regional integration. Still, economic and political developments will continue to affect individual Mercosur countries, Heymann observes. He reflects on the possibilities for concerted regional action.

Commenting on both Park and Heymann, Amar Bhattacharya, of the World Bank, said that financial experts still talk about fixed versus floating exchange rates for a *country*, whereas the crucial issue is the stability of exchange rates within a *region*. Bhattacharya raised the question of what would be an appropriate regional group in order to establish a regional financial arrangement. He came to the conclusion that it does not need to be a single group or currency bloc, but rather a variety of regional groups (e.g. in Latin America, the Latin American Reserve Fund, ECLAC, Mercosur, the Andean Pact). Such groups are important, he said, because they give voice to smaller countries, create the feeling of "ownership", and provide regional surveillance and policy dialogue. In addition, groups like the Latin American Reserve Fund and the Chiang Mai Initiative give liquidity support to a member in financial trouble.

In a lively debate about the regional integration efforts in East Asia and South America, various issues were discussed including the IMF's monopoly of conditionality, exchange rate stability, market failure in assessing financial risk (in countries and regions), the division of roles between global and regional players, and G-7 intervention in debt negotiations. On the last issue, concerning G-7 intervention, Leslie Lipschitz and Yung Chul Park had opposing views. Lipschitz said that every single IMF finance package is always the result of serious discussions between the Fund and the country concerned, and that the idea of G-7 interference in negotiations between the Fund and Korea was wrong. Park retorted that it was not the G-7 interfering in a coordinated way, but the United States alone who were telling the Koreans what to do. "And it was only when the G-7 agreed and came up with a new financing package that the markets finally took it seriously and stopped attacking the Korean currency. That is on the record. I am not making up the story."

The fourth and last part of the book presents the views of five officials expressed in a joint panel discussion. José Antonio Ocampo (ECLAC) tells why he is in favour of a greater role for regional institutions in the world order. Heiner Flassbeck (UNCTAD) stresses the importance of addressing a crucial topic that remains unresolved, namely a regional approach to the exchange rate issue. Paul Jenkins (Canadian Department of Finance) focuses on the need for establishing a predictable framework for crisis resolution. Leslie Lipschitz (IMF) reports on the new approach of the Fund to crisis prevention and crisis resolution, and gives his view on the complementary role that regional groups can play. Bill White (BIS) discusses the role of the Bank for International Settlements in both crisis prevention and crisis management.

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Part I

Lessons from European Economic Integration

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Regional Exchange Rate Arrangements: Some Lessons From Europe[1]

Charles Wyplosz

1 Introduction

Regional arrangements are in vogue, at least on paper. The Western Hemisphere, already equipped with NAFTA and Mercosur, is discussing the Free Trade Area of the Americas (FTAA). With the Chiang Mai Initiative, East Asian countries are attempting to deepen financial cooperation. The Caribbean countries are also working on deepening their arrangements, and steps are being taken in Africa. Yet, regional efforts have rarely been successful over the last fifty years or so. This is partly explained by the official international emphasis on multilateralism, backed by such powerful institutions as the IMF and the World Bank. But another part of the explanation is that, to exist at all, regional arrangements must add to the fairly extensive web of already existing multilateral agreements. This, in turn, requires deeper integration, and, therefore, some sacrifices in terms of sovereignty – thus raising the costs of agreements whose benefits are typically marginal relative to existing multilateral arrangements.[2]

Europe provides the standard example of a successful regional arrangement. It is natural, therefore, to ask why it has succeeded and whether its experience reveals lessons that could be used elsewhere in the world. A vast literature explores various aspects of this question. This paper focuses on a particular aspect of regionalism, financial arrangements and the related choice of exchange rate and capital mobility regimes.

The attraction of regional exchange rate arrangements is in part stimulated by a new conventional wisdom, the hollowing-out view, which holds that there is no workable middle ground between floating and hard

1 Paper presented at the conference on "The Role of Regional Financial Arrangements in Crisis Prevention and Management: The Experiences of Europe, Asia, Africa and Latin America", organised by the Forum on Debt and Development (FONDAD) in Prague on 21-22 June 2001. I have benefited from comments by conference participants, in particular my discussants Zdeněk Drábek and Bill White. This version draws on joint work with David Begg, Barry Eichengreen, Jürgen von Hagen and Lászlo Halpern. The opinions presented here are my own, however.

2 For an analytical background on the politics of regional agreements, see Aggarwal and Dupont (1999).

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pegs. It predicts that traditional fixed exchange rate regimes, still in place in more than half of all countries, are doomed in a world of unfettered capital flows. According to this view, those countries that wish to limit exchange rate flexibility among themselves will have to go all the way to hard pegs. The relevant regional arrangement is a monetary union or joint dollarisation. In this discussion, full capital mobility is taken as a natural Darwinian step in mankind's evolution. Europe's experience emerges as a potential blueprint.

The thesis of this paper is that Europe's story is very different from the one suggested by the current conventional wisdom. I argue that the commitment to fixed exchange rates has all along taken precedence over capital mobility. Exchange rate stability has been seen as a pre-condition for trade integration, the only way of establishing a level-playing field for international competition. The decision to adopt a common currency has come very late, much as capital mobility has been restrained for decades, and established only after achieving a high degree of trade integration, along with powerful supporting institutions. Put differently, regional trade integration, exchange rate stability and institution building came first, capital mobility and monetary union came last.

The following section sets the stage; it describes the exchange rate regimes adopted in Europe over the last 50 years. Section 3 builds up the case that trade was a key concern behind the commitment to exchange rate stability. Having noted that fixed exchange rate regimes are inherently unstable, Section 4 looks at the various measures that were adopted in an effort to increase the chance of survival of the fixed exchange rate arrangements. These measures at times severely constrained the financial markets, both domestic and external. But is it not the case that such measures are costly and inefficient? Section 5 attempts to answer that question and, surprisingly perhaps, finds no such evidence. Quite to the contrary, in Europe at least, domestic financial repression seems to have supported growth. The last section attempts to distillate the lessons from Europe's experience. It argues that the choice of an exchange regime cannot be dissociated from the choice of a regime of capital mobility. Countries which are open, or country groupings which aim at deepening trade integration, may indeed opt for a fixed exchange rate regime. Hard pegs are an option, but not the only one once financial repression is not seen as sinful.

2 Exchange Rate Arrangements in Europe

This section briefly lists the different arrangements adopted in Europe since the end of World War II. It illustrates two key aspects of Europe's

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monetary integration: a constant quest for internal exchange rate stability and a succession of daring advances and setbacks.

Bretton Woods. The Bretton Woods agreements of 1944 provided indirectly for fixed exchange rates within Europe but it was not a joint undertaking, nor was it intended to further any specific European goals. The agreements matched European interests, but also those of the US equally preoccupied with the restoration of trade links. Faced with an acute shortage of dollar balances, European countries did not move to establish currency convertibility from the outset. As they concentrated on developing bilateral payment settlement agreements, both among themselves and with non-European countries, they started to work out their own arrangements.

The European Payments Union. The European Payments Union (EPU) was set up in 1950 to simplify the cumbersome web of some 200 bilateral payment agreements. It worked as a multilateral clearing system, focusing on the overall balances of payments of its member countries vis-à-vis the union. Generally considered as a success, the EPU is credited for having helped the resumption of intra-European trade. The EPU had some drawbacks, mainly its tendency to encourage trade amongst its members, discriminating against non-members.

Convertibility. The next major move, the restoration of currency convertibility in Europe in 1958, was decided collectively, alongside the adoption of the Treaty of Rome, the foundation of Europe's Common Market. Convertibility initially only concerned the current account. For many more years, the capital account remained subject to fairly draconian restrictions in most countries. The arrangement provided for a high degree of exchange rate stability, with few realignments. The first major depreciation, by the UK, did not occur until 1967. It was followed by a depreciation of the French franc and a revaluation of the Deutschemark, both in 1969.

The Snake. By the time the Bretton Woods system collapsed during 1971-73, further imbalances had accumulated inside Europe. After a series of realignments, most European countries undertook to maintain limited margins of fluctuations for their bilateral exchange rates while the other developed countries let their currencies float. The resulting arrangement, the Snake, was a mixed success; most countries were able to keep up with the arrangement, but speculative pressure forced others – mainly France, Italy, and Sweden – to exit the Snake. Outside of Britain, there was no serious questioning of the wisdom of keeping exchange rates pegged.

The Werner Plan. The main setback from European monetary integration during 1971-73 was the abandonment of the Werner Plan. Completed in 1970 and endorsed by the Council of Ministers in 1971, the

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

Werner Report had recommended the rapid adoption of a common currency. It mapped out three stages, including the pooling of foreign exchange reserves for joint interventions. The turmoil surrounding the breakup of the Bretton Woods system led the larger countries to aim at more modest steps, partly out of pragmatism, partly as a pretext to escape a move that was clearly ahead of policymakers' thinking. The smaller countries, which were seeing their own policy autonomy decline, were frustrated by the failure of the Werner Plan but unable to shake the domination of the larger countries.

The European Monetary System. Monetary integration soon took another direction, though. The European Monetary System (EMS) was agreed upon in 1978 and launched in 1979. Eight of the then nine members of the European Community became active members of the exchange rate mechanism (ERM). When the euro was launched in January 1999, all members of the European Union were part of the ERM, with the exception of Sweden, the UK, and Greece. Greece joined the ERM later that year.[3]

The European Monetary Union. During its first ten years of existence, the ERM frequently underwent crises. By the early 1980s its survival was very much in doubt, especially as a series of attacks affected the French franc in the wake of the election of President Mitterrand. The political reaction turned out to be another show of support for fixed exchange rates. The authorities rededicated themselves to a new ERM, one where the DM would play the role of central currency. This "Greater DM area" gradually asserted its credibility and became seen as such a success that policymakers grew emboldened and resolved to move to the next logical step, monetary union.[4] But the ERM success was concealing a buildup of tensions. The combination of accumulated imbalances and of a major policy mistake – the denial that German unification would require a DM revaluation – triggered a round of violent speculative attacks. Two countries (Italy and the UK) left the ERM, many were forced to devalue, some of them several times. The ERM was radically changed when its margins of fluctuations were widened to the point of irrelevance. Yet, while the ERM currencies were officially quasi-floating, unofficially the monetary authorities endeavoured to keep them within narrow margins, in fact quietly mimicking the defunct ERM.

Summarising, since the early 1950s, with the notable exception of

3 Among European non-member of the EU, Switzerland has traditionally steered its own currency alongside the DM, even though it has always been very careful not to declare an official linkup, and has occasionally used the exchange rate as a tool of monetary policy.
4 A detailed review of this evolution is provided by Kenen (1995).

Britain, the European countries have continuously sought to tie their exchange rates. The Bretton Woods system initially provided an adequate framework which did not require any additional explicitly European initiative. When it fell apart, Europeans promptly moved to develop their own arrangements, starting with the rather informal Snake, moving on to the more structured and cohesive EMS, and ending up with a full-blown monetary union. This history reveals a strong commitment to exchange rate fixity, even as most other developed countries, including the UK, were moving in the opposite direction of increased flexibility.

3 Why Exchange Rate Stability: Market Shallowness, Discipline or Trade?

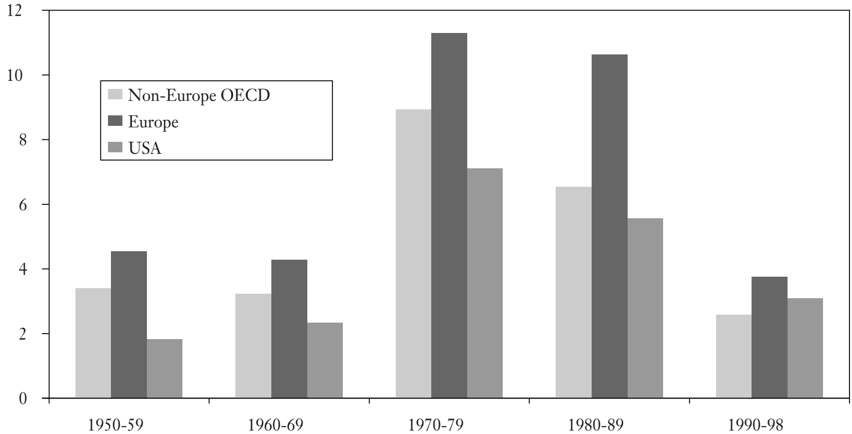
There are several reasons for wanting to limit exchange rate variability. The most commonly cited reasons are a lack of sufficiently deep financial and exchange markets, a strategy of importing monetary discipline, and a quest for stability for trade purposes. This section argues that, in Europe, the key motivation was trade.

Financial and exchange markets were shallow in Europe in the 1950s. After the move to current account convertibility in 1958, capital account restrictions remained widespread, partly motivated by the belief that it would help to operate the fixed exchange rate system. By the late 1970s, Europe had deep enough markets to operate reasonably efficient exchange markets, yet capital restrictions remained widespread. The UK had liberalised in 1979 but was not part of the ERM; within the system, Germany was the first, and for a long while the only country, to make the move towards lifting capital controls in 1981 (see Table 1).

It is often claimed that most countries wanted to use the nominal exchange rate as an anchor to import the Bundesbank's discipline. This view is wholly revisionist. To start with, the discipline argument predicts that Europe's inflation rate should have remained close to that of the US during the Bretton Woods period, and then close to the German rate. It also predicts that Europe's inflation should have been lower than in the other industrialised countries which have been floating for most of the post-Bretton Woods era (Japan, the UK, Switzerland and Canada; and more recently Australia and New Zealand). Figure 1 does not bear out these predictions. On average, Europe (excluding the floaters, Switzerland and the UK) exhibits the worst inflation performance in the OECD area. If discipline was the motivation, it did not work. Most likely, it was not.

Next, the view that exchange rates can be used as an anchor is fairly recent, at least in European official thinking. Arguing that the inflation

Figure 1 Inflation in the OECD Area



Non-Europe is Japan, Canada, Australia, New Zealand, Switzerland and the UK.
Source: IFS.

anchor argument lays as the motivation for the setting up of the EMS involves mixing up timing. It is only after the wave of currency crises of 1983, once France adopted the "Franc fort" strategy, that the EMS started to function asymmetrically with the DM as its recognised anchor. When the EMS was created, reference was explicitly made to nominal exchange rate stability, not to the desire of anchoring inflation to best practice in Germany. Realignments were not only possible but actively practiced and always justified as a "correction" of accumulated inflation differentials. In fact, the EMS was explicitly set up as a symmetric system, with no centre currency. Its rules carefully avoided adopting the Bretton Woods presumption that countries with high inflation and a weak currency would bear the burden of adjustment in case of misalignment and market pressure. Responsibility for exchange market interventions was strictly bilateral, with unlimited support from the strong to the weak currency country. Much to the discomfort of the Bundesbank,[5] the EMS was aiming at a "regression toward the mean", not attempting to build up pressure towards best practice.

The view that exchange rate stability promotes commerce has no theoretical support (uncertainty can either encourage or discourage international trade depending on assumptions) and limited empirical support.

5 As documented in Eichengreen and Wyplosz (1993), the Bundesbank had arranged for a private agreement with the German Treasury that would suspend the intervention clause if it determined that it was threatening price stability. This clause was invoked during the Italian lira crisis in September 1992.

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

See for example Kenen and Rodrik (1986) for a sample of industrialised countries and de Grauwe (1988) for the European Union; a recent review and more weak evidence is provided by Flam and Persson (2000), with stronger evidence in Pozo (1992), Rose (2000) and in the recent literature on the border effect (Helliwell, 1998). Yet, this motivation has been crucial. Policymakers happened to believe that nominal exchange rate stability matters for trade, in spite of the theory and the evidence, and possibly for good reasons.

Most of the empirical evidence is based on high frequency (typically from one month to one year) fluctuations in the exchange rate. At such frequencies, there exist cheap hedging instruments, so that it is not surprising that the effect of high frequency exchange rate volatility is weak or non-existent. For technical reasons (chiefly the lack of enough observations), the literature does not deal with lower frequencies, in particular with the often deep multi-year currency cycles (e.g. vis-à-vis the dollar, the yen has depreciated by 47% between 1978 and 1985, then appreciated by 52% between 1985 and 1988, to depreciate again by 28% until 1990, and appreciate by 48% by 1995; similar fluctuations can be found for the DM, e.g. a 92% depreciation between 1979 and 1985, followed by a 52% appreciation by 1987). Such fluctuations cannot be insured against, at least not cheaply or conveniently.[6] They simply wipe out established competitive positions. It is difficult to believe that they do not hurt trade.

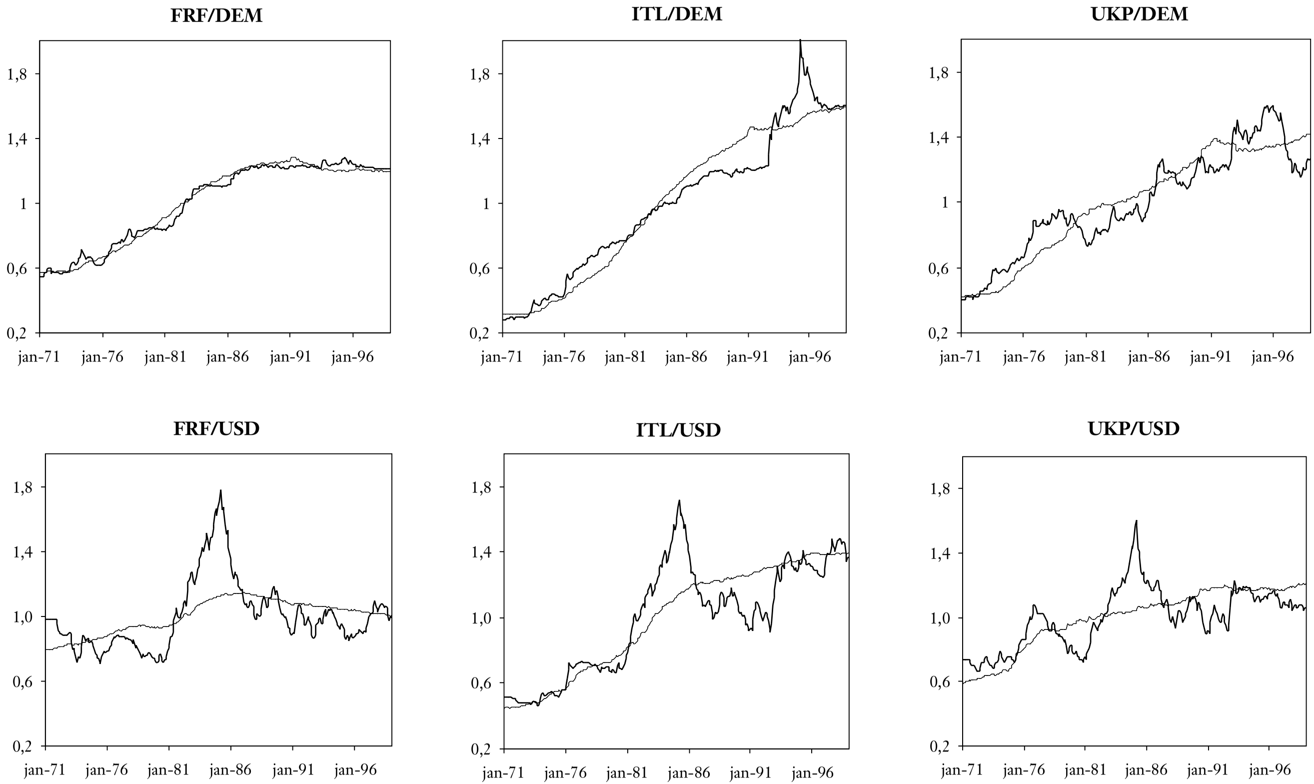
Evidence on the stability of intra-European exchange rates is presented in Figure 2 for the three most important intra-European exchange rates vis-à-vis the DM. The figure displays the actual and PPP exchange rates[7] of the French franc, the Italian lira and sterling pound relative to both the DM and the US dollar. For comparison purposes, they are all expressed as indices computed to average 1.0 over the sample period. While PPP is not necessarily a fact of life, it seems to act as a reliable anchor for most OECD countries. Intra-European rates have differed little from PPP, in sharp contrast with the other exchange rates, with the UK sitting in-between.

It is important to note that it is not the *nominal* exchange rate that was stabilised (another nail in the coffin of the discipline argument), but the *real* rate. Indeed, the ERM provisions for realignments and actual management relied heavily on PPP. Figure 2 also reports the monthly variance of

6 In principle, firms can cover long-term trade exposure by acquiring matching positions but they do not seem to do so.

7 PPP exchange rates are computed using CPIs and take as a base the average exchange rate over the sample period. None of the conclusions drawn are sensitive to the use of a particular price index or to the choice of a base level.

Figure 2 Exchange Rates: Actual and PPP



Source: IFS, CD-ROM.

log-deviations of the actual from the PPP exchange rate; for France and Italy this variance is much smaller vis-à-vis the DM than vis-à-vis the US dollar. For Britain, which did not share the continent's preoccupation with stabilising intra-European real exchange rates, the variances vis-à-vis the dollar and the DM are similar.

Summarising, this section argues that the European countries have identified real exchange rate stability as a key policy target. The discipline argument for exchange rate stability aims at the nominal, not the real exchange rate: nominal rates were anything but stable and Europe's inflation performance has been worse than in most other developed countries. The view that exchange rates were kept pegged because the markets were too shallow to be efficient is not convincing either. That may have been the case in the 1950s and the 1960s when the currencies were simply not convertible, but certainly not in the 1970s and beyond.

4 Exchange Rate Stability or Capital Mobility?

The emphasis on exchange rate stability should have implied a willingness to give up the use of monetary policy for domestic purposes. That has not been the case. Until the mid-1980s, most European countries fully intended to retain their monetary instrument. The first country to completely and explicitly give up monetary policy independence, the Netherlands, did so only after 1982. In fact, in a large number of countries, monetary policy was not only seen as a macroeconomic tool, but also as an instrument to support fiscal policy through the financing of budget deficits, and even as one of the means to conduct structural policies. Interest rates were kept low, often negative in real terms, and bank lending was often directed to favoured sectors and to firms identified as national champions.

The conflict between exchange rate stability and the active use of monetary policy was reconciled through internal and external financial repression, i.e. the use of widespread regulation designed to restrain financial markets. Domestic financial repression included quantitative limits on bank credit, ceilings on interest rates, directed lending, priority to budget financing, limits on the development of stock markets, etc. External financial repression took the form of capital controls, including administrative restrictions on inflows and outflows, the interdiction to lend to non-residents, the banning of forward transactions, the obligation for exporters to remit foreign currency earnings, etc. Domestic financial repression allowed the authorities to control the interest rate independently of credit and money supply growth. External financial repression was mainly designed to prevent international transactions from undercutting

Table 1 Year of Liberalisation in Postwar Europe

	Internal	External
Austria	1981	N.A.
Belgium	1978	1990
Denmark	1980	1988
Finland	1970	
France	1985	1989
Germany	None	1981
Ireland	1969	1992
Italy	1983	1990
The Netherlands	1981	1986
Norway	1984	
Portugal	N.A.	1992
Spain	1966	1992
Sweden	1983	
Switzerland	1975	1980
United Kingdom	1971	1979

Sources:
Exchange controls from Bakker (1996), p. 220.
Credit ceilings from Cottarelli *et al.* (1986), unpublished appendix.

domestic repression. In some countries, external repression was also seen as a way of 'keeping domestic savings home', mercantilism applied to finance. Mostly as a by-product at first, restraints on capital movements also limited the ability of markets to attack the currency.

While Europe has been quite fast at deepening its internal trade, it has been notoriously slow at liberalising its financial markets, both internally and externally. Table 1 reports the final year of full liberalisation. Restrictions did not apply continuously, they were applied on and off according to perceived needs. Even in periods when restrictions were not enforced, the empowering legislation remained in place, no doubt reminding investors and citizens that the regime was *de jure* one of restraints. This section first documents and then interprets financial repression.

4.1 Domestic Financial markets

Internal restrictions mostly took the form of credit ceilings and other limits on credit availability. These restrictions were designed to control the money supply while interest rates could be kept at non-market clearing levels, typically lower. The outcome was a rationing of liquidity, with real interest rates remaining negative in real terms for extended periods of time.[8] Officially, interest rates were kept low to promote investment but the real motivation was to permit a cheap financing of budget deficits. In fact, the authorities were quite explicit on that point. For example, the French authorities had established a queuing system for bond issues by the private sector, in particular hollowing out periods when the Treasury was issuing its own debt.[9]

4.2 *Capital Account Convertibility*

External liberalisation occurred several years after internal liberalisation (Table 1). Various measures were in place to restrict capital movements. They mostly relied on direct administrative controls affecting citizens, firms and financial intermediaries. Belgium operated a dual exchange market separating commercial from financial transactions. Full, unconditional liberalisation was not mandatory until the Single Act of 1992, with accelerated effect on July 1990, except for Greece, Portugal and Spain which were granted grace periods.

The main aim was to keep domestic interest rates lower than implied by the interest parity condition. While it is often asserted that capital controls are ineffective, this has not been the case in Europe, as documented in Figure 3. The figure shows that the controls succeeded in creating long-lasting wedges between the two exchange rates (commercial and financial) in Belgium, and between the internal and external franc interest rates in France. Such deviations represent large profit opportunities. These unexploited opportunities are remarkable because they were riskless since they did not entail either exchange or maturity risk (the returns are in the domestic currency on identical assets). Of course, there was evasion and the measures never were 100% effective. Yet, the fact that the markets were unable to arbitrage away profit opportunities for significant periods of time – often more than one year – is clear evidence that the controls were effective. Despite widespread belief to the contrary, this should not come as a surprise. Evasion is always costly because it is illegal, which creates a rent that eats into arbitrage profits. The figure also indicates that, in quiet periods, the wedge disappeared. This corresponds to either temporary suspensions of the restrictions or to markets' ability to cheaply circumvent the capital controls given enough time.

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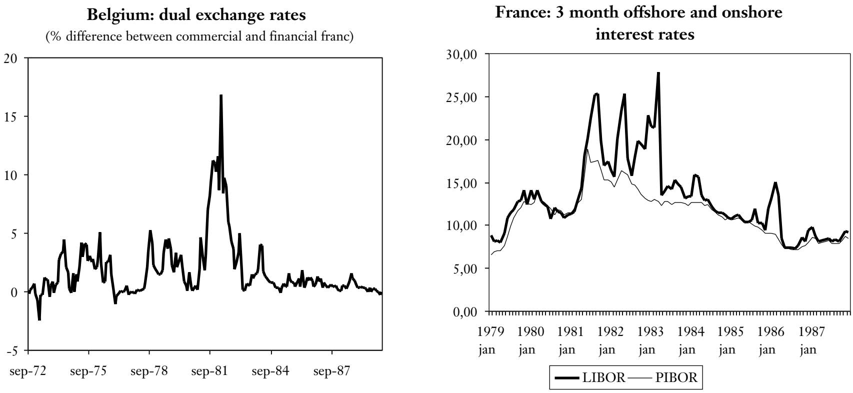
8 The only country where real interest rates have not been negative during the postwar period is Germany.

9 For a detailed discussion of this point, see Wyplosz (1999).

Figure 3 Effectiveness of Capital Controls



Sources: Belgium: Bakker (1996); France: Burda and Wyplosz (1997).

4.3 Impact on Domestic Financial Institutions

Almost by definition, financial repression looks bad. Is it not the case that it hampers both saving and borrowing, that it thwarts competition in financial markets with associated efficiency costs, possibly even breeding corruption and misuse of financial resources? The conventional answer (see e.g. Eichengreen, Tobin and Wyplosz, 1995; Furman and Stiglitz, 1998) is that financial markets are far from perfect. In the presence of information asymmetries, which leads to instability and occasional, catastrophic crises, second-best theory warns that first principles can be seriously misleading. This is not a proof that external financial restrictions are harmless, simply a reminder that their costs and benefits must be balanced before drawing policy prescriptions.[10] This section looks at the costs.

Beck *et al.* (1999) have developed a set of criteria of performance of financial systems. There is no clear indication that European financial systems have been seriously inefficient, at least as far as bank overhead costs and interest margins are concerned. However, the detailed analysis in Wyplosz (1999) suggests that this favourable assessment conceals rent extraction by governments: banks have long benefited from an implicit state subsidy through protection from internal (e.g. interest rates were

10 Until quite recently, there has been little research into the costs and benefits of capital controls. For recent papers, see Arteta et al. (2001), Edwards (2000), Grilli and Milesi-Ferretti (1995), Kraay (1998), Quinn (1997), Rodrik (1998) and Wyplosz (2001a).

regulated) and external competition in exchange for deficit financing at attractive conditions. This is a clear case of crowding out of the private sector by the public sector.

The main conclusions that emerge from the overview of financial repression in Europe in Wyplosz (1999) are as follows. First, domestic financial repression affected financial intermediation, crowding out the private sector to the benefit of public sector financing. Domestic and external financial repression jointly allowed a segmentation of the domestic financial markets from world markets, delivering at times lower than market-clearing onshore interest rates. And more than a decade after full internal and external liberalisation, Europe's banking and financial markets are still undersized relatively to the US. Financial repression has long-lasting effects. Thus, the adverse effects have been far from trivial, and are lingering more than a decade after full liberalisation. But how harmful have they been to growth? This is the issue taken up in the next section.

5 Overall Assessment: How Bad Was It Really?

The macroeconomic development literature (see e.g. McKinnon, 1979), eventually enshrined as the 'Washington consensus', argues that financial repression hurts economic growth. This view is largely informed by the experience of developing countries, for example Latin America over 1950-1970. A possible problem with the conventional wisdom is that it is based on the experience of countries which simultaneously resorted to a wide array of extensive controls, often alongside serious political instability and many other potential impediments to growth, of which financial repression was just one component. In Europe instead, a quick look reveals that its best economic growth performance was achieved in the postwar period, fastest in the 1960s at the heyday of financial repression while goods markets and trade were being liberalised.[11]

Section 3 argues that financial repression was, partly at least, driven by the trade-related concern with real exchange rate stability. Section 4 documents the effects of repression on financial markets. An assessment of Europe's strategy then requires tracking the impact of trade integration and financial repression on the growth performance. It could be that trade integration buoyed growth while financial repression slowed it down, with an overall favourable impact. It could also be that fast growth was simply a catch-up process after the damages of the war, too powerful to be blocked

11 South-East Asia too offers another counter-example to the conventional wisdom, see Rodrik (1998).

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by financial repression. In that view, growth would have been even faster had financial markets be liberalised earlier.

Since Europe stands out among the developed countries for its commitment to exchange rate stability, but otherwise differs little, it is natural to compare its performance with that of the other OECD countries. This is done using the now standard approach developed by Barro and Sala-i-Martin (1992).[12] The approach accounts for catch-up by including the beginning-of-period GDP per capita. It then adds a variety of variables which, theory predicts and previous empirical investigations often confirm, affect growth performance: a measure of education (to proxy for investment in human capital), demography, health, trade openness, saving behaviour and infrastructure factors. The approach uses panel data for two reasons: it looks for general sources of growth, shunning national idiosyncrasies; and in order to eliminate shorter-run aspects, it uses low-frequency data which severely limit the number of observations per country hence the need to increase the sample size, which is achieved by pooling as many countries as possible.

As the aim is to study Europe's experience relatively to other similar developed countries, the sample includes the 14 OECD countries for which adequate data is available: Australia, Belgium, Denmark, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Spain, Switzerland, United Kingdom, United States. The sample period is 1960-95 and, as is customary, cyclical effects are eliminated by using low-frequency, five-year, observations.

Given the similarity of OECD countries, several of the variables found significant in the empirical growth literature which includes both developed and developing countries, play no role here and are left out. On the other hand, the specificity of Europe and the issues at hand suggest adding two institutional aspects: the weight of government – measured as its share of total employment – and the independence of monetary authorities – approximated by the inflation rate.[13] The focus, however, is set on the role of financial repression. Internal and external repression is captured by two dummy variables developed in Wyplosz (1999) and extended here for the non-European OECD countries. A dummy measuring the exchange rate regime is also included.

The results are displayed in Table 2. Neither the fixed effects nor the time dummies (when used) are reported. The first four columns present

12 For related work on samples including developing countries, see Rodrik (1998), Edwards (2000), and Arteta, Eichengreen and Wyplosz (2001b).

13 There is much evidence linking inflation and central bank independence, see e.g. Cukierman and Lippi (1999). For an opposite view, see Posen (1993).

different estimations of the same model with country-specific fixed effects, depending on whether subperiod-specific intercepts are allowed or not, with and without cross-section weights (GLS estimation). The last two columns include additional variables as explained below. The estimates appear to be very robust to the choice of estimating procedure and generally in line with the literature. The credit constraint dummy is everywhere highly significant and precisely estimated to *raise* average annual growth by 1%. The capital controls dummy is also found to have a positive effect on growth but it is only significant at the 10% confidence level in columns (1) and (2), and not significant in columns (3) and (4). Operating a fixed exchange rate regime appears to reduce growth, but this effect is not systematically significant in column (3).

Although the catch-up effect is captured by the beginning-of-period level of GDP per capita, it can be argued that Europe's distinctive experience may be driven by the additional need to make up for World War II destruction, spuriously captured by the financial repression dummy variables. In order to check this possibility, two additional variables have been added: column (5) includes the gap in per capita GDP vis-à-vis the USA, and column (6) further adds the drop in GDP between 1938 and the trough year between 1940 and 1947.[14] The results remain largely unchanged, certainly for the variables of interest, while the additional variables are never significant at the 5% confidence level.

Thus, in contrast with conventional wisdom, internal financial repression – captured by the presence of credit constraints – is found to have a *positive* effect on growth, adding on average one percentage point to the annual performance (measured by growth in per capita GDP). The effect of capital controls is not well established, possibly not significant, but certainly not adverse. The adoption of a fixed exchange rate regime has a small, negative but hardly significant impact on growth. Importantly, trade openness raises growth: a 10% increase in the ratio of the average of exports and imports to GDP is found to raise annual economic growth by 0.2%. It may be that the survival of a fixed exchange rate regime requires financial repression, so we need to look at the overall package, financial repression *plus* fixed rate regime. The effect of such a package on growth is found to be positive. According to the estimates in column (4), the combination of a fixed exchange rate, credit ceilings and capital controls adds annually 0.9 percentage points to growth, without even taking account of the favourable effect of increased trade integration. This is a large number.

It is unclear what precisely lies behind these results. They certainly

14 When there was no decline in GDP per capita over 1938-1947, the end-of-war year is conventionally set in 1945.

Table 2 Financial Repression and Growth Performance

Dependent variable: average annual growth rate of GDP per capita

	OLS No time dummies (1)	GLS No time dummies (2)	OLS With time dummies (3)	GLS With time dummies (4)	GLS With time dummies (5)	GLS With time dummies (6)
GDP per capita	-0.050 **	-0.054 **	-0.043 **	-0.048 **	-0.139 *	-0.062
Beginning of sub-period	-4.172	-4.511	-3.372	-4.375	-2.539	-1.980
Capital controls	0.007	0.004	0.002	0.003	0.006 **	0.001
	1.760	1.839	0.699	1.532	4.708	0.304
Credit constraints	0.010 **	0.010 **	0.011 **	0.010 **	0.010 **	0.008 **
	2.977	3.409	4.280	5.175	6.369	2.964
Fixed rate regime	-0.007 *	-0.008 **	-0.006	-0.004 *	-0.004	-0.003
	-2.135	-3.593	-1.764	-2.375	-1.615	-1.235
Inflation	-0.207 **	-0.198 **	-0.179 **	-0.186 **	-0.187 **	-0.122 *
	-5.150	-7.585	-4.045	-5.588	-8.017	-2.377
Openness	0.021 *	0.019 *	0.025 **	0.023 **	0.021 **	-0.006
	2.067	2.343	2.713	3.943	3.545	-1.942
Size of government	-0.014	-0.009	-0.016	-0.018 **	-0.028 **	-0.009 *
	-1.038	-0.980	-1.589	-2.962	-5.256	-2.440
Higher education	0.004	0.003	0.001	0.002	0.009	0.008 **
	0.441	0.419	0.115	0.528	3.140	3.003
Fertility	-0.012	-0.014 *	-0.014	-0.009	-0.004	-0.002
	-1.419	-2.463	-1.080	-0.990	-0.372	-0.135
Saving ratio	-0.001	-0.004 *	-0.002	-0.007 **	-0.008 **	-0.001
	-0.259	-0.899	-0.564	-2.704	-3.339	-0.233
GDP/capita gap					0.251	0.052
(relative to US)					1.938	0.721
World War II						-0.003
						-0.747
Adjusted R^2	0.716	0.825	0.822	0.959	0.941	0.962
S.E.R.	0.009	0.009	0.007	0.007	0.006	0.009
N. observations	83 m	83	83	83	83	83

Sources: GDP, openness (exports plus imports of goods and services as a share of GDP), size of governments (ratio of public employment to total employment) and saving ratio: OECD *Economic Outlook*, December 1999; Capital controls and credit restraints: Wyplosz (1999); fertility and higher education: Barro-Lee data base from World Bank web site; inflation: IFS; World War II drop in GPD per capita from Appendix C in Angus Maddison, *Monitoring the World Economy, 1820-1992*, OECD Development Centre, Paris, 1995.

Notes: t-statisitics in second line, **(*) significant at the 1% (5%) confidence level; White heteroskedastic-consistent standard errors. Fixed effects allowed.
Estimation period: 1960-1995 with 7 five-year sub-periods. Not reported:country-specific (fixed effects) and period dummies. All variables in logs.
Unbalanced panel of 14 OECD countries: Australia, Belgium, Denmark, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Spain, Switzerland, United Kingdom, United States.

challenge conventional wisdom, but not accepted general economic principles. We know from second-best theory that there is no presumption that financial repression has negative effects in the presence of financial market imperfections, for example credit rationing or connected lending. More generally, other non-market distortions which often coexist with financial repression, may have strong adverse effects and contribute to the conventional wisdom. Europe indeed has long been characterised by widespread government intervention in the good and labour markets.[15] But the formal evidence presented here certainly does not support the view that financial repression *in and by itself* has hurt growth in postwar Europe.

6 Lessons From Europe

6.1 One Step at a Time

The main conclusion is that, in continental Europe, exchange rate stability has been considered as the lynchpin of efforts to achieve trade integration. Capital mobility has long been seen as of secondary importance and, when it rose to the top of the agenda, monetary policy independence was given up relatively easily. True, much independence had been given away to sustain the EMS. The only country that had retained monetary policy independence was Germany, due to its gradual emergence as the centre of the EMS. Why did Germany accept to give up the DM? This is a crucial question to draw lessons from Europe.

One view is that that the whole strategy was only possible because it was carried out with much wider objectives than just a common market. In that view, the required political will was steadied by an ambitious vision which included, from the start, a monetary union and eventually a federal union. This view is both correct and misleading. It is true that the underlying logic has been political reconciliation after centuries of wars. On the other side, there has never been any detailed master plan, nor any set deadline. For example, a German proposal has recently brought back to life the goal of a 'United States of Europe'. But opposition to this proposal runs equally deep, with profound national divergences and national public opinions equally divided. and indication that there is no master plan, and there never was any. A telling example is the monetary union. In 1971, the Werner Plan was deemed wholly unrealistic, and it was immediately scuttled. As late as 1988, when the idea of a monetary union resurfaced, it

15 Studying the French postwar experience, Sicsic and Wyplosz (1996) conclude that public subsidies and directed lending have had a sizeable negative impact on growth.

was widely met with the same scepticism. It took an exceptional event, the collapse of the Berlin Wall, to trigger a deep reassessment that no political leader would have predicted just a few weeks before.[16] Even the celebrated countdown to monetary union, with a terminal date set in concrete, was only accepted at the last minute in Maastricht.

The more sober view is that Europe's integration has always been characterised by a process of muddling-through, two steps forward and one step backward, with deep and lingering divergences as to what the end objective is. But each integration step makes the next one more likely. The desirability of adopting a monetary union was being discussed, and staunchly opposed by Germany and a few others, before the Berlin wall fell. It was available on the shelf, and could be pulled out to form the basis of a historical political deal whereby Germany would give up its currency in return for support for its unification. Thus, integration can be seen as a dynamic process, but one that is not predetermined, at least in the policy-makers' eyes. It makes bold, unplanned moves possible when the occasion arises unexpectedly. Time is not of the essence, opportunities are.

Thus, Europe's lesson No. 1 is that what matters is a political will to seek closer economic and financial integration, but not tied to any precisely defined plan and schedule. Lesson No. 2 is that opportunities must be quickly seized when they arise.

6.2 Centre Country

The role of Germany is often seen as crucial in the adoption of a single currency. The message would be that regional integration needs at the centre of the process a champion, a leading country that provides the political and economic impetus. Here again, some caution is needed. There is no doubt that it was crucially important that Germany was both the largest economy and home to the anchor currency within the EMS. The anchor currency probably has to belong to a large country, but luck had it that the Bundesbank had many features of what has become the hallmark of modern central banks that could be used as a blueprint: a clear price stability objective and a monetary policy committee (the Direktorium) which was designed for a federal state.[17]

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16 Gros and Thygesen (1998) argue that one does not need to invoke a political deal to explain Germany's acceptance of EMU. Once the other countries had recognised the pre-eminence of price stability and central bank independence, they claim, Germany was willing to give up the DM. From an economic viewpoint, this makes sense, but the political costs were considerable and required a 'sweetener'.

17 Should the NAFTA countries consider a monetary union, the Fed model would be less ready-made for the task of building up a common central bank.

Equally important was Germany's post-war approach to foreign policy. Its acceptance of a subdued role – the self-imposed price to pay for Nazism – largely removed suspicion that it wanted to exert leadership. Its professed desire to develop its influence only within the context of a united Europe has been, and will remain, crucial. The EMS would never have been created had it been built as an asymmetric arrangement based on the DM. It took several years before the DM organically emerged as the system's centre, and it did so because the other large countries had failed to develop responsible monetary policies, and were keenly aware that they had only themselves to blame for their demotion. In retrospect, it could be seen as clever strategy on the part of Germany but this would be, again, a revisionist view. Much of this evolution was unplanned and, most likely, unforeseen,

Lesson No. 3 is that, more than a leading country, deep integration requires confidence-building steps. This is a slow process.

6.3 Institutions

Another feature of Europe's integration is the early buildup of institutions. The European Commission was set up in 1958 by the Treaty of Rome when the Common Market was launched. Its powers and ambitions were initially quite limited. It has become the advocate of integration, binding together two opposite forces. On one hand, it embodies the collective interest and the gains from cooperation. On the other hand, it derives its powers from governments which represent national interests. This explains its often arcane decision process and many of its shortcomings. The Commission's inherent internal contradiction is not often appreciated: its role is to manage those elements of national sovereignty which have been given up by its member states while it needs approval from the member states which are instinctively loath of relinquishing politically sensitive decision powers. The fact that the Commission exists, and has seen the range of its responsibilities grow considerably since it was created, cannot be overestimated. Not only does the Commission act as the lobby for integration, it also undertakes the background work needed to study further steps. When the time is ripe, the project is readily available in the Commission's drawers.

Besides the Commission, Europe has built up a vast array of institutions, as it has gradually expanded the scope for cooperation beyond economics. Each step usually illustrates the same uneasy compromise between integrationist and nationalistic forces. A good example is the European Parliament. It has few powers, its most illustrious being the right to throw out the Commissioners. Its most recent formal task is to supervise the

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European Central Bank (ECB), even though supervision is limited to expressing its opinion. And, of course, the European System of Central Banks (ESCB) is a new institution which has been granted the authority of all member central banks. Note, however, that the ECB itself, the n+1th central bank, is under control of the ESCB which include the n other central banks.

Institution building lies at the heart of Europe's success at integration. Each institution cements the willingness of member states to devolve some of their powers. Each institution provides a forum where national differences must be reconciled. Eager to deepen integration, these institutions are often coming forward with new suggestions and, when they politely clash with member governments, the important points of disagreement are plainly visible to public opinion.

Lesson No. 4, therefore, is that integration is made considerably easier when backed by regional institutions. Europe's success is largely due to the early creation of a number of institutions, how imperfect they may be.

6.4 Exchange and Capital Flow Regimes

Europe's experience runs against the view that financial markets ought to be promptly liberalised and if that means giving up the exchange peg, so be it. The strategy adopted in Europe puts trade integration and exchange rate stability at centre stage and if that means delaying financial liberalisation, so be it. There is no evidence that Europe's strategy has had an adverse effect on its growth performance. Quite to the contrary, capital flow liberalisation has a tendency to be destabilising in the wake of rapid liberalisation, as Argentina, Chile, Mexico, Korea, Malaysia and many other emerging market countries have discovered much to their grief.[18] On the other hand, there is neither strong argument nor empirical evidence that trade integration may be welfare-reducing.

The choice of an exchange rate regime ought to be considered as part of a package that may include, if needed, some degree of financial repression. Indeed pegged exchange rate regimes are inherently unstable in a world where financial shocks eventually challenge the hardest commitment of the monetary authorities. Given enough time, pegged exchange rate regimes ultimately collapse. Financial repression is a useful backup to reduce the incidence of financial shocks and make fixed exchange rate regimes more manageable and longer lasting.

It is interesting to note the evolution of capital controls. They were initially designed to back domestic financial repression with mercantilistic

18 For an overview, see Calvo, Leiderman Reinhart (1996). See also Wyplosz (2001a).

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undertones. The controls owe much of their bad reputation to this original sin. When domestic restrictions were lifted, external restrictions were gradually made more market-friendly, relying less on administrative interdictions. The motivation also shifted towards slowing down speculative capital to support the fixed exchange rate regimes.

Lesson No. 5 is that full capital mobility is not sacrosanct. It provides support for a strategy of regional integration that starts with trade opening and exchange rate stability, leaving capital mobility as distant goal.

7 Conclusion: What Does It Mean for Other Regions?

This section briefly sketches implications of Europe's experience for current debates on regional integration. It is important to recognise at the outset that Europe's way is not the only possible one. Nor is there any presumption that regional integration is always and everywhere desirable. The view taken here is that, *if* regional integration is deemed desirable, Europe's experience offers some useful lessons.

7.1 Central and Eastern Europe

The countries of Central and Eastern Europe are unique in many ways. They emerged a decade ago from 50 years of central planning and their natural fate is to join the European institutions. Regional integration within a greater Europe is at the forefront of their strategy, with strong popular support. The main surprise is that, even though at the outset of the transition process they shared the same recent history and the same ambitions regarding European Union membership, the countries of Central and Eastern Europe have rejected the narrower regional approach. They could have first sought to achieve economic integration among themselves and then collectively access to the European Union.[19] Their refusal to adopt such a strategy partly reflects older historical misgivings. It is also based on the suspicion that the strategy could have delayed accession. Given how slowly the accession negotiations have proceeded, they may have been right.

Lesson No. 3, the need for a benevolent leader, is essentially moot. The ready existence of a centre, and a relatively clearly defined accession path removes many of the stumbling blocks. Political will, which is Europe's lesson No. 1, exists in Central and Eastern Europe, but not to the same

19 In-depth discussions of sub-regional integration efforts in Central and Eastern Europe, see Teunissen (1997, 1998).

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extent within the European Union. The centre's wavering, explained by a conjunction of special interests, is sapping support for accession in the candidate countries. This is where the role of institutions (lesson No. 4) is crucial. A process has been formally launched, and it is masterminded by the Commission, which sees to it that it does not stall, despite many a government's desire to avoid confronting national interests which, rightly or wrongly, feel threatened.

On the other side, the ready-made nature of the accession process does not make things unambiguously easier. In fact, the Union's long history creates serious difficulties. The Copenhagen Council has adopted the principle that the *acquis communautaire* – eurospeak for the rules adopted over fifty years – must be taken on board by the newcomers. One clear case where this is problematic concerns the exchange regime. The Maastricht convergence criteria are considered a part of the *acquis*. This implies that EMU membership cannot occur until two years after the new member countries have joined the ERM in its second reincarnation, which itself must await until they have accessed the Union. Yet, the situation of Central and Eastern European countries differ considerably from the one that prevailed in western Europe in the early 1990s. For example, by 2004 Estonia will have operated for a decade a currency board – vis-à-vis the DM first, and the euro next. It makes little sense for that country to first dismantle its sturdy currency board, then adopt the fragile ERM2, and finally ditch its currency.

More generally, Lesson No. 5 is studiously ignored. Full capital mobility is an *acquis*. Combined with ERM2, the result is a potentially explosive mix, more so than ERM1 that was itself unable to withstand the pressure of capital liberalisation. To start with, in contrast with ERM1, ERM2 does not provide for the collective support of the pegs. Thus the Central and Eastern European countries will be alone when facing speculative pressure. Next, accession is likely to trigger large capital inflows. As has been the experience in many parts of the world, capital flows have a tendency to revert themselves for a variety of reasons, some of which are not understood. The likely financial instability, coupled with the application of *acquis* designed in other times for other countries, is a recipe for trouble.

7.2 East Asia

Interest in regional exchange rate arrangements has grown in East Asia following the crises of 1997-98. The countries of the region have discovered, through the contagion process, that their fates are linked in the eyes of international financial markets. They naturally think of ways of responding collectively to the previously unexpected challenge. Talks of a monetary union are taken seriously. The Chiang Mai Initiative can be seen as an attempt to build a collective defense against speculative attacks. How far can they go in this direction? The lessons from Europe send a sceptical message.

Lesson No. 1 emphasises political will, Lesson No. 3 calls for confidence-building steps. East Asia does not seem ready on either dimension. The region is clearly not at peace with itself. One of the two regional giants, Japan, remains seen with deep suspicion. The other giant, China, operates with a different political regime and is not really a market economy. While the latter may change as China becomes part of the WTO, the fact that national animosities remain virulent more than 50 years after World War II suggests that the appetite for deep integration is not there and that no country, or group of countries, is in a position to exercise leadership. Indeed, in spite of a higher degree of trade integration than within the European Common Market, the countries of the region have not been able to build any collective trade agreement. Numerous attempts have resulted in a myriad of bilateral agreements, but the big picture remains as elusive as ever.[20]

Europe's own sequencing is not necessarily the only possible. Having achieved *de facto* a high degree of trade integration, the Asian countries could proceed first with a collective exchange rate arrangement, possibly even a monetary union. Indeed, Lesson No. 2 says that every opportunity must be seized. The 1997-98 crisis has created a sense of commonality in the area of financial instability, and this realisation should not be discarded because it does not fit the standard approach to economic integration. Chiang Mai can thus be seen as a promising first, confidence-building step. But, in line with trade agreements, Chiang Mai only aims at bilateral arrangements. It clearly violates Lesson No. 4, which puts in centre stage the buildup of collective institutions.

Talks of an Asian Monetary Fund (AMF) were more promising in this respect. The abandonment of the project illustrates another reason for scepticism. The AMF idea clearly displeased the IMF and the US, and they had enough muscle to kill it. The project was not well thought through – another illustration of the crucial usefulness of institutions that can nurture blueprints and keep them ready for when the time is ripe – and probably ill introduced. Yet, Europe had agreed long ago to a European Monetary Cooperation Fund, and the ERM agreements provided for mutual financial assistance that clearly competed with the IMF's, and no one seriously objected. One could envision an AMF issuing guidelines and

20 For a detailed presentation of past attempts, current arrangements and the current state of play, see Scollay and Gilbert (2001).

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exercising surveillance, providing resources and preparing the ground for more ambitious steps. The Asian countries have shown a lack of political will to stand up to external influence. Regionalism has taken the back seat.

This sensitivity to outside interests is also visible in several plans to limit exchange variability now that most of the (official or unofficial) dollar pegs have been abandoned. Talks often centre of establishing basket pegs, with baskets including the US dollar, the euro, and the yen. The use of baskets is meant to reduce the dependence on the dollar. Given the depth of regional trade integration, intra-regional currencies stability is desirable, a feature well in line with Europe's experience. This would logically call for a collective arrangement similar to the EMS, rather than the very roundabout attempt *via* basket pegs. Strangely enough, such an idea is not explored.

Lesson No. 5 seems today the hardest to apply. Capital liberalisation has happened in most countries and back-tracking is seen, especially in Washington, as a backward move. Yet, the use of pegs (multilateral or external baskets) calls for some restrictions on capital mobility.

The obvious solution, then, would be to aim directly at a monetary union. There are good reasons to think that the idea is premature. To start with, giving up monetary policy sovereignty is politically complicated, as Europe has found out. In the current mood, Asia seems far from being ready for such a radical step. In addition, from an economic viewpoint, real convergence is an important pre-requisite. Unless the Asian Monetary Union starts with a small number of countries which are at a similar stage of development, the construction could prove to be unsustainable.

7.3 Latin America

Much as in Asia, the Tequila contagion has brought home the perception of a commonality of interests throughout the continent. But the first reaction, Argentine's short-lived bid to dollarise, has been to seek individual protection in the North. The FTAA project further reinforces the impression that Latin America is not ready for a major collective step. Yet, in many ways, Latin America is more advanced towards regionalism than Asia. Regional trade agreements are in place, for example, and the idea of a common political house dates back to the 19th century. Yet, Europe's lessons suggest that little progress is likely to be achieved without deep rethinking.

Lesson No. 1 certainly applies. Argentine and Brazil are the two major players, and it is hard to envision any regional agreement which is not driven by these two countries. Yet their rivalry is crippling. Mercosur could be seen as a confidence-building step, in line with Lesson No. 3, which further suggests that trade is a good way to start. But Mercosur lacks the proper institutional backup, as required by Lesson No. 4, and the experience so far does not suggest that trust has been established. The rules of the game are not strictly adhered to. *Faits accomplis* abound and the active use of the exchange rate to achieve trade advantage sap the construction. Unsurprisingly, regional trade is not very deep, even though much progress has been achieved over the last decade. Unless Mercosur establishes an institution with features of the European Commission, including powers to nurture rules of the games and then enforce compliance, it will remain as much a source of conflict as an integrationist step.

Lesson No. 2 is that regional integration progresses when opportunities are promptly seized. The reaction to the Tequila effect is a good example of a missed opportunity. The current focus on the FTAA initiative also acts as a diversion from regional integrating efforts unless, of course, one is ready to consider the whole of America as a region. But that is not what history and trade patterns suggest. Sceptics already predict that the FTAA initiative will fail. A serious crisis in Argentina, which would spill over to much of the region, is seen as very likely. For regional integration, such events could provide the required trigger for new regional initiatives. But such initiatives cannot be invented on the spot, they require serious advance work, which in turn necessitates an institutional backup. It is not clear that any existing institution has the corresponding mandate.

Finally, Lesson No. 5 – capital movement liberalisation ought to come last – seems to be, as in East Asia, beyond the point. Most of the continent has now fully liberalised its capital flows. Barely a year ago, the view that Latin America has become an area of financial stability, complete with sound banks and lively stock markets, was popular in Washington. A more sober appraisal is that financial stability remains as elusive as ever in the region. The case of Argentine seems to remind us that extreme monetary discipline, meant to ban forever the shadow of financial instability, is delivering deflation and depression, not stability. Of course, fiscal discipline is also needed, but just how much all-around discipline can real-life politicians deliver? Backtracking on capital liberalisation may be less foolish than it currently seems.

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Comment on "Regional Exchange Rate Arrangements: Some Lessons from Europe," by Charles Wyplosz

Bill White

Growth in the global economy, and especially the United States, has recently been decelerating sharply. In this light, it is somewhat amusing to hear many previous advocates of New Era economics now say "Well, we always knew that the stock market was overvalued ..., we always knew that investment cycles were still possible ..." I think this kind of historical revisionism is too easy. We should rather be asking ourselves how we came to believe certain things at certain times, and what factors caused us to revise our views when we did.

Regarding Charles' paper, I like his overview of what went on in continental Europe, particularly in the post-war period until the mid-1990s. It has some very intriguing results, not least of which is that financial repression was good for Europe, as indicated by his statistical estimates. While I am more than a little suspicious about this, as I will argue later, I do agree with the associated proposition that governments should be very careful about how they go about financial liberalisation. Sequencing, particularly in so far as it affects external capital flows, can be very important. Moreover, the period of transition seems inherently to be a dangerous one. This applies even in cases where the target state of affairs is judged to be totally desirable.

My principal criticism of this paper, and perhaps I am actually inviting Charles to write another paper, reflects the fact that this is a conference on the role of regional financial arrangements in crisis prevention and management. Unfortunately, what I did not see in the paper was exactly how the analysis it contains actually relates to this topic. A related criticism about focus is that the second part of the paper, in which the lessons are drawn, seems to me to have very little to do with the first part, in which a rather straightforward historical description of European economic developments is presented.

Focusing then on the lessons themselves, Charles seems to be saying that continental Europeans have always valued fixed exchange rate systems. This is because the benefits have been thought to exceed the costs, even when these costs include a significant degree of financial repression to

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make the fixed rate systems functional. In effect, recognising the reality of the "impossible trinity", Europeans have opted for financial controls to square the circle.

The benefits of fixed exchange rates, as argued in the paper, seem to be of two sorts. First, they encourage trade, competition and growth. Second, the fixing of exchange rates can lead on to a single currency, which may be both economically and politically desirable. What about the costs of financial repression? Basically, the paper says that the costs are not large. Indeed, repression may even be good for you in its own right. While Charles does not say this explicitly, he seems to suggest that other regions might want to go down the European path. That is, they might wish to institute regional fixed exchange rate systems and then gradually evolve the institutions needed to foster the movement to a single currency. If this is the basic lesson for other regions to be drawn from this paper, based on European experience, I would argue that it may not be generally valid. Let me explain why. In effect, I question in turn the analysis of each of the benefits and costs just described.

I do not dispute the fact that continental Europeans have traditionally preferred fixed exchange systems. Where I do disagree with Charles is his suggestion that the principal reason for this was the belief (and I will return to this) that fixed exchange rates encourage trade and growth. Other reasons suggested by Charles for this preference could also be plausible. A first possibility is that fixed rate systems were chosen to foster stability given that financial markets were shallow. This could be historically true, but there is a logical problem with this argument. If Europeans consciously kept financial markets shallow in order to fix the exchange rate, there must have been some other more fundamental motivation than the absence of well-developed financial markets.

However, there remains a second and more plausible reason for this preference. It is that Europeans preferred fixed exchange rates in order to encourage discipline and price stability. With Germany as the European anchor, this view seems very much in accordance with conventional wisdom. Charles, however, disagrees with this conclusion on the following grounds. He argues that, if Europeans were after discipline via fixed exchange rates, they ought to have had lower inflation rates than other countries. I think this logic is incorrect. Fixing an exchange rate amongst themselves in no way provides an inflation anchor relative to some other group of countries. And, in any event, fixed exchange rates only give the participating countries similar rates of inflation over the long run. Nigel Lawson, it will be recalled, tried at the end of the 1980s to peg the pound to the Deutsche Mark. His experience was that, before you get to price convergence, it can be a very long run indeed.

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In spite of all these counterarguments, Charles continues to conclude that the real motive behind the decision of Europeans to fix the exchange rate was to promote trade. But this is where I have another problem. As even Charles himself says in the paper, there is absolutely no empirical evidence that fixed exchange rates encourage trade. I invite you to take a look at the broadest set of data. What happened after the collapse of Bretton Woods? The answer is that trade exploded when currencies started to float. And what has happened in recent years since many smaller countries have chosen to float their currencies? Again, the growth of trade volumes has been dramatic.

I also found unconvincing Charles' discussion of why the literature on this topic might be wrong. In the very short run, exchange rate volatility might make cross-border trade less attractive. However, this risk can be easily hedged in modern markets. In the medium term, exchange rate misalignments could conceivably hollow out the trading sector of the country with the overvalued currency. However, this effect would be only temporary and would be matched by the stimulus to trade given to others.

So to sum up, I simply do not believe that fixed exchange rates are needed to promote trade and growth. Nor do I accept that this belief, in fact, provided the principal motivation behind the revealed preference of continental Europeans for fixed exchange rate systems.

The second postulated benefit of fixed exchange rate systems, as argued in Charles' paper, is that they may lead on to a single currency. The question of course is whether such a single currency would be economically and politically desirable for regions other than Europe. As for economic desirability, one has to go back to the literature on optimum currency areas. In this context it is not so obvious that there are many such regions already out there, with the possible exception of those Gulf States already pegged to the dollar. As for the political desirability of a single currency, the impetus provided to the concept by the two world wars in Europe can hardly be underestimated. In contrast, were Canadians and Mexicans to be told that accepting a single currency with the United States would lead to political unity, I doubt there would be great popular enthusiasm.

Finally, let me turn to the costs of the financial repression which might be needed to make a fixed exchange system work properly. Charles recognises that internal financial repression does have costs in that it leads to a lower quality of financial services and inefficient resource allocation. In particular, such a system often leads to a wasteful government getting enhanced access to national savings. However, he argues (and I agree) that liberalised domestic financial systems also have costs associated with the booms and busts caused by alternating waves of optimism and pessimism in a credit-based economy. But the former set of costs seems to me, although

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perhaps not to Charles, to dominate the latter. If so, this makes internal repression broadly undesirable and explains why the vast majority of countries in the world are now moving towards financial liberalisation. As for financial repression with respect to the external accounts, I would again argue that there are significant costs, even if liberalisation also holds certain dangers. These latter concerns have been attested to by a number of recent crises in emerging market economies, which has led countries to be more careful about how and how quickly they go about removing capital controls. It has not, however, led to any kind of a significant move in the direction of reimposing controls.

What is the bottom line for me? Fixed rate systems in themselves need not enhance trade or growth, although in some cases they might do so. Nor do they necessarily lead on to the development of a single currency. And even if they did have this tendency, it is not clear that a single currency would be desirable on either economic or political grounds. As for the costs of financial repression, I believe they could be significant. For all these reasons, I conclude that the positive aspects of the post-war experience with fixed exchange rate systems in continental Europe may not be easily replicated elsewhere.

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Comment on “Regional Exchange Rate Arrangements: Some Lessons from Europe,” by Charles Wyplosz

Zdeněk Drábek

The paper by Charles Wyplosz covers what is perhaps one of the most fascinating political and economic processes in Europe in modern times – the economic integration of European countries. From the integration of coal markets to the adoption of common currency – the euro – the West European countries have continuously defied the critics when they pushed for more and more markets to be integrated and for more and more countries to join in. This process of widening and deepening the integration process has been quite unique in the world.[1] The European Union has, therefore, a considerable experience in making its own regional arrangements work. Undoubtedly, the EU has also a great deal of experience to share with other countries attempting to create something similar, albeit perhaps less ambitious.[2]

I have been, therefore, very pleased to find in the paper a brief history of different monetary arrangements. Such a review is important especially when it comes to discussions of monetary issues. It is quite easy to forget what has happened in the past, and for this reason it is useful to remind ourselves that the process was slow and piecemeal, that it was not always smooth and that it required a considerable degree of coordination and foresight, and that it also required the fulfilment of certain conditions. The brief review of the exchange rate arrangements is particularly instructive in stressing the argument about the important role of the financial sector and reminding the reader of the long period during which financial markets were repressed. Similarly, and perhaps even more importantly, the paper reviews the speed and sequence of capital account convertibility in individual countries and shows how long it took the EU countries before they eliminated their restrictions on capital flows. Obviously, the central argument in promoting this course of policies was the emphasis on the stability of exchange rates.

With regard to Charles Wyplosz’s review of European economic history

1 For more details see, for example, WTO (1995), chapter II.

2 There is a variety of lessons that a paper such the one of Charles Wyplosz could cover. For example, he could have looked at the effects of the EU on trade flows, investment, on trade policies or policy responses of third countries. See, for example, WTO (1995).

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I only have two minor criticisms. The first regards the alleged commitment of the EU authorities to fixed or stable exchange rates. While this statement may not sound controversial, it is not clear what is actually meant by the commitment to the stability of exchange rates. Do we really mean commitment to fixed exchange rates or do we mean commitment to a stable exchange rate fully recognising that stable exchange rates may involve some reasonable degree of flexibility and exchange rate movements? This issue is particularly relevant once we take into account the differences between nominal and real exchange rates, or on a more sophisticated level, when we talk about deviations of actual from equilibrium exchange rates. The paper does make a distinction between fixed exchange rates and the rates under the Bretton Woods system. Nevertheless, it seems to me that the author has primarily in mind the stability of exchange rates, an issue that is rather different from the more specific and narrow question of fixed exchange rates. This is a matter that can be easily sorted out.

My second minor criticism is that the author does not make a distinction between two types of financial restrictions. One type of financial restrictions involves domestic financial flows. Another type of restrictions are those that affect cross-border financial flows. It appears that the author is exclusively concerned about the latter – i.e. what he calls 'external convertibility' – and, in particular, about the speed with which the capital accounts in Europe have been opened. I am raising this because it is not evident from the paper to what extent the member countries used various monetary restrictions and regulations to channel resources into what they perceive to be their priority sectors. I am not an economic historian and have not studied the credit markets of the 1960s and 1970s, but I would be surprised to find in Europe in the 1970s highly regulated credit markets and interest rates. Nevertheless, some restrictions were undoubtedly in place with some credit regulation directing credit into priority uses. Moreover, the patterns must have differed from country to country. Some countries did more of these restrictions, others did less. In brief, it would be useful to make a clear distinction between the types of restrictions (internal/external) and to identify the main trends and differences among countries.

Let me now come to my main point. Charles' central idea is that the pattern of economic integration in Europe was entirely driven by the attempt to first integrate the goods markets and to promote trade. I very much agree with this statement.[3] I find it, therefore, also very plausible and

3 I am also painfully aware that the statement represents a gross simplification of what actually happened in the EU over time. There clearly was a continuous pressure within the EU for widening and deepening of the integration process, as I have already noted and as documented in WTO (1995).

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correct to argue that some notion of exchange rate stability was important for that process. In addition, I also find it quite plausible that this process was somehow linked to what Charles calls the "process of financial repression". Now, when we look at his econometrics, the empirical evidence seems to confirm these conclusions. But there is other empirical evidence that is provided in the paper but could be additionally used, and this comes from the historical experience of centrally planned economies. It seems to me that these countries provide by far the best case studies of repressed financial systems and the way in which these systems were used to suit the intent of government officials. These were countries in which financial markets were repressed *par excellence* and the system worked precisely to feed into some notion of growth and social priorities. One must obviously ask what kind of growth and social priorities, but the system worked, at least up to a certain point. Another example occurs to me from my experience of working in Asia, most notably in the Philippines and in countries such as Korea. The Philippines and Korea were always seen as two countries with rather different policies of financial liberalisation. The Philippines was a country that was pushing for financial liberalisation much faster than Korea, which had a long, and quite well history of financial restrictions and of directed credit.[4]

Charles argues that the integration process was built on two main pillars – exchange rate stability and financial repression. On the exchange rate stability, enough has already been said both in the paper and in my comments above, and I fully agree with the relevant comments of Bill White, my partner in this debate. Perhaps the only exception in this agreement is my preference for stable exchange which I offer here as a rhetorical footnote. I am convinced that a certain degree of exchange stability must have been extremely important even for the Asian countries that Bill has dismissed in his comments. After all, we know that the local currencies in South-East Asia have been linked to the US dollar for some 20-30 years and served them well. The conventional wisdom and prevailing argument of the time was that one reason why the countries have been growing so fast was precisely the fact that they had a clear notion of the advantages of stable exchange rates. Unfortunately, as we all now know, the policy eventually collapsed but hardly for reasons of stable exchange rates but for failing to recognise the divergent pattern of domestic inflation and productivity patterns vis-à-vis the rest of the world.

But the most interesting and unusual thrust of the paper is obviously the argument on financial repression. The critical notion for me, as it is

4 Wyplosz is fully aware of the peculiarities of the Korean policy which was well documented by, for example, Rodrik whose work on the subject he also quotes.

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for Bill White, is the question: what are the policy implications of his argument? One can look at this question from two different angles. First, what are the policy implications for countries with *open* financial regimes, the ones that have been already liberalised? Second, what are the policy implications for countries that are still managing various restrictions on the operations of their financial systems? I am personally finding it difficult to answer these questions, and would find it even more difficult to make a sensible recommendation to countries that have already liberalised. Such a recommendation would imply for the governments to reverse their policies, with serious implications for credibility of government policies and for the efficiency of financial markets.

Let me now raise two separate points that I would like to develop by asking the following questions. What are the merits of capital account liberalisation? Why would countries want to remove restrictions on capital account transactions? My responses are based on the experience of somebody who has worked in various countries in which governments have taken the liberal approach to transactions on the capital account for one key reason – these countries lacked domestic savings and needed to mobilise additional savings from abroad. It is quite well known that one argument for capital account liberalisation is the need to attract foreign capital, which obviously must be free not only to "come in but also to get out" when it is no longer profitable for it to stay in. How this is done is another matter. For example, countries could start with the liberalisation of long-term capital flows while retaining certain restrictions on short-term capital. In Europe and in the EU in particular, the low level of domestic savings was probably never a major issue, because European savings tend to be relatively high. The same holds for countries of East Asia, which also have high savings rates. This should be contrasted with developing countries such as those in Africa, some transition countries or countries in Latin America. This "savings argument" is clearly important for these countries.

Another important argument for capital account liberalisation is privatisation. This was clearly one of the driving motivations for the liberal attitude in the Czech Republic. Privatisation became a priority policy objective domestically, and as a result, it drove the argument on capital account liberalisation. How could the Czech government privatise if it had no access to foreign capital? After all, the only capital that was available at the time was either in the hands of the state or abroad. And how would the government attract foreign capital without allowing foreign investors to repatriate profits, dividends, and if they decided to liquidate their investment, their capital? On the other hand, arguments calling for capital account liberalisation on the grounds of balance of payments financing are

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far more dubious and less convincing. Countries in which capital accounts have been liberalised for BOP or fiscal deficit financing reasons – such as Mexico and Argentina – have tended to be exposed to great volatility of capital flows and vulnerability. I would, therefore, argue that the liberalisation of capital account driven primarily by the latter factors is very risky.

What these arguments suggest to me is the presence of linkages between the capital account and what government economic policy does domestically. In the above example of privatisation, for example, government officials should obviously be asking questions about the speed and the scope of the capital account liberalisation. If one is concerned about instability of the external account or fragility of external balances, one of the critical questions must also be how fast and how much does one want to privatise. Assuming that the government in question wants to privatise "a lot", it will have to assume that it may increase its exposure to instability of capital movements. In other words, it may overburden the system. Referring again to the Czech example, it is now easy to see in retrospect that that these questions were not asked, primarily because the privatisation was driven by fiscal considerations. To repeat, the point that I am making is that one of the lessons of capital account liberalisation must be that there are strong linkages between the elimination of restrictions on foreign currency transactions with domestic policies and objectives and that these linkages must be coordinated.

The final point with regard to regional financial arrangements which I would like to raise is the critical question about the relationship between foreign investments and the merits of regional financial arrangements. Is a free trade arrangement within a region enough to attract foreign investment, assuming that the RTA has as one of its objectives to attract foreign investment? The answer is probably 'yes, but up to a certain point only'. There are other policy issues that can play an important role. One of them is the question of exchange rates. There can be no doubt that a RTA with a fixed exchange rate regime or common currencies provide extra incentives for foreign investors, *ceteris paribus*. Another important issue concerns the operation of financial markets and in particular the role of public finance and their harmonisation. These issues are not discussed in Charles' paper. Given the limited objectives of his paper, this is not surprising but the issues are important. Take, for example, the case of financial harmonisation. Should it be a part of effective regional arrangements? Was financial and/or fiscal harmonisation important in the European experience? Without having the benefits of hard-core evidence, I would suggest that some degree of fiscal harmonisation is important. Otherwise, we would not be having as much debate about tax competition as we

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actually do. Thus, I would argue that some fiscal harmonisation is necessary especially because of the argument about tax competition. But I am aware that the evidence is not clear-cut. As Richard Baldwin and Paul Krugman argue in a recent paper, the case can be made for exactly the opposite to fiscal harmonisation.[5] They argue that harmonisation is not important. Still, I am convinced that it is an issue that should be addressed in the context of discussing regional arrangements.

Let me conclude with another rhetorical question, one that I trust could be of considerable interest to this audience and to anybody seeking the path of regional integration. Namely, what can regional arrangements do to help stabilise financial systems? Or, rather, what can they do to help reduce the countries' vulnerability against unstable capital flows? Do they possess the necessary instruments and pre-conditions to protect the member countries against capital surges and flights?[6] Again, that is a topic that was not discussed in Charles Wyplosz' paper. This is perhaps somewhat unfortunate. It seems to me that regional trading arrangements can operate in two different directions. They can be seen as instrument of economic policy to reduce these countries' vulnerability against unstable capital movements. For example, one can envisage a system of regional arrangements in which countries may cooperate in defending their currencies, and reducing their (excessive) levels of international reserves.[7] On the other hand, regional arrangements may also be origins of financial instability and of unstable capital movements given the fact that the member countries may be permitted to move along different inflation paths and pursue different monetary policies. Both of these differences are likely to affect the attractiveness of their capital markets and the attractiveness for foreign investments. But, as I have already noted, this a subject for another paper of Charles Wyplosz.

References

Baldwin, Richard and Paul Krugman (2000), "Agglomeration, Integration and Tax Harmonization", CEPR Discussion Paper No. 2630, Centre for Economic Policy Research, London, November.

5 For more details see Baldwin and Krugman (2000).

6 One could obviously ask other questions such as about the merits of regional arrangements as an instrument of trade liberalisation. But this would put us on a more familiar ground. See, for example, Panagariya (1999), pp. 477-511.

7 This could be particularly the case of countries in South-East Asia which have historically relied on building up their reserves.

Panagariya, Arvind (1999), "The Regionalism Debate: An Overview", In: *The World Economy*, Vol. 22, No. 4, June, pp. 477-512.
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Comment on "Regional Exchange Rate Arrangements: Some Lessons from Europe," by Charles Wyplosz

Brian Kahn

The History of African Regional Integration

I will try to comment on Wyplosz' paper in the context of the African experience. I think the paper provides a very useful framework for looking at the African experience. His first lesson is that regional integration has an internal logic, that each step makes the next one more desirable. Unfortunately the opposite also applies to the African experience with integration – the experience has been one of numerous integration failures. I think the more failures you have the more suspicious countries become of getting involved in these regional integration initiatives.

Ironically, if we look at Africa, the most successful regional integration stories have been the ones that were imposed by colonialism. In those cases, the issue of reducing national sovereignty was not an issue, it was simply imposed. Whereas now national sovereignty comes to the fore and this becomes a problem. The one I am thinking of specifically is the French Franc Zone that has France as the agency of restraint. The future of that zone is now in question, given the new status of the French Franc. Other colonial legacies that worked successfully are the Southern African Custom Union (SACU) and the Common Monetary Area (which evolved from the Rand Monetary Area). Apart from these, most other African initiatives have been plagued by enormous numbers of problems. For example, the East African Economic Community (EAEC) collapsed in the early 1970s. In West Africa alone there are more than 30 regional integration treaties. According to the African Development Bank, "an overall assessment of Africa's experience with regional integration reveals…that regional integration and cooperation groupings have achieved limited success...(T)he consensus is that there has been no significant increase in intra-regional trade. While intra-regional trade remained stagnant, the continent also experienced marginalisation in international trade. Also evident is the failure of Africa's regional groupings to attract foreign direct investment."

An additional complication in Africa is that there have been numerous

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overlapping initiatives. For example the South African Customs Union (SACU) overlaps with the Common Market for Eastern and Southern Africa (COMESA) and the Southern African Development Community (SADC) and the recently signed Free Trade Protocol. These overlaps create their own problems. Then you have a number of different initiatives and a lot of them there are stronger on the rhetoric than on the actual implementation. So overall, within Southern Africa there is a very messy situation of regional integration.

At the continental level, we have the new African Union (AU) which is to replace the Organisation of African Unity (OAU). The Constitutive Act of the African Union has in some sense tried to go ahead of itself in terms of establishing institutions such as an African Monetary Fund, an African Central Bank and an African Investment Bank. In proposing an African Central Bank, the Constitutive Act has a view of a common monetary area for Africa, but there is no discussion on how this and the other institutions are going to work. Also it is interesting that in the Constitutive Act there is no view that the trade issues must come first. In the Act there is no provision for trade issues. So very broadly speaking, the history of African regional integration is very problematic. Although integration is seen as important, there is no clear view of how this should be achieved, nor is there any view as to the need for the sequencing of trade and monetary integration.

Political Will and Confidence Building

The second point, about the need for political will, is a critical one. Africa is a continent with its fair share of dictatorships. Even in some democratic countries, succession is provided for in the constitution. So if leaders are unwilling to give up sovereignty internally, it is hard to imagine these countries giving up sovereignty externally – which is part of the integration process. The experience of regional integration initiatives in sub-Saharan Africa provides ample evidence of political forces that have frustrated economic motives.

The political will to engage in regional integration also relates to the issue of stages of development. I think a lot of the regional integration attempts would require a change in labour mobility, particularly in areas of very high unemployment. This could create problems for countries that would attract labour but already have high unemployment, like South Africa.

With respect to confidence building, this also boils down to the centre country issue, specifically confidence in the centre country. Many of the debates in Southern Africa about regional integration, particularly monetary integration, focus on the 'problem' of South Africa being the dominant country. South Africa contributes 70 percent of total GDP of Southern Africa and is by far the most developed industrially. That does create a great deal of suspicion about South Africa's motives in the regional integration route. But you cannot get away from the fact that South Africa is dominant and it is difficult to think of a regional system not involving South Africa. In fact, there is no doubt that South Africa will have to take some leading role in any successful integration initiative, even though it is resistant to doing that. A further problem is that even though South Africa is the leading country, it is still a developing country.

Economic Convergence and Financial Integration

Another issue that Wyplosz raises in his paper is that one should start with trade and then move to financial integration. I think that is generally recognised in the Southern African region (although as mentioned above, not at the continental level). However, I find it difficult to think of no financial integration or no economic convergence at all when such diverse macroeconomic conditions prevail. In SADC for example, we have very divergent inflation rates, to the extent that some countries have single digit inflation while others are in triple digits. If there is no move towards regional financial integration, it is hard to see how intra-regional trade relations can actually be successfully developed. If you have highly divergent fiscal deficits, inflation rates, etc., it will make this first step of trade integration more difficult, particularly if inappropriate exchange rate policies are followed.

Finally, a comment on the issue of capital accounts and capital mobility: In Africa, generally, the move towards financial liberalisation has happened to some extent, but not to the same extent as in Europe. In South Africa, for example, we resisted a lot of pressure in the mid 1990s to liberalise very quickly. And I think the IMF agrees with us now that we got it right in that sense. However, there surely is a point at which financial repression does become dysfunctional to the whole system.

One only has to look at Zimbabwe, where we have a classic case of old-style financial repression, where they have an inflation rate of over 60 percent and an exchange rate that has been kept fixed for a few years (apart from a five percent devaluation last year). They have now reduced the interest rate to about 11 percent in order to reduce the cost of financing the fiscal deficit. The end result of that is predictable. There is simply no foreign exchange available in the country today. Exports are collapsing and companies are closing down. In the last month or so, five foreign companies suspended operations because they cannot import the

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necessary equipment.

Obviously, in the case of Zimbabwe we are talking about major financial repression. I think that we have to distinguish between the financial controls that are supportive of market-based, real exchange rate stability, and a system that exists now in Zimbabwe (and as existed previously in Zambia, where financial repression resulted in a major real exchange rate appreciation). I think it is important that that distinction is made.

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Floor Discussion of "Lessons from European Economic Integration"

Yung Chul Park raised the question of whether any of the European Union integration arrangements had not brought benefits to global integration. His own view was that they had been building blocks rather than stumbling blocks. He then observed that in the case of East Asia, trying to tie the currencies of the region tightly to one another would not be easy.

"We have two major currencies, one is the Japanese yen and the other the Chinese yuan. The yuan has become the currency to reckon with, especially because China's trade share in East Asia has increased so much over the last ten years. So somehow we have to incorporate these two diametrically opposed currencies in an East Asian monetary arrangement. That is why we are thinking about some sort of a basket of currencies. We don't know yet what currencies we are going to put in the basket, but nevertheless we are skirting around the critical issues. We do not talk about creating a 'yen bloc' and if we would start talking about it then there is no hope of moving forward any reasonable initiative at this stage."

Park raised a point about financial repression. "As a Korean, I should know something about it. It is our experience that it makes sense to distinguish between repression in a market-oriented financial system and in a bank-oriented system. Our experience with the bank-oriented system is that financial deregulation does not lead to free market activities or to the liberalisation of the financial system, at least in the short run. Because most of these bank-oriented systems are pretty much dominated and controlled by a few major financial institutions. So the authorities may deregulate their control, but then these major banks tend to continue the same financial repressive behaviour. In this case, you don't see much difference between the period in which financial markets and institutions were controlled and repressed and the period in which they are deregulated and liberalised."

Park also raised the issue of institution building. "In my view, institution building is very important. In East Asia we don't have the institutions that Europe has, but at the same time we have too many institutions right now: a regional bank, regional meetings of finance ministers, the Chiang Mai Initiative, the East Asian Summit, you name it, too many. My question to Charles Wyplosz is: What institutions are crucially important to get this kind of European arrangement on the drawing board in East Asia and push

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it forward? What institutions are important from your experience and how do you nourish these institutions?”

Daniel Heymann raised doubts about the usefulness of a blueprint. “In Latin America, there is a tension between two views. On the one hand, there is the view that financial arrangements and exchange rate agreements should be assessed from a historical perspective, stressing that there is no blueprint and that you sort of grope your way to some solution. On the other hand, there is the view that there should be a blueprint. Coming from a country like Argentina, in which at a time of capital controls people were getting their wages in the domestic currency and changing them into dollars the very same day and then spending their dollars to make their daily purchases, the impression that you have is that capital account liberalisation was thrown upon you from Washington instead of being decided by policymakers looking at cost and benefits. Some exchange rate choices sound strange when you look at them from far away, but when you see them from a day-by-day perspective they are quite obviously intuitive.”

János Vincze stressed the importance of looking at the interdependence of various institutions in the financial and labour market spheres. “I have two points,” he said. “One is the necessity to look at the interdependence between any of these institutions and how they determine each other and the second is that the whole set of institutions must be judged by how these institutions are able to respond to shocks. This latter point is not an easy test, because there is only one shock at a time and institutions are developing because people usually try to find answers to a problem in the long run. One of the main benefits of this disturbing experience of a shock is that you are motivated to try and devise economic structures that maybe are not optimal but may be able to respond properly to different kinds of shocks.”

Amar Bhattacharya raised four sets of questions. “First, to what extent is regional financial market integration the same as regional financing arrangements for crisis prevention and crisis management? And what does this distinction imply in terms of differences in institutional arrangements? For example, if the two concepts are not the same, can we have regional financing arrangements for crisis prevention purposes without having regional financial integration? Second, if the pursuit of exchange rate stability is basically for trade integration purposes, what implications does that strategy have for crisis prevention and crisis management? Third, regarding Europe’s experience with capital account liberalisation, why is it that countries starting with quite different initial points, not just in macroeconomic circumstances but in terms of microeconomic structures and prudential regulation and supervision systems, have come close in terms of improving their ability to withstand crisis? To what extent is this

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the result of convergence of national standards, and to what extent is it because of an implicit regional arrangement that has been in place? And fourth, to what extent have financial markets changed fundamentally making yesterday's prescriptions no longer valid for today? Is not the essential question we are grappling with today, that the world has changed and the implications that has in terms of crisis prevention and management?"

Leslie Lipschitz was struck by Wyplosz' emphasis on the choice of capital account liberalisation. "In the East Asian case, we have a fair amount of capital account liberalisation and I don't see how you could get the genie back into the bottle. I cannot imagine that you could impose successfully any kind of capital account restriction on the Philippines or on Indonesia, where a large part of the business community is very internationally integrated. The inter-corporate flows, the inter-family flows are extremely difficult to tackle. So I think this is totally improbable."

Reply by Charles Wyplosz

"Yung Chul asked many questions and I can't answer all of them. He asked, for instance, 'what institutions matter?' One is the European Commission. This is an institution that has broad powers, which is an active lobby for integration, and which has its own legislation for member countries. It is important that it was created from the outset, from day one of the Treaty of Rome. The second important institution is the European Monetary System (EMS). The big difference between the Chiang Mai Initiative and the EMS is that agreements within the Chiang Mai Initiative are supposed to be negotiated bilaterally, whereas the EMS is a very precise set of agreements that was negotiated multilaterally. The third important institution is the European Central Bank. These are examples of important institutions, but there are more.

The second point that Yung Chul brought out is, how do we deal with the fact that East Asia has two dominating currencies that are rather different, the Japanese yen and the Chinese yuan? He raised the political question of what currency one should peg to. One of the lessons of Europe is that by doing it collectively you remove some of these political problems. When the EMS was created it was created as a completely symmetric set of bilateral agreements and there was no presumption of who, which country would intervene when there would be a crisis. By doing it in a multilateral way, everybody is the same and you get away from the political sensitivities.

Daniel wondered whether one needs a blueprint or not. What I meant to say is that it is very dangerous to think, we first need to agree on how we go from A to Z before we move from A to B. That is why I said, you don't need a blueprint. But at the same time I was saying that it is very important to have a continuous debate on how to do things, if only for the sake of not having left out any options when the occasion arises. For example, in the case of Europe there has always been a discussion of the Treaty, of the vision of the future of European integration. And if there had been no previous thinking about that future, which many people considered a crazy idea which would never see the light of the day, European monetary integration would not have happened.

There was a recurrent theme: have financial markets changed to the point that there is no going back to financial repression? It would take several conferences to answer that question. So in two quick shorts. One thing that has changed is that our knowledge and competency in financial regulation and supervision has increased. The second thing is this view that we have all this wonderful technology and that there is just nothing economists can do to restrict capital movements. I think this is completely wrong. The effectiveness of the financial instruments at the same time increases the effectiveness of regulation, and if we wanted to restrict capital movements we could use all this technology for that. So I don't agree with the view that you can't put the genie back in the bottle because the genie has become so sophisticated. I think the bottle too has become much more sophisticated.

A different question is, once you have moved to liberalisation and liberalisation is followed by crisis, what do you do? Do you go back to restricting capital movements knowing that you may have to free them again and then open the door to another crisis? That is an argument for nonreversibility. On the other hand, if you want to have exchange rate stability you may decide that is has costs. It really is a question of cost-benefit analysis. There is no black-and-white answer.

Zdeněk said that the experience of the centrally planned economies showed that financial repression did not work. Maybe I did not make clear enough that I believe that for the goods market liberalisation is really crucial. But for financial markets liberalisation is less essential, because financial markets are prone to market failures. Goods markets are much less prone to market failures. So my view is that liberalising goods markets yields great efficiency gains, but I am not sure about that for financial markets."

Part II

Managing Economic Convergence and Financial Stability in the EU Accession Countries of Central and Eastern Europe

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Managing Economic Convergence and Financial Stability in the Czech Republic

Oldřich Dědek

1 Introduction

One of the key economic policy issues for countries aspiring to become members of the European Union is that of "real versus nominal convergence". This is indeed a pivotal issue, as it deals with the identification and sequencing of the key decisionmaking priorities for the candidate countries to follow. This problem can be rephrased in simple terms as "Copenhagen versus Maastricht".

Seen from the official point of view, the conclusive and regularly evaluated benchmark for accession to the European Union are the so-called Copenhagen criteria.[1] These criteria, together with political requirements such as the rule of law, stability of democratic institutions and respect for human rights and the rights of minorities, also contain a set of relatively general economic criteria – in particular the requirement for the candidate countries to have a functioning market economy and to be able to withstand competitive pressures and market forces within the Union.[2] On the macroeconomic level, the economic part of the Copenhagen criteria is interpreted in such a way that the top priority must be given to enhancing economic growth and closing the performance gap between the candidate country and the member states of the Union.[3] However no specific numbers are given to indicate the desired speed of economic growth.

1 The progress of the candidate countries in meeting the Copenhagen criteria is mapped out in regular reports of the European Commission. The fact that domestic politicians closely watch the conclusions of these reports is illustrated by the commotion about the latest report for 2000. This concluded that "the Czech Republic can be regarded as a functioning market economy and should be able to cope with competitive pressure and market forces within the Union in the near term, provided that it keeps up and completes the implementation of structural reforms". This opinion was interpreted as ranking the Czech Republic as a third-wave country. This produced many critical responses, as well as a positive result in the form of redoubled political efforts to remedy the problems found.

2 These requirements entail a large number of mostly microeconomic tasks – completing structural reform and privatisation, improving law enforcement, strengthening the banking sector, developing local financial markets, etc. It is considered a natural consequence that the above tasks, if implemented, will foster economic growth.

3 This is a matter of definition. Given the more or less constant labour force, economic growth is tantamount to an increase in labour productivity.

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

Another undeniable fact is that the mandatory focus on fulfilling the Maastricht criteria, which lay down explicit parameters for inflation, long-term interest rates, public budgets and the exchange rate, represents the later stage of preparing for accession to EMU. In fact, there is not much freedom for discretion. By adopting the *Acquis Communautaire* (the entire body of European laws), the candidate countries committed themselves to adopting the single currency. They were denied the so-called opt-out clause, which – as a privilege of some current EU member states – stipulates the right to retain the national currency. By preparing to join the EU, the candidate countries are automatically undertaking to draw up, when they become members, a convergence programme specifying guidelines for the adoption of the euro. The clear progression – "first membership in the EU and then membership in the EMU" – however, creates an obvious sequencing for the official obligations of the Copenhagen and Maastricht criteria.

Many economists believe that this sequencing is right and grounded. They believe that the two sets of criteria – the real convergence of Copenhagen and the nominal convergence of Maastricht – compete with each other to some extent. They are concerned that "exaggerated" ambitions within nominal convergence, i.e. the emphasis on low inflation or low public debt, will hurt real convergence. They argue that a narrow focus on the Maastricht criteria will result in slower growth and that more time is needed to close the performance gap between the accession countries and the EU member states.

There exists, however, an alternative view, highlighting the strong elements of complementarity between the processes of real and nominal convergence. This view has been adopted by the European Central Bank, which maintains that the processes should be followed in parallel. In other words, the fact that the Maastricht criteria are not obligatory for accession to the EU should not prevent the macroeconomic policies of the candidate countries being, in the medium run, consistent with the Eurozone policies.[4]

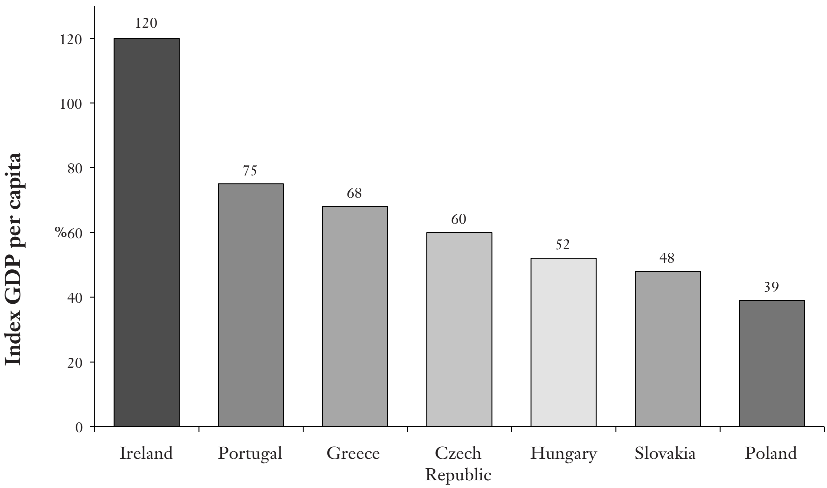
How might the desired accord be achieved in practice? And how many trade-offs between real and nominal convergence do policymakers have at hand? Each candidate country will have to choose its own path, taking into account its own historical experience and social preferences. This applies equally to the Czech Republic, which in the previous period of economic transformation gathered a large volume of empirical evidence which should now be put to use.

4 European Central Bank (2000).

2 A Case Study of Non-Sustainable Growth

The statistics show that in 2000, Czech per capita GDP was approximately 60% of the EU average (see Figure 1). At the same time, the economically weakest EU members recorded higher values: Greece 68% and Portugal 75%. Amongst the candidate countries, the Czech Republic was outperformed by Slovenia (71% of the EU average), but was ahead of Hungary (52%) and Poland (39%).

Figure 1 Comparison of Economic Strength of Selected Countries

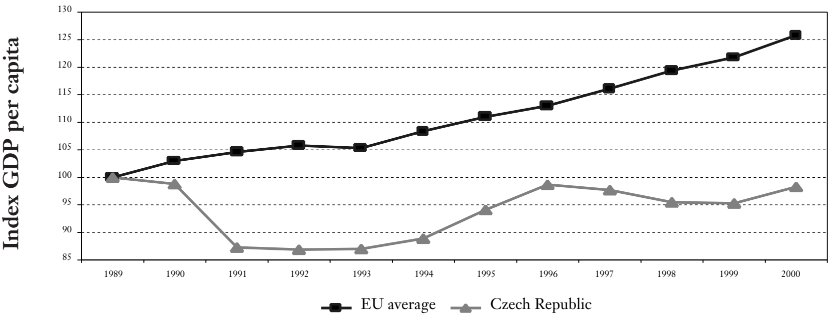


Note: GDP per capita in purchasing power parity in 2000; EU average = 100.
Source: OECD (2001).

A more alarming finding than the mere existence of a performance gap at any particular moment is the fact that the gap between the Czech Republic and the EU countries has a widening tendency (see Figure 2).

Whereas in 1990 the Czech Republic's GDP per capita was approximately 69% of the EU average, the following decade of transition saw the gap increasing by almost 10 percentage points. This comparison clearly suffers from many flaws. It ignores the simple truth that the candidate countries have undergone sweeping social changes, accompanied by an inevitable transformation recession. The statistical GDP data are not able to take account of the huge leap from a shortage economy and distorted international trade to market structures where price respects the sovereignty of the consumer and profit is a reflection of business success.

Figure 2 Widening of the Performance Gap Between the EU and the Czech Republic



Note: Fixed prices; 1989 = 100.
Source: Vintrova, R. *et al*. (2001); CNB database.

However, the fact remains that the Czech Republic has fallen back from the EU economic level.[5]

Under these circumstances, the importance of economic growth cannot be overstated. It is evident that a growing economy has higher financial capacity for completion of transformation objectives and adoptions of European legislation. Growth fosters an increase in competitiveness, which in turn is a pre-requisite for prosperity in a club of countries respecting the four fundamental freedoms of free movement of persons, goods, services and capital.

The EU also has a an interest in accelerating growth in the accession countries It does not need weak members depleting structural funds, demanding various waivers, and generating fears of destabilisation of the common labour market without offering offsetting benefits to the others. So, acceleration of real convergence quite rightly becomes the key priority for the economic policies of candidate countries, and will be closely watched by the EU.

In this context one should recall that the Czech economy showed a very promising performance just a few years ago. In 1995 and 1996, economic growth reached levels of 5.9% and 4.8% respectively. In these years, the Czech Republic was dubbed the "Central European tiger" or "the

5 Revisions to the national account statistics in 1997 showed that the transformation recession in the Czech Republic in the 1990-93 period was smaller than in Hungary or Poland. Prior to the revision, the prevailing opinion had been that the Czech Republic had shown the largest transformation decline. Similarly, the loss of output during the second recession in 1997–98 now looks more benign (up to one percentage point more) following statistical revision in 2001.

front-runner of the transition economies". In an atmosphere of transformation achievements and strong macroeconomic figures, the restrictions on free movement of capital were largely abolished and the Czech currency became externally convertible. Seen in retrospect, the rate of opening of the economy may appear too fast, but it mirrored the optimism of the times.

The period of boom came to an abrupt end in 1997: a speculative attack on the koruna, austerity packages accompanied by tight fiscal and monetary measures, and a political crisis followed by a protracted period of economic downturn. The country learned the lesson that economic growth must have another important characteristic – it must be sustainable. From this point of view, the macroeconomic performance prior to the monetary turbulence of 1997 exhibited serious flaws. Rising domestic demand was met largely by imports, as the non-restructured domestic supply suffered from many bottlenecks. Current account deficits were to a large extent financed by short-term capital. Real wage growth outpaced labour productivity growth. The misaligned domestic fundamentals were further shaken by volatile global financial markets.[6]

Czech policymakers thus saw with their own eyes that a boom-bust pattern prolongs the process of catching up with the EU and translates into extra costs. Using the terminology of today, we can say that the one-sided preference for real convergence failed.

3 Shadow Importance of the Maastricht Criteria

Now the economic recession has been overcome, the prospects of the Czech economy appear more optimistic. The economy showed the first signs of recovery in the second quarter of 1999, and since then the positive growth trend has continued. Furthermore, inflation has stabilised at a relatively low level, close to the price stability required by the Maastricht criteria.[7] However, it must be admitted that this situation is not fully the result of deliberate policy by the central bank, but of a largely opportunistic exploitation and anchoring of external disinflationary pressures.

The following finding is of even greater significance: although there is no official requirement to meet the Maastricht inflation target, the benefits of low inflation are evident. For example, low inflation has translated into a

6 A more detailed explanation can be found in Dědek (2000).

7 Consumer inflation measured by the year-on-year change in the CPI reached 4.2% in the first half of 2001. "Net inflation" (which excludes changes in indirect taxes and regulated prices) was 3.0% as at the end of 2000.

low interest rate differential, which is discouraging inflows of speculative capital. At the same time, a stable low-inflation environment encourages FDI. These positive effects of low inflation help to safely finance the current account deficits that are an inherent part of the process of transition. Low inflation also keeps currency appreciation at bay, thus helping to preserve external price competitiveness. Other things being equal, it also puts the state budget under less strain, as it slows down the triggering of various mandatory indexation rules.

There is no obligation to meet the Maastricht interest rate criterion, but nobody has any doubts that a low and stable interest rate contributes significantly to economic growth. Banks can evaluate more projects as less risky and worth financing over a longer period of time. The costs of financing for businesses are lower, households enjoy cheaper mortgages, and interest payments on state debt are less of a burden.

The central banker should continuously emphasise the mutual dependency between the inflation and interest rate criteria. Interest rates can be low only if the inflation rate is low. Pressures on the central bank to follow the reverse trend, i.e. to maintain low interest rates despite high inflation, may lower the credibility of monetary policy and are therefore counterproductive.

As already mentioned, the Czech economy recovered from recession and has embarked on a path of growth, with rather positive market expectations. There are concerns, however, about the danger of twin deficits, i.e. an increase in both the current account and public sector deficits.[8] These risks have been repeatedly pointed out by international institutions – e.g. the conclusions of FSAP mission saw the current trends as contributing to the vulnerability of the economy.[9] Furthermore, it seems that no radical solution is politically feasible. On the income side, it is difficult to envisage an immediate increase in taxation, not to mention that a significant hike in tax rates could also negatively influence both inflation and economic growth. On the expenditure side, there has been a palpable aversion to reducing the current welfare schemes and to taking unpopular

8 The "passive scenario" of the Ministry of Finance, which assumes continuation of the entrenched trends, estimates the public spending deficit in the 2001–03 period at 6-7% of GDP. The dominant course of fiscal consolidation as presented by the government in its Pre-accession Economic Programme is based on a substantial increase in VAT and indirect taxes, which is not likely to be received well in Parliament.

9 The FSAP (Financial Sector Assessment Programme) under the auspices of the IMF and World Bank, an important element of the new financial architecture, strives to improve the quality of financial systems in the member states. The Czech Republic was among the first countries to allow a thorough examination by the project. The Czech Republic is also doing well in the ROSC (Reports on Observance of Standards and Codes), which examine in detail the status of observance of international standards in the financial sector.

steps, especially before the June 2002 elections.

Again it is proven that although no external authority is pressing on the Czech Republic to meet the Maastricht budgetary requirement, economic reality and macroeconomic prudence are urging for complying with this requirement. A political commitment to the Maastricht criteria would make it easier to consolidate public finance.

Last but not least, there is the Maastricht exchange rate requirement. One can doubt the real benefit of this criterion for exchange rate stability if it stipulates keeping fluctuations within a 30% band. With such a wide band, the Czech koruna would have met the requirement even in times of currency turbulence (see Figure 3).

Figure 3 The Nominal Exchange Rate of the Koruna Inside the Maastricht Band

Note: Range ±15% from the national central parity.
Source: CNB database; own calculation.

The exchange rate criterion is a very soft restriction on those candidate countries that are aware of the benefits of exchange rate stability and would therefore strive to contain fluctuations within a much narrower range than the Maastricht one. Therefore, the only real importance of Maastricht type stability is that it sets out a minimum "quarantine period" of two years in the form of membership in ERM II for each candidate country aspiring to adopt the single currency. It may, however, look strange and unchallenging to require the candidate countries to pass a lengthy exam in external price stability when these countries have the proven ability to maintain a stable exchange rate. But these are rules of the game which the European Union refuses to change with respect to the equal treatment principle.

The Czech currency is now in a regime of managed floating – with much greater emphasis on "floating" than on "managed". Is this the best arrangement in the pre-accession period, or are there other viable alternatives? The answer is that a higher degree of exchange rate flexibility would better suit the specific features of the pre-accession period, but the benefits of the current regime lie largely in negative delimitation. In other words, any other exchange rate regime based to a greater extent on officially declared stability (a fixed rate, currency board or unilateral "euro-isation"), poses greater risks when one takes into account the degree of openness of the Czech economy with respect to capital flows. This experience was reconfirmed by the series of exchange rate crises in the 1990s, which warn against a combination of pegged rates, liberalised capital flows and inconsistent economic policies.

It is often said in defense of floating that exchange rate flexibility serves as a shock absorber. However, we should not overestimate this role. A number of examples may be found of a liberalised financial account being driven by motives that conflict with concerns regarding the current account, where the former usually prevail over the latter. The dominance of capital flows results in a longer-term trend of nominal exchange rate appreciation, which adds to the real appreciation driven by the higher domestic rate of inflation. This contributed to the widening of the external imbalance in the period prior to the Czech currency turbulence of 1997 and became a risk factor in the recent fragile recovery of the economy.[10] Furthermore, it is evident that the exchange rate fluctuations of the Czech currency are often a result of swings in global currencies. They are not, therefore, generated by domestic economic affairs. Nevertheless, these externally induced events have significant implications for the domestic economy.[11]

The current regime of managed floating is thus the second-best alternative which should not cloud the benefits for a trade-oriented economy deriving from exchange rate stability. But does a first-best solution exist at all and, if so, what is it? On the general level, the adoption of the single currency could be the answer. This will mean that an irrevocably fixed rate will be introduced with respect to the Czech main trading area, which will undoubtedly enhance trade and strengthen competition. The Czech economy

10 These cases are symptoms of a more general problem dubbed by some authors as "fear of floating". See Goldfajn and Olivares (2001) and Krugman (2001).

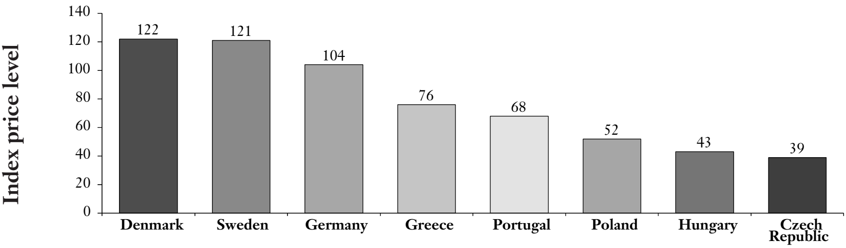
11 An illustrative example of the negative impact on the exchange rate caused by global currencies was the period of strengthening of the dollar against the euro. The koruna was falling against the dollar and rising against the euro. As key commodities are purchased in dollars, a stronger dollar makes imports more expensive. Most exports on the other hand go to EU member states, so a weaker euro translates into lower export income. The trade balance was thus hampered on both the import and export side.

will once and for all escape the threat of a monetary crisis, for where there is no national currency no speculation can be made against it. This will, no doubt, come at the price of new problems, as the winding-up of a national currency is no trivial issue. Notwithstanding these problems, it is still good news for the Czech economy to be able to participate in a joint project responding to the many challenges of worldwide economic globalisation.

4 Closing the Price Gap

The price level problem has become one of the most hotly debated issues under the umbrella of real versus nominal convergence. The basis for the dispute is the "hard" empirical fact that the price levels in the candidate countries are below those in the EU member states. This problem is particularly acute for the Czech Republic, as its price level stands at about 40% of the EU average (see Figure 4).

Figure 4 Comparison of Price Levels



Note: Price levels in purchasing power parity in 2000; EU average = 100.
Source: OECD (2001).

This observation raises a number of questions. Is the Czech economy not committing a fatal mistake, by having a disinflation strategy that focuses on achieving inflation comparable to the EU average? Is such strategy not in fact counterproductive, only postponing the necessary hike in prices to bring them to the same level as in the European Union? Is the central bank not exposing the economy to the danger of a massive price jump upon entry to the EU? There are even doubts about the consistency of the Maastricht criteria per se. How should it be possible to close the price gap, either through higher inflation or through nominal appreciation, when the Maastricht criteria in parallel require price and exchange rate stability?

The law of one price

The discussions about catching up with the EU price level often confuse two theories – the "law of one price" on one hand and the "Balassa-Samuelson effect" on the other.

The law of one price belongs to the family of models accentuating the aspect of disequilibrium thinking. Its driving force is the alleged disparity of values of products at home and abroad. Pricing arbitrage follows to remedy the pricing anomaly: the demand for cheaper domestic goods drives domestic prices up, thus converging them to those abroad. The outstanding gap between domestic prices and those in the European Union seemingly provides empirical grounds for this theory.[12] But does the statistically determined gap really indicate the extent the prices would have to jump?

Figure 5 has been frequently used as a demonstration of the strong correlation between GDP per capita and the price level. However, if this is a regular pattern, the only correct method for determining the size of the price anomaly is not to measure the distance to the EU average, but to measure the vertical distance to the estimated regression line. In other words, if the regression line slopes at about 45 degrees, then the Czech Republic with its 60% of the EU average GDP has a "legitimate right" to about 60% of EU average prices. The remaining deficit then cannot be linked to the closing of the price gap by way of pricing arbitrage, but to the closing of the average productivity gap with respect to the EU member states. When the price level is only about 40% of the EU average, the space for catching up the gap is not 60% (= 100% - 40%), but only 20% (= 60% - 40%). This "distance" is then a lot shorter, approaching the measurement error.

And there is an additional factor. The size of the price gap cannot be inferred simply from a statistical comparison which does not capture "microeconomic details" such as transportation costs, quality and reputation of goods, varying consumer preferences, and so forth. These factors, if they are the root of the price anomaly, do not themselves pose the risk of a price jump, as entry to the European Union will not bring anything new. Pressure to increase prices may be expected in areas where

12 Figure 4 points to the existence of vast differences in price levels also within the EU. These differences are also changing very slowly. According to the OECD (2001), the difference between Denmark and Portugal reduced by only 11 percentage points during the last decade (in 1990, the two countries stood at 126% and 61% respectively vis-à-vis the EU average, whereas in 2000 the corresponding figures were 122% and 68%). The difference between Spain and Denmark, on the other hand, widened by 4 percentage points during the same period.

entry to the EU will lead to elimination of trade barriers or implementation of large-scale state aid programs.[13] In other words, if no significant trade barriers exist for a given commodity group, the assumption is that the prices in the given commodity group have already been realigned. This should be the case regardless of any comparative statistical analyses which do not take into account the above microeconomic details.

From the viewpoint of putting monetary policy into practice, the following remark is very relevant – the opinion that the price gap problem will be solved by way of stimulating higher inflation is simply not true. Higher inflation means price increases in general. The price gap, on the other hand, reflects certain disproportions in relative prices. Higher inflation means only that the alignment of relative prices will happen at a higher price level, as the general rise in prices does not itself change the price ratios. And if the higher inflation leads to a weakening of the currency, the price gap will be reproduced with this amount of weakening.

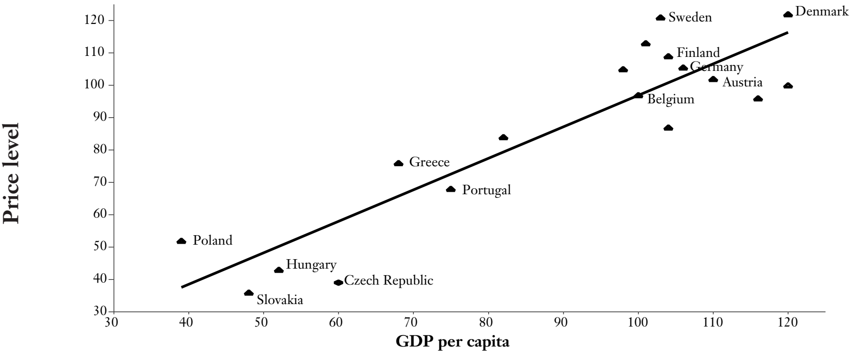
The Balassa-Samuelson Effect

While the adjustment mechanism in the law of one price is put into motion by a state of disequilibrium, the Balassa-Samuelson (BS) effect is based on equilibrium reasoning. The model envisages transmission of a wage increase in a tradable sector with a higher rate of productivity into a non-tradable sector with a lower rate of productivity. The assumption of equalisation of wages in the two sectors drives wages in the non-tradable sector up, causing higher inflation. If we drop the assumption of a fixed exchange rate, the model predicts a real appreciation of the domestic currency against foreign reference currencies.

It should be noted that the logic of the BS model does not mention the need to narrow or close the price gap. It only mentions that higher productivity will lead to a real appreciation of the currency or, if the exchange rate is fixed, to a higher inflation rate. So it also works in reverse – a lower productivity rate vis-à-vis a reference country will be the condition for preserving or even broadening the price gap. In any case, the BS model is, particularly for candidate countries, topical in its message that higher productivity or faster growth will lead to higher inflation. A too

13 Large potential for a price leap exists in the agricultural commodities sector, where price distortions can be attributed to the Common Agricultural Policy. According to a study by Vintrova et al. (2001), joining the CAP could translate into prices of food increasing by 35%–45%. The restrictions in place could also be used to explain why the price of arable land is approximately one tenth of the price in the EU countries neighbouring the Czech Republic. Price gaps may also be attributable to lower indirect taxes and unfinished changes in administered prices.

Figure 5 Statistical Interdependency Between the Price and Economic Level



Note: Measured on the basis of PPP; EU = 100.
Sources: OECD (2001); CNB calculations.

ambitious disinflationary policy may thus be viewed as a hindrance to productivity growth, inhibiting real convergence.

We cannot deny the BS effect its logical consistency. However, we should make an assessment of its empirical importance. The estimate of the strength of this effect will determine a lower limit for reducing inflation, which – if not respected – may logically damage productivity growth and the speed of real convergence. The strength of this effect also determines whether any inconsistency really exists in the Maastricht criteria. If this effect is not significant, it could be easily absorbed by the slack permitted by the criteria.[14, 15]

Intuitively, we can envisage a gradual reduction in the significance of this effect. It seems that the traditional way of regarding the service sector as non-tradable is losing its relevance owing to the fact that a great number of non-traded activities are now subject to strong international competition. Globalisation processes driven by technological innovations are leading to a reduction of transaction costs, and subsequently to a reduction of the relative weight of purely non-traded commodities.

Finally, we have to point out that the paradigm of the BS effect shows

14 See Szapáry (2000) for a survey of estimations of this effect from different authors.
15 If the inflation criterion tolerates an excess of up to 1.5 percentage point above the reference level and the exchange rate criterion is a 30% fluctuation range, then a moderate BS real appreciation can easily be split into inflation and nominal exchange rate values which still meet the Maastricht criteria. Furthermore, this kind of decomposition will have to be observed only during membership in ERM II, so the binding period may be only two years.

one fundamental flaw – abstraction from capital flows, as if the exchange rate and inflation rate were to be judged solely on the basis of the current account. This crucial omission may be fatal, particularly for a small open economy with a high degree of capital mobility.

Once we introduce the capital account into the model, we can see a new set of consequences of a high inflation rate. A wider inflation differential, maybe even caused by the BS effect, tends to be reflected in a comparable interest rate differential. The inflow of short-term capital stimulated by the higher domestic interest rates triggers an exchange rate strengthening, helping to reduce inflation. A stronger exchange rate, other things being equal, translates into slower economic growth, thereby reducing domestic inflation. Adjustment mechanisms carried by the capital flows may, however, cause "overshooting", becoming a trigger of subsequent economic turbulence. A small open economy should avoid situations in which excessive capital flows are about to cause macroeconomic instability.

Last but not least, a model which, in theory, justifies the positive correlation between growth and inflation, should not be used as an alibi for inflation generated by an overheating economy, driven by real wages growing faster than labour productivity, excessive fiscal expansion and mounting government debt. These are intolerable inflation risks which have nothing to do with the BS effect. On the contrary, the model urges an interpretation stressing the strong relationship between convergence of price levels on the one hand and convergence of labour productivity rates and maintenance of macroeconomic stability on the other. The model does not explicitly mention the impact of ignoring this relationship. However, there is a track record of countries stricken by monetary crises.[16]

5 Policy Coordination in the Czech Republic

The policy trade-offs involved in the issue of real versus nominal convergence demand coordination between the government and the central bank. Both these institutions must have a say, as the implications of their policies are crucial for solving the problem. On the other hand, the implications of the two sets of policies are mutually dependent. However, the law requires the central bank to decide independently of the government. An efficient system of coordination is therefore needed, suggesting suitable policy mixes while respecting central bank independence.

16 A warning example of consequences of price and wage catch-up not backed by catch-up in labour productivity is the reunification of Germany, which was made possible only by huge transfers from the old to the new federal states.

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

At least two reasons exist for why monetary policy within an inflation targeting regime creates a suitable environment for successful coordination and communication between the government and the central bank. The first important consideration is that the inflation target may become a bridge between government and monetary policies. While respecting the operational independence of the central bank, the government gets an opportunity to be involved in the process of setting the inflation target. The government will thus participate in setting the key parameters for suppressing inflation, such as the speed of disinflation and the definition of price stability. Simultaneously, it is in the interest of the central bank that the government supports the inflation target, as this adds to the credibility of monetary policy. And higher credibility is widely recognised as a vehicle for reducing the cost of meeting the target. Furthermore, the fact that the government accepts the inflation target means that the target will be made part of government economic policy. In other words, on the one hand the government creates better conditions for hitting the inflation target, and, on the other hand, any measures taken by the central bank aimed at achieving the inflation target cannot be interpreted as an act of hostility towards the government.

In what form have the above features been reflected in the practical policies of the Czech authorities? Although the history of inflation targeting in the Czech Republic is still short, we can already distinguish three stages.

Inflation targeting was launched in December 1997, when a short-term target for the end of 1998 and a medium-term target for year 2000 were announced.[17] The concept of "net inflation", which is in fact the consumer price index minus changes to regulated prices and indirect taxes, was chosen as the factor for steering monetary policy.

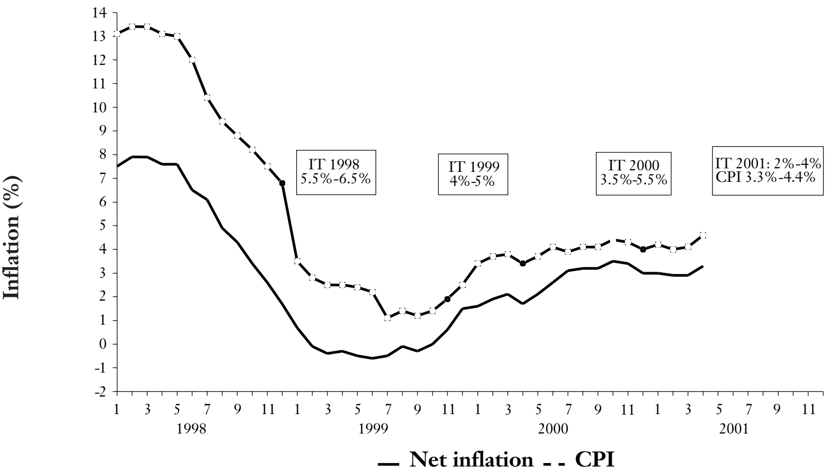
The first inflation targets were declared unilaterally by the Czech National Bank (CNB). This "self-targeting" approach was occasionally criticised. It must, however, be remembered that at the end of 1997, a new anchor was being sought for monetary policy, as the exchange rate anchor had been lost in the currency turbulence. The country was experiencing a political crisis, so it was very difficult to spend time discussing conceptual issues of monetary policy with the government. The need for a new anchor was further exacerbated by a dramatic rise in inflation expectations. When comparing the actual inflation figures with the 2000 target, it was obvious that the CNB envisaged a moderate disinflation. But events took a different turn, owing in particular to a strong and unexpected influence from external factors such as an extreme drop in oil prices, imports of subsidised agricultural products and aggressive pricing between retail

17 In November 1998, an intermediate target was set for the end of 1999.

chains. In conjunction with the upcoming economic recession at home, this resulted in faster-than-expected disinflation. Eventually, it all led to an undershooting of the inflation targets and an only gradual return to the originally planned disinflationary trend.

The second stage started with the approval of a document entitled *CNB Monetary Strategy* in March 1999. In this document, the CNB presented a longer-term vision for gradually embracing the European standards for price stability, quantified in the form of a net inflation target of 2%±1 percentage point for the year 2005. However, more importantly, the Bank's strategy was incorporated into a document entitled *Medium-Term Economic Strategy of the Government of the Czech Republic* and subsequently into a document entitled *Joint Assessment of the Economic Policy Priorities of the Czech Republic*, which outlined the Czech Republic's path into the EU.

Figure 6 Confronting Inflation With Inflation Targets



Source: CNB database.

The dealings with the government, and in particular with its economic experts, were no walk in the park. Many an edge had to be softened and many a position clarified. The discussions on the practical implications of the price level issue were the most contentious. The result – in the form of consensus on the joint position of the government and the central bank – was achieved not only on the strength of the individual arguments, but also by the desire to present a consensus on economic issues to the European Commission.

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

If the consensus was reached under the pressure of reputation risk, one must ask whether the *CNB Monetary Strategy* accepted by the government is not getting obsolete. After all, the turbulent period of 1999-2000 exposed the Czech economy to a negative oil-price shock and the after-effects of recession. In the light of this test, the central bank's vision still seems to be standing its ground. In principle, the longer-term plans are still being met. The sharp disinflation was followed not by a resurgence of inflation, but by an anchoring of inflation expectations at a lower level. The missing of the medium-term inflation target for 2000 by only a narrow margin should, under the given circumstances, be interpreted as an achievement.

At present, inflation targeting is at the start of its third stage. This had a problematic beginning. In January 2001, a controversial amendment to the Czech National Bank Act entered into force. This imposes an explicit obligation on the central bank to consult and reach agreement with the government on the inflation target. This new feature introduced into inflation targeting has met with criticism from the European Commission as an element compromising the independence of the central bank. In the event, this provision was soon abolished by the Constitutional Court, which found it to be a breach of the independent status of the central bank as guaranteed by the Constitution.

However, this episode opened up a debate on how it is that the central bank can have operational independence, but not the sole authority to set targets. Reconciliation of the principle of target dependence, i.e. a form of government involvement in setting inflation targets, with the European legislation thus requires voluntary and not compulsory cooperation. From this point of view, the law did not have to codify the need for cooperation, as inflation target consultations had already become part of the communication between the central bank and the government.

The current stage has also seen the introduction of some technical changes to inflation targeting, such as description of the inflation target in the form of a continuously descending band and a switch to targeting headline inflation as measured by the overall consumer price index.[18] The new concept was approved by the government in April 2001. This motion reflected not only the consensus of the two main policymaking bodies with respect to continuing the disinflationary trend, but also the willingness of the government to put agreement regarding the inflation target on a more long-term footing.

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18 The new inflation target puts annual headline inflation at the level of 2 to 4 percent at the end of 2005. When this plan is compared with the ECB's inflation target of 0 to 2 percent for the harmonised consumer price index, we can intuitively conclude that the CNB inflation policy hopefully leaves sufficient space for the adjustment of relative prices and for the Balassa-Samuelson effect.

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Financial Stability, Monetary Policy and Integration: Policy Choices for Transition Economies

János Vincze

1 Introduction

In the 1990s, emerging markets went trough a number of regional and globalising crises, sometimes quite unexpectedly, that caused great harm. The concurrent reappearance of global financial markets and of a number of financial crises with a clear regional and international dimension prompted both policymakers and academics to reconsider financial liberalisation and international integration.

For transition economies in Eastern Europe (hereinafter referred to as TEs), whose clear political goal is to join the European Union, the recent experiences of emerging markets contain manifold lessons. Other problems are specific to the EU accession process, and may bear likeness to the ERM problems of 1992-93.

In this chapter, I start from the observation that not all financial crises seem to be equally destructive. I make an attempt to distinguish between financial structures and monetary policies that have the potential to amplify real disturbances, and thereby lead to crises *par excellence*, and those where fluctuations have risk-sharing features, and do not aggravate real shocks. Crises in the first category could be defined as "bad", the second as "good" or "acceptable". The construction of a financial architecture should, first of all, serve to avoid destructive or "bad" crises. Such bad crises do not automatically include all serious financial crises. Even large turbulences can be regarded as acceptable and inevitable phenomena. Dampening these turbulences may actually cause social damage, because a better risk-sharing in society would be prevented.

In the central and eastern European countries the main financial policy issue is the preparation for full membership to the EU, which is widely thought to be able to reduce their vulnerability to financial crises. I claim that this is true mostly with respect to "bad" crises. However, being "locked in" by a regional arrangement will not prevent financial crises from happening, as Mexico's crisis after its accession to NAFTA illustrates. Therefore, it is useful to examine whether and how the accession countries

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may become vulnerable to financial crises before and even after joining the EU.

Section 2 elaborates on the idea of distinguishing between bad and acceptable crises. In the following two sections I will focus on identifying harmful financial crises. Section 3 focuses on the domestic financial structure, and Section 4 tries to sort out the role of monetary policy. TEs' experience with financial crises will be analysed in Section 5, which will also look at the direction in which these countries are heading. Monetary policy choices will be addressed in Section 6. Finally, Section 7 comments on desirable policy actions.

2 Distinguishing Between Crises

It is usually believed that financial crises are harmful *per se*, because they cause great trouble in societies. Also, financial crises and vulnerability to crises are deplored because they prevent monetary policy from efficiently managing inflation, either because a crisis makes it impossible, or because vulnerability to crises softens the determination of policymakers. In addition to these general issues, crises in the TEs in the near future could delay accession, or after accession, lead to prolongation of the period before monetary unification. Moreover, it is thought that financial liberalisation and integration, in themselves, increase the likelihood of crises. As TEs do not have very well-developed financial infrastructures, they are especially vulnerable to crises, since the accession process requires total capital account liberalisation and exposes the domestic financial sectors to outside competition. The conclusion is a dilemma: their financial sectors must be improved and stabilised before accession, but liberalisation itself is a dangerous process, in which caution is absolutely necessary.

One may say that the only perfectly safe financial system is no financial system at all. Our understanding of financial intermediation suggests that no system without risks exist, whether it is based on banks or on securities markets. Even complete securities markets would not necessarily put an end to fluctuations. Although intermediaries may improve the allocation of risks and resources, when "open" markets are incomplete, they cannot obtain a first-best allocation.

Can we imagine a world where there are no financial troubles, but where recessions and other types of real disturbances still exist? Indeed, one of the main functions of the financial sector is to provide insurance against risks. However, if risks are real and cannot be eliminated by fiat, then it is reasonable to assume that somebody must at some time suffer,

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and that financial sector problems may indeed be part of a scheme for optimal risks distribution. In this view, crises help to give a state-dependent character to risk allocations, which is indispensable for efficient risk-sharing when non-diversifiable risks exist.[1] This idea does no imply that all banking, debt, asset market or exchange rate crises are optimal, i.e. contingent outcomes constituting part of a first-best social allocation. It only means that they may have a useful function, and that the crises we dislike must be those that aggravate the natural risks of economic life, or those that worsen rather than improve risk-sharing in society. The real problem therefore is not that financial crises occur, but that they may hit the most defenseless with an extraordinary force. And as many recent crisis episodes seemed to possess this unpleasant feature to a large degree, they led to a denouncement of liberalisation. However, we may find recent examples where the financial crisis did not seem to involve much "real" trouble. Then the question is not how to reduce vulnerability to crises in general, but rather, how to create a financial architecture whereby possible financial disturbances belong to a risk-sharing arrangement and may help share real exogenous risks.

Let me give an approximate definition of a "bad" financial crisis. 1. Real shocks are amplified in a "bad" crisis. 2. A "bad" crisis may be caused by shocks that are not related to real economic fundamentals. 3. In a "bad" crisis, losses are not shared and the poor suffer relatively more than the rich. It must be clear that the whole financial architecture, including markets, intermediaries, monetary policies, is responsible for the character of financial crises, and that interaction between the components is crucial.

To illustrate that it is possible to distinguish between "acceptable" and bad crises, I am going to assess some financial crises that occurred during the 1990s. What was the nature of the 1992-93 ERM crisis? For several countries – notably Italy and the United Kingdom – the general opinion was that the crisis did not bring any harm, but rather, the opposite. The crisis had neither real nor inflationary adverse effects. In fact, the devaluations may have contributed in some cases to the recovery. In other words, one can interpret the adjustable and vulnerable ERM as a sort of optimal arrangement in which real disturbances, such as the German unification, resulted in a financial crisis.[2]

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1 In this vein, Allen and Gale (1998a) argue that bank runs may, in some circumstances, be vehicles for achieving first-best allocations. Default risks have been known to improve (see e.g. Obstfeld-Rogoff, 1996, Chapter 6). Also, devaluations and uncertainty about inflation can give a state-dependent character to nominal contracts, making markets "more complete".

2 A less favourable interpretation is, of course, that countries where the crisis had no real causes also suffered, like France. However, was it a great problem for the French economy? There is little evidence that it was.

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In contrast, the Mexican Tequila crisis of 1994-95 may be considered as a harmful crisis. Mexicans suffered acutely for years after the crisis, while US investors were proudly informed by their government that they did not lose any money. This was probably one of the most invidious consequences of the crises in the 1990s.

The Asian crisis of 1997-98 is another crisis that caused great harm. Several East Asian economies went into severe and prolonged recessions, with unjust distributional consequences. It would be very difficult to assign these to existing real shocks that may have preceded the crises.

The financial sectors and monetary policies of both Mexico and the East Asian countries contained some serious flaws that I will analyse in the following sections.

3 Vulnerability and Financial Architecture

The literature gives a number of features of financial systems which could be blamed for the amplification of real disturbances. It appears that the presence of moral hazard, the large fluctuations in asset prices, the existence of financial market linkages and the lack of hedging possibilities are the most common suspects. I will briefly explain each of these features.

Moral hazard is generally regarded as one of the main reasons that a financial accelerator exists. Moral hazard not only has natural (exogenous) causes, but can also be created by policies and institutions (see Eichengreen and Hausmann, 1999). Exchange rate pegging and explicit or implicit government guarantees result in moral hazard.

Large *asset price volatility* and bubbles have characterised many recently liberalised financial markets and banking systems. However, poor quality of supervision, weak regulatory frameworks and inexperience usually lie at the root of these problems.

Financial market linkages have been powerful mechanisms for transmitting disturbances internationally.[3] On the other hand, the work of Allen and Gale (1998b) suggests that such transmitting is, to a large extent, the result of too little liberalisation and that full international integration would contribute to minimising exposure to international spillovers.

The lack of hedging opportunities (Eichengreen and Hausmann, 1999) implies that international investors find their investments in emerging markets too risky. By developing strategies to alleviate this problem, they increase the vulnerability of the countries involved. These strategies

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3 See Darvas-Szapáry (2000) on the role of the regional aspect after the Russian crisis of 1998.

involve, for instance, lending in foreign currency on a short term. Financial market liberalisation and the entry of foreign firms into domestic financial markets can also help to solve these problems, whereas monetary unification can be an even more stable remedy.

Al these features played important roles in the Latin American and Asian crises in the 1990s. Moral hazard via implicit guarantees was a well-documented feature of many Asian economies, and regulation was far less than perfect, resulting in asset price bubbles in Thailand, for instance. Several Latin American countries, suffering from the Tequila crisis, may not have had many currency hedging possibilities. Also, domestic financial markets were usually very poorly integrated with international financial markets, but dominated by government and domestic participation.

From the above, it seems that incomplete liberalisation and restricted foreign entry into domestic financial markets, accompanied by weak supervision, and not liberalisation and integration *per se*, are the things that cause harmful financial disturbances. One objection may be that full liberalisation will increase the potential for foreigners to engage in destabilising speculation in the foreign exchange market. My argument is that there is good reason to believe that foreigners would probably use the access to lending and borrowing in the "domestic" currency for hedging purposes, whereas otherwise they would have to behave in ways (e.g. preferring short-term foreign currency lending) which may cause harmful financial disturbances. The appetite for speculative profits can grow if monetary policies are inappropriate (see next section), but this can be avoided. On the other hand, having foreign lenders expose themselves to genuine exchange rate risks (i.e. risks that have "real" sector origins) provides an important risk-sharing possibility. Foreigners willing to lend in Hungarian forints will share the losses when the forint would depreciate.

Another possible objection is that too much internationalisation may keep the financial sectors of TEs underdeveloped. What are the main arguments for the judgment that the financial sectors in TEs are relatively inefficient? A number of comparable indicators pointing to this inefficiency exist. They include measures of financial depth, interest rate spreads, market capitalisation, etc. However, one should refrain from a hasty interpretation of these indicators.

First, financial depth and the overall size and liquidity of asset markets may be closely related. As a large part of money demand comes from financial transactions demand, small financial markets may in themselves reduce money demand. Second, there may be important offshore markets that take up a large part of financial business for several TE currencies. Third, these countries are usually open, but their foreign trade is not invoiced in their own currency, thereby decreasing money demand.

Fourth, some countries have an increasing share of multinationals or other groups of firms that conduct much of their business internally, also implying that their activity requires little "domestic" money. Fifth, the leverage of the multinational sector can appear to be too low, despite the fact that parent enterprises may be highly levered. Thus, there must be substantial financial intermediation in foreign markets, resulting in domestic investments. Sixth, to a certain degree foreign banks lend directly to domestic enterprises.

To sum up, several factors suggest that the usual indicators do not show how easily enterprises may have access to financial services, as these financial services have already been integrated into world markets. Domestic interest rate spreads may reflect a worse mixture of borrowers than those who can get credit from some lender. Of course, the indicators also show the consequences of "primeval sins" (domestic money is not used in transactions involving foreigners), and/or those of size effects. Having said that, it remains true that financial development is not very sophisticated in TEs, especially in the household sector. This sector remains vulnerable for financial sector problems, for instance in the case of a real estate price bubble. However, a degree of trust may be placed in the learning capabilities of financial institutions. Even without any specific regulatory effort, too much risk-taking may be avoided by the financial institutions themselves, having learnt from the mistakes of the past decade. Whereas one may have a sober view of the rationality of the market, one may be confident that markets react to recurrent events, even without government intervention.

4 Monetary and Exchange Rate Policy and Financial Stability

Central banks in emerging economies have pursued a style of monetary politics aimed at disinflation that might have had unwelcome effects on financial stability. This strategy involved a heavily managed (almost or practically pegged) exchange rate, coupled with sterilisation, which tried to give a significant positive excess yield (premium) on the home currency.[4]

Table 1 in the Appendix illustrates this traditional *peg cum sterilisation* regime for four countries that practiced it and suffered from an exchange rate crisis. This policy implies that in "tranquil" periods, the excess yield has a significantly positive mean and a relatively small variance. The average premium was as high as 11 percent in Mexico, and ranged from 3

4 We will define $\pi = i - (i^* + ds)$ as the premium on the home currency, where i is the home interest rate, i^* the foreign rate and ds the rate of future devaluation of the home currency.

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to 5 percent in Thailand, Korea and Indonesia. However, there is also some probability that, due to a surprise depreciation, the mean of the excess yield in the whole regime becomes closer to zero, and its distribution has a larger variance and also possesses features of non-normality, such as excess kurtosis and non-zero skewness. For the aforementioned four countries, there is at least a tenfold increase in variance; the skewness becomes large and negative, while excess kurtosis is significant, together indicating "large" negative outliers.

Disinflation under the (adjustable) *peg cum sterilisation* policy was based mainly on the exchange rate anchor, but, as it were, without full confidence. The lack of total confidence explained sterilisation and the resulting positive average yield differential, which was thought to be helpful in defending the peg. This strategy was also believed to be disinflationary, because it gave respectably high real interest rates, for our sample ranging roughly from 4 to 8 percent. In this framework there was a very likely gain for everyone willing to invest in the country's currency, or alternatively, to borrow in foreign currency. It is common knowledge that one type of gambler prefers this type of gamble, tending to neglect small probability events. This gambler is satisfied with even small gains and may forget a large loss might occur when the small probability (unfavourable) outcome is realised. It is widely believed that this policy aggravated the East Asian crises when they came. The mechanism is as follows: there is an implicit, but uncertain, guarantee by the government that it will not devalue, while it keeps the nominal interest rate above the foreign rates.[5] The interest rate differential is high enough for many firms or banks to prefer borrowing in foreign currency, which results in a currency mismatch, making them very vulnerable to adverse shocks.

The apparent failures of these policies have led in two directions. One direction has resulted in stronger rigidity by way of a currency board arrangement, and the other one, recently very popular, involves floating exchange rates. Table 2 in the Appendix shows the corresponding statistics for the four countries in their post-crisis "flexible" regimes. One can see that the practice of flexibility is more diverse than that of pegging. The premium was large and positive in Mexico and Indonesia, while small in Korea and negative in Thailand. In all cases, variances have increased substantially. Real interest rates are again positive but with large differences across countries. In Indonesia it was almost 20 percent on average, whereas in Korea it fell below 3 percent.

It may be too early to assess the performance of the new regimes, or

5 See again Burnside-Eichengreen-Rebelo (1999).

even to determine what characterises them precisely. From the point of view of engendering financial fragility, one may have suspicions. The countries with large average excess yields may increase their vulnerability, as this may attract speculation in a floating regime, too, by (nearly risk neutral) foreigners, or can result in desperado behaviour by residents. On the other hand Calvo-Reinhart (2000) show that many "nominal" floaters practise exchange rate management, though, in some cases, not so much by direct exchange market intervention, but rather, with the help of nominal interest rates. This in itself may cause disturbances in the financial system.

5 Past and Future Crises in TEs[6]

Several TEs have suffered from some kind of financial crisis in the last decade. In Russia, virtually all types of crises appeared simultaneously in 1998. There was first a stock market crisis with significant real repercussions, then a sharp devaluation with foreign (including private) debt moratorium and with bank runs resulting in a collapse of the payment system. After years of currency instability and banking sector problems, Bulgaria in 1997 witnessed a currency attack that resulted in a full-blown banking crisis with runs. Default was avoided, and there was no stock market crisis, there being no stock market of which to speak. In Romania, a permanent state of banking and currency problems has prevailed. In 1997-98, the foreign exchange situation exhibited the features of a crisis with large depreciation, though no bank runs and no collapse of financial intermediation ensued. The Slovak Republic was able to defend its fixed exchange rate system, despite an attack during the Czech crisis of 1997. However, the Russian crisis of 1998 triggered the collapse of the fixed exchange rate system, leading to a large depreciation of the Slovak koruna.

In all of these examples, fundamental problems produced the crises in the, sometimes, rather simple financial systems. The root of the problems was patently fiscal, though for the Slovak Republic, this statement is not easy to prove by reference to traditional fiscal accounts. Despite the fact that the financial systems were obviously not robust or efficient in these countries, the financial crises were definitely adjunct to the very real troubles that plagued these economies. There seems to be no evidence that the financial sphere made things definitely worse. On the other hand, it is possible that Bulgaria and the Slovak Republic were stimulated by their respective financial crises, and the reform processes gained momentum in their wake. In fact, it may be true for the other two countries as well.

6 This section is, to a large extent, based on Árvai-Vincze (2000).

The three Baltic countries (Lithuania, Latvia and Estonia) have had different experiences. They all have rigid exchange rate regimes – currency boards in Lithuania and in Estonia, and a strict peg in Latvia. They have liberalised their financial sectors rather boldly, but they have been more exposed to Russian trade than most other TEs. The Russian crisis had a severe impact on Latvia, due to the economy's high exposure to Russian markets, but Latvia did not have to abandon the exchange rate regime. Even though we cannot speak of a full-blown banking crisis, several banks experienced bank runs and liquidity crises after the Russian crisis. There was a modest rise in interest rates, though capital flight was not substantial, as foreign participation in Latvia's capital markets was insignificant. Stock prices had already been declining for several months before the crisis; thus, there was no significant immediate effect on the stock market. Although Lithuania was also vulnerable to contagion from Russia, the currency board arrangement survived the storm and the consequences of the Russian crisis were more substantial in the real economy than in the financial markets. Financial markets basically reacted the same way as in Latvia. Estonia was a similar case as the other two Baltic economies, though with less damaging consequences to the real economy, due to its lower exposure to Russia. Nevertheless the stock market was hit hard by foreign investors' loss of confidence. As an automatic response to the liquidity shortage in a currency board system, there was an immediate rise in interest rates, but capital flight was not substantial.

The three Baltic states represent an interesting experiment inasmuch as liberalisation was coupled to very rigid exchange rate policies. These countries managed to survive the Russian crisis and its aftermath in a relatively intact state, proving that this mix of policies can be effective in avoiding bigger troubles. The Russian crisis was definitely "real" for these economies, and, almost out of necessity, their financial sectors were not as robust as possible. Still there were relatively few disturbances, like those in Latvia, that might have been an indication of a "bad" crisis. Indeed, one may say that these countries were definitely vulnerable to economic crises for real reasons. In this light, the experience of the Baltic states may be seen as a success. An alternative interpretation would be that the troubles after the Russian crisis are attributable to the inflexible exchange rate arrangement. Although this interpretation might make sense, the burden of proof rests with its advocates.

In May 1997, the Czech Republic was the target of speculative attacks which the monetary authorities were not able to withstand, and the fixed exchange rate system had to be relinquished. The repercussions of the currency crisis in the capital market were less severe than expected. Though the currency crisis did not lead to a liquidity crisis in the banking

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system, the serious problems in the Czech banking sector, which had been accumulating for years, became more visible. In my opinion, the Czech crisis was not a bad crisis either, as it inflicted little damage to the economy, at least no additional damage to the real sources of the crisis. This was even though at the time, the Czech economy did not exhibit all the features I recommend in Section 2, and that previous exchange rate policies had belonged to the adjustable *peg cum sterilisation* category.

My view is that the Czech policy regime exhibited the features of an implicit risk-sharing arrangement. It was based on a risky strategy of fast disinflation and quick resumption of growth within a framework where the government's influence was strong via its possession of the banking system. Because things turned out unfavourably, the implied exchange rate regime was able to implement cost sharing via the devaluation that put some of the burden on the shoulders of non-residents investing in koruna denominated assets. The crisis again worked like a catalyst, leading to a policy that, after some years, seems to be producing positive results. Today, the Czech banking sector is in much better shape and, to a large extent, in foreign ownership. Though the crisis caused the abandonment of the exchange-rate-based disinflation strategy, the current monetary policy is reasonable, in that it avoids giving unnecessarily good investment opportunities, and by providing a fundamentally stable nominal exchange rate.

Poland's monetary authorities had widened the fluctuation band in several steps before finally letting the zloty float in April 2000. This move may have been influenced by the desire for an "independent" monetary policy and aimed at pre-empting potential speculative attacks. The Russian crisis had some adverse impacts on exchange rates and asset prices, but Poland may have had some real exposure to Russia. Still, there is little evidence that the post-Russian crisis disturbances were really serious. Poland has put great weight on disinflation, surrendering monetary policy to that goal. (However, in order to cushion the impacts of the Russian crisis, Poland somewhat eased it striving at the end of 1998). It is conceivable that in Poland the adverse effects of a disinflationary strategy based on the interest rate channel might have been instrumental. The mini-crisis at the beginning of 2000 may have been caused by the anti-inflationary zeal that resulted in very high zloty real interest rates and in high premia.

In Hungary, banking problems had been solved via consolidation before 1995, though its costs may have contributed to the recurrent small attacks on the currency during 1994-95. The currency problem was managed via a large devaluation and the implementation of a stabilisation programme. In 1998, after the Russian crisis, stock prices dropped sharply, but had no important real effects. The exchange rate came under some pressure, but was defended almost costlessly.

In Slovenia, by pursuing extremely cautious macroeconomic policies, all types of crises are avoided, at the cost of maintaining relatively strong capital controls. It has not suffered from any crisis, but it has also seen relatively little liberalisation. This mixture of policies was enabled by good initial conditions, but Slovenia seems to be situated on a dangerous middle ground now, which may be a cause of future troubles, unless a bolder reform of the financial sector materialises.

6 Monetary and Exchange Rate Policies in TEs

TEs have produced a wide variety of exchange rate and monetary policy regimes. Table 3 in the Appendix shows statistics on Hungary, the Czech Republic, Poland, and Estonia in different time periods.

The Czech Republic followed a *peg cum sterilisation*-style policy before its crisis of May 1997. Columns (1) and (2) in Table 3a illustrate this, showing a reduction in the average premium, and a substantial increase in the variance. However, note that the changes between the columns are not as sharp as those between Tables 1a and 1b, as the Czech crisis was a relatively mild one compared to those in East Asia and Mexico. In 1997, Czech monetary policy switched to a floating regime, and column (3) shows that this resulted in a somewhat higher premium, with higher variance and more outliers, as well as in a definitely higher real rate.

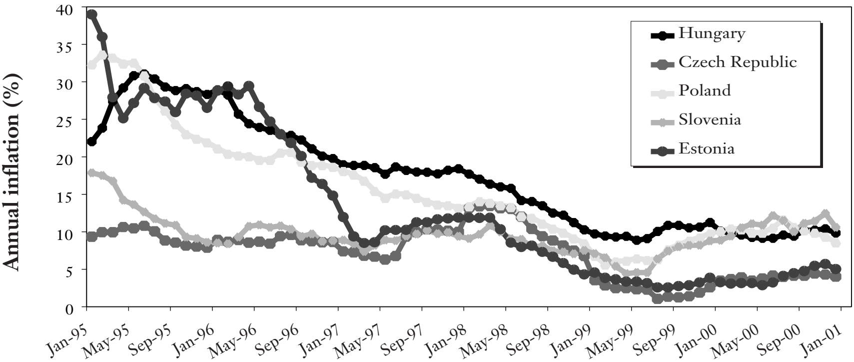
From 1993 onward, Poland increased its exchange rate flexibility gradually, starting with a traditional crawling peg, then widening the bandwidth until abolishing it. Splitting the sample into two shows what it has meant. There was an increase across subsamples in both the premium and the real interest rate, and there was an increased variance in the premium, accompanied with somewhat more "normal" higher order moments.

After its mini exchange rate crisis in 1995, Hungary moved from an adjustable peg regime to a crawling band with a ±2.25 bandwidth, retaining to it until April 2001. Because, most of the time, the band was defined for a basket of DM and US dollar, I am reporting statistics for both currencies. Column (3) and (5) in Table 3b show the statistics before the Russian crisis, and column (4) and (6) for the whole period (columns (3) and (4) refer to DM statistics). One can observe here again the features of the *peg cum sterilisation* regimes, but without a proper crisis. The large difference between the premia is attributable to DM/dollar exchange rate changes.

Estonia has been a devoted currency boarder, fixing its krona against the DM from quite early on during transition. Columns (1) and (2) in Table 3b show the small premia in tranquil times, and the somewhat increased premia, if we include the turbulent periods of the Asian and Russian crises. Non-normality appears even in normal times, but the obvious difference between this and the *peg cum sterilisation* strategy is the size of the premium. Note the large negative average real interest rates.

From the tables, it seems that all countries, except Estonia, had significantly positive real interest rates. One may pose the question whether these were important for inflationary developments. Figure 1 would suggest that this was not so much the case. Estonia had the most spectacular disinflation of the five countries whose inflation rates are displayed, and it has, together with the Czech Republic, recently been a forerunner in the inflation front.

Figure 1 Inflation in TEs, 1995-2001



Indeed, Table 4 can be invoked to give a different explanation for differential inflation developments in the region.

Table 4 Inflation and Exchange Rate Changes
(in percentages)

	Price level change	DM exchange rate change
Czech Republic	45	–2
Slovenia	65	26
Estonia	82	0
Poland	103	33
Hungary	135	85

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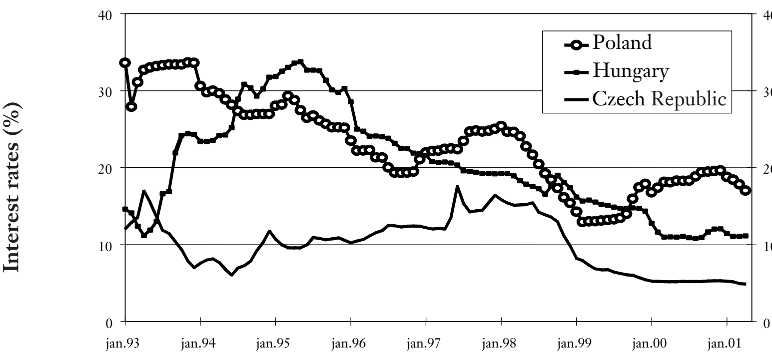
The only change in rankings occurs between Estonia and Slovenia, where Slovenia has the highest per capita GDP, and Estonia, a former Soviet republic, probably has the most distorted price system at the beginning of transition. The above data suggest the following interpretation. Real interest rates have probably played minor roles in inflation developments. The style of monetary policy, or the exchange rate regime, did not really determine inflation either in the short or in the long term. Short-term movements in the rate of inflation were probably due to common causes (oil prices, agricultural shocks), whereas monetary policy mattered for lower frequency price changes, mostly via its relationship with the nominal exchange rate.

What about the relationship between these monetary policies and financial vulnerability? Above we noted the role of *peg cum sterilisation* policies in the Asian and Mexican crises. Again, we find large premia with small variances, which is also suspected to have played a role in the crisis, in the Czech Republic before 1997. In fact, Czech monetary policy has recently moved towards much lower interest rates premia (see Figure 2). Polish interest rates became quite high in the second subperiod, while interest rate volatility has probably been greatest in Poland (see Figure 2). Poland has been struggling with balance of payments problems in recent years, and it is possible that besides fiscal policy, its monetary policy might have contributed to this. Hungary's crawling band system seemed to work reasonably well from the point of view of financial stability, as it had more built-in flexibility than pegs. This policy, however, performed worse than most others in inflationary terms (see Figure 1). On the other hand Estonia's currency board, which performed quite well in terms of inflation, was not a safe haven against the turbulence of international financial markets.

Figure 2 Three-month nominal interest rates in Poland, Hungary and the Czech Republic, January 1993 - April 2001



This broad menu of monetary policies might have important attraction for investors when there are regional shocks. Providing different exchange rate regimes is apparently tantamount to offering different assets where asset yields have the same regional factor, and these different asset yields react differently to the same source of uncertainty. In other words, countries have provided investors with significant diversification opportunities. This might have contributed to the popularity of the region. Now, is this a stable arrangement and, if not, what would be the consequences of changes thereof?

Hungary's recent switch to floating rates suggests, although it does not necessarily imply, some convergence between exchange rate policy styles. If there is a move towards uniformity, and it will almost necessarily happen if several countries aim at fulfilling the Maastricht criteria simultaneously, then this diversification possibility will pass and capital flows may become either smaller or possibly more volatile. It is not unlikely that uniform policies played important roles not only in the East Asian crises but also in the ERM crisis. Taking this into account, either the sequencing of Monetary Union entry or the changing of the Maastricht criteria might be of some help. As the latter would be very difficult to change, the first solution appears to be more viable. However, it would obviously also trigger political tensions. Thus, there is a distinct feeling that the two pre-euro years may become the most susceptible to capital flow volatility and attacks.

The recent worldwide move towards flexible exchange rates, and the strong emphasis put on the interest rate channel of monetary policy have been motivated by several ideas. One goal certainly was to diminish financial vulnerability, and another was to manage inflation more successfully. The latter goal can be decomposed into two elements. First, countries wish to target low inflation on average, and second, they would like to stabilise inflation. Both ideas are explicit in the Maastricht criteria, and very strongly imbued in EU mentality. If we have reasons to doubt both the necessity of having very low inflation at all times and the desirability of little inflation variability, then *a fortiori* we have a case against the very active use of the interest rate or, the interest rate channel, which is the same, in TEs. In the following, I will develop an argument to this effect.

There are good reasons to believe that the real exchange rate is going to appreciate in the accession countries. Whether this is strictly related to the so-called Balassa-Samuelson effect, or, can be explained by other causes is not important here. Indeed, there might be other factors behind the increase in the price of services relative to that of industrial goods. Real appreciation on a CPI basis seems to be unavoidable, provided that TEs fulfil the hopes of faster development and modernisation. Now the question is whether this will be carried out by way of a positive inflation differential or nominal exchange rate appreciation. Thus, in order to attain the EU average, it is almost certain that, aside from temporary manipulation, one would have to resort to nominal appreciation.[7] No one doubts nowadays the advantages of having a low rate of inflation, lower than that prevailing in many TEs at the moment. However, a few percentage points higher inflation than that achieved in Euroland is acceptable. If appreciation requires high average excess yields, then, though potentially helpful against inflation, it may also increase vulnerability by attracting hot money. With very robust financial systems and with very good prudential regulation, the problem may not be very serious. However, it is questionable whether all accession countries would pass this test, on account of the weaknesses of their financial sectors. This is an example of the importance of interactions between monetary policies and financial structures in determining vulnerability.

One might also argue that striving for very little inflation variability can be counterproductive. It is clear that both long-run and short-run relative price changes have occurred and will occur in TEs for good reasons. For instance, there are very good reasons to believe that food prices are much more volatile in TEs than in developed economies. As the share of food prices in the CPI is also higher, this imparts an incipient volatility to the CPI as well. Efforts to stabilise the CPI may cause variations in relative prices that would not make any sense. An active monetary policy implying frequent and possibly large nominal changes would certainly cause additional relative price variation, and therefore allocational distortions.

7 Summary and Policy Conclusions

In this chapter, I distinguished between "acceptable" and "bad" financial crises, seeking to identify the features of financial structures and monetary policies that are most likely to be responsible for the distinction. The analysis of financial crises in TEs has shown that although none of them have exhibited the properties that would make the avoidance of a bad crisis very likely, they have not had any "bad" financial crises in the sense assigned to the term in this study. There are two possible explanations: either this has happened by chance, or their financial infrastructure has been so underdeveloped that it has not had the necessary strength to

7 Nominal appreciation and the concomitant "weighing-in" problem are analysed in Szapáry (2001).

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produce a truly bad financial crisis. As the countries under review seem to be intent on developing their financial sectors, they remain or will become vulnerable to bad crises in the future. What then are the best ways to escape from this predicament?

A recurrent topic in Section 2 is that liberalisation and integration are the only safe strategies in the long run. In the case of TEs, there is one reason why caution must not bear enormous weight in the immediate future. The reason is that EU accession will, at any rate, require virtually full liberalisation, and there is some advantage to the idea of starting experimentation with a liberalised system before that date. One important caveat is that the quality of prudential regulation must be improved, as it appears to be a necessary part of any modern financial system. The biggest challenge is how to cope with asset price bubbles. In this respect, recent regulatory experience must be incorporated into the regulatory frameworks as fast as possible. It must be noted, however, that regulators can trust the learning capacity of the private sector.

This leads to another major point: privatisation of the financial sector must proceed quickly, and if it is done fairly and without restrictions, then it will almost necessarily involve a very high foreign ownership share in all TEs. Indeed, in the last few years enormous progress has been made in this field, even in those countries whose bank privatisation used to lag behind. Foreign banks' participation is useful not just because they have experience in general and in particular with recent financial turmoils, but also because this can ameliorate moral hazard, which is potentially the most dangerous factor for financial vulnerability.

A general lesson from the Asian crises appears to be that several of the countries that suffered most from the concatenation of financial sector and currency crises had had a policy of liberalisation oriented toward domestic ownership. Now some of the TEs have not made the mistake of stimulating moral hazard via implicit guarantees. However, it can be an important problem for Slovenia, which appears to have chosen a cautious and protectionist approach so far, that it can run into serious difficulties at the time it would most need some respite. Cleaning up the inevitable mess that accompanies the early stages of transition is an important prerequisite for every country wanting to enter the European Union successfully.

The analysis of monetary and exchange rate policies showed that the relationship between these policies and financial vulnerability is very complex. We have learnt of the dangers inherent in currency pegs, and may have misgivings about actively independent policies in floating regimes. I raised the question, whether the goals of avoiding financial instability and attaining low and stable inflation are fully consistent.

The Central and East European countries have no intention of developing financial and/or monetary policy cooperation among themselves. They all look at the European Union individually as the vehicle through which they can eventually enjoy the fruits of large-scale integration. In view of the regional character of some of the recent financial turbulences, this neglect of each other's policies may have repercussions. On the other hand, they all trust that Central and Eastern Europe, as a distinguishable economic region, will soon disappear.

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Appendix

Table 1a Measures of Monetary Policies in the Peg Cum Sterilisation Regime in Tranquil Times

	(1) ME 1991:4 -993:11	(2) TH 1991:4- 1997:3	(3) KO 1991:4-1997:7	(4) IN 1991:4-1997:4
(1) prem	0.1104	0.04	0.052	0.0336
(2) var	0.0016	0.0018	0.006	0.0008
(3) ske	-0.563	0.3038	-0.7545	-0.1443
(4) kurt	0.5311	-0.0851	1.5191	2.1837
(5) rrate	0.05	0.0395	0.0822	0.0377

Table 1b Measures of Monetary Policies in the Peg Cum Sterilisation Regime Including the First Months of the Crisis

	(1) ME 1991:4-1995:2	(2) TH 1991:4- 1997:6	(3) KO 1991:4-1997:10	(4) IN 1991:4-1997:7
(1) prem	0.064	-0.0036	-0.0301	-0.0085
(2) var	0.0172	0.0537	0.2322	0.0534
(3) ske	-3.063	-5.375	-5.97	-5.961
(4) kurt	11.175	31.183	36.817	38.289
(5) rrate	0.054	0.0381	0.08	0.0377

Notes:
ME: Mexico, KO: Korea, TH: Thailand, IN: Indonesia.
prem: the average premium on the US dollar.
var: the empirical variance of the premium.
ske: the empirical skewness of the premium.
kurt: the empirical kurtosis of the premium.
rrate: the 3-month real interest rate on the domestic currency.

Table 2 Measures of Monetary Policies in the New Floating Regimes

	(1) ME 1997:1-2000:9	(2) TH 1998:3- 2000:9	(3) KO 1999:1-2000:9	(4) IN 1998:5-2000:8
(1) prem	0.10	-0.04	0.0137	0.3368
(2) var	0.0410	0.0556	0.0172	0.6707
(3) ske	-0.379	0.8011	-0.4024	1.1316
(4) kurt	1.1815	0.1909	1.1782	0.5819
(5) rrate	0.076	0.0394	0.0269	0.1939

Note:
The beginning months in this table were chosen so as to exclude the most turbulent periods.

Table 3a Monetary Policy Measures in TEs

	(1) CZ 1993:1-1997:1	(2) CZ 1993:1- 1997:7	(3)CZ 1998:1-2000:9	(4) PO 1993:1-1996:12	(5) PO 1997:1-2000:9
(1) prem	0.0658	0.048	0.0764	0.0624	0.1111
(2) var	0.0077	0.0125	0.018	0.0241	0.0366
(3) ske	0.2708	-0.669	-0.878	-0.954	-0.758
(4) kurt	0.0077	1.226	1.327	1.261	0.5319
(5) rrate	0.0197	0.0197	0.058	0.0326	0.0831

Table 3b Monetary Policy Measures in TEs

	(1) ES 1993:9-1997:9	(2) ES 1993:9-1999:2	(3) HU 1995:10-1998:4	(4) HU 1995:10-2000:9	(5) HU 1995:10-1998:4	(6) HU 1995:10-2000:9
(1) prem	0.0052	0.0258	0.0914	0.075	-0.019	-0.039
(2) var	0.0003	0.0019	0.0045	0.0074	0.0113	0.0188
(3) ske	-1.33	1.249	-0.431	-0.785	-0.749	-0.7435
(4) kurt	8.133	1.306	-0.700	1.76	0.513	0.2431
(5) rrate	-0.172	-0.11	0.0468	0.0495		

Notes:
CZ: Czech Republic, PL: Poland, HU: Hungary, ES: Estonia.
In Table 3 the premium and correlation refer to the Deutsche mark, except in Columns (5) and (6) of Table 3b where they refer the US dollar.

Comment on Oldřich Dědek and János Vincze

Stephany Griffith-Jones

I will comment on two papers, which are very good, although I have some disagreements with the second paper.

I found Oldřich Dědek's paper very interesting and enjoyed the brief but very thoughtful reflection on the Czech currency crisis. I must say that, Oldřich was among the few Czech economists who also did a good analysis of the potential risks *before* the crisis. Unfortunately, it was a minority of Czech economists who saw the risks in advance. This is a common feature in many such crises, as the "we are different" approach tends to prevail. I also enjoyed the analysis of the possible tensions between the Copenhagen criteria for economic growth and real convergence and the Maastricht criteria. And I enjoyed the analysis of the Balassa-Samuelson effect and the emphasis on lower price levels in the Czech Republic and other transition countries to those in the EU.

There could be a problem in the sense that, because of the Balassa-Samuelson effect, and because of this one-price-effect, once countries like the Czech Republic or Hungary join the EU, they might engage too ambitiously in disinflation policy. This could hinder high growth of both the economy and of productivity, and therefore inhibit the real convergence. Therefore I would agree more with Vincze's paper, that countries like Hungary, which start from a high level of inflation, should perhaps be allowed some flexibility. The policy implication here is not so much for the country but for the Maastricht criteria. They could be modified so that they would allow for higher levels of inflation in this transition period, so that growth is not hindered. Growth is such an important objective. I am not arguing here for very loose macroeconomic policies. I am very aware that the fiscal deficit is large at present in the Czech Republic. I am just arguing for greater flexibility of the inflation level, because the Maastricht criteria are so tight. Many people have argued that even in the West European context they are too tight, but I think this is particularly so in the transition countries.

I also like the link between these factors and the connection with capital flows. And I agree with Oldřich when he says that there should be a policy for prevention of excessive capital flows playing havoc in the moment of accession. But would this also include the possibility of discouraging flows,

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if these were excessive? That is, should the Czech Republic, and other transition countries, keep some instrument for possible discouragement of capital flows à la Chile and Slovenia? And would it be possible given the restrictions that both the EU and the OECD poses. But of course, other policy instruments would be possible if there were capital surges, such as tightening of fiscal policy in a countercyclical way.

My next point is on FDI. Oldřich points to the benefits of inflation as attracting FDI. I agree that FDI has many benefits and is positive. But I think we may have overrated the stability of FDI. There is increasing evidence that, particularly as a crisis approaches, the multinationals make a lot of hedging, especially for FDI that is directed to services or other domestically sold goods, where there is a higher exchange rate risk. This hedging may actually generate quite a lot of pressure on currencies, as has been the case recently in Chile and Brazil. Of course, FDI is more stable than other flows, but it is perhaps not as stable as it was in the past. So this hierarchy of volatility is still valid, but much less so than some time ago.

Finally, Oldřich raises an interesting discussion at the end of his paper about the coordination between the central bank and the government on inflation targeting and about the autonomy of the central bank. I would like to make a comment in general on this issue, not limiting myself to the Czech case.

Table 1 Autonomy and Objectives of Central Banks

Objectives / Autonomy	Only Inflation	Inflation plus others (e.g. Growth)
Yes	I	II
No	III	IV

In Table 1 in the first square, the preference of the central bank is disinflation; there is a sole objective of disinflation and the central bank is totally autonomous. That combination is problematic because it gives too much priority to inflation and not enough priority to growth, wherever there is a trade-off. Therefore, maybe in the future, one should think about either a little bit less autonomy for central banks or greater importance for other objectives. I am thinking about the differences between the US and the European central banks in particular. The US, very clearly in the 1990s, has followed a policy that, more than in Europe, was supporting growth, perhaps because growth and employment are much more explicit

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in the objectives of the Fed. That itself, is not a bad thing. There may be some movement; either towards quadrant II or quadrant III, which may be desirable, especially for transition or developing countries.

I will turn now to János Vincze's paper. I like that he points to the hierarchy in financial systems, between primitive, well-developed and middle systems. He says that the middle systems are prone to crisis. On that, I would put two caveats.

One needs to emphasise that even advanced economies are prone to crises, although for them these may be less costly. Countries like Sweden and Finland have had major crises, because there are imperfections in the financial markets. And I even would argue that the Asian crises are to a certain extent not only the result of mistakes in the policies in the countries, but, as is commonly accepted, also of mistakes in the international capital and lending markets. And what is actually particularly interesting, is that it is not just Keynes and Stiglitz and Wyplosz and these people that are saying it, but increasingly there is a literature among market participants, who say: 'Markets are not efficient, and we should have an alternative behavioural school, that starts assuming imperfections in capital markets, which actually uses this perception of imperfections to try and make money'. So it is also becoming self-fulfilling in that sense. A particularly interesting paper e.g. is Persaud (Persaud, Avinash, 2000), that won last year's price from the Institute for International Finance, the institute of bankers. I just mention it because of the disturbing interaction between herding and market sensitive risk management practices. It argues that the models used by the most sophisticated banks actually accentuate herding and volatility and so on, and therefore create contagion. Therefore, it is a bit worrying that the proposed new Basel Accord relies so heavily on the criteria of the advanced international banks themselves. Relying on banks' own models for capital purposes could make flows even more volatile, more pro-cyclical. Of course, in emerging markets there are more imperfections and weaknesses, but there are quite a lot in developed markets too.

The second issue on this hierarchy in financial systems, which the paper does not really address, is how do you pass from this more primitive financial sector to a fully integrated one? What should be the timing and sequence? What are the lessons for Eastern Europe of the West European experience as described by Wyplosz and others?

Another disagreement I have is that the paper, like quite a bit of the literature, overstresses the issue of moral hazard as a cause of crisis. In financial crises in the past, we did not have the IMF or even lenders of last resort nationally, so I think it is a bit overrated. There is obviously an element of moral hazard but it is a bit exaggerated.

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One of the solutions to the problems of domestic financial systems is the possibility of selling domestic banks to the foreigners. I think that is what is actually happening in these countries. They have a very high proportion of foreign ownership of the banks. About 90 percent of the banks in the Czech Republic and in Hungary are in foreign hands. This may have many benefits, but it also has costs. There has not been a careful assessment of the net balance of all countries; what is the impact of resource allocations, financial efficiency and so on? I know some work that is going on at the World Bank, but I am not sure whether there is enough of that. We should not jump to conclusions; there is a very rapid process of increasing foreign ownership, but I am not sure if that has been carefully assessed.

Another small point is that the author emphasises that investing in the local currency of an emerging country is always a good thing. But I think, as we see from the Czech and the Mexican case, this is not always true. Indeed, the origins of the Mexican peso crisis started with Treasury bonds in local currency, so the key issue remains country risk. That is, in the literature, what people like Hausmann don't really emphasise enough. Even though it may be good to have less foreign exchange exposure, by issuing paper in local currency, this does not necessarily eliminate all the problems.

One of my strong disagreements is the distinction – Oldřich already mentioned that – between good and bad crisis. A maybe more interesting distinction is between developed and emerging market crises, because most emerging market crises are extremely costly. Whereas in developed countries usually, not always, there can be currency crises that do not interact with the banking sector, and which may have positive effects (as some argue when the UK left the ERM). I agree very much with Oldřich that the crisis in the Czech Republic was certainly a bad crisis. GDP growth in the Czech Republic in 1993-96 was beginning to take off at 3-4 percent. Then there are three years of negative growth. In the phase of transition, this is quite serious. Not as dramatic as the Asian crisis and the Mexican peso crisis, but it is quite a loss of output. The rate of unemployment in the Czech Republic was 3.5 percent, which is extremely good. And now it is three times as much, and it is very hard to bring down high levels of unemployment. So these are quite high costs of the crisis.

In advance, you never know if a crisis will be good or bad. So it is much better, of course, to prevent crisis and to try to manage booms, as we talked about in previous FONDAD conferences. You should have some type of mixture of fiscal, regulatory and other measures to discourage excessive inflows. I would like to mention the excellent chapter in BIS Papers, March 2001. It is a very thoughtful analysis of how regulatory mechanisms could be countercyclical to help prevent crisis. This is much healthier than this dramatic effect of discipline through crisis.

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It is a bit strong to say that the best way to prevent capital flows disrupting the pre-accession period of these countries, is to liberalise as much as possible the financial sector, because it could actually make these countries more vulnerable.

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Floor Discussion of "Managing Economic Convergence and Financial Stability in the EU Accession Countries of Central and Eastern Europe"

Commenting on Dědek's paper, Miroslav Hrnčíř wondered whether real and nominal convergence are competing or complementing each other. "On the one hand, there is this extreme idea: forget about controlling inflation, what is important is the growth rate. On the other hand, the accession countries are expected to strive for the EMU membership and thus have to accept the nominal Maastricht convergence criteria. So there are two approaches. One is that you join the EMU as soon as possible, because before the accession you are subject to capital flow volatility and increased capital flows. The other is that it would be wrong to prematurely fix the currency when you are still catching up, because you still need to adjust your price level.

Let me illustrate with the case of the Czech Republic. The Czech GDP per capita is about 60 percent of the EU while our price level is about 40 percent of the EU level. This price level discrepancy is due to domestic economic sectors. From that point of view the Balassa-Samuelson argument is quite valid, that there is wide scope for price increases in the service sector and for a rise in incomes. We should recognise that the catching up of the economy will lead to a rise in price levels that should not be interpreted as genuine inflation. Continuing deregulation, implementation of the EU standards, agriculture policy and environmental standards are all long-term processes leading to price level changes. The changes will take several years, if not a decade.

So if we would take rigidly the present regulations or the Maastricht criteria, the entry into the EMU is going to be a much longer process than currently is expected. My question is: what would be the proper timing and proper process of entry into the EU and into EMU?"

Commenting on Vincze's paper, Hrnčíř argued that the Czech currency turbulence of 1997 was not so bad because it created room for considerable changes in the institutional framework and in policymaking. "I agree that it would have been better to do this without a crisis," he said, "but when the crisis happened, the follow-up developments created the conditions for a more balanced and sustained growth in the Czech Republic, and we see already the first results."

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Daniel Heymann argued that the interpretation of financial crisis as a proper response of the system to a shock is not what in reality happens. "Typically, crises do not happen like well-understood shocks in a system where you have escape clauses that allow you to adjust to those shocks. The point is that in the case of Eastern Europe you might expect to be subject to shocks during the transition, and then the role of flexibility is quite important. Avoiding speculative activity is extremely important in Latin America, we know that. So watching over the system to prevent speculative activity and the outbreak of crises in that respect is quite important."

Brian Kahn compared the discussion about the Maastricht and the Copenhagen criteria to the inflation targeting problem policymakers in South Africa grapple with. "It seems that too much responsibility is placed on monetary policy in this context, while we see very little discussion about complementary policies. We talk about coordination between governments and other organisations, but not very much is said about industrial policy and other policies which might be more important for sustainable growth. That is one issue.

The other issue is full employment. As Stephany argued, you should strive for a central bank that combines autonomy with multiple objectives, such as inflation-plus-growth or inflation-plus-employment objectives."

Leslie Lipschitz was concerned about the way the real convergence was being discussed. "We are talking about real changes and then we are looking for financial instruments. But you cannot do anything with monetary policies to affect these changes in the real economy. If we are talking about real convergence, what do we mean? We mean presumably very large capital inflows, which change capital-labour rates towards West European levels in the Czech Republic, with big productivity gains. Then it is a given that you are going to have big deficits and you are going to be highly subject to any fluctuation in risk premia. So the real question is: how do we get information to the market in a systematic way so we don't have big jumps in risk premia? That is probably impossible.

While we are talking I did a calculation of the magnitudes of the Balassa-Samuelson effects for a stylised Czech Republic that resulted in an equilibrium real appreciation of 7.5 percent a year. Now that is interesting, because I was very struck by János' Table 4, where, if I read it right, it says that in Poland we have a real appreciation of 70 percent and in the Czech Republic some 25 to 50 percent. You have an exchange rate change and a price change, and a huge real appreciation. These might well be equilibrium exchange rate changes.

If that is what is really happening out there – I assume not all of it really is – how do you deal with that through an exchange rate policy? If you

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have fixed your exchange rate and you have huge inflows, your monetary policy is going to be overwhelmed, stabilisation is going to be massively costly, and you are going to have a pre-1997 Czech situation. If you float your exchange rate and try to have interest rate independence, that is, you try to keep your interest rates well above German rates despite the fact that you have a real appreciation, you are going to get an overshoot of your exchange rate to the point where it is expected to be depreciated, which is going to screw your traded goods sector over time. So these are the real problems. It is not at all clear to me how you find a monetary solution to these problems.

On monetary policy, given that you don't have a solution, is there anything one should *not* do? János made the point that there is a moral hazard problem when financial markets think there is an implicit guarantee that the nominal exchange rate is going to be fixed. When people believe that, we get the situation as we had in Asia, in which there are private agents with massive foreign exchange exposure, slowdowns and when you eventually force a change you cripple your real economy."

Heiner Flassbeck had a problem with the way Leslie Lipschitz discussed the mechanics of inflation rate, interest rate and exchange rate. "I think we have a very loose way of talking about risk premia," he said. "You get for a time an inflow of capital, which looks great and which is good for stabilising inflation. However, this will become a big problem later on because the exchange rate depreciation which is necessary in the long run, as we all know, will come up too late because the market is not anticipating it in an orderly way. So there is this dilemma which, in my view, is different from Leslie's interpretation.

To illustrate the dilemma, if you have an inflation rate of 10 percent in all the accession countries – Czech Republic being the exception – and you want to come down to the 2 percent EU level, you need a 20 percent depreciation of the nominal exchange rate in 4 years time, because 8+6+4+2 is 20.

How to get at this 20 percent depreciation? If you fix the exchange rate you have a problem, but if you make it flexible you have, at least in the transition period, also a big problem because it is most probable that you get a nominal appreciation which adds to the real appreciation that you anyway have, due to your high inflation rate. In my view, the only solution would be the middle ground solution, namely to get early accession, not to the EMU but to the EMS system, and to ask for a mechanism which gives you the time to bring about an orderly appreciation of 20 percent and adjust the interest rate in an orderly way. Then you would have an additional and efficient incentive for capital inflows."

Zdeněk Drábek found it a bit ridiculous to talk about hypothetical

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situations. “I would be very interested to hear the actual situation in the Czech Republic and Hungary. On conventional Copenhagen criteria, if you talk about an output gap and if you take your figure of GNP per capita for the Czech Republic of 60 percent of the EU level, surely there must be somewhere in the ballpark the situation that existed in Spain and Portugal when they were acceding the European Union. So why would this be an issue for the Czech Republic of today? I think the issue is that the European Union is very worried about labour mobility and it is very worried about structural funds and their funding. That is one issue.

The other issue is the Maastricht criteria. I thought that the accession to the European Union for us, Central European countries, meant that we accede to the European Monetary Union on day one. I thought that the adoption of the common currency would not be a matter that we could negotiate but a criterion for our accession.

The third issue is the price gap. I think Leslie has been identifying the main problems. If I were a banker and I was certain that there was a price level gap of 40 percent, I would be very worried to negotiate entry. But the problem may not be that serious, partly because, as several of you pointed out, part of the price difference is due to price differences in the non-tradable sector. Therefore, for the central bank the interesting question would be to ask how important the non-tradable sector really is in this example, and therefore, implicitly, what the potential for the Balassa-Samuelson effect to work itself through the system would be? That is the critical issue.”

Xavier Cirera drew some lessons from the Spanish case. “How was the situation in Spain or Portugal at the beginning of the transition? In Spain, the income per capita was something like 65 percent of the European Union average. However, the important issue missing in the debate is the time dimension. Spain had a preferential trade agreement with the European Union since the 1970s, entered into the European Union in 1986 and then into the European Monetary Union in 1997. That is a lot of time and that is very important for real convergence. Both for real and nominal convergence you need time.

Another thing is that after the accession to the European Union in 1986, Spain suffered a huge capital inflow partly because of inflationary policy based on high interest rates. This triggered a real worsening of the trade balance. If you add the Balassa-Samuelson effect, you can expect the same for transition economies. So accession has effects on the real sector and on the tradable sector, which are very important.

Also, Spain suffered three devaluations, two in 1992 and one in 1993. So the record of crisis prevention of the European Monetary System is not very good, that is the first point. The second point is that in 1992, there was implementation of the Single Act, and there was financial liberalisation in Spain and Portugal. I wouldn't say that financial liberalisation triggered the crisis, but it helped to trigger the crisis.

Finally, I would like to raise a question to Dědek and Vincze. During the negotiations the accession candidates had the possibility to ask for a transition period for implementation of the Single Act, as has been applied to Spain. Why has none of the accession countries asked for this transition period?"

Yung Chul Park addressed the issue of foreign ownership of financial institutions: "Stephany said that one should assess the costs and benefits associated with the foreign ownership of financial institutions. Dědek was suggesting Bill White to undertake a study on the role of foreign banks in emerging market economies at the BIS.

East Asia's experience has been that in most of these crises, in countries like Thailand, Indonesia and Korea, the share of foreign ownership of financial institutions has gone up substantially from almost zero to around 35 percent in Korea and 40 percent in other countries. It is about time to re-examine the behaviour of foreign owned banks in emerging markets. If you think that the banks should take care of those small and medium-sized firms which do not have access to capital markets: These foreign banks don't want to touch small and medium-sized firms at all. They try to develop good relationships with major players, big manufacturers, and the high-income consumers by providing very specific services. They completely ignore the small and medium-sized high-risk borrowers.

Maybe I am exaggerating a little bit, but it is about time to look into the behaviour of foreign banks. The World Bank is doing a big study so they might come up with something interesting, we hope."

Reply by Dědek and Vincze

Oldřich Dědek stressed that a good crisis is the one that did not happen. "There are examples of countries that found themselves in a pre-crisis situation and managed to find a solution, a sort of adjustment without recession. I have in mind particularly, for example, Hungary in 1995. Hungary was on the verge of a crisis and some people thought the Mexican case might repeat, but the Hungarian government was bold enough to go ahead with a package to resolve the situation even though the package was unpopular and trade unions protested. In the Czech Republic something different happened. Our austerity packages were launched after the speculative attack, not before. So the timing of rescue packages is an important factor.

On the Maastricht criteria, I fully agree that the Maastricht criteria are a

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pre-condition for EU entry, but at the same time, transition countries are required to work out pre-accession programmes, and on the entry they are required to follow convergence programmes. As far as the inflation-growth trade-off is concerned, I think it is a true paradigm for a closed economy. For an open economy we should have a triangle: growth, inflation and external imbalance. External imbalance is a sort of inflationary debt as well, because excess demand, if demanded from the domestic market, raises inflation; if it is channelled abroad, it creates a current account deficit. So it is important to have in mind all these components and take this trade-off into account.

Let me answer the question of Xavier Cirera why we did not ask for a transition period like Spain once had. The position of a transitional country is that we have to swallow 40.000 pages of *Acquis Communautaire*. We could apply for transition periods, but there is strong competition among accession countries. Particularly the Baltic Republics are fierce competitors and they are refusing transition periods, spoiling the market for other countries. Countries are afraid that asking too much from bureaucrats in Brussels might frustrate the country's accession to the EU.

My last comment is related to the discussion of the Balassa-Samuelson effect. The model is not complete; it is designed as if the country is only linked abroad by the current account. There is no role for capital flows in the model, so it is not a true model. I think that exchange rate fluctuations are primarily caused by capital flows, not by the Balassa-Samuelson effect."

János Vincze said that the origins of the Czech crisis of 1997 dated back to the period 1993-96, when growth was not based on sound economic principles. "The reason why the Czech growth became negative after 1997 was that it was based mostly on consumption and large real wages increases that exceeded productivity growth. Actually, in those three years the Czechs were somehow happily throwing away the advances they had made around 1993. So the troubles of the late 1990s were created before 1997.

About the exchange rate guarantee, what I hold is that pegging with sterilisation really was more or less what is meant by giving an exchange rate guarantee, but with some important condition. The interest rate is not just the guarantee but also the incentive to dollarise your liability. What is even more important is the interaction between different parts of the financial architecture that complicates this sort of exchange rate regime."

Part III

Regional Economic Integration in East Asia and South America

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Beyond the Chiang Mai Initiative: Rationale and Need for a Regional Monetary Arrangement in East Asia[1]

Yung Chul Park

1 Introduction

After the financial crisis touched off in July 1997, Japan proposed the creation of an Asian monetary fund as a framework for promoting financial cooperation and policy coordination in the region. This would help Asian economies prevent and/or better manage future financial crises. Although the proposal received a positive response from a number of East Asian countries, it was shelved on the objection of the US, EU, and the IMF. The idea was revived again when the finance ministers of ASEAN countries plus China, Japan, and South Korea (ASEAN+3) agreed in May 2000 to establish a system of swap arrangements within the ASEAN+3 countries. This became known as the Chiang Mai Initiative (CMI). It involves (i) an expanded ASEAN Swap Arrangement (from five members to ten), and (ii) a network of bilateral swap arrangements among ASEAN countries, China, Japan and South Korea. The CMI swap arrangements will provide liquidity support for member countries experiencing balance of payment difficulties in order to prevent an extreme crisis or systemic failure in a country and subsequent regional contagion such as occurred in the recent Asian financial crisis.

Emergency support facilities such as the CMI, which are similar to other regional and international "lender of last resort" facilities, are primarily for systemic purposes and as such, would be used infrequently. Since the intent of the CMI is to be proactive, there is a need to define a mutually agreed framework for inter-country cooperation amongst the ASEAN and ASEAN+3 agencies, that can quickly and effectively implement emergency assistance at the required levels when a need arises. Moreover, a group approach would ensure that any conditionality associated with the financial assistance would be consistent across countries.

1 A revised version of a paper presented at the conference on "The Role of Regional Financial Arrangements in Crisis Prevention and Response: The Experiences of Africa, Asia, Latin America and Europe" organised by FONDAD at the Czech National Bank in Prague, 21-22 June 2001. Date of revision: May, 2002.

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As a background for the discussion on the CMI, this study begins with the question of whether regional financial arrangements, whatever forms they may take, are needed in East Asia, and if so, whether they would be effective in safeguarding the region from future financial crises. To answer these questions, I describe the basic framework of the CMI in Section 2 and recent developments in the negotiations and prospects for the CMI in Section 3. In Section 4, I discuss some of the arguments in the economics literature opposing the creation of regional financial arrangements. These arguments are then countered in Section 5 with several contrasting views which suggest that regional financial mechanisms could complement multilateral trade and financial liberalisation, and therefore promote global financial stability. I present some concluding remarks in Section 6.

2 The Chiang Mai Initiative (CMI)

On May 6, 2000 in Chiang Mai, Thailand, the finance ministers of ASEAN+3 countries agreed to establish a system of swap arrangements within the ASEAN+3 countries. This agreement is known as the Chiang Mai Initiative. Since then, deputy finance ministers of the ASEAN+3 have negotiated the details of the initiative to produce a basic framework for the ASEAN Swap Arrangement (ASA), Bilateral Swap Arrangements (BSAs) and a repurchase agreement (Repo) among the thirteen countries. The framework was approved by the meeting of the deputies on November 7, 2000 in Beijing. A progress report on the CMI was then reported to the summit meeting of the thirteen countries two weeks later.

The CMI has two components:

(i) an expanded ASEAN swap arrangement; and
(ii) a network of bilateral swap and repurchase arrangements among the thirteen countries.

In 1977, five ASEAN countries – Indonesia, Malaysia, Philippines, Singapore, and Thailand – agreed to establish an ASEAN swap arrangement (ASA) to provide liquidity support for the participating countries experiencing balance of payment difficulties. In May, 2000, the ASA was expanded to include all ten member countries under the CMI and the total amount of the facility was raised to $1 billion from the initial amount of $200 million.

The currencies available under the ASA are the US dollar, yen and euro. The euro, yen and Euro LIBOR interest rates are used as the base rate for swap transactions. Each member is allowed to draw a maximum of twice its committed amount from the facility for a period not exceeding six months, subject to an extension for another period not exceeding six months.

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The BSA is a facility designed to provide short-term liquidity assistance in the form of swaps of US dollars with the domestic currencies of a participating country. The maximum amount of drawing under each of the BSAs will be determined by bilateral negotiations. However, it is expected that disbursements to a member in need of liquidity assistance will be made in a concerted manner through consultation among the swap-providing countries. One of these swap-providing countries will then serve as the coordinator for the consulting process.

The BSA is complementary to the IMF's financial assistance in that countries drawing from the facility are required to accept an IMF programme for macroeconomic and structural adjustments. However, the BSA agreement allows an automatic disbursement of up to 10 percent of the maximum amount of drawing without any linkage to an IMF programme. Nonetheless, a number of the participating countries have expressed reservations on the linkage of the BSA with the IMF conditionality and have proposed a gradual increase of the 10 percent automatic drawdown to abolish the IMF linkage after a period of transition. Several countries have also emphasised the need for creating a surveillance mechanism for the CMI. At the fifth ASEAN finance ministers' meeting in April 2001 in Kuala Lumpur, there was consensus that the BSA would be complementary and supplementary to IMF facilities. The ASEAN ministers also agreed that "the terms and modalities of the BSA should take into account the different economic fundamentals, specific circumstances, and financing needs of individual countries". This agreement implies that the contracting parties of the BSA could deviate from the basic framework on setting terms and conditions of the swap arrangement.

Participating countries will be able to draw from the BSA for a period of 90 days. The first drawing may be renewed seven times. The interest rate applicable to the drawing is the LIBOR plus a premium of 150 basis points for the first and first renewal drawings. Thereafter, the premium is increased by an additional 50 basis point for every two renewals, but not exceeding 300 basis points.

The Repo agreement is also established to provide short-term liquidity to a participating member through the sale and buyback of appropriate securities. The basic features of Repo agreements are to be finalised through bilateral negotiations between the contracting parties. Securities of the Repo agreement are US Treasury notes or bills with a remaining life of not more than 5 years and government securities of the counterpart country of the Repo.

The period of the Repo agreement is one week, but could be extended on the termination value date by agreement between the contracting parties. The minimum amount for each Repo transaction requested is five percent of the total amount of the Repo agreement. In each Repo transaction, the buyer will be given a margin of 102 percent for US Treasury notes or bills and 105 percent for government securities of the counterpart country.

Since the ASEAN+3 summit meeting in November 2000, Japan, China, and Korea have been negotiating BSAs with the ASEAN countries. Japan concluded its negotiations for at least eight swap arrangements during the meeting of the finance ministers of the ASEAN+3 in May 2001. Both China and Korea are reported to have made progress in their negotiations with the ASEAN participants.

3 Progress and Prospects: CMI Negotiations

Progress in Negotiations

Since the ASEAN+3 summit meeting in November 2000, Japan, China, and Korea have been negotiating BSAs with each other and with the ASEAN countries (see Table 1). Japan has been most active in the process and has concluded negotiations with both Thailand and Philippines for establishing a BSA amounting to $3 billion each. Japan and Malaysia have agreed to add $1 billion more to the initial amount of $2.5 billion of the existing BSA between the two countries.

Japan has contracted a bilateral swap of $2 billion with Korea, and Korea has been negotiating with both China and Thailand for similar arrangements. China and Thailand are expected to conclude a BSA on the order of $4 billion.

Among the ASEAN member states, Singapore and Brunei have shown little enthusiasm from the beginning for promoting the CMI, primarily because they believe the BSAs with their neighbouring countries will be one-way arrangements in which they will be asked to provide a large amount of liquidity in case of a crisis affecting the ASEAN region. However, Japan has made progress in bringing Singapore into the system by proposing a BSA that uses local currencies rather than the US dollar. In fact, Japan has proposed a similar local-currency BSA with China that is equivalent to $3 billion in its size.

Indonesia has not shown any strong interest in negotiating possible BSA arrangements with other participating countries because of its preoccupation with resolving domestic economic issues and managing its huge foreign debts – not to mention escalating political instability. Recently, however Indonesia has indicated its intention to negotiate a BSA

Table 1 Current Status of BSAs Negotiations Among the ASEAN+3

	Korea	Japan	China
Korea		– contract (7/4/01) – $2billion plus – the existing $5billion – won/dollar – one way	– agreement – $2billion – won/yuan – Two-way
Japan			– agreement – $3billion – won/yuan – Two-way
Thailand (7/4/01)	– agreement – $1billion – won/Bhat – Two-way	– contract (7/28/01) – $3billion – Bhat/dollar – one way	– contract – $2billion – Bhat/dollar – one way
Philippines	– in negotiation	– contract (8/30/01) – $3billion – peso/dollar – one way	– in negotiation
Malaysia	– in negotiation	– contract (10/5/01) – $1billion plus – the existing $2billion – Ringgit/dollar – one way	– in negotiation
Singapore		– in negotiation	

with Japan, but it does not appear to place a high priority on the CMI.

At present, the total amount of BSAs covering all 13 countries is estimated to be around $20 billion. The maximum amount of money any individual country can draw varies a great deal. In the case of Thailand, the maximum is about $6 to 7 billion, 10 percent of which can be drawn automatically ($600 to 700 million).

Given the relatively small amount of liquidity available through the CMI, could the BSA system serve as a credible and effective system of defense against speculative attacks in the future? Financial participants will continue to be unimpressed with the amount of liquidity available and will likely ignore the CMI unless the ASEAN+3 is able to increase the number of BSAs and expand the swap amount of each BSA.

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Monitoring and Surveillance

From the inception of the CMI, Malaysia has opposed the idea of establishing any linkage between the IMF and CMI and has insisted on creating a regional organisation capable of conducting economic reviews of and promoting policy dialogue among the participating countries. However, other members, in particular Japan and China, have argued for a cooperative relationship with the IMF at an early stage of the CMI development in order to make it more credible. Also, it could eventually result in Malaysia's acceptance of temporarily linking the BSAs with IMF conditionality until a formal surveillance mechanism is established. Malaysia agreed to the IMF linkage providing that the participating countries establish a study group for analysing how a regional organisation for CMI surveillance and monitoring could be established and what the structure and functions of such an organisation would be.

Most participating countries agreed in principle that the CMI should be supported by a regional organisation that reviews economic developments in the region, could promote policy dialogue and coordination among the members, and could impose structural and policy reform for the countries drawing from the BSAs. The ASEAN+3 finance ministers agreed to organise a study group to produce a blueprint for an effective mechanism of policy dialogues and economic reviews for CMI operations at the ADB annual meeting in Honolulu on May 9, 2001. Japan and Malaysia were chosen to co-chair the group. The study group met in Kuala Lumpur on November 22, 2001 to discuss its report on possible modalities of surveillance prepared by Bank Negara Malaysia and the Japan's Ministry of Finance.

Prospects for Financial Cooperation in East Asia

East Asian policymakers who initially conceived the idea of the CMI would easily concede that as it is currently structured, the BSA system has a long way to go before it can be accepted as an effective mechanism of defense against financial crises in the eyes of financial market participants. One serious problem is that the thirteen countries have failed to articulate whether and how they are going to develop the CMI as a regional financial arrangement in the future. Although two years have passed since the system was established, the leaders of the CMI group have yet to produce an operational structure of the BSA, in particular a monitoring and surveillance mechanism, and it is highly unlikely they will do so any time soon.

As a result, many financial industry experts have expressed doubts as to whether any country facing an incipient crisis could draw from the BSAs that they contracted with other members, and if they could, how much liquidity would be available. Participating countries could refuse any further support exceeding the 10 percent automatic draw. In particular, if there is no effective mechanism of surveillance which could impose policy conditionality, many participating countries are not likely to activate their BSAs for fear of losing what amounts to be their short-term loans.

There is also a need to coordinate the activities of the CMI with other liquidity assistance programmes such as the Manila Framework supported by the US, Australia and New Zealand. Most of the CMI countries also participate in APEC and other regional arrangements. At some point in the future, the leaders of the ASEAN+3 may have to decide on the mode of cooperation and division of labour in promoting regional growth and stability between these institutions and the CMI.

As fear of another round of financial crisis has receded with a recovery that has been faster than previous experience would predict, the ASEAN+3 countries have become less interested in enlarging and institutionalising CMI operations. The interests of the ASEAN+3 have recently shifted to creating free trade areas in the East Asian region. The ASEAN members have already agreed to develop an ASEAN free trade area. Japan has concluded a free trade agreement with Singapore and proposed negotiations on a similar agreement with Korea.

China has indicated its interest in negotiating free trade agreements with the ASEAN and other neighbouring countries. China has made no secret about its long-run objective of establishing a Chinese Economic Area in East Asia comprising the ASEAN, Taiwan, Hong Kong and China itself. This is undoubtedly a desirable development. However, as will be discussed in subsequent sections, regional financial arrangements could facilitate trade expansion by stabilising bilateral exchange rates of regional currencies and by minimising the disruptive effects of financial market turbulence. For this very reason, it would be in the interest of East Asia to carry out the extension of the CMI parallel with negotiations on establishing free trade areas in the region. Nevertheless, the prospects for financial cooperation and policy coordination in East Asia are not very promising at this stage.

One reason for this uncertain outlook is that except for Japan, no other potential swap lender – including China – is prepared to increase the amounts of its bilateral swaps with other CMI members. China and Japan, which were expected to provide leadership in forging regional support for expanding and consolidating the BSAs as a regional institution, have not been able to agree on a number of operational issues including a surveillance mechanism. No doubt, Japan has financial resources it could make available for the swap financing for the ASEAN and Korea (China is

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not expected to borrow from Japan). However, unless Japanese authorities receive some sort of assurance that their short-term lending will be repaid, they are unlikely to lead the institutionalisation of the CMI. As a condition for the expansion of the CMI, Japan emphasises the need for creating an effective surveillance mechanism for the region in which it can exercise influence commensurate with its financial contribution. China feels that it cannot play second fiddle to Japan in any regional organisation in East Asia. This deadlock appears to be the most serious roadblock to the further development of the CMI.

Another reason is that China and Japan have different interests in and hence different strategies for economic integration in East Asia. As far as China is concerned, economic integration with the ASEAN-10, with South Asian and Central Asian countries may be more important, both economically and geopolitically, than free trade with either Japan or South Korea. Given the gap in technological and industrial sophistication and size of GDP between China and Japan, Chinese policymakers may feel that neither Japan nor Korea is a good partner for free trade or financial cooperation.

China borders Russia and many of the South Asian and Central Asian countries in addition to several ASEAN members. It is natural therefore for China to seek expansion and deepening of its trade and financial relations with these neighbouring countries. To this end, China has been courting the ASEAN for a free trade agreement and in November of 2001, China joined the Bangkok agreement on a free trade area which includes Russia and the South Asian countries. China has also taken a leading role in establishing a cooperative arrangement known as the Shanghai cooperation organisation that includes Russia, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan as well as China.

In contrast, Japan has not been able to articulate its strategic interests in East Asia. Japan has been in the forefront of supporting greater economic cooperation among the East Asian countries, but the geographical contiguity of East Asia from the Japanese point of view has not been altogether clear to its partners in East Asia. Japan has been promoting integration among the ASEAN+5, but surprisingly, questions remain as to the identity of the two countries added to the initial ASEAN+3. At one point, the five countries were China, Japan, Korea, Australia and New Zealand. At another, Australia and New Zealand were replaced by Taiwan and Hong Kong in defining the five-country group.

According to Wall (2002), Japan is not interested in free trade in East Asia per se; instead, Japan is engaged in the discussion of free trade agreements and other financial arrangements with other East Asian countries in order to counter China's expansion, and in so doing, maintain its leadership role as the region's largest economy.

Japan appears to be concerned with China's rise both as a military and economic power in East Asia. If the current trend continues, China could marginalise Japan's role as East Asia's leading country. Many analysts believe that Japan's active involvement in regional economic integration is therefore motivated by its desire to maintain its traditional pole position. Added to this suspicion, Japan is perceived to be more interested in containing China than advancing the causes of economic development and welfare. Japan is a declining power which is unwilling to resolve its wartime legacies and disputes on historical and territorial claims. Japan has also been gripped with a decade long recession and has been unable to restructure its economy. Combined with the absence of a strategy in East Asia, these developments have undermined Japan's ability to pull East Asian countries together for regional cooperation and integration.

What, then, is the likely course of development of the CMI and related regional financial integration in East Asia? One possible scenario is that China and Japan may reach an agreement on an institutional setting and augmentation of the existing BSAs. For instance, China may give in to Japan's demand for de facto control over the monitoring and surveillance in return for Japan's pledge for a substantial increase in financial assistance in the form of one-way swaps and ODA to ASEAN members. China could agree to this scheme, if it sees the possibility of concluding a free trade pact with the ASEAN members in the near future. A free trade pact with the ASEAN could circumscribe Japan's influence on ASEAN affairs even if it is a major provider of financing.

Another scenario focuses on the possibility of China taking a more aggressive leadership role in regional integration by contracting larger swap arrangements with the ASEAN members. That is, China may take charge of consolidation of the CMI while negotiating a free trade pact with the ASEAN. In this case, the original CMI will become ASEAN+1. Realising that financial integration is an integral part of a successful free trade area, China may indeed seriously consider this option.

A third scenario is an enlargement of the CMI members by including Australia and New Zealand and possibly other countries from South Asia. This is the one favoured by Japan. Japan believes that it would be easier to deal with China if more countries were supporting its strategy. However, many members of the ASEAN+3 believe that forming a critical mass of the CMI, which is yet to be realised, should precede any enlargement of the BSAs. Since the enlargement is not likely to substantially increase the availability of short-term financing, the third scenario will not be taken seriously.

A fourth scenario envisions a division of East Asia as it is defined to include the ASEAN+3 between two currency blocs, a remimbi and a yen

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bloc. Many experts believe that given the growing export market in China the ASEAN members will be driven by market forces to join in a Chinese Economic Area in the long run. Formation of a currency union among the ASEAN+1 will then naturally follow expansion of trade between ASEAN and China. Japan would then look to Korea as a potential partner for free trade and currency union.

For the next two years or so, however, the ASEAN+3 are not expected to make any major breakthroughs in enlarging the BSAs. Financial officials from the thirteen countries will continue to meet regularly to discuss ways of enhancing policy reviews of the members. In a recent meeting in Yangon, Myanmar (April 2, 2002), a proposal was put forward to restructure the informal ASEAN+3 Finance and Central Bank Deputies Meeting (AFDM+3) as Deputies Policy Review Group, which will be supported by an administrative unit and a group of eminent people (GEP). At the Yangon meeting, several alternative suggestions were made for creating a surveillance unit which included relying on the existing regional institutions such as the ADB. However, the AFDM+3 could not reach any agreement.

While the discussion on formalisation of the CMI has made little progress so far, China, Japan and Korea have launched another initiative for regional financial integration by undertaking a joint study on the feasibility of creating regional capital markets in East Asia. This proposal would be announced at the ADB meeting in May, 2002.

4 Arguments Against Regional Financial Arrangements

Ever since the proposal for creating an Asian monetary fund was made, the idea has been opposed by the US, the EU and the IMF for a variety of reasons. Although recently both the US and the IMF have lessened their opposition to regional financial arrangements, they still maintain that the arrangements should be both complementary and supplementary to the IMF financing facilities (Köhler, 2001). The opponents of a regional financial arrangement in East Asia raise two issues. First, they argue that the ASEAN+3 countries have yet to develop economic, social and political preconditions that could support a regional financial arrangement. Many of the participating countries have been embroiled in numerous territorial and economic disputes of one kind or another among themselves, animosity toward Japan because of atrocities carried out during World War II lingers on. For many years, the three countries have been mired in the controversy over historical interpretations of Japan's role in East Asia in the 19th and the early 20th centuries.

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As Eichengreen (1999) put it, East Asia lacks the tradition of integrationist thinking and the web of interlocking diplomatic agreements that could encourage monetary and financial cooperation in Europe. As a result, the opponents claim that since East Asian countries are not ready for – or capable of – creating and managing an efficient financial arrangement, their efforts at financial cooperation in an institutionalised setting could produce undesirable consequences for countries in other parts of the world. Many argue that the regional funds in particular could aggravate moral hazard problems associated with excessive borrowing and loose macroeconomic policies of participating economies.

It may be true that regional financial arrangements could pose a serious moral hazard problem. At this stage of development, East Asians may not be prepared to negotiate an international treaty that 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, hence, may pose a serious problem of policy discipline. However, moral hazard is not a problem that will beset regional arrangements alone. The IMF is not immune to this problem. The moral hazard concern is so serious that some people even question whether the IMF should continue to play the role of a quasi-lender of last resort, and for them, the creation of regional monetary funds must be an anathema. (The Meltzer Commission, 2000) The task force report of the Council on Foreign Relations (1999) advises the Fund to adhere consistently to normal lending limits in order 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 institution have not been made clear. As Sakakibara (2000) puts it, if those countries unaffected by the East Asian crisis have no political incentive for contributing their own money, they should say so instead of using the moral hazard argument as an excuse for opposing regional arrangements in East Asia.

For over a half century, European countries have worked hard to develop a wide web of political and diplomatic agreements which has served as a foundation for cooperation on monetary and financial matters. Certainly, such a web does not exist in East Asia, and as far as East Asia's limited capacity is concerned, Eichengreen and Bayoumi (1999) have a point. Indeed, if the European experience is any guide, East Asia may take many years to develop an effective cooperative arrangement for finance, not to mention a monetary union.

While the importance of political preconditions for establishing an effective regional financial mechanism can not be denied, it should also be noted that the ASEAN+3 countries have participated in various regional

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groupings. The ASEAN was established in the 1970s, and since then it has contributed to consolidating unity, promoting free trade, and providing mutual financial assistance among the member states. The ASEAN countries have more than thirty years of experience with regional cooperation. The ASEAN+3 have also been active members of APEC. Some of these countries have participated in the Manila framework; and there are other regional cooperative arrangements such as SEACEN and SEANZA which have provided informal fora for policy dialogue.

Recent economic developments in East Asia may suggest that political integration has become a less important constraint than before, largely because many of East Asia's central banks now enjoy greater independence than before and, more importantly, democratic principles are taking root in the governance of these countries. East Asia is changing and may be on the brink of an historical evolution, as Europe was half a century ago (Bergsten, 2000). It is true that there are not many political and economic issues on which all thirteen countries participating in the CMI could agree, and regional financial cooperation has been one of them. But by delegating regional financial affairs to the CMI or similar institutions, the East Asian countries could bypass political issues and disputes and work toward building regional trust.

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 defense mechanism to the extent that it could help protect them from future crises. After three years of crisis management, East Asia has also developed a large pool of skilled and experienced people capable of managing regional financial cooperation and policy coordination.

The opponents to the CMI also argue that there may be no need for regional funds and other arrangements in a globalised world economy where a growing proportion of the trade in goods and services is increasingly conducted in cyber space. Worse yet, these regional financial mechanisms could impede multilateral trade liberalisation and global financial integration. The ongoing revolution in information and communications technology will accelerate both globalisation and virtualisation. What the world economy needs, therefore, is a new system of global governance which may include a global central bank and global regulatory authorities. In the case of the financial markets, and the financial services industries, the scope of governance could be increased to the level of the world so as to realise scale economies and to accommodate the market forces driving financial globalisation. 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, 1999). 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 for adoption by emerging market economies (EMEs) and developing countries (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.

The architects of the CMI have a more ambitious goal in developing the CMI. They plan to expand the CMI not only as a financing mechanism for the member countries experiencing balance of payment problems but also as a launching pad for creating a full-fledged regional monetary fund, eventually establishing a common currency area in the region. That is, the CMI planners are emulating the steps European countries have taken during the post-war period for regional integration in Europe.

On this longer-term issue, which is political in nature, Eichengreen (1999), Eichengreen and Bayoumi (1999), and Bayoumi, Eichengreen and Mauro (2000) argue that while a group of East Asian countries may satisfy requirements for an optimum currency area as much as the EU does, it has not developed the necessary political preconditions for a durable regional arrangement, and certainly not to the degree that Europe has. These authors argue that “any monetary arrangement that seeks to stabilise exchange rates in the absence of the necessary political preconditions will be fragile and crisis prone”.

Drawing on the European experience, one might emphasise the need for the efficient management of a relatively long period of transition to a common currency peg and ultimately to a common currency. East Asian countries would therefore have a better chance of defending themselves against crisis by focussing attention on crucial areas of structural reform and trade policy rather than wasting time and energy on a premature idea such as an East Asian EMS. In this regard, Bayoumi *et al.* are more constructive in that they suggest a number of objectives that must be achieved during the transition period along the lines of the debate underscored by the Maastricht Treaty.

These objectives include promoting wage and price flexibility, reforming and strengthening the financial sector, strengthening central bank independence, harmonising monetary policy, and creating barriers to exit. Few East Asian policymakers are naive enough to believe that they will be able to work out an agreement on creating an East Asian monetary fund or a common currency in the near future. At best, these options are long-term objectives; the CMI arrangement is a first step toward achieving these goals. In this respect, it would be in the US and European interest to support expansion and consolidation of the CMI for developing a financial cooperative arrangement.

5 Rationales for Regional Financial Arrangements

Since the early 1990s, many of the East Asian countries have made sustained efforts to deregulate and open domestic markets, including financial markets, to foreign competition. As a result of trade liberalisation and market orientation, East Asia has seen a large increase in intra-regional trade and investment. In terms of the importing country data, intra-regional trade in East Asia (ASEAN+3 and Taiwan) was more than 50 percent of the region's total trade (see Table 2a and b) in 1998 when the entire region was in a deep crisis. There is every indication that this trend will continue. Financial liberalisation and market opening has also

Table 2a Exporting Country Data Unit
(in percentages)

		Importing Countries							
Exporting Countries		East Asia	(East Asian NIEs)	(ASEAN4)	(China)	(Japan)	USA	Others	World
East Asia	1990	40.0	19.7	7.3	4.4	8.6	26.6	33.4	100
	1996	48.8	20.0	10.5	9.1	9.2	22.1	29.1	100
	1998	42.6	18.4	7.8	9.1	7.4	24.5	32.9	100
East Asian NIEs (Korea, Hong Kong, Singapore, Taiwan)	1990	41.3	12.3	8.7	8.8	11.4	27.9	30.8	100
	1996	49.9	11.4	12.0	16.9	9.6	20.7	29.5	100
	1998	45.4	11.9	9.3	17.0	7.1	22.4	32.2	100
ASEAN (Indonesia, Malaysia, Thailand, Philippines, Vietnam)	1990	52.1	21.8	4.3	2.0	24.0	18.8	29.1	100
	1996	53.3	25.4	6.9	3.0	17.9	18.1	28.6	100
	1998	47.1	22.3	6.9	4.1	13.9	21.4	31.5	100
China	1990	65.2	47.6	2.9		14.6	8.5	26.4	100
	1996	55.5	31.1	3.9	–	20.4	17.7	26.8	100
	1998	48.4	28.7	3.5	–	16.2	20.7	30.9	100
Japan	1990	29.7	19.7	7.8	2.1		31.7	38.7	100
	1996	42.7	24.7	12.7	5.3	–	27.5	29.8	100
	1998	33.5	20.2	8.1	5.2	–	30.9	35.6	100

Table 2b Importing Country Data Unit
(in percentages)

Exporting Countries		Importing Countries				
		East Asia	(East Asian NIEs)	(ASEAN4)	(China)	(Japan)
East Asia	1990	43.3	66.5	51.4	51.4	26.8
	1996	49.4	67.1	52.4	53.5	35.8
	1998	50.3	74.0	55.2	65.4	35.5
East Asian NIEs (Korea, Hong Kong, Singapore)	1990	14.3	14.2	19.9	33.2	11.1
	1996	15.3	14.5	20.7	28.9	11.7
	1998	15.5	15.3	23.9	30.4	10.2
ASEAN4 (Indonesia, Malaysia, Thailand, Philippines)	1990	7.7	9.1	4.1	4.0	10.7
	1996	9.1	11.4	6.3	3.6	12.5
	1998	9.7	13.1	9.2	5.9	12.0
China	1990	7.2	15.3	2.5		5.1
	1996	10.4	18.6	2.5		11.6
	1998	12.1	23.8	3.6		13.2
Japan	1990	14.1	27.9	24.9	14.2	
	1996	14.7	22.5	22.9	21.0	
	1998	13.0	21.8	18.6	20.2	
USA	1990	18.0	21.1	13.5	12.2	22.5
	1996	16.6	18.5	13.6	11.6	22.9
	1998	16.9	19.9	15.3	12.1	24.0
Others	1990	38.7	12.4	35.0	36.3	50.7
	1996	34.0	14.4	34.0	34.9	41.4
	1998	32.8	6.1	29.6	31.5	40.5
World	1990	100	100	100	100	100
	1996	100	100	100	100	100
	1998	100	100	100	100	100

contributed to the integration of financial markets in the region and establishing a closer linkage between East Asian and international financial markets. The growing integration of intra-regional trade in goods, services and financial assets has increased the demand by the business community in the region for stabilising the exchange rates of East Asian currencies. More than anything else, the Asian crisis in 1997 has awakened the region to the need of establishing a region-wide mechanism of defense against future financial crises. There have been several other developments that have encouraged the formation of a regional financial arrangement in East

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Asia. In this section, some of these developments are discussed as a background for examining whether they could maintain the momentum for enhanced regional cooperation and lead to the formation of monetary unification in East Asia in the long run.

Regional Trade and Financial Integration

Recent studies by Rose and Engel (2001) show empirically that the formation of a currency union leads to a substantial increase in trade and a lower volatility of real exchange rates among the countries joining the union. One of the major objectives of creating a regional financial arrangement in East Asia such as the CMI is to stabilise bilateral exchange rates of the regional currencies. By organising a financing mechanism that could provide some cushion for adjustment to adverse external shocks, a scheme like the CMI could alleviate some of the problems that may hinder the introduction of a regional collective exchange rate mechanism. Financial cooperation could therefore produce economic conditions favourable to establishing a free trade area in East Asia.

As Rose (1999) points out, trade is mostly regional and "the fast track to trade liberalisation of late has tended to be regional". The regional nature of trade is likely to grow in importance, as it has in East Asia. With this growing trend in regional trade integration, it is clear East Asia will lose disproportionately more from trade disruptions caused by currency crises than otherwise. This means that the East Asian countries have a collective interest in preventing the contagion of the crisis. In this regard, the CMI could be considered another regional initiative for promoting free trade. Together with the deepening of trade integration, East Asia has also witnessed a growing mobility of capital with liberalisation of capital account transactions in many countries in the region. Although the benefits of capital mobility could be substantial, capital market liberalisation has brought the danger of making financial crisis much more disruptive than otherwise along with it. Despite the series of financial crises throughout the world in recent years, the economics profession still does not fully understand the causes and prevention of financial crises. Given this lack of knowledge of crises, the second-best solution is to strengthen defenses against them. A regional financial cooperative arrangement could be such an effort.

Stumbling Blocks or Building Blocks?

Any argument for regional arrangements must begin by answering the most fundamental question: i.e. whether regional groupings, whatever forms they may take, are conducive to or likely to interfere with multilateral free trade and the orderly globalisation 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 – in particular, that of the EU – suggest that they have been a complement and supplement to multilateral trade and financial liberalisation. That is, they have been building blocks to rather than stumbling blocks 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.

Six years ago, Lawrence (1996) pointed out that the forces that were driving the wave of regionalism at that time might differ fundamentally from those driving earlier moves toward regionalisation in this century and that the regional initiatives represented efforts to facilitate their members' participation in the world economy rather than their withdrawal from it. Trade and financial developments since then do not seem to challenge this observation. Many developing countries are motivated to join regional groupings as their participation could facilitate implementation of a strategy to liberalise and open their economies. 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 globalisation.

A New International Financial Architecture

One development that has encouraged regional cooperation in East Asia has been the slow progress of the reform of the international financial system. The urgency of reform in 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 create its own system of defense. For this reason alone, there has been increasing support in East Asia for developing a regional defense mechanism in the form of financial cooperation. This support has culminated in the Chiang Mai Initiative of ASEAN+3 (CMI) for creating currency swap arrangements among the thirteen countries. This agreement is widely perceived as a major step toward strengthening financial cooperation among the East Asian countries. A regional financial cooperative scheme such as the CMI 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 financial arrangement 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. An East Asian monetary fund could also be designed initially as a regional lender of the last resort while the IMF assumes the role of prescribing macroeconomic policies to the member countries of an East Asian monetary fund.

International Reserve Accumulation

Many EMEs and DCs, particularly those which have experienced a financial crisis, are taking steps to increase their foreign exchange reserves above the level that has been regarded as adequate in terms of their import requirements. Before the onset of capital account liberalisation in the 1990s, developing economies were preoccupied with the management of the current account, and as far as the adequacy of reserves was concerned, the rule of thumb was holding a reserve level equivalent to imports of three or four months. For instance, Korea had accumulated a large volume of foreign exchange reserves ($96.1 billion at the end of 2000) equivalent to 21 percent of its GDP, in part because of the increased volume of its capital account transactions, but largely because of the need to build up a war chest to stave off a speculative attack to protect the economy from financial crises. At the end of 2000, the volume of reserves as a percentage of GDP in Korea was more than three times the level of 1996. A similar development has taken place in other crisis-hit countries in East Asia (Table 3). In Indonesia, the ratio of reserves to GDP almost doubled between 1996 and 2000. In the Philippines, the ratio climbed to 27 percent at the end of 2000 from less than 9 percent three years earlier. Compared to these countries, reserve accumulation has been relatively modest in both Thailand and Malaysia. Yet, these countries have also added more than 10 percentage points to the ratios they had at the end of 1997. By any measure, this level is excessive, costly, and represents a clear case of a misallocation of resources. In a recent speech at a Tokyo conference, Stiglitz (2002) argued that the existing dollar-based reserve system benefits the US whereas developing countries bear a disproportionately heavy burden of holding large amounts of reserves to counter volatility in the currency market. He went on to say that an Asian monetary fund, which would have provided a quicker remedy to the Asian financial crisis, can be

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Table 3 Foreign Exchange Reserves and Current Account Balance
(in millions of dollars and percentages)

Year	Foreign Exchange Reserves: millions of dollars	Foreign Exchange Reserves: percentage of GDP	Current Account Balance: millions of dollars	Current Account Balance: percentage of GDP
		Korea		
1996	34,037	6.5	-23,005	-4.4
1997	20,368	4.2	-8,167	-1.7
1998	51,975	16.2	40,365	12.6
1999	73,987	17.8	24,477	5.9
2000	96,131	21.0	11,040	2.4
2001(f)	105,191	23.5	6,000	1.3
2002(f)	119,323	23.9	2,000	0.4
		China		
1996	107,039	13.1	7,243	0.9
1997	142,762	15.8	36,963	4.1
1998	149,188	15.8	31,472	3.3
1999	157,728	15.9	15,667	1.6
2000(f)	168,277	15.4	12,000	1.1
2001(f)	178,387	14.9	7,000	0.6
2002(f)	188,152	14.2	4,000	0.3
		Hong Kong		
1996	63,840	41.4	-3,509	-2.3
1997	92,823	54.3	-6,159	-3.6
1998	89,625	55.0	3,891	2.4
1999	96,255	60.5	10,545	6.6
2000	107,560	65.8	8,806	5.4
2001(f)	-	-	4,000	2.3
2002(f)	-	-	1,000	0.6
		Taiwan		
1996	88,038	31.5	10,923	3.9
1997	83,502	32.7	7,051	2.8
1998	90,341	32.6	3,437	1.2
1999	106,200	35.9	8,384	2.8
2000	106,742	36.4	9,316	3.2
		Thailand		
1996	37,731	20.7	-14,691	-8.1
1997	26,179	17.3	-3,021	-2.0
1998	28,825	25.7	14,243	12.7
1999	34,063	27.5	12,428	10.0
2000	31,947	26.0	9,200	7.5
2001(f)	33,802	28.2	7,000	5.8
2002(f)	35,050	28.0	4,700	3.8

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Table 3 (continued)

		Indonesia		
1996	24,024	10.6	-8,532	-3.8
1997	20,609	9.6	-5,790	-2.7
1998	22,713	23.0	4,102	4.2
1999	23,540	16.2	578.3	4.1
2000(f)	27,464	18.5	8,400	5.7
2001(f)	31,164	19.2	7,000	4.3
		Malaysia		
1996	27,009	26.7	-4,462	-4.4
1997	20,788	20.8	-5,936	-5.6
1998	25,559	35.0	9,529	13.1
1999	30,588	37.7	12,606	15.9
2000	29,075	32.6	8,850	9.9
2000(f)	30,632	32.6	7,300	7.7
2002(f)	32,640	32.0	5,000	4.9
		Philippines		
1996	10,030	12.1	-3,949	-4.8
1997	7,266	8.8	-4,353	-5.3
1998	9,226	14.9	-1,546	2.4
1999	13,242	17.3	7,911	10.3
2000	13,048	27.4	9,349	19.7
2001(f)	14,452	19.1	8,400	11.1
2002(f)	15,971	20.3	8,000	10.2
		Singapore		
1996	76,976	83.7	13,898	15.1
1997	71,392	85.2	16,912	20.2
1998	75,028	99.9	21,025	23.3
1999	77,176	89.3	21,254	24.0
2000	80,362	82.2	21,715	22.2

Note:
(f) estimates by the Institute of International Finance.
Sources: Institute of International Finance, and the central bank websites.

an alternative model, providing a good basis for a new global regime.

In theory, floating rates and capital account liberalisation are supposed to reduce the need for holding a large amount of reserves. In the aftermath of the 1997 crisis, East Asian crisis countries – except for Malaysia – have moved to a flexible exchange rate system and deregulated their capital account transactions to a considerable degree. However, as far as reserve holdings are concerned, experiences with floating rates and participation in international financial markets in these countries for the past three years has not strengthened the belief that a flexible exchange rate system and opening domestic financial markets would substantially lessen their vulnerability to future crises.

In fact, liberalisation of capital account transactions has increased the demand for reserves largely because capital flows have been unstable and unpredictable in these countries. Furthermore, access to international capital markets has been rather uncertain for many EMEs. For these reasons, adequacy of reserve holdings is often gauged by the amount of short-term foreign loans and a good benchmark is that the ratio of reserves to short-term foreign debts should be equal to one or even a little higher. Even when this high benchmark is adopted, reserve holdings of the crisis-hit countries in East Asia are excessive. In both Korea and Thailand, the ratios have been greater than 2, and even in Indonesia, it has fluctuated between 1.3 and 1.45 (see Table 4). This requirement raises a number of questions as to whether the EMEs should borrow at all from the short end of international capital market and whether it would be advisable to ask these countries to open their financial markets.

If the EMEs have to maintain an amount of reserves equal to their short-term foreign indebtedness, this means that they must secure long-term foreign loans or accumulate current account surpluses in order to meet the reserve requirement. Commercial banks hold a small fraction of their deposit liabilities which are mostly short-term, and they can do so because, among other things, they have access to the domestic lender of last resort. Except for the IMF, there is no international lender of last resort for EMEs to turn to. The IMF as a quasi-lender of last resort could provide an additional issuance of SDRs, but at this stage of international financial reform, it is not altogether clear whether the institution could play the role of a crisis-lender. Could the EMEs then make arrangements with international banking institutions to establish private contingent lines of credits they could draw from in case they come under speculative attack? The Mexican experience is instructive in that the availability of contingent credit lines does not increase liquidity once a financial crisis breaks out because the banks which provide contingent credit lines to the central bank withdraw other credits extended to firms and financial institutions in order to reduce their country exposure (Carstens, 2001).

One could argue that restructuring ailing corporations and unsound

Table 4 Foreign Reserves/Short-Term Debt

	Indonesia	Korea	Thailand	Taiwan	China	Chile
1998. IV	0.89	1.31	1.15	5.24	4.37	1.68
1999. II	1.45	1.43	1.53	6.46	5.75	1.52
1999. IV	1.33	1.69	2.23	6.24	7.75	2.06
2000. I	1.38	2.19	2.21	6.53	7.45	1.67
2000. II	1.32	2.06	2.32	7.43	7.28	1.63
2000. III	1.35	2.14	2.72	7.33	7.63	1.41

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financial institutions together with institutional reform of accounting, auditing, and corporate governance should take precedence over regional cooperation in East Asia since it would strengthen the foundation of stable and sustainable growth and hence help fend off speculative attacks in the future. While it is true that the crisis-hit countries have a long way to go before cleaning up their financial institutions and improving profitability and balance sheets of their corporations, there is little evidence suggesting that economic restructuring alone could safeguard these economies against speculative attack. This is because international financial markets are prone to panic, herding, and contagion of crisis.

In the absence of a global or regional lender of last resort, and given the limited availability of private contingent lines of credit, EMEs may therefore have to hold a larger amount of reserves than otherwise would be needed, and to do so they may have to run a sizeable surplus on the current account as the East Asian crisis countries have done since the crisis broke out in 1997. Thus, the reserves accumulation in EMEs suggests an undesirable implication for the future trade relations between developing and developed countries and for growth of the world economy. Developing countries that liberalise their current and capital account regimes and participate in international financial markets will attempt to generate surpluses on their current accounts. As the number of these countries increases, trade relations between developing and developed countries are likely to deteriorate. Therefore, both developing and developed countries will find it in their best interest to search for other schemes that could reduce holdings of foreign exchange 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 have to hold 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 almost $800 billion. Depending on how these reserves are pooled 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.

An East Asian Common Currency Area

Many studies have shown that a nominal exchange rate fixed at an untenable rate was invariably one of the major causes of financial crises as in the cases of Mexico, East Asia and Russia. For a while, after the eruption of the East Asian crisis, the flexible exchange system was the accepted norm in the new international financial architecture. For some EMEs, currency unions and currency boards were an alternative regime, but usually only under unusual circumstances. The new consensus, however, did not last very long. Williamson (2000) and Frankel (1999) argue that intermediate regimes such as the BBC system are more likely to be appropriate than the corner solutions for many EMEs. In particular, Williamson advocates several intermediate regimes with soft margins. Fischer (2001) suggests that developing countries which are not exposed to capital flows could choose from a wide range of intermediate regimes and that flexible exchange rate systems suitable for EMEs could include crawling bands with wide ranges.

If indeed East Asian countries find it desirable to be on some type of intermediate regimes, then one can make a stronger case for creating regional financial cooperative arrangements. In the long run, the East Asian countries could work together to develop an East Asian common currency area after a transition period during which a mechanism of coordination of exchange rate policies is established. An East Asian financial arrangement could therefore serve as a forum for articulating and preparing for these monetary options.

In the short run, the adoption of intermediate regimes will raise the question of which currency or set of currencies should serve as a reference rate to which exchange rates of East Asian currencies will be stabilised. East Asian countries have diversified their export markets over the last two decades with the result of reducing their dependence on the US market. As the regional market grows in East Asia, the linkage with the US dollar has complicated their exchange rate policies. Furthermore, the bilateral exchange rates of the dollar, euro and yen have exhibited substantial swings in recent years and instability of these major currencies has exerted negative effects on growth in EMEs (Reinhart and Reinhart, 2001).

Emerging market economies, individually or as a group, can exercise little influence on the movements of the bilateral exchange rates of these major currencies. EMEs therefore may be able to reduce adverse effects on EMEs of higher volatility of the three currencies by linking their currencies to a currency basket consisting of the US dollar, euro and yen currencies. Linking to the US dollar, East Asian countries risk the danger of aggravating volatility of their nominal effective exchange rates. In recent months, the Japanese yen has declined in value relative to the US dollar and euro. With the yen depreciation, other East Asian currencies have also depreciated much more than warranted vis-à-vis the US dollar due to

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expectations that these countries will suffer the loss of competitiveness of their exports, in particular when they compete with Japan in exports markets in the US and Europe, although there has been little visible change in their economic fundamentals.

If linking to the US dollar is not a viable option, then East Asian countries may have to consider identifying a basket of currencies for a reference rate for their nominal exchange rates. To the extent that stabilising nominal effective exchange rates of regional currencies in East Asia is an important policy concern, then it follows that East Asian countries may be better off with a common basket of currencies. A regional financial arrangement could serve as a body for managing a common peg system in East Asia.

6 Concluding Remarks

It is certainly true that one cannot overemphasise the importance of restructuring the economy of East Asia 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.

Until recently, it appeared that the CMI was losing momentum, and because of the slow progress in BSA negotiations among the ASEAN+3 and most of all, a relatively small amount of liquidity that is likely to be available to the participating countries in case they face speculative attacks, the international financial markets have ignored the existence of the CMI. However, there has been an emerging consensus that East Asians must join forces to establish regional financial arrangements which will help them fend off speculative attacks and, in so doing, stabilise East Asian financial markets. Given the different interests of the various countries with respect to regional financial cooperation, it is not altogether clear whether the East Asians will be able to successfully negotiate the creation of such arrangements. Details of the swap arrangement mechanism among the ASEAN+3 countries will have to be worked out, and it is too early to tell whether the thirteen countries 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 joining the WTO, Chinese policymakers realise that they may have to liberalise and open their financial markets and financial services industries sooner than expected. They also realise 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.

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However, China will find it very difficult to support any regional arrangements dominated by Japan.

Japan has an important role to play, as the second largest economy in the world and as a member of the G-7, in promoting regional cooperation in East Asia. While Japan and the other East Asian countries cannot, and should not, ignore the wishes of the US 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 once again become 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 formalising and implementing 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 that are likely to emerge among the East Asian countries 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 institutions should contribute to the stability of the international financial system, as the Asian Development Bank has done in 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 developed their 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, 2000).

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Comment on "Beyond the Chiang Mai Initiative: Rationale and Need for a Regional Monetary Arrangement in East Asia", by Yung Chul Park

Leslie Lipschitz

The topic of this paper looks innocuously narrow. But the paper is not very precise on what is meant by a "regional monetary arrangement" and it covers a range of issues: regional financing arrangements, the appropriate exchange rate regime for east Asia and for emerging market economies more generally, moral hazard, regionalism versus globalism, and the new international financial architecture.

I am reminded a bit of Douglas Adams' book *The Hitchhikers' Guide to the Universe* in which the super computer Deep Thought is asked to answer the ultimate question of "Life, the Universe and everything". If I recall correctly, after generations of pondering it comes up with the answer 42. At which point the disappointed sages realise that the question had not been formulated properly.

To try and avoid this problem I will start with some delineations:

- What ought we to think about regional financing arrangements like the Chiang Mai Initiative (CMI) or the broader swap arrangements under study by the Manila Framework Group (MFG)?
- This question is quite distinct from what we ought to think about exchange rate regimes in Asia (and more generally for emerging market countries) and the viability of a common peg or even a common currency.
- And, thirdly, how, if at all, does all this relate to the new international financial architecture?

Regional Financing Arrangements

It is important to understand the context. These financing initiatives did not occur in a vacuum, but rather in the context of much more vigorous regional peer surveillance in the aftermath of the Asian crisis. Regular meetings of the MFG and APEC provide an opportunity for intense discussion of developments in Asia and developments in the rest of the world that impinge on Asian countries. For the IMF (the "Fund") these meetings have been highly informative – they have helped us understand

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regional and domestic policy priorities and constraints. We gather from the participants that they have found Fund and World Bank participation useful because we have brought to the meeting a frank assessment of downside risks in the global environment that could have implications for domestic policies.

The dangers of regional finance – the problems one might have with an Asian Monetary Fund – are outlined in Yung Chul's paper. Clearly, regional financing arrangements should be supplementary to, not substitutes for, global financing arrangements. This is a simple matter of diversifying risk – no sensible insurance company would offer flood insurance only to a group of homes all in the same valley. Second, it is appropriate to be wary of any large pool of unconditional finance that could skew the balance between adjustment and financing. If a country needs to adjust, it needs to adjust – a certain amount of conditional finance may ease the adjustment path, but financing cannot, in the end, substitute for adjustment. Finally, of course, a large pool of relatively unconditional financing – especially if coupled with a quasi-fixed exchange rate – could exacerbate moral hazard.

I do not see any of those problems with the current move toward regional financing arrangements – the CMI and the ongoing discussions under the umbrella of the MFG. Among the participants there are now much more candid surveillance discussions focused on vulnerabilities in individual countries and on the appropriate policies to reduce them. There is certainly a growing consensus on appropriate priorities in adjustment programmes – witness recent discussions on Indonesia. As Yung Chul points out, activation of the major swaps under the CMI requires a Fund-supported programme. This notion of parallel financing with the Fund was not inserted at the behest of the Fund, but at the insistence of the major (potential) creditor countries in the Initiative. The Fund has not sought to be actively involved in the ASEAN+3 process or the particulars of the design of the CMI, but participant countries have consulted the Fund at various stages of the discussions.

I think that the CMI, and the regional financing discussions within the MFG, represent a marriage of the considerations governing regional financial arrangements with those governing global financial arrangements. At their best they will exert peer pressure for strong policies, and, at times of need, they will provide reliable parallel financing. The Fund's view of these developments is wholly positive.

Exchange Rate Regimes

On the topic of exchange rate regimes I must point out that I am speaking personally, not for the IMF – the matter is far from settled and there is no

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clear IMF view.

We are all familiar with the menu of options – BBC (bands, baskets and crawl), soft pegs, hard pegs, dollarisation, dirty floats, pure floats, and corner solutions (i.e. either a very hard credible peg or a clean float) – and with the arguments of the various advocates for each.

I was struck in Yung Chul's discussion of exchange rate regimes by his deep distrust of the market. Japan is depreciating, therefore Thailand, Indonesia, and Korea follow suit. The markets get it wrong, it is time for Asia to think about something other than floating exchange rates.

Unlike Yung Chul, I think the evidence of the recent past (crisis in the Czech Republic, Russia, Asia, Brazil, Turkey, etc.) overwhelmingly favours floating – albeit floating with a strong anti-inflationary commitment by an independent central bank. Any type of government exchange rate guidance increases the likelihood of private agents getting into trouble by taking large uncovered forex positions. Moreover, explicit, or even implicit, exchange rate limits are a bit like drawing a line in the sand and daring the markets to cross it; this is a crazy game that countries tend to lose. It is worth noting how well New Zealand and Australia weathered the Asian crisis, and the degree of private hedging in response to a true float.

The notion of a common currency for East Asia or even a common peg is, I believe, quite premature. And I have problems with much of the literature on this issue.

First, it is argued that for a fixed rate or a common currency cycles should be correlated. Clearly, this makes sense in some respects: increasing trade within a common currency area will increase cyclical correlation, and to the extent that cycles are correlated there is less need for independent monetary policy. But surely correlated cycles in any area increase the amplitude of these cycles. Much better is to have uncorrelated cycles; in the US, the north-east is subject to influences different from those in energy-rich Texas-Louisiana or those on the west coast. This however requires an ability to have (a) significantly different fiscal positions and some transfer mechanisms, (b) wage and price flexibility, and (c) labour mobility. Perhaps one of these three safety valves is in place in Asia.

Second, if Asian emerging market countries are buffered by dollar-yen-euro swings, it is not clear why some common peg will be more effective than a float – particularly if relative sensitivities to different major currencies differ between, say, Korea and Thailand.

Third, I think that Charles Wyplosz was probably correct at the beginning of our discussions: If you really do want more fixity you have to think about capital controls. And here I think there are reversibility problems. It will be difficult to get the genie back into the bottle, particularly in places like Indonesia and the Philippines.

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Finally, the experience of fixed exchange rate regimes in emerging market Asia has been less than comforting; and one cannot help but be concerned about new financing mechanisms that would make available vast sums to defend an exchange rate against market forces that, in the end, could prove overwhelming.

In sum, I think it is far too early to think of a regional currency arrangement.

The New International Financial Architecture

If there is any one theme in the new architecture, it is this: everything possible should be done to reduce vulnerabilities and to anticipate and forestall crises. This is the context of the CCL, of the new-style IMF surveillance, of FSAPs and ROSCs.

Yung Chul laments the cost of the very high reserve holdings that may be required under the Greenspan-Giudotti rule that suggests 100 percent reserve cover of maturing debt. But this rule of thumb is, I think, misinterpreted. The point is not that a country should necessarily hold huge reserves, but rather that it should have a reasonably well-managed debt and reserve profile. Clearly it should avoid some of the problems of the past – e.g. capital account regulations that create incentives for short-term bank borrowing in foreign exchange rather than for foreign direct investment, or the issuance by government agencies of long-term bonds with put options that effectively convert them into short-term bonds when spreads widen.

In new-style IMF surveillance we spend an awful lot of time trying to assess vulnerabilities. The various Early Warning System (EWS) models tend to find significant empirical weight in variables like reserve cover of short-term debt. But these models are as often wrong as they are right – with a high incidence of type 2 errors – and they are only a starting point. On the particular question of reserve cover, a specific case may help to clarify the general issue.

New Zealand in 1999 showed very high vulnerability on the basis of some EWS models – not surprisingly in that its reserve cover of short-term debt was only about 17 percent. Our assessment, however, was that it was not very vulnerable at all. This rested on a number of observations:

- There was ready private sector access to foreign financing at reasonable spreads (50-75 basis points).
- Banks were robust.
- There was a true floating exchange rate.
- The private sector was highly hedged against foreign exchange risk.
- Much of the foreign debt was intra-corporate and much in local currency; etc., etc.

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Hence our assessment was that this was a well-managed country that was not particularly vulnerable – despite the low reserves and despite the mechanical model results.

The bottom line is that (a) there is no mechanical foolproof way of assessing and minimising vulnerability – it takes judgment; and (b) there is, ultimately, no substitute for good macroeconomic policies and robust domestic institutional arrangements. I believe that the development of the various Asian regional economic fora is a positive aspect of the new international financial architecture – a force for beneficial peer pressure that will improve our assessment of vulnerabilities and our appreciation of the macroeconomic and structural policy changes needed to safeguard against them.

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Regional Interdependencies and Macroeconomic Crises in Mercosur

Daniel Heymann[1]

1 Introduction

In the relatively short history of Mercosur, the countries of the region have gone through wide macroeconomic fluctuations. Macroeconomic turbulence is not a novelty for Argentina, Brazil and their partners, but it has shown different features in recent years, particularly concerning the strength and nature of regional spillovers. Regional macroeconomic interdependencies became more visible with rapid growth of intra-regional commerce, and the feeling of a "Mercosur component" in the international demand for each country's assets, despite the unequal size of the Mercosur economies and the low starting levels of trade. However, there was little movement in establishing concrete forms of macroeconomic cooperation. On the contrary, recent macroeconomic disturbances, particularly the Brazilian currency crisis of 1999 and the deep recession and financing difficulties of Argentina, set in action strong centrifugal forces. By 2001, the prospects of Mercosur were in doubt. Member countries reconsidered their trade strategies and there was much public scepticism about the benefits of the integration project. The collapse of the convertibility regime deepened the Argentine crisis to an extreme of serious economic disorganisation, while the Brazilian concern was mostly to limit contagion. In such circumstances, regional macroeconomic cooperation was hardly a possibility. Still, regional effects will continue to play a part in the macroeconomic performance and policies of the Mercosur countries. In this chapter, I will briefly comment on the macroeconomic experience of Mercosur, and reflect on the possibilities for concerted regional action.

2 The Macroeconomic Experience Until 2001

The integration process in the Mercosur area started in a period of macroeconomic instability throughout the region. Between the start with

1 Comments by J. Martin, F. Navajas, A. Ramos and J.J. Teunissen are acknowledged. The opinions are those of the author.

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bilateral agreements in 1985 and the formal creation of Mercosur in 1991, Argentina and Brazil strongly felt the effects of the debt crisis of the early eighties. The lack of effective stabilisation strategies resulted in very high inflation in Brazil and hyperinflationary outbreaks in Argentina. The macroeconomic volatility did not prevent governments from engaging in negotiations to promote intra-regional trade, but it made public and private agents concentrate on the short-run swings. The Mercosur project did not become at this point an important factor in economic decisions.

During the nineties, the economies of the area went through drastic changes. The period was marked by an international environment quite different from that of the eighties, and by reforms in policies and economic institutions.[2] Argentina and Brazil liberalised their trade regimes, as Uruguay did before. The members decided that Mercosur would move towards a customs union, to be established (with some sector exceptions) after a few years of transition. Large-scale privatisations took place, especially in Argentina, where most of the state enterprises were quickly transferred to the private sector. The concern for reducing fiscal deficits and ending high inflation was widespread throughout the region. However, in every country the stabilisation policies had different timings and features. Substantial differences remained in macroeconomic policies, in aspects as crucial as exchange rate regimes.

The scarce degrees of freedom of economic policies and the low levels of initial trade[3] strongly limited the willingness and the ability of governments to cooperate effectively in macroeconomic matters. Official pronouncements stated the intention to coordinate fiscal, monetary and exchange rate policies, but did not specify concrete actions, although macroeconomic matters were to be periodically reviewed by groups of country officials. On the other hand, the initial Mercosur agreements were quite specific and detailed regarding the timetable of trade integration.

In the first part of the nineties, macroeconomic performance within Mercosur varied widely. The output level fluctuated in Brazil, while inflation remained very high. Argentina established in 1991 its convertibility system, with a fixed exchange rate to the dollar, when the stabilisation programme urgently needed credibility and any form of monetary management was regarded with deep distrust. This strict regime strongly conditioned policy choices later on. The immediate effect was a rapid disinflation, associated with a recovery in the supply of credit and

2 A general discussion of the reform processes in Latin America can be found in CEPAL (2001) and Stallings and Peres (2000). The cases of Brazil and Argentina are studied, respectively, in Baumann (2000), and Heymann and Kosacoff, eds. (2000).

3 As an example, Argentine imports from Brazil were less than 650 million dollars in 1990. Four years later, those flows had risen to over 4 billion dollars.

more optimistic expectations, which fuelled a sharp increase in output and domestic demand. The trade balance quickly shifted from large surpluses to sizeable deficits, due to a surge in imports. The rapid rise in the value of imports from Brazil became a point of public attention. At the end of 1992, Argentina raised a fee applied on imports, including those from the Mercosur region, from 3 to 10%. This measure generated discussions with the partners, but did not cause at that moment strong objections from Brazil. The use of tariffs for macroeconomic purposes indicated the limited range of the available instruments, and suggested the types of tensions the integration project may be subject to.

The issue of macroeconomic coordination was widely discussed since the early period of Mercosur. According to some opinions, some type of regional agreement on macroeconomic policies was a condition for progress in trade integration. However, the governments had few incentives to make regional commitments, since these would further restrict their choices in macroeconomic management, or put existing policy institutions – like the Argentine monetary system – into question. There were suggestions to moderate the fluctuations of inter-country relative prices and trade flows, like the application of safeguard clauses involving tariffs on imports from within the region, or the use of tax-subsidy instruments to manage bilateral effective real exchange rates. In 1993, the Brazilian authorities proposed the definition of real exchange rate bands; in the case of divergence due to a devaluation in one country, the others would be authorised to raise tariffs on its goods.[4] The Argentine government rejected the idea, and in turn offered its own proposal that in practice would have made the Mercosur partners peg their currencies to the dollar as Argentina had done unilaterally.

This disagreement reflected different views about macroeconomic policies. In Brazil, it was argued that the Argentine fixed exchange rate would induce an unsustainable real appreciation of the peso, leading to a devaluation in the near future. From the Argentine side, the main macroeconomic problem of the area was often perceived to be the instability in Brazil, manifested in rapid inflation and a high real exchange rate.

The divergences in macroeconomic policies and performance did not prevent a very large growth in intra-regional trade, while the operation of Mercosur seemed to become an increasingly important consideration in private investment decisions. Moreover, the governments were able to

4 The proposal included a regional intervention fund, although it was recognised that the resources would be limited, and the fund would be relevant mainly for the smaller countries in the region.

define comprehensive agreements on trade policies. Although there was some discussion (especially in Argentina) about the convenience of establishing a free trade area, rather than a customs union, it was decided that, since the beginning of 1995, a common external tariff would apply for a wide range of goods, and that national tariffs for the remaining items (like capital goods) would converge after a transition period.[5]

In the mid-nineties, the macroeconomic behaviour of the region still varied substantially. Brazil implemented its stabilisation programme in 1994 and Argentina went through a financial crisis and a deep recession in 1995. At the same time, the evolution of trade flows reflected an increase of regional interdependencies.

The Brazilian stabilisation package initially used a fixed exchange rate as an anchor, but this was meant as a short-term instrument. While measures were taken to discourage capital inflows, no major reforms were introduced in monetary institutions. Such clear differences with Argentina's convertibility system signalled the reluctance of the Brazilian government to give up monetary and exchange rate flexibility. The specific design of the Real programme did not cause much discussion in the other Mercosur countries. The much lower inflation and the demand expansion in Brazil created positive spillovers for its partners, precisely at a time when Argentina was showing a downturn in real economic activity.

The behaviour of the Argentine economy generated different interpretations. Some analysts expressed concern about the current account deficits, particularly given the low levels of domestic savings. The pension reform (implemented in 1994) caused an immediate fall in government cash revenues and raised fiscal borrowing requirements. The authorities maintained that the fiscal situation was under control. Regarding the current account deficits, they stressed the productivity gains in various sectors of the economy, and argued that the large increases in domestic absorption could be viewed as an appropriate response to expectation of higher incomes. However, it was clear that a continued expansion of spending and output required a fluid supply of international credit. The raise in the US interest rates in 1994 slowed down spending and the turmoil caused by the Mexican devaluation at the end of that year triggered a deep financial crisis and a sharp recession.

The crisis in Mexico and its repercussions on Argentina came as a shock for the public and the authorities. Preventing a crisis like the one that

5 The name itself of the trade area (Mercosur: Common Market of the South) already indicated that the ultimate aim of the participants was to achieve tight forms of integration (however, neither Brazil nor Argentina showed interest in establishing regional entities). It may be noted here that in its origin Mercosur had not only economic purposes, but was also intended to end the political rivalries from the past.

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occurred in 1995 had not been a policy issue. There was a drastic fall in the demand for Argentine assets, soon followed by strong doubts about the solidity of banks, which resulted in a large decline in deposits and a drastic contraction of credit. This triggered an abrupt recession, while unemployment rose by 6 percentage points in about half a year.

Argentina's convertibility system was endangered, as reserves dropped and the authorities were required to sustain the liquidity of the banking system under attack. It soon became clear that the Argentine authorities were determined to defend the fixed exchange rate, and that they had widespread public support.[6] A large package of loans arranged by multilateral organisations eased tensions in the financial markets, precisely at a moment when the run on the banks was speeding up. Demand for assets started to revive, and domestic spending recovered. The rapid increase in exports to Brazil also had an important macroeconomic impact,[7] and clearly contributed to the output recovery that was under way by the end of 1995. From the Argentine perspective, it was as if an "implicit" (and, certainly, fortuitous) coordination had operated, with Brazil expanding its purchases when Argentina was absorbing a negative shock.

The crisis of 1995 showed the sensitivity of the Argentine economy to the moods of international financial markets. It also revealed the importance attached by the public to the fixed exchange rate. The policy responses to the fragility of the banking system consisted mainly of the reinforcement of prudential regulations. The crisis generated a definitely positive perception about the consequences of Mercosur integration. This view persisted in the following years, as the economies of the region went through a phase of expansion with rapidly raising intra-Mercosur trade, and a convergence in macroeconomic performance, featuring especially the drastic reduction of inflation in Brazil.

This behaviour diluted worries about the macroeconomic functioning of the region. For Brazil, the spillovers from its partners lost visibility in the face of the improvement in its own economy, while the impulses transmitted by Brazil to the other countries were clearly favourable. In these circumstances, the parties of Mercosur felt no urgency in contemplating scenarios of regional economic disturbance. Some attention was given,

6 The argument that the incumbent government was willing and able to guarantee the maintenance of the parity with the dollar probably played an important part in voting decisions in the 1995 presidential elections, particularly for the large number of individuals who had taken debts denominated in dollars.

7 Between 1993 and 1995, Argentine exports to Brazil nearly doubled; those additional sales represented approximately 1% of Argentina's GDP. Although very large, the increase in Argentine exports to Brazil was proportionally smaller than the aggregate growth in Brazilian imports, which suggests that the driving effect came from the demand side.

however, to the issues of macroeconomic coordination over the long run, with an active discussion of the possibility of moving towards the constitution of a regional currency area. Still, it was clear that such a process could hardly be started in the immediate future, given the well rooted differences in monetary institutions and prevailing opinions about the regimes best suited for each country. For the longer-term perspective, much would depend on the evolution of the real economic aspects of the integration project.

After the Asian crisis of 1997, the region again experienced macroeconomic instability. Interdependencies had increased with the rising trade flows and the perception of investors that there are common elements in the performance of the Mercosur countries. The volatility of international financial markets could have induced the search for a common regional response. However, this did not happen. After the Russian crisis of 1998, which strongly affected the region, the concerns of Brazilian policymakers were centred on the fragility of its own financial situation, with very high interest rates, pressures in the exchange market and reduced levels of economic activity. Meanwhile, the Argentine authorities made efforts to convince asset holders that they should "differentiate" the Argentine economy from that of Brazil, pointing to the preventive measures to strengthen the banking system, and to their fiscal prudence (although the fiscal situation was showing weaknesses). Thus, once again, the macroeconomic evolution of Brazil was typically seen in Argentina as a source of instability. In turn, Brazil dealt with its domestic matters without showing much preoccupation with the effects on its neighbours. In Brazil, the position of the Argentine authorities was often interpreted as non-cooperative, and especially unwelcome in difficult times.

Mercosur experienced strong tensions after the attack on the Brazilian currency and its sharp depreciation at the beginning of 1999. The Brazilian shock immediately induced a rise in the "country risk" indices for Argentine bonds, even if it was less sharp than in the Russian episode. Initially, there was much concern in Argentina about the possibility that Brazil would enter a phase of large financial instability and low economic activity. In fact, inflation in Brazil did not rise much and real output did not fall as feared, while interest rates gradually came down from very high levels. Argentine exports to Brazil dropped, thus contributing to a deepening of the recession and a worsening of the fiscal situation in Argentina, both directly and through its effects in asset markets. The drop in exports to Brazil, the competition from lower priced Brazilian products, and worries that investments would shift to Brazil, led in Argentina to the call for restrictions to Mercosur trade. Brazil flatly rejected trade measures by its partners in response to its devaluation. Notwithstanding the statements of the authorities that progress of Mercosur remained a policy priority, the episode raised questions about the prospects of macroeconomic coordination within Mercosur, but also about the future of trade and investment policies.

In Brazil the mood was different. The Brazilian economy recovered in 1999, and continued to expand in 2000, with a moderate inflation and declining interest rates. This was widely interpreted as indicating that the Brazilian depreciation, although a traumatic event, had had favourable consequences. Inflation could be kept well under control with a monetary policy that allowed for exchange rate flexibility. Many Brazilian analysts saw the economic difficulties of Argentina mainly as the result of a stubborn insistence in maintaining the inflexible currency regime.

The Argentine government chose to continue the fixed parity to the dollar while the main trading partner had sharply devaluated, the dollar was strong, export prices had fallen and foreign financing was much less fluid. It feared that a devaluation would result in very high costs, given the general denomination of their financial contracts in foreign currencies. To completely rule out the possibility of a devaluation it was proposed to eliminate the existing "escape clauses" altogether, and move to full dollarisation. In Brazil, the proposal induced critical reactions. It would have closed the option of monetary cooperation with Brazil over the long run, and was seen as contrary to the advance, or even the survival of Mercosur.

Argentina maintained its convertibility system, and the recession continued in 2000. This time, the banking sector did not show noticeable liquidity problems, and did not become object of distrust by depositors, although the supply of credit to private borrowers contracted as growth in deposits slowed down and the public sector increased its demand for loans in the domestic market. The government made efforts to control the fiscal situation. Although higher tax rates and spending cuts generated a non-negligible primary surplus, the deficit rose because of the increasing interest payments. The growth of public debt and the visible difficulties in strengthening fiscal policies caused strong concern. As the recession persisted and the need for adjustment continued, the public became pessimistic about income prospects, which weakened domestic demand and indirectly influenced tax revenues. The aggregate volume of exports had resisted the 1999 shock without a large fall, but the value of sales dropped. The performance of exports was in clear contrast with the rapid growth of previous years.

While Mercosur was going through a period of trade frictions and uncertainty about its future as a trade area, the countries had taken steps to define some guidelines for macroeconomic convergence. There were common views about the importance of running low-deficit fiscal policies and keeping inflation low. It was also accepted that there was an element of regional public good in the macroeconomic stability of each country. The guidelines had analogies with the targets that European countries established at Maastricht, but there was no presumption that the Mercosur economies were to unify their currencies, and exchange rates were not part of the set of guidelines. The numerical criteria were meant as indications of policy intentions, which the parties could use as benchmarks in discussing the macroeconomic situation of the region. The agreement reached in December 2000 was that the countries would announce targets for inflation and the net deficit of the consolidated public sector. Since 2002, there would be a 3% cap on the fiscal deficit, with Brazil being allowed a 3.5% level in the first two years. Also, starting in 2005, those countries with net public debts of over 40% of GDP would determine trajectories that would reduce them to that level. Inflation was to remain below 5% between 2002 and 2005; thereafter, an "inflationary core" would be defined, with an annual maximum of 4%. In case a country deviated from the guidelines, it would be required to present a set of corrective measures, which would be discussed by the economic authorities of the area. The enforcement mechanisms were clearly lax, although the exercises could generate over time reputational effects that create incentives for governments to satisfy the guidelines and to use them in their own internal bargainings. However, the regional guidelines did not result in visible effects, as the Argentine crisis rapidly worsened.

By the end of 2000, the Argentine government was practically cut off from international credit markets. A large emergency package of credits by multilateral agencies and local financial institutions caused only transitory relief. After some weeks, the indications that fiscal outcomes were definitely off-target made country risk coefficients shoot up again, and led to the resignation of the economic authorities. A new economic team proposed deep cuts in government spending, but the programme caused strong opposition, and was not put into practice. In March 2001, the authorities imposed a tax on banking transactions, raised tariffs on consumption goods and reduced those on extra-regional imports of capital goods, which was reluctantly accepted by Brazil. The government also announced sectoral "competitivity programmes" with measures such as tax rebates. Reserve requirements were lowered to reduce the crowding out effect of government bond sales to the banks. A large swap operation with outstanding bonds was carried out, in order to cut financing requirements of the government in the following years. Although the interests on the newly issued bonds were high, the authorities saw the swap as a crucial measure to dissipate the immediate fears of default. Beyond the urgencies of financial management, economic policies faced the task of reinforcing the expectations that the economy could meet the conditions for external and fiscal solvency.

In the changing economic conditions of the nineties, the currency board regime and Mercosur had been crucial "fixed points" of Argentine policies. Now they came under discussion. The authorities proposed to modify the exchange rate system, maintaining the features of convertibility, but pegging the peso to a dollar-euro basket. This measure tried to provide more stability to the domestic price level, and it was meant to signal a rejection of the alternatives of devaluation and dollarisation. However, the modification in the monetary system raised the fears of devaluation, especially after the government decided to apply immediately the euro-dollar basket to commercial transactions.

In Argentina, some opinion leaders suggested to transform Mercosur into a free trade area, or advocated a bilateral trade pact with the US – clearly regarded with disfavour in Brazil – while others wanted Mercosur to go further in its economic integration, and act jointly in the negotiations for the Free Trade Area of the Americas (FTAA). However, in Argentina, voices demanding protection appeared to be louder than those stressing the advantages of producing for the regional market, especially at a moment where the Real was again experiencing a substantial depreciation. The integration project clearly had lost its momentum and its appeal to the private sector.

The anticipation of a hard landing for the Argentine economy had become widespread. In the last months of 2001, the level of activity dived vertically, as the capital flight accelerated and future income prospects were viewed with more and more pessimism. Fiscal revenues went rapidly down, which contributed to a further increase of country risk spreads. By the end of November, the public's rush to convert bank deposits into foreign assets became a massive run. In response, the authorities imposed restrictions on the withdrawals of cash from the banks, and established exchange controls. These measures, in effect, suspended the convertibility of deposits into currency, and that of pesos into dollars, which were at the core of the monetary and financial systems. The decision of the IMF to deny the disbursement of funds in December sent a clear message. The social situation aggravated by the liquidity squeeze, which affected particularly lower-income groups who operate in the informal economy. This led to strong tensions, culminating in riots after which the national authorities resigned. The credibility of the fixed exchange rate system had vanished and the economic conditions eventually led to a deep institutional crisis.

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3 Macroeconomic Interdependencies

In the nineties, the volume of bilateral trade between the two largest countries of Mercosur remained small. The ratio of trade to GDP is much lower than in the European case. The economies stayed rather closed and, in the case of Brazil, the share of the regional partners in its total trade was quite low. However, trade flows showed a high variability, so that changes in bilateral trade were quite large. Thus, sometimes, the swings in the regional exchanges of goods reached magnitudes comparable with those of the incremental movements of trade between European countries. On several occasions, the shifts in trade with Brazil have had macroeconomic effects on Argentina. The impulses in the other direction were smaller, but not insignificant. During the nineties, the increase in intra-regional exports represented a significant fraction of the total growth in Brazilian exports.

The evidence about the determinants of trade flows between Argentina and Brazil indicates that there has been an asymmetry in the effect of the macroeconomic variables (real output and exchange rate) of the buyer and the seller. Roughly speaking, the influences on the demand side have been more important, both for the Argentine sales to Brazil and for the flows in the opposite direction. This feature was again observed in 1999 when, given the devaluation in Brazil and the recession in Argentina, there was a sharp fall in the bilateral exports and imports. Another salient characteristic of trade between the two countries was that, although exchange rate effects were sizeable (with long-run elasticities of the order of 1), there was a particularly large response to the level of activity in the economy of the importing country. Thus, the volatility of trade flows seems to have been due in part to shifts in real exchange rates, but mostly to the fluctuations in real output.

The perspective of an easy access to the regional market and the expectation that this would be a growing one were probably important factors in investment decisions during the nineties, and in particular induced FDI to the area. By contrast, uncertainties about Mercosur had a negative effect on investment since the late nineties, especially in Argentina. The regional effects on real investment, even if hard to quantify, were a source of interdependence. However, the external financing of each country proceeded through international markets, and the credit movements between the economies (leaving aside those directly connected with trade) were quite small. Accordingly, the transmission of impulses through financial channels worked through the perceptions and decisions of international operators.

Contagion effects on asset demands may be induced by a variety of mechanisms. Establishing the relevance of each one in concrete instances is not a trivial matter, and prediction is even more difficult. Still, there has been some evidence of correlation between the prices of assets of different "emerging markets", which may increase during crisis episodes (Calvo and Reinhart, 1995; Eichengreen, Rose and Wyplosz, 1996; Ganopolsky and Schmuckler, 1998; Rigobon, 1999). The "country risk" indicators of Argentina and Brazil show associations in their movements, but the differential interest rate spreads of the two economies also shows wide shifts. For instance, while by late 1996 the yield of Argentine bonds was somewhat higher than that of their Brazilian analogues, by the end of 1998 the Brazilian risk factor had risen substantially above that of Argentina, and the gap further increased in early 1999. By contrast, later on, the Argentine spread was clearly larger, and grew well above the indices for Brazil and other "emerging markets', as the prospects of default caused a precipitous fall in the prices of bonds.

This behaviour indicates that the specific conditions of each economy had a definite influence on asset prices, and that there was a certain "differentiation". The financial interdependence was neither automatic nor necessarily tight. At the same time, however, there are concrete reasons why the valuation of assets of both economies do indeed depend on one another. The Brazilian credit markets suffered comparatively little from the Argentine crisis in 2001, which has contributed to the relief in international financial circles about the weak contagious effects of the troubles in Argentina. It seems unlikely, however, that the supply of credit to each country would become entirely de-coupled.

All Mercosur countries experienced macroeconomic effects from others in the region, especially in periods of turbulence. Although countries had an interest in avoiding "excess volatility" of the region as a whole, it did not result in a concrete set of actions that the parties were willing and able to undertake.

The Mercosur economies have wide differences in size. Brazil is large for regional standards (even more so after the Argentine devaluation of 2002), and perceives itself as such. A Brazilian economy that generates the expectation of steady growth and low inflation may naturally evolve into a regional "focal point" regarding the configuration of economic policies and the response to shocks. But that expectation remained to be established. Argentina had a particular pattern of economic relations, with Brazil as its main trading partner, a good part of FDI coming from the EU and a dollarised financial system, while a group of influential opinion makers saw a trade association with the US (possibly with dollarisation) as the best alternative available. This mixed pattern created a potential for tensions, especially at times of uncertainty about the macroeconomic

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performance of the Mercosur economies. The member countries seemed to be in doubt about the significance of the integration project, and looked at the attitudes of their partners with concern.

The macroeconomic policy approaches showed some convergence over time, but also clear-cut contrasts. The differences in monetary policies in Argentina and Brazil in the nineties can be ascribed to a great extent to the specific conditions of each economy, although at times the analytical views also diverged. In practice, the exchange rate policies were placed "out of discussion" when considering macroeconomic cooperation in the region.

It was often stressed that the development of Mercosur should start with easy steps, like the exchange of information and discussion of economic projections and policies, to establish a practice of working together. However, such routines were not developed in Mercosur. They may have had a non-trivial content in making it easier for partners to predict the behaviour of others and to consider opportunities for common action. An expectation of repeated interaction could have helped in creating incentives for the participants to establish "mutual confidence". While macroeconomic cooperation among countries not participating in a trade area is clearly conceivable, in practice, progress in dealing jointly with macroeconomic issues seems to require that the partners perceive their economic relationship as a convenient long-term project. By the end of the nineties, that was an open question in Mercosur. At the same time, the controversies that were raised about the trade and investment policies of the countries of the region underscored the influence of macroeconomic conditions on the attitudes concerning intra-regional commerce. Trade and macroeconomic matters should have been considered in conjunction, and with a long-run perspective. However, this would not have made the problem easier, particularly when turbulences shortened the decision horizons.

4 Crisis Prevention: Some General Comments

Economic crises have been much analysed. Much of the recent effort has been directed to modelling large currency depreciations or abrupt falls in spending and credit flows within a framework that assumes that agents understand the workings of the environment (although they may be surprised by the realisation of random exogenous shocks, from known probability distributions). The approach allows for coordination failures (in the form of "bad collective choices" among multiple equilibria, perhaps triggered by a realisation of some extraneous "sunspot variable"), but always maintaining the presumption that individual plans are consistent with one another, and that expectations are "as good as can possibly be" given the information available. Quite apart from the usefulness of the results of that work, the expectational assumptions contrast with the common observation that crises tend to motivate agents (and analysts) to "rethink" the implicit or explicit models that they had been applying in order to make interpretations and forecasts.[8]

Large disturbances often happen when too optimistic income expectations – leading to a rapid expansion of credit supply and demand – are put into question. This type of crisis appears to be associated with revisions of beliefs about the trend of incomes, with consequences for the anticipated solvency of debtors and the willingness of agents with access to credit to enter into debt.[9]

From this point of view, the emergence of crises would be related to difficulties in projecting the future value of "fundamental variables", which in turn may induce agents to form incoherent expectations and make decisions that depart from a "sustainable path". Such difficulties are likely to be particularly relevant in economies that are undergoing transitions in their configuration or performance, and where past patterns of behaviour do not form a sound basis for making forecasts. "Model uncertainty" would then seem an integral part of the process leading to a crisis, although, once this happens, the features of propagation and amplification mechanisms (through credit channels, for example) may show recurrently observed features.

The previous argument could have concrete implications. First, crises would typically be hard to anticipate. To identify a situation of excessive spending, the actual evolution of the economy has to be compared to a reference path, which can only be determined by making some conjectures about the economy's future opportunities and performance. Pre-determined numerical criteria that try to distinguish between sustainable and unsustainable behaviour would be at best rough rules of thumb that may be qualified or modified by informed judgments. Being alert to the possibility of crises would require active working in interpreting data and

8 In this connection, the attempt to extract lessons from crisis episodes presumes that there are new elements to be learned from such phenomena, which were not already incorporated in existing models. It seems paradoxical that much of this work is carried out under the methodological assumption that the beliefs of agents have already "converged to the true model", and according to which the new data that the analyst uses to consider alternative hypotheses would add nothing to the knowledge of the decision makers in the system.

9 The argument refers to the traditional macroeconomic theme of intertemporal coordination (cf. Leijonhufvud, 1981). The connections between expected trends, wealth perceptions and fluctuations in credit and aggregate spending have been explored in Heymann and Sanguinetti (1998), Heymann (2000) and Heymann, Kaufman and Sanguinetti (2001).

analysing scenarios. In a regional setting, this draws the attention towards a routine of joint monitoring of the economic evolution. The opinions of the partners may increasingly gain importance, and eventually lead to actions decided by consensus.[10]

Second, it is analytically appealing to contemplate the determination of economic policies through a set of "contingent rules", which serve to guide expectations and, at the same time leave flexibility to react to shocks. Actual policies are typically set either through more or less strict rules, or in a rather "open ended" way. One of the reasons is imperfect knowledge of the model. The preferred combination of both types of policy scheme, and the institutional "level" at which actions should be taken, seems the outcome of informed groping, rather than the result of a grand exercise of once-and-for-all optimisation. Possibly, preventive measures would take these two forms. For example, prudential regulation of banks, through well-defined restrictions on the portfolios of intermediaries seems to have had effects in preventing the propagation of shocks through the banks (although, clearly such prudential considerations face trade-offs with objectives regarding the cost and segmentation of credit). Fiscal management on the basis of cyclically adjusted variables can be envisaged, although estimating the trend-cycle decomposition is precisely a big difficulty in transitional situations. In any case, there would be room for more or less "flexible" policies that take into account that the risk of crisis could call for "precautionary savings". In these fields, there are opportunities for regional cooperation, such as coordination of bank regulations, and the analysis of common projections and policy alternatives. "Mutual insurance" schemes may be considered, although they are difficult to design and implement.

Crises are likely to combine doubts about a country's solvency with strong liquidity constraints. Access to credit may be tightened to an extent that does not correspond to the debtor's capacity to repay in "normal times" and with a more adequate provision of funds. This point has been recognised, and in recent years, there have been several large international operations to provide liquidity assistance to "emergent" economies. There have been proposals for setting regional funds, that may do part of that work and "constitute a link between individual countries and a strengthened and reformed IMF" (Agosín, 2001; cf. also Griffith-Jones *et al.*, 2001). These may possibly act as "first line of defense" in case of liquidity shocks on some countries, especially if they are of comparatively small size. Their operation would require the establishment of criteria for lending, which can be a useful exercise for regional cooperation.

10 Such exercises of joint monitoring can lead to more formalised schemes of "peer review" (cf. Ocampo, 1999), with a potential signalling effect on third parties.

However, the Argentine episode of recent years is a particularly dramatic instance where the potential mechanisms for crisis prevention failed to work. In Argentina, too optimistic expectations in the nineties and political problems, like the "game" between national and provincial fiscal authorities, resulted in excessive spending. The economy was ill-prepared to adjust to lower dollar value of incomes, particularly due to the dollarisation of the financial system.

The Argentine adjustment problem exceeded the regional capacities. In fact, beyond the relevance of statements of support by the Brazilian government, the role of Mercosur in the process that led to the breakdown of the convertibility system was quite limited. The behaviour of out-of-region agents showed the absence of concrete criteria and procedures to deal with solvency problems, and to help countries to handle matters as complex as the exit from convertibility in a dollarised economy.

5 Post Scriptum: The Argentine Crisis in Regional Perspective

At the beginning of 2002, the Argentine peso was finally devalued. The outcome confirmed the worries about the large exit costs of convertibility. In particular, the whole system of economic contracts was put into question, and the urge of the public to withdraw their funds from the banks was only (and partially) suppressed by a compulsory reprogramming of deposits. The collapse of the exchange rate parity opened problems as deep as that of re-defining monetary and fiscal policies and that of handling the effects of the depreciation on the real value of assets, liabilities and the regulated prices of public utilities, in an economy where trust in the political system was practically non-existent, the expectations of creditors and debtors were irreconcilable, the government had defaulted on its debt and, in addition to already sharp recession, day-to-day transactions were constrained by tight liquidity restrictions, even as the demand for foreign exchange appeared very strong. In these conditions, the disturbance went much beyond those typical of (even turbulent) currency crises, or big recessions: the economy was left in a disorganised state, as public and private agents groped for new patterns of behaviour to operate in a system where contracts had been disrupted and many agents had suffered large wealth losses. This left an extremely complex task of reconstructing basic elements of the economic system, while the processing and allocation of the large costs of the disturbance was under way. Meanwhile, the messages from abroad mostly urged the definition of a "sustainable programme" (left unspecified as a whole, apart from the requirement that more pressure to adjust be put on national and, particularly, provincial fiscal policies) before any form of assistance could be contemplated. Thus, the first quarter of 2002 passed without concrete negotiations between the government and the IMF.

In this instance, too, Mercosur was not a major actor. The Argentine crisis did not show strong financial repercussions on Brazil. Movements in foreign trade induced by the Argentine situation did not seem to cause large macroeconomic consequences in Brazil, although the fall in Argentina purchases was quite large. As for Argentina, the sharp real devaluation of the peso and the drastic fall in domestic demand greatly increased the quantitative importance of exports for the domestic economy. Consequently, the regional effects on the Argentine economy became more important.

Mercosur was launched during a period of much uncertainty, and has continued with governments of different political colours. Over time, it became a visible part of the economic environment for agents and policymakers. Since the last part of the nineties, the integration project suffered a very severe setback. However, it is unlikely that the strengthening of the economic relations between the countries that took place during the nineties will be wholly reversed. In spite of the increased asymmetries, the regional performance will remain a permanent concern in each economy. Whether Argentina can establish eventually a stable monetary system without a strict external anchoring, will undoubtedly be an important factor in the regional interactions.

The countries of the Mercosur region have concrete arguments to keep investing in establishing practices of cooperation, particularly in macroeconomic matters. The gains to be obtained in the long run from those regional cooperation efforts would depend on the intensity of interdependencies, and therefore on the size of the economies of the regional partners. The likelihood of large shocks, but also the expectation of long-run growth or recovery of the economies of the region provide an incentive for some type of regional approach to macroeconomic problems.

Over time, regional policy cooperation may possibly perform limited but important roles in dealing with the incentives to use trade frictions as demand-shifting devices, and in signalling that Mercosur intends to continue to provide the framework for regional trade in the future. Post-crisis joint monitoring of the macroeconomic evolution seems particularly relevant. It matters greatly to have a common framework available to evaluate scenarios and policy options, and to consider responses (even if "ad-hoc") to new disturbances, or measures to help sustain recoveries. The regional guidelines on public finances and inflation that were agreed in 2000 had little immediate impact, and clearly they did not operate as actual restrictions for the decisions of each country. However, at some point, they may serve a purpose in defining common attitudes regarding central aspects of policies, and as indicators of objectives and triggers for discussions.

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Comment on Yung Chul Park and Daniel Heymann

Amar Bhattacharya

I will look at the papers of Park and Heymann together: What do they tell us about regional arrangements? Daniel's paper provides a very good overview of the history of Mercosur, in a very textured way, and informs us about the problems that arose. There is not much to comment on what happened.

There are two kinds of obstacles in Mercosur that are worth highlighting. The first is the asymmetric marriage between Brazil and Argentina, but that is not *per se* the Achilles heel. The Achilles heel is: trying to make a marriage with a country that decided to fix its currency, and a country that decided to keep its options open in terms of exchange rate arrangements.

Why does it matter? It matters because in the new world the shocks are coming in the form of capital movements. It is not macroeconomic disturbances or trade disturbances that are driving the story. There is an exogenous shock, driven by "model uncertainty", as Daniel calls it very nicely. As a result, there is a huge change in relative prices between the currencies of Brazil and Argentina, and that of course makes the marriage completely untenable. That is the fundamental flaw of the Mercosur arrangement. As long as this remains it is not possible to achieve stable trade relations, nor macroeconomic policy coordination. So I share the very cautious prognosis about what will happen.

Second, there is uncertainty in terms of competition between Mercosur and the Free Trade Area of the Americas (FTAA). There is clearly uncertainty about the evolution of the exchange rate regime and the transition of it in Argentina, and it is very clear that Brazil has moved very speedily not just to a floating exchange rate regime but to an inflation targeting system that now makes their system much more irreversible. This makes the chances of success of Mercosur smaller.

I'd like now to step back and use Daniel's paper, and the issues that Yung Chul Park covered to ask: what is it what we mean by regional financial arrangements? A lot of the traditional discussion has been driven by trade integration, trade blocs, etc. And from there we go to financial integration, exchange rate coordination, exchange rate alignment and maybe even a simple currency bloc. What was interesting in the previous

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discussion is that we were talking about fixed versus floating exchange rates *for a country*. But the issue that matters is really fixity of exchange rates *within a regional bloc*. This is the point Charles Wyplosz was making before. Do East Asian countries, for example, want to see greater fixity in exchange rates between themselves even if they want to float vis-à-vis others? And what does that imply in terms of crisis prevention and crisis management?

The issue of what a national approach on exchange rate policy ought to be, is an important issue, but I do not believe it should be the central topic of this conference; after all, this conference is about regional arrangements. Having said that, I would say that the issues of regional financial arrangements or crisis prevention and crisis management are not necessarily the same as for trade blocs, and this is something that is worth pushing the boundary of thinking. What do we mean by an appropriate regional bloc, what do we mean by regional financial arrangements and what are appropriate blocs to constitute such regional arrangements?

In particular – if I pick up on the very important insight that is stressed in the paper by Daniel – there is in this world this "model uncertainty". You can think about it as a boom-bust problem – that is, as expectation changes that happen in the boom period versus the bust period. What are the reasons for these very large surges and withdrawals of capital flows and is there a correlation in these surges and withdrawals between groups of countries? There could be many reasons for it. A first reason, obviously, may be the degree of real integration. But there are also expectation changes that are driving such contagion. So there is no simple answer as to why we have contagion. Given that, what are the criteria that we would think of in terms of an appropriate universe for putting in place regional financial arrangements?

One is contagion and there are very good measures of contagion. You could say that the 'Tequila' crisis in Mexico affected Argentina and Brazil more than East Asia. There are very good estimates of it. I make that point because it shows that contagion can happen even outside a trade bloc; it was not Mercosur that triggered contagion but it was Mexico.

A second criterion for regional financial arrangement could be risk pooling. There is covariance risk in the group that is suffering contagion. So if you want risk pooling you draw in people that are not that much correlated to you and that have deep pockets. So maybe regional financial arrangements should have a broader membership rather than a narrow membership.

A third point was implicit in what Yung Chul Park was saying. The Chiang Mai group – if my personal recollection goes back to December of 1997 in the meeting after the Manila Framework group meeting – excludes

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the Anglo-Saxons. There were four economies who were members of the Manila Framework group that were not invited to the December 1997 meeting that became the origin for the Chiang Mai group. The reasons for this may be – like José Antonio Ocampo was saying – the degree of ownership there is in a group that is willing to commit itself in a political sense. I only raise this to say that clearly trade is not the appropriate benchmark for defining a "regional" group in terms of financial arrangements. You are not going to get to a world of instantaneous exchange rate coordination and a currency bloc.

So, what is an appropriate group? I do not think we have yet an answer to that. Nor is it necessarily that it is a single group. Let me illustrate by giving you an example. In East Asia, since the East Asian crisis, there has been a major revamping of the APEC finance ministers' process to focus on issues of what they had been calling regional financial architecture. If you look at the agenda of any APEC finance ministers' meeting, you will see that it has been more focused on the financial aspects of coordination, not just in a macro sense, but on prudential regulation, on corporate governance, credit rating agencies, you name it.

Second, there are two groups that have been set up that are quite unique, the Manila Framework group and the Chiang Mai Initiative. These are the first groups that have been explicitly set up to deal with financial crises. Most of the other groups, the Mercosur group, for example, come from the trade angle. Even the Andean Reserve Fund, I would argue, is not really a financial crisis-driven but a development finance-driven concept. The innovation of these two Asian groups was that they are really driven by having some kind of a regional element in terms of responding to financial crisis. Then you have ACEP (Asia-Europe parliamentary meeting), which was created to foster trade between Europe and Asia, but has also been very focused on responses to crisis.

Again, the point that I am making is that when you are talking about regional arrangements there is not one regional group but there are indeed many different regional groups, and it is important to say that we are talking about regional *financial* arrangements, not regional *financing* arrangements. Because a lot of the elements of what I would consider part of the regional architecture are actually spread out between these different sets of groups.

Similarly, in Latin America, there is the Latin American Reserve Fund, there is the Western Hemisphere Finance Ministers' process, there is ECLAC, Mercosur, the Andean Pact, there is a variety of groups again, that are carrying out the discussions. Which takes me to a fundamental point about architecture and the division of the work by all parties. In a sense there is a continuum: you have things that are truly international,

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especially in the area of financial architecture, because capital markets are inherently global. And my personal view is that a lot of the discussions, especially about the rules of the game, have to take place at this international and global level. But, there are roles that can be very importantly played by regional elements as a complement to the international and the national arena.

So what is the agenda in terms of regional integration?

The first is the rules of the game. A point that José Antonio Ocampo made and I share, is that regional groups bring voice to those who are often given less voice in so-called universal groupings. It is therefore an important way of not only extending, but including smaller participants in the process. But it is also a way, as Yung Chul Park was implicitly suggesting, of getting 'political buy-in' at the political level and therefore reinforcing what can be done at the multilateral level.

There are three levels, or areas, that may be important in terms of the rules of the game in a world of "model uncertainty". The first is in terms of macro rules of the game. I was struck by Daniel's paper – that Mercosur had actually come to establishing some Maastricht equivalent of macroeconomic rules – I was not aware of it. I think that is quite an interesting innovation, just as a signalling element if nothing else. To this, I would add the whole discussion of standards, financial sector rules etc. And in that context, I would say, this could also be about the importance of safeguards and prudential arrangements, which are not beggar-thy-neighbour. If you want to deal with the "model uncertainty", the accelerator problem or the multiplier problem, it may help to have some commonalities in terms of what Daniel called precautionary arrangements. So again, this may be a useful mechanism where you could have regional arrangements in terms of complementing discussions at the international level.

The second element, as Leslie was suggesting, is what one would call enhanced surveillance. There can be an inherent complementarity and productive tension between multilateral surveillance, regional surveillance, peer review, and, ultimately, surveillance by the market place. There is a range of possible arrangements as we find them, for example, now in East Asia. The surveillance is taking place in Asian finance ministers' processes, that is in ASEAN+3 and APEC. In my view, the most intensive surveillance, with by far the best quality, takes place in the Manila Framework group.

So there is surveillance in very different groups; there is peer review, policy dialogue. We are still at the quite rudimentary stage vis-à-vis policy coordination in the kind of precautionary measures that Daniel was talking about. None of us has talked about the 'peer support' capacity building

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help that can come from regional arrangements. The big countries then can help in a big way. Korea can share experience, and I know it is valued very much by other countries in the region. So, in these regional arrangements, it is not just a question of monitoring and peer review but there is also a support mechanism.

The final part of the framework is mutual insurance. In any risk pooling $n+1$ is better than n, unless you have complete coincidence of shocks. Having three members is better than just risk pooling by yourself. But there is absolutely no doubt that within regions the covariance risk is high. What that implies is that there is a big contrast between Latin America and East Asia. As Daniel points out in his paper, one of the reasons why mutual insurance has not played out well in Latin America is because Latin America sometimes has been in perpetual crisis, with very little reserves to run the show. Therefore, nobody is willing to put money into a common kitty, when your back is against the wall and you are trying to protect whatever limited pool that you may have. Now, the contrast between Latin America and East Asia is that the pool in East Asia is much larger, giving East Asia much greater options. But that raises all the questions of what does that do in a Mc Dooley sense, in terms of giving you a bet to pay them.

Then on the topic that was most intensely debated: why should there be a monopoly in international coordination of liquidity support? While I think there can be complementarity, let me add to the debate by saying why I think there is a coordination problem. Essentially, when you are dealing with systemic crises, as opposed to short-term fluctuations, the basic problem is the one that Daniel mentioned in his paper; that is, uncertainty about insolvency, combined with a liquidity problem. It is not a question of insolvency *or* liquidity. It is uncertainty about whether a borrower is insolvent and, *at the same time*, has a liquidity problem. That is the reality of suspended crises. In that context there are two types of coordination problems that arise. The first is the point that Leslie mentioned, which is the balance between adjustment and financing. And somebody has to be an arbiter about that balance. It can be dressed up as conditionality, you can talk about it many days, but there is a real problem about how much adjustment should there be and how much financing should be provided, and there has to be an arbiter. The second coordination problem is, if there is a perception about private sector involvement, then in a *global* capital market you need a *global* coordinator for engagement of the private sector. The lenders are not regional but global players. Therefore, you will need a global coordinator to come in. What kind of private sector involvement should there be? Should there be private sector involvement at all? Who is going to set the rules of the

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game? For both of those reasons, I would argue that there is an argument for the IMF to be at centre stage in playing a coordinating role.

That does not mean that there is not – as Leslie was pointing out – a role for regional financing arrangements. Regional financing arrangements can do two things. One is, they can intervene so that small problems do not become big problems. But there is a very fine judgment that has to be made about whether that is the case, and that takes you to set a 10 percent rule a 20 or 25 percent rule, but some kind of rule has to be set and regional arrangements could be a mechanism to deal with the short-term volatility. But the moment you are in a systemic dimension, I think you have these fundamental coordination problems and there has to be the kind of complementarity. That is why there is a fundamental need for a coordinator.

So regional arrangements versus a monopolistic coordinator may be a false distinction, and may not be that useful in a practical sense. What you could argue for is that you should set up arrangements that have two aspects of dynamics in it. One of it is financial and the other is, what I would call, improved governance. The financial one is that there is complementarity in terms of what the IMF is able to provide by liquidity support and what the so-called second line of defenses were not able to do. And while regional financing arrangements can play a role, their role will be greater the more endowed the region is with the kind of financing that East Asia has in place. At the political or governance level regional financial arrangements will create a certain healthy tension between global multilateral institutions and the regional institutions. But it could enforce a reconciliation of views. If I caricaturise the previous discussion, Leslie said there is a need for conditionality; Park said regional conditionality would be tighter and more stringent than Fund conditionality; and Ocampo said there should be no conditionality at all. But the reality is, there has to be a decision about at what point do you intervene with conditionality and at what level would you be prepared to intervene without conditionality – which is very much the decision the IMF had to face in terms of their various interventions.

Floor Discussion of "Regional Economic Integration in East Asia and South America"

Doubts About the IMF Monopoly

José Antonio Ocampo wondered whether the IMF should really have a monopoly in the provision of international liquidity. "In development banking the world long ago moved from monopolies," he observed. "There is the World Bank, there are the regional development banks, and there are also subregional development banks. But somehow we maintain the position that in the area of liquidity provision there should be a monopoly. Why? Why should the world have just one actor in the area of liquidity provision? Where is the strong argument for that? I think this is really an untenable position."

Ocampo stressed that the smaller countries would benefit from a move towards a regional monetary arrangement. "It is the small actor in the international scene that would benefit. For example, El Salvador or Honduras or the Czech Republic. Not Japan or China or France or Germany; those countries have a powerful position vis-à-vis the IMF."

Ocampo believed that the move towards regional regimes would also be good for competitive reasons. "When the IMF has it wrong, and there is no reason to think that the IMF can never have it wrong, there is no other institution saying that it is wrong. This is a strong argument in favour of having other actors go against the analysis of the IMF and generate an independent analysis by themselves."

Ocampo shared Park's view that strong conditionality is not really part of the question for regional monetary arrangements. "You probably cannot have an unlimited supply of funds without some sort of conditions. But there are other factors that determine whether you pay or not. A good example is the former Andean Reserve Fund, now called the Latin America Reserve Fund, though it is still basically an Andean fund. Even during the debt crisis of the 1980s it has never lost a single cent while it has never had any conditionality. The basic reason for this is that the member countries have a sense of ownership of the institution. I mean, if you really want to be a beneficiary next time, you have to fulfil your obligations."

Heiner Flassbeck supported Ocampo's critical stance on the role of the IMF as the sole global institution in addressing financial crises. "Clearly, a global system would be the best," he said. "But the strange thing is that,

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since we do not yet have a global system, countries are pushed to find unilateral solutions. However, you cannot have national solutions for international problems of money and finance. In my view, the unilateral solutions are totally inconsistent and absurd. So, a regional arrangement for the provision of liquidity in times of crisis can be more attractive than the monopolistic arrangement we have now with the IMF."

Flassbeck observed that, in practice, the regional funds always have some conditionality. "Europe always had a certain kind of conditionality. But there may be quite different forms of conditionality and there may be quite different traditional social relations in a country, which give reason to a different kind of conditionality. I agree with Yung Chul and José Antonio that the same degree of pressure and the same force to adjust can be much better applied at the regional than at the international level by a global monopolist."

Yung Chul Park addressed Lipschitz' comment that a regional arrangement would have to be supplementary or complementary to what the IMF is doing. "When we spoke to the Managing Director of the IMF, he said that the IMF is supporting the Chiang Mai Initiative but only on one condition: 'It has to be complementary or supplementary to the IMF facilities.' He emphasised that sentence five times. The Chiang Mai Initiative has, until now, been structured in that way. But the question is: why? Why has it to be complementary and supplementary to the IMF? I have not yet heard any credible explanation."

The Exchange Rate Question

Flassbeck disagreed with Leslie Lipschitz' plea for free floating. "I think we should stop fighting strawman permanently. If you say, 'We all know that exchange rates in Asia had been fixed too much, they should have been more flexible', hardly anybody disagrees. That is not the point. The point is whether we have to move from a soft peg to the corner of fully flexible exchange rates. These have shown to be extremely difficult to manage for small economies. That is the big question.

But what advice has been given to the Asian countries? They have all been advised to liberalise capital flows. Nobody has advised them how to arrange reasonable and rational exchange rate regimes and nobody has assisted them in doing that because, as I said earlier, this would be a global task, or at least a regional task; it cannot be done by a country alone. Because the exchange rate of one country is at least the exchange rate of another. So it is ridiculous to say that we have a national solution for an exchange rate regime. The exchange rate is by definition a multilateral thing."

Zdeněk Drábek observed that those who blame East Asian countries for

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having applied the wrong exchange rate policies, are misinterpreting history. "The East Asian countries are now being criticised, but for twenty or thirty years they were praised for applying the right kind of exchange rate policies. The exchange rate system worked and worked very well. The only big problem was that at a certain point things were wrong and that nobody noticed that they were wrong. As we were trying to design warning signals for the capital movements, presumably we should have developed a similar kind of warning signal system for countries. But to say that East Asians had it wrong with the exchange rate for twenty or thirty years, is a complete misreading of history."

Oldřich Dědek stressed that, in times of trouble, an overshooting of the exchange rate may be seriously detrimental to the economy. "The policy of high interest rates aims at preventing excessive exchange rate overshooting and restoring credibility in the currency. I do not think that using some policy measures to prevent excessive overshooting has anything to do with moral hazard. In my view, overshooting may have dramatic consequences for the economy. So I have some sympathy for the idea of regional monetary arrangements if they help prevent these dramatic consequences of exchange rate overshooting. Then it would be a good idea. Not when they aim at defending an exchange rate when the fundamentals are wrong."

Park dwelled on the exchange rate question too. "The trend is that most of the countries in East Asia are now moving towards some sort of intermediate regime. They are going to control their capital movements to some extent, with the blessing of the IMF. There is also clearly a need for creating a common basket to peg their currencies to and the question is: what kind of currency should be put in the basket? These are the kind of questions that the thirteen countries of the Chiang Mai Initiative are debating among themselves.

Fixing the exchange rate at national level is not an issue. One of the reasons why we in East Asia are moving towards intermediate regimes is simply because the system of floating rates with deregulated capital market transactions and monetary inflation targeting does not seem to be working very well."

The Markets Can Have It Wrong

Bill White observed that bank money has been haemorrhaging out of Asia ever since the Asian crisis. "The question is: is it connected to the situation in those countries or to the broader global situation?"

According to White it relates to both. "In addition to these global phenomena acting against the best interests of Asia, things like NASDAQ which was doing so wonderfully, there are clearly the idiosyncratic things

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that Leslie points out. I mean, virtually every one of those countries has got either a significant economic or political problem that investors are conscious of."

Oldřich Dědek agreed with White but stressed that the markets can have it seriously wrong. "We now question the drastic overshooting on the stock markets. But everybody knew that the stock market was wrong in the United States and elsewhere for five to six years. Why didn't we say that before? That is the question. But we all know that the market got it wrong for a long time..."

Park also raised doubts about putting too much faith in the markets. "The notion that we hear constantly from the IMF is, if we push harder and if we work harder to restructure our economies, especially improve corporate financing and banking standards and things like that, we will not have to hold as many reserves as we do now, and the market will realise it. But again, it is not what we observe in the market. Most of the crisis-hit East Asian countries have been successful in reforming their financial institutions and corporations. They have made progress on average. But even if you are making progress in reforming your economic system, the markets do not seem to appreciate and recognise the progress you make. That is our constant frustration."

Global and Regional Rules of the Game

Turning to Daniel Heymann's paper, José Antonio Ocampo emphasised that international financial institutions pretend that they treat countries equally, while in fact they do not because there is a basic asymmetry between the countries. "In Latin America, for example, you only have three countries that could have a systemic influence in Latin America. The other thirty-three countries do not have this influence. That basic asymmetry is reflected in the fact that the countries are being treated differently. The negotiating power that Brazil, Mexico and Argentina have had in international negotiations is totally different from the negotiating power of the smaller countries. The only way the smaller countries can protect themselves is by seeking competition in the provision of services. It is just like the smaller enterprise that would have to shut the door easily if it cannot compete in the provision of services. Because of this basic asymmetry of small players not having real power over the decisions of the major international institution, we have to move to another system.

Why should the IMF not be structured as a network of regional reserve funds? I mean, why don't we adopt the US Federal Reserve System structure or the European Central Bank structure? That would be much better for the IMF's future than the current structure.

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One comment on Daniel's paper, following up on what Amar has said. The Asians responded to the recent crisis with a common proposal. In Latin America the two major South American countries, Argentina and Brazil, responded by trying to differentiate from each other whereas one would think that they, as partners in Mercosur, would try to coordinate. This paradox comes out very clearly in the paper. Charles Wyplosz points out in his paper as lesson number one: you have to have political will. Why was the political will available for creating Mercosur in the late 1980s and why is it lacking ten years later?"

Yung Chul Park explained why the thirteen East-Asian countries of the Chiang Mai Initiative got together and started talking about the establishment of a regional monetary arrangement. "After the Asian crisis the so-called East Asian Development Model has been under trial. The jury is still out, but as of now, everything that one associates with the East Asian Development Model seems to be wrong. That is the perception we get from our discussions with the international financial institutions including the IMF, the United States, and the G-7 countries. So, it is natural that these East Asian countries are now trying to create some sort of new critical mass at the initial stage. Once they establish this critical mass I am sure the Chiang Mai arrangement will be open to just about anybody because the larger the membership the better the system is going to be as a first line of defense against any kind of impending financial crisis."

Amar Bhattacharya stressed that global institutions are still needed in times of crisis. "Look at Ecuador, Turkey, and at the Korean debt restructuring in late 1997, they were essentially negotiations requiring the involvement of the private sector on the global scale. The creditors were not regional creditors, they were global creditors. So, whoever is going to be responsible for overseeing the debt arrangement, saying 'These are the rules of the game you have to follow,' it cannot be a regional institution; it has to be a global institution. That is the point."

Stephany Griffith-Jones supported Bhattacharya's view. "Amar is right," she said. "There are two coordination problems. One is adjustment, and the other is finance. If you look at finance, Amar is right, the credit markets are global and the debtor countries are not. So one would hope that global institutions would balance the differences in interests and power between the creditors and the country. But the other issue is, that there has to be a global actor who can provide a proper balance between adjustment and finance. And here José Antonio is also right: the more regional arrangements you have, the more power you have as a small member country. That is what the Europeans do; they don't go to the IMF."

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The IMF as the Global Coordinator?

Yung Chul Park contested the view that one needs a global institution to coordinate creditors and debtors in times of crisis. "It is not clear to me why this would be necessary. Sure, in dealing with the debtors, the creditors come from all over the world. But the regional institutions could easily negotiate the terms of repayment, the conditions under which these countries are going to borrow. Why not? I don't understand why these negotiations have to be conducted at the global level or at the level of the IMF or any other financial institutions that has some leverage or influence. Many East Asian policymakers are unhappy about the subjugation of the Chiang Mai Initiative to the IMF system.

I was involved in managing the crisis in 1997. I can tell you that when a country is in a crisis and every second counts, you don't have time to argue against someone who is going to provide money. There is no time for any kind of intellectual or analytical discussions. You have to accept most of the structural and other macro reforms they ask you to implement. You have to, otherwise you don't obtain the financing. Our problem at that time was not the conditionality of the IMF, but that of some of the G-7 members. They said, 'You have to liberalise this and you have to liberalise that, and then the markets will regain confidence.' In the end it was the G-7 intervention in the market that aborted the crisis. In other words, it was the G-7 that was able to restore confidence in the Korean economy. IMF finance packaging and conditionality did not do anything. These G-7 countries realised that they had to restructure the financing package and increase the amount of liquidity available and in the process they added more items to their conditionality. In this respect, the IMF is very limited in serving as a global institution."

Leslie Lipschitz argued that he had probably negotiated more IMF finance packages than anyone on earth and could not imagine ever having been in the situation where there is blank interception. "Every single IMF standby loan that was negotiated was the result of serious discussions. Every comeback, every position that the authorities had, every analysis of every diagnosis was very seriously considered. Those here, sitting on the other side of the table with me in various Czech negotiations in 1995, know that we agonised over everything. At the end of the day we might have found there were issues on which we struggled to find an agreement, and negotiations were tough, but it was not an imposition. This notion of a conspiracy of highly coordinated G-7 countries sitting in Washington on the phone giving the Fund Mission's Chief detailed directions is just wrong. The G-7 just doesn't have the organisational ability to do that."

Park retorted: "Your facts differ from my facts and there isn't anybody who could tell us who is right and who is wrong, but I have seen in Korea during the crisis how negotiations go, and I can tell you that they went quite odd...”

Bill White also had the impression that the Korean negotiations were quite odd. “At one point, correct me if I am wrong, it wasn’t the G-7 but it was a very senior US Treasury official who was actually on the same floor as the Fund team at the hotel...”

Park: “That’s true. But Leslie is right as far as G-7 coordination is concerned. The G-7 countries did not coordinate their policies. It was just the US who took the lead. And Leslie is also right in that they were not telling the IMF mission what to do. They were just telling the Koreans what to do and that was the end of the story. As Bill just said, one senior US Treasury official was in the conference hall just about every day from December 10, 1997 to Christmas Eve, persuading the Japanese, the Germans and the other G-7 countries to provide money and to do this and do that. And only when the G-7 agreed and came up with a new financing package, the markets finally took it seriously and stopped attacking the Korean currency. That is on the record. I am not making up the story.”

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Part IV

The Role of Regional and Global Institutions in Crisis Prevention and Management

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The Role of Regional Institutions

José Antonio Ocampo

The role of regional institutions in the international financial system is one of the most prominent items missing from the mainstream discussion and agenda on international financial reform. It is absent from the main Northern reports[1] and from the views on financial reform which come from the IMF (though the position of the new IMF Managing Director is more positive in this regard). The main manifestation of this gap in recent years was in the opposition to the creation of an Asian Monetary Fund in 1997, although this idea was revived in 2000 in the form of a swap arrangement between the ASEAN countries, China, Japan and Korea.

There are four basic arguments for a strong role of regional institutions in this area.[2] The first is a classical risk-pooling argument. Regional and subregional development banks, even those made up entirely of developing countries, are likely to face lower risks than individual members. This creates the potential for profitable financial intermediation.[3] Also, despite contagion, critical demands for funds do not coincide exactly in time, a fact that generates the possibility of a useful role for regional reserve funds or swap arrangements as a first line of defense during crises.[4] If these mechanisms are effective, they can play a useful role in reducing contagion.

The second argument relates to the virtues of complementarity between world and regional institutions. Given the heterogeneity of the international community, world and regional institutions can play useful complementary roles. Thus, aside from those mechanisms that involve major industrial economies, macroeconomic policy coordination will work best in regional organisations. These organisations can also play a useful role in setting norms, in the adaptation of international norms to regional conditions (given different regulatory traditions), and in reducing learning costs and sharing experience with institutional development. They could also establish mechanisms to ensure surveillance of their regulatory systems and, eventually, regional currencies. The fact that, at least in the

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1 See, for example, Council on Foreign Relations (1999), and Meltzer and others (2000).
2 For a broader discussion of these issues, see ECLAC (2000, chapter 2), Agosin (2000), Ocampo (1999, 2000) and Park and Wang (2000).
3 The experience of the Andean Development Corporation (Corporación Andina de Fomento) reflects this.
4 See, for example, the experience of the Andean, now Latin American Reserve Fund (Agosin, 2000).

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area of trade, globalisation has been accompanied by strong regionalism, further points to the virtues of such complementarity.

The third is an argument for competition, particularly in the supply of services to smaller and medium-sized countries. World institutions are likely to serve best those actors who have some systemic influence. Smaller players do, in fact, face a very unfavourable power relation vis-à-vis large institutions. This creates a strong argument for a division of labour whereby regional institutions can and should play a stronger role in relation to small and medium-sized countries. Indeed, the best defense for smaller players is competition in the provision of services to them. Hence, the competition between world and regional organisations in the provision of development bank services, emergency financing or technical support is, undoubtedly, the best arrangement for small and medium-sized countries.

The last may be called the "federalist" argument. No matter what arrangements are adopted, the voice of small and medium-sized countries is unlikely to be strong in global institutions. This may lead, in turn, to a lack of commitment ("free rider" attitude) on the part of these countries. This can be remedied by the establishment of regional institutions in which their voice does matter, together with a sense that those institutions are truly part of a broader international order. Moreover, the sense of "ownership" of these institutions by developing countries creates a special relationship between them and member countries that helps to reduce the risks that regional and subregional development banks and reserve funds face, further encouraging the virtues of risk pooling.

These are strong arguments for giving a prominent role to regional institutions in the world order. The best example in this regard is, undoubtedly, the European Union. Indeed, these arguments point to the need to think of the virtues of providing global public goods in the area of finance (as well as in many others) through a network of either complementary or competitive institutions. The International Monetary Fund of the future could be viewed, in this regard, as the apex of a network of regional and subregional reserve funds and swap arrangements[5] – i.e. a structure more akin to that of the European Central Bank than its current centralised one. In turn, competition in the provision of development finance between the World Bank, the regional development banks and a growing set of regional and subregional banks entirely owned by developing countries is probably the best arrangement in this area, together with increased direct access by all developing countries to international private capital markets.

5 See United Nations Task Force (1999) and Ocampo (2000).

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A Regional Approach to the Exchange Rate

Heiner Flassbeck

In our discussion, a crucial topic remains unresolved. Everybody talks about globalisation but only a few mention that we have a globalisation of markets but not of politics. The fact that globalisation has not yet reached politics is, in my opinion, the main contradiction in international policy. It leads people to protest against the laissez-faire approach to globalisation. Politicians are pressing workers and companies in our countries to adjust "flexibly" to globalisation, while the very sector that fails to adjust to globalisation at all is politics.

To give an example, I think in our globalised, free-trading economies it is absolutely essential to have something like a globalised monetary regime or a global exchange rate regime. But politically this is out of the question at present. Why is it out of the question? Many countries, particularly the larger ones or the big blocs, are not willing to commit themselves. They hand out conditional credit to other countries via the IMF, but would never accept any obligation for their domestic economic policy stemming from international developments.

The same lack of a globalised view leads to the idea or ideology of pushing countries into the corners of either fully flexible exchange rates, on the one hand, or absolutely fixed rates on the other. It is an attempt to find a unilateral solution for a problem that is multilateral by definition. This inconsistency proves to be disastrous.

Hence, the real test for the credibility of the proponents of globalisation and liberalisation preaching the benefits of a global free market is the monetary question. The idea of pushing neighbouring developing countries like Brazil and Argentina into different corner solutions, has failed. To put it in slightly provocative terms: the IMF healed Brazil by killing Argentina, and the problem is that the Fund did not even reflect on that. I was involved in negotiations with Brazil in 1999, and tried to convince the G-7 and the IMF to consider the consequences for Argentina of floating the Brazilian real, but nobody listened. First, we solve the Brazilian crisis, they said, and then we will see what happens in the rest of Latin America. However, in my view, this kind of inconsistent policy cannot go on. Unilateral solutions have proved to be untenable, not only in the long run but even in the short run.

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In the final analysis, Argentina proved both corners to be wrong. Currency boards or dollarisations fail, as the real exchange rate may still be very flexible if trading partners depreciate. To restore competitiveness, deflation is a not an instrument, as it worsens the overall situation of the country. Free floating fails, as it tends to move the real rate far beyond the flexibility needed to cope with external disequilibria, destabilises trade, and prevents a reasonable monetary policy with low interest rates. Unilaterally managed floating cannot work on a global scale either if there are no multilateral rules to avoid competitive depreciations. The basic problem is: there is no such thing as a country's exchange rate. Your exchange rate is always the exchange rate of many others. Put simply: unilateral solutions cannot deal with a multilateral problem.

It seems to have been forgotten that Argentina's currency board, once praised by the IMF and the G-7 as one of the successful "corner solutions" in international monetary affairs, has been a persistent invitation to international investors to buy high-yield Argentine assets. With a spread of up to 1000 basis points even in normal times, an absolutely fixed exchange rate and very low inflation, Argentine assets seemed to be a perfect bargain and direct proof of the benefits of open capital markets to lenders and borrowers. The question of how investors in fixed capital inside Argentina could survive with real interest rates that were about ten percentage points higher than those in the United States never occurred to those praising Argentina for its open capital account.

Like every other country in trouble, Argentina needs low real interest rates, a lower but stable real exchange rate and a stimulating fiscal policy. Any arrangement now under discussion with the IMF that doesn't deliver such a constellation of the most important variables, will fail and push the country over the cliff. In addition, a solution for Argentina has to be designed without killing Brazil and the other Latin American competitors again. To achieve this, the country and its trading partners urgently need an exchange rate regime which is flexible enough to allow for the adjustment of fundamental disequilibria accumulated during the currency board phase and stable enough to avoid future cumulative depreciations and wide gyrations of real rates which destroy the trade relations as well as the financial system in this part of the world. However, the European experience with managed floating of that kind indicates that such a system will only be workable with the assistance of the central bank of a reserve currency. Obviously, this can only be the US dollar.

If stability and prosperity in the globalised world are to be sustained and regained, governments and central banks of the reserve currency countries have to assume responsibility for a proper working of the system far beyond austere rescue packages and irrelevant structural adjustment programmes.

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Short of a world monetary order a solution will hardly be found. Only if this is realised dare we say that globalisation has reached the level of politics.

As long as such a solution cannot be realised the second-best way out is to head for regional solutions. Regional solutions may even offer advantages not offered by others. However, I do not join the traditional optimal currency areas debate. As general economic criteria are hardly available, a regional solution is mainly a question of political will and the political ability to force domestic adjustment and to assume responsibility for the system as a whole. Europe, with Germany as the anchor, is a good example in this respect. In all its crises, Europe always came out stronger than before and, most of the time, with the vision to reach a specific objective like monetary union.

It is important to note that, for 40 years, Europe has been in a transitional stage. Soft pegs or hard pegs should not be tabled as the end of the story. Exchange rate systems should be discussed as transitional stages. And the main question should be: can the system I choose be a reasonable transitional stage towards something like monetary union either on a regional level or even, ultimately, at global level? Here I think some form of peg, more flexible than in Asia, perhaps even a little more flexible than in Europe, is extremely helpful, for example, for the accession countries in Eastern Europe. If the exchange rate problem is solved, many other problems of openness are solved too.

Leslie Lipschitz said earlier that he supports completely flexible labour markets. I said, perfectly flexible means, in the European case, that you should be able to have a unit labour cost increase of 2 percent annually. An increase, not a drop of 20 percent or something like that in Argentina now. I quickly admit that in the case of negative supply side shocks you need real wage flexibility to adjust without inflationary second-round effects, but under any normal circumstances the stated unit labour cost flexibility is sufficient. I think it is extremely important to discuss these points concretely, namely to define flexibility, and not just to use popular phrases like "flexibility". If wages are flexible enough, they can 'substitute' exchange rates changes, which are always very difficult to handle in whatever exchange rate regime. As long as wages are not fully flexible in the above-mentioned sense, intermediate exchange rate regimes are necessary and workable. In the literature, the opposition to an intermediate regime has gone far too far.

A different question is whether exchange rate changes are a proper instrument to fight real shocks. I don't think they are. They can only substitute for the flexibility of nominal wages. But exchange rates cannot absorb real shocks. The academic discussion of exchange rates is clearly inconsistent on this point. We have now been teaching the whole world,

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for more than three decades, that inflation is not an instrument for economic policy, because we cannot fool people about the *value of money over time*, which is inflation. Everybody agrees that people learn quickly and attempts to fool them will fail in the long run. The same holds for the *value of money in space*, that is the exchange rate. Nonetheless, the mainstream view asserts that the exchange rate is a policy instrument permanently available in all countries to fight real shocks. But if the public learns that the change in the value of money over time is an attempt to fool them about their real income or real wealth, they will learn the same about the exchange rate. So arguing the case for floating as an instrument for fighting real shocks is not consistent.

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A Predictable Framework for Crisis Resolution

Paul Jenkins[1]

I will focus my remarks on what needs to be done to prevent and manage crises, both regionally and at the global level. A set of principles and presumptions should be established that help prevent crises by improving efficiency and stability in capital markets. For crisis management, they must create conditions for more orderly negotiations between debtor countries and creditors.

I think that there is a consensus, at least at the level of principle, that large assistance packages do distort international capital markets, not the least by truncating the distribution of expected returns facing lenders. And it is in part for this reason that some efforts to reform the private sector have become a fairly standard feature in the international assistance packages. But the international community and its institutions are much less successful in translating this rather vague agreement that the private sector should bear the consequences of its lending decisions into consistent and concrete actions, particularly when faced with the requirements of real world financial crises.

The results have tended to be ad hoc, arbitrary and confusing for the private sector. We are in a situation where countries deemed to be of systemic importance are still provided with assistance packages that would have been unthinkable a few years ago, and certainly which far exceed ordinary Fund access limits. When private investors are expected to participate in debt restructuring, the impression is often created that what the official sector is really after is burden sharing. The contribution asked seems to be driven by the expediency of a need to fill a certain balance of payments gap, rather than any other considerations.

The result is that a new source of risk is being introduced in the international capital markets, with lending decisions based on guesses of which countries are too politically important to be subjected to debt restructuring, rather than by assessments of underlying risk and return. Clearly, a market in which private investors make the decisions to invest, but the official sector bears much of the risks, cannot be efficient. But nor

1 The views expressed are not necessarily those of the Department of Finance or the Government of Canada.

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can a market be efficient when the official sector intervenes in an unpredictable or even haphazard manner.

The state of affairs has some clear implications for the international institutions, both at the global and regional levels, and their efforts to achieve what has become known as private sector involvement. Certainly there is a role for arrangements that have been discussed for a few years, collective action clauses for example, that make it more likely that borrowers and creditors go renegotiate their debts in the midst of the often difficult and tumultuous circumstances of financial crises. And there is a role for mechanisms whereby the international community, say the IMF, could endorse a country's decision to declare a standstill on debt repayments. But I think it is right to say that these arrangements alone are rather far along the list of steps that are necessary. They alone would not be effective in achieving more stable and efficient capital markets, unless one thing is achieved: a fundamental commitment to limiting official financing for countries in crisis.

Misconceptions About the Limiting of Official Finance

There are a number of ways such limiting of official financing could be operationalised. One way would be to adhere more strictly to access limits as a percentage of quotas, either the existing ones or alternative ones. Another way would be to look at rules relating to the financing of current account deficits together with reserve flaws. But the fundamental objective would be to prevent situations in which massive capital outflows are financed with official flows. So it would imply operationalising the long forgotten Article VI of the Articles of Agreement of the IMF (see box). Of course, this is not a new proposal. The ideas behind it have figured, at least implicitly, in the debate on private sector involvement over the last few years. But if implemented, they would represent a fairly major shift. And like a lot of changes, these ideas are subject to criticism, which I think is based on some misconceptions or misunderstandings. I will briefly discuss five of these.

The first misconception is that governments are being motivated mainly by the desire to shift the financial burden of assisting countries from themselves to the private sector. In fact, that would be a rather bad objective. The proper objective of private sector involvement is not burden sharing. It is not a zero sum game in which international institutions transfer to the private sector the financial responsibility for crisis management. Rather it is to create the conditions for stable international capital markets, something that should be a positive sum game for the private sector.

The second misconception is that the debates often cast the problem in terms of rules-based versus case-by-case approaches. Certainly, we support

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Articles of Agreement of the International Monetary Fund

Article VI: Capital Transfers

Section 1. Use of the Fund's general resources for capital transfers

a) A member may not use the Fund's general resources to meet a large or sustained outflow of capital except as provided in Section 2 of this Article, and the Fund may request a member to exercise controls to prevent such use of the general resources of the Fund. If, after receiving such a request, a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the general resources of the Fund.
b) Nothing in this Section shall be deemed:
c) to prevent the use of the general resources of the Fund for capital transactions of reasonable amount required for the expansion of exports or in the ordinary course of trade, banking, or other business; or
d) to affect capital movements which are met out of a member's own resources, but members undertake that such capital movements will be in accordance with the purposes of the Fund.

Section 2. Special provisions for capital transfers

A member shall be entitled to make reserve tranche purchases to meet capital transfers.

Section 3. Controls of capital transfers

Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(*b*) and in Article XIV, Section 2.

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a framework that sets up some predictable rules of the game. One of these would be the presumption that official resources would be limited, much more so than they are now. But beyond that, a well-defined framework would clarify the circumstances under which the international community would sanction a country's decision to declare a standstill, as well as clarify the principles to guide renegotiation of external debt such as equal treatment between and among official and private creditors. Of course, any such rule would need to be a guideline and not a straitjacket. A framework for private sector involvement would provide more clarity amid financial crises, but it should not be applied in a rigid fashion, without reference to the countries concerned. This is to say that any rules-based system would have to be applied on a case-by-case basis. So this distinction between rules-based versus case-by-case does not make sense.

The third misconception is that the Article VI solution is intended to tilt the balance towards borrowers and away from lenders. This is just not true. The private sector has always been involved in resolving financial crises, so whether it should or should not be involved is not an issue. What is an issue is whether there should be a predictable framework that provides some ground rules for this involvement. Clearly a predictable framework is better than a set of unpredictable ad hoc arrangements. Because when you do not know what happens when debt needs to be restructured in some future crisis, you cannot properly assess the risk of the loan, and there is a danger that if you cannot price it properly you are not going to make the loan. The result that one would expect is that investors are less willing to provide loans, even to the more creditworthy emerging countries, and this translates into less investment in emerging markets, slower growth, the persistence of poverty and a less dynamic and prosperous global economy.

Providing more predictability is not just a matter of the official sector laying down some arbitrary rules for the private sector, it also requires us to consider carefully our own actions as official creditors and insure that these contribute to fairness and flexibility. For over 40 years we have had the Paris Club as a forum where governments renegotiate debt from countries no longer able to pay them. But it is more than just a place, a creditor club, which deals with bilateral debt; it is increasingly a place where the official sector establishes principles and precedents, what we call soft law for the treatment of similar cases in the future, and which increasingly are providing an example for the private sector creditors. We need to make sure that in establishing the soft law the official sector takes adequate account of the interests of the private sector and does so in a consistent and fair manner, and again, does not become a source of uncertainty, but rather predictability.

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The fourth common criticism I would like to address, relates to the concern that some of the particular measures described encourage involuntary or non-market solutions to payment problems. I think this criticism comes very close to inversion of the truth. In fact, it is massive international assistance packages that are the non-market solutions to the problems, the ones you would consider only under exceptional circumstances in our own domestic economies, because of their potential to distort capital markets. Moving away from these practices is a step back toward market-based solutions.

The fifth and final concern or misconception I like to address relates to the view that by limiting official financing and thereby encouraging or indeed requiring default, the international community is eroding the sanctity of private contracts. My response would be that attaching the highest priority to the sanctity of contracts is incompatible with the functioning of efficient real world markets, in which changes in circumstances sometimes require changes to contractual terms. One can interpret in fact the high-interest spreads on emerging market debt as reflecting the recognition that unforeseen circumstances may require changes in the terms of the contract. From this perspective, the only world in which changes are truly ruled out, is the one in which debt contracts are complete in the Arrow-Debreu sense, taking into account all possible eventualities. Clearly, we are not in such a world, and therefore the possibility of debt renegotiations is something the official sector should contemplate and even embrace.

Conclusion

I hope that my remarks will help clarify the underlying objectives and rationale for efforts to improve financial crisis management, such as those in which we in Canada have been involved for several years. The goal here is not about suddenly introducing non-market considerations into the operation of international capital markets, or arbitrarily imposing costs on market participants. It is not bred of hostility to market forces. Quite the opposite. Our goal is one that the most market-oriented should support: ensuring that assessments of risk and return by international investors are undistorted by uncertainty about the actions of the official sector and that we experience fewer and less severe financial crises.

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The Complementary Role of Regional Groups

Leslie Lipschitz

There is a great deal of ground to cover. I am going to focus, first, on saying a few things that I believe are important. Thereafter, I shall try to respond to some of the provocative points raised.

Let me start with the issue of IMF surveillance and crisis prevention. There is, I think, a degree of frustration with the abstractness in the discussions about reform of the international financial architecture. A sense, perhaps, that we have a whole new alphabet soup of initiatives – FSAPs, FSSAs, ROSCs, CCLs, etc., etc. – but there is insufficient real change on the ground. I believe that there *are* real and important changes in how surveillance is being done in the Fund – particularly with respect to the emerging market countries which are most at risk from capital account crises – and I will try and say something about this. Next I will say a few words on what I see as the complementary role of regional bodies in both surveillance and crisis financing. Finally I would like to address briefly the issues of private sector involvement and access limits on Fund support of countries' programmes.

The criticism of surveillance has been fairly clear. The so-called External Evaluators of Surveillance (a group led by John Crow of Canada) and the last internal IMF review of surveillance came up with similar concerns: The Fund's surveillance of individual countries should be more continuous and rigorous and should be focussed on anticipating and forestalling crises; it should bring all the cross-country and global wisdom available (from the Fund's *World Economic Outlook* and the *International Capital Markets* reports) to bear on this objective; and its coverage should be selective, with structural and institutional issues covered to the extent that they have appreciable macroeconomic relevance. This sounds sensible and straightforward, and, indeed, it does not constitute much of a revolution for the Fund's surveillance of the major industrial countries. But it has wrought a revolution in the process and framework for surveillance of the emerging market countries.

The new process involves supplementing the annual consultations with these countries with detailed quarterly vulnerability assessments and interim monthly updates. The quarterly exercises try to assess the countries based on six independent inputs:

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- Changes in the *World Economic Outlook* that have particular significance for the countries involved. This entails sitting down with the economists doing the world economic outlook and trying to assess which developments – e.g. sharp changes in the terms of trade or in demand for high-tech components – are likely to have an influence on the vulnerability of each of the emerging market economies.
- Early Warning System (EWS) Models. We look at a set of EWS models – some developed inside the Fund, some run by outside financial institutions. These models do not have a great track record – they miss some crises and predict many that never occur – but they do force a process of assessment in order either to accept or reject their results. As such they are useful as one element of a vulnerability exercise.
- Market information on borrowing spreads, equity prices, exchange rates and contagion. Besides a general assessment of the market conditions for emerging economy financing, much of this work is focussed on contagion: for example on pairwise correlations of changes in borrowing spreads across emerging market countries. One objective is to assess whether country X is likely to be vulnerable to a crisis in country Y.
- Financial sector robustness. This draws often on the results of Financial Sector Assessment Program (FSAP) work or other work by our experts on the financial sectors of emerging market countries. In many cases this work entails specific stress tests of the financial sector in relatively adverse counterfactual scenarios.
- Financing requirements. This entails a detailed assessment of the external financing requirements of each of the countries under consideration based on both current account developments and amortisation schedules. It requires a fair amount of detail on the structure of debt and an assessment of rollover ratios and access to financial markets for different types of instruments under alternative scenarios.
- Finally all of this information is pulled together for each country and discussed in some depth with the country desk at the Fund. The country economists on the individual economies have by far the best insight into institutional detail, political constraints, and the state of play on policies; they play a critical role in integrating all of the inputs from the other aspects of the process into a sensible judgment on likely developments and policy imperatives.

I believe that this process is part of a sensible response to the capital market crises of recent years and the in-depth assessments of surveillance – both in-house and external. It goes together with much more candid discussions of vulnerabilities with our Board and more candid staff reports. The best examples of the latter are probably the post-programme monitoring papers on Russia and some of the Asian crisis countries. All of

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this may not sound like a revolution around this table, but it is totally different from the way the Fund did business ten years ago. It is clear that there is no silver bullet: there will be problems that we do not anticipate, and others that we are powerless to forestall. We will make mistakes. But much has been achieved in response to recent history, and that alphabet soup of new processes and mechanisms is being sensibly integrated into the process of surveillance.

Let me talk now a bit about the regional role and try to address some of the discussions we had earlier. Why not just a regional financing arrangement to supplant the global system? First, the most obvious point is that raised earlier about covariance risk – the notion that no sensible insurance company would provide flood insurance to clients all located in the same valley. It seems obvious that if all the countries that are party to the Chiang Mai Initiative are hit by a large common shock, they will have difficulty bailing one another out. Moreover, common shocks or synchronised cycles are probably more likely as regional economic integration advances. So there has to be money from outside for any crisis that is region wide.

Second, there is the point that Daniel Heymann raised about uncertainty – there is, perhaps a natural tendency to underplay problems in one's own neighbourhood. It is often difficult to distinguish a pure liquidity crisis from a solvency crisis. Moreover, a liquidity crisis that leads to higher interest rate spreads or an exchange rate change may well quickly become a solvency crisis in circumstances where balance sheets are sensitive to interest rate or exchange rate risk, or where there are substantial contingent liabilities. In this light, it seems to me that the position adopted by the Chiang Mai Initiative constitutes a sensible middle ground. As I understand it, this position is as follows: if a participating country runs into a crisis that it wants to characterise as purely a short-term liquidity problem, the principal creditor participants could (if they agree) advance a well-defined small amount of money for a short time. Beyond this, financing will require an arrangement with the Fund. Thus, for example, Japan would not be required to finance a defense of the exchange rate of the Philippines with very little conditionality for an extended period. Any such financing, beyond small amounts and the very short term, would entail an adjustment programme supported by the Fund. Significant regional financing under the Chiang Mai Initiative would thus supplement rather than supplant global mechanisms.

I do not think that the situation in Asia now is very different from that in Europe in the 1970s and 1980s. The Italian crises of 1974-77 and the problems in Greece in the mid- and late 1980s were very characteristic of the difficulties involved in a tough rigorous assessment of one's

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neighbours. In the case of Italy, there was a clear perception in Europe that Fund involvement was essential. In the case of Greece, there was an EU supported programme (designed, incidentally, by a Fund economist who had moved to the Commission) in 1985. In the subsequent years, however, there was enormous pressure on the Commission economists to put a very sanguine gloss on developments under the programme and immediately after it. I recall one mission that I led to Greece where the dissonance between the Commission's assessment and that of the Fund was quite deafening. Clearly, it is difficult to be vigorously critical of the policies of one's neighbours and regional partners, and a degree of distance is helpful.

Two more small points in reaction to some of the things others have said. First, contagion is global: it is entirely possible for Indonesia to be affected by developments in Argentina or Russia. An analysis of capital markets *cannot* be regional it must be global and it requires wisdom on the global economy. Second, it is of no use complaining that markets are irrational – my own view is that risk premia and spreads are often quite erratic and capricious, but one nevertheless has to live with this reality and, most importantly, to put in place policies that make economies robust to such market shifts.

None of this should suggest that the new mechanisms for regional surveillance in Asia – under APEC or the Manila Framework Group for example – are not welcome. They are developing into an important force for strong policies and neighbourly peer pressure. For us in the Fund they have also been enormously helpful in bringing to the fore clear thinking on regional issues and the constraints on policies. But, given the considerations mentioned above, it seems clear that regional arrangements for both surveillance and financing need to be reinforced by the global mechanisms that are in place.

Finally, a very quick word on Paul Jenkins' views on private sector involvement and strict access limits on Fund financial support. This is, I think, the most difficult issue that the Fund membership will need to face in the next year or so. There is immense appeal to the notion of very strict rules on access, and to the notion that private market participants need to face stringent market penalties so as to be encouraged to price risk appropriately. But the issues involved – legal and institutional as well as purely economic – are devilishly complicated. I believe that we are at the beginning of the process of resolving them, that there is a great deal of work ahead, and that it is simplistic to suggest that a purist solution can be imposed.

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The Role of Regional and Global Institutions

William White

I seem to have different views about the role of exchange rates than some others at this meeting. If I heard Heiner Flassbeck right, he said that exchange rate changes are not a good instrument to solve real shocks. I am not sure that is true. A real shock has to be absorbed. The question at issue is whether letting the exchange rate move leads to a more satisfactory overall outcome in the process. Let me use an example drawn from my Canadian experience; namely, the effects of an increase in commodity prices and the terms of trade. The real effect is that the commodity-producing sector must gain at the expense of (say) manufacturing, but this can be done in either an inflationary or a non-inflationary way. In the former case the exchange rate is held constant. Rising profits in the commodity sector lead to higher wages that spread to manufacturing. This in turn leads that sector to try to raise prices to restore profit levels. In the latter case, in contrast, the exchange rate is allowed to strengthen. This reduces the prices of all tradable goods, again to the particular discomfort of the manufacturing sector.

My second point has to do with what Paul Jenkins just said about rescue packages in sovereign crises. I think one of the reasons why the crisis packages have been so big is that people have looked into the abyss of the market solution and have been unwilling to accept that outcome. They say, "No, that is just too painful. We can't do that. There is no way the private creditors and the debtors can sort it out." What is now being suggested as an alternative are means to make the market solution less disorderly and painful. Suggestions include some combination of better financial standards, Fund lending into arrears, and the incorporation of collective action clauses into both new and existing bond contracts. I think further work along these lines would be very useful.

I agree with Leslie Lipschitz that there has recently been a major change in the way the Fund seems to be looking at things. There is now a much greater appreciation of the possible dangers arising from international capital flows. However, I was a little disconcerted by the extent to which his comments seemed to focus on country-by-country problems and issues. Fortunately, near the end of his comments he did note that the problem of capital flows might not be country specific. Rather, there could be

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swings in confidence in international financial markets that could have repercussions everywhere. Moreover, a large number of countries could be affected simultaneously by shared shocks of other kinds; effects on international trade of sectoral difficulties (e.g. IT), changes in world energy prices, profits earned by multinationals from global operations, and the simultaneous and instantaneous access to the same information globally. International financial institutions, including the BIS, must give higher priority to monitoring changing global vulnerabilities and exposures of this sort.

As far as the BIS is concerned, let me go back to the role of regional and global institutions in crisis prevention and management. Let me be very clear about what the BIS is not. It is not an agency that tells people and countries what to do. Rather, it is a cooperative agency. We exist primarily to bring people together in order to talk about the issues of monetary stability and financial stability. We wish to encourage the sharing of understanding and to discuss what can practically be done to address shared problems. The networks established through this cooperative process seem to us to be very important. The fact that everyone knows each other, that they share many similar values, and that they at least understand others' views about economic processes is helpful for both crisis prevention and crisis management. As well, without calling into question the primacy of our clients' interests, we at the BIS also try to develop new ideas and to disseminate them. For example, as noted below, over the last few years we have been doing a lot of work on the possible pro-cyclicality of liberalised financial systems and how such tendencies might be reconciled with other more desirable attributes of such systems.

Crisis Prevention

We at the BIS tend to think financial crises have become more common as the system has become more liberalised. In effect, we have moved back to a world similar to that which prevailed before World War I when commerce was global, capital flows were unrestricted and a high degree of economic volatility was the norm. The question that then arises is what might be done about this, using public policy or the influence of the public sector.

There are three different platforms at the BIS for addressing these problems, all using a cooperative approach. First, we have situated at the BIS groups like the Basel Committee that bring together national experts concerned about the health of financial institutions. The recent work of the Basel Committee, particularly on the Core Principles of Banking Supervision and on the New Basel Accord, needs no further elaboration here. Second, the Committee on the Global Financial System (CGFS) is

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another Basel-based committee, again made up of national experts, which worries about developments in financial markets. About two years ago the CGFS received a mandate from the G-10 Governors to start looking at financial vulnerabilities in a much more serious way. So now, in preparation for CGFS meetings, the staff of the BIS provides up-to-date statistics and analyses of market risks, credit risks and liquidity risks for financial markets in both the industrial and emerging market economies. The third platform supporting the international financial system is the infrastructure. Here, the Committee on Payments and Settlements Systems is playing a big role by helping to develop global standards.

With respect to all three platforms, an important task is motivating people in different countries to actually implement the international standards that will make their domestic financial systems more robust. In this endeavour, the World Bank and the IMF are playing a very useful role. Broadly put, reliance is being placed on the three incentive systems, or "pillars" that underlie the new Basel Capital Accord. First, people must be convinced it is in their own best interests to pursue reforms. Second, oversight from the official community and peer pressure can play a useful role. Finally, market discipline and the rating agencies can also give some impetus for countries to do the right thing.

At this conference, we have concentrated on the issue of crisis prevention at the regional level. One problem with this approach, in so far as the BIS is concerned, is that we have been working hard in recent years to become an institution with global reach rather than one which is primarily regional (European). In fact, we have made welcome progress over the last five or six years even if there is still much to be done. One thing to note is that, unlike the Fund, the BIS is not an organisation with universal membership. Rather, we can allow selective membership and, indeed, have done so by offering shareholder status to only some of the more important emerging market countries. We want global reach and global input to our discussions, but the issue is how meetings and discussions at the BIS can nevertheless be kept small enough to be efficient.

Of course, this approach still leaves us with an inclusion problem that we all recognise. One way we are trying to deal with this is by using cooperation with regional central banks more effectively than we have done in the past. We have opened a regional office in Hong Kong, and are planning to open one in Mexico City. This will facilitate direct contact between the BIS and regional central banks. The other thing we are trying to do is to interact more with existing groups whose purpose is to promote central bank cooperation in particular regions. In Latin America, the principal such group is the Centro de Estudios Monetarios Latinoamericanos (CEMLA). However, Asia (and to a lesser extent Africa) presents something of a political problem for us because of the multiplicity of regional central banking groups to which Amar and others alluded. Given certain rivalries, the issue of who to cooperate with takes on some importance. Nevertheless, we are proceeding as best as we can by dealing with all initiatives on the basis of their individual merits, and by trying to build on the strengths of the different groups as we see them.

Crisis Management

Crisis management is essentially the Fund's business. The principal way the BIS was drawn into it in the past was through so-called "bridge loans". These occurred when a country was expected to receive a drawing from the IMF, but there would be a technical delay before the money was actually disbursed. In such cases, the BIS would lend the money up front, subject to a takeout by the G-10 central banks (most of whom would be indemnified by their Treasuries). In recent years, as the Fund's disbursement process has improved, there has been much less need for this. In the past, it was also the case that some loans were made primarily for cosmetic purposes. There is now a greater understanding that such loans often offer no material advantage and can even be counterproductive.

Nevertheless, the experience that the BIS has had in negotiating bridge loans might still allow it to play a useful role in assisting initiatives to raise foreign exchange reserves in support of chosen exchange rate regimes. One possibility in this area would be regional initiatives like the Chiang Mai and ASEAN+3 arrangements. Another would be attempts to raise funds in addition to IMF lines. Consider the case of Korea in 1998, where the US Treasury tried to arrange such support bilaterally from many countries. These efforts did not succeed, in part because each participating country had grounds for concern that other countries were negotiating better deals than they were. Demanding, in the middle of a crisis, that the troubled country negotiate simultaneously with a very large number of counterparties was never a very practical proposition. An alternative might have been to use the multilateral templates and legal documents developed by the BIS. This would have ensured fair and transparent treatment of all those involved, and thus facilitated negotiations. This was the outcome when the BIS helped arrange multilateral support for Brazil in 1998. A further role for the BIS might be to provide protection, given its immunities, to the foreign exchange reserves of sovereigns in the midst of a liquidity crisis. Akin to the need for ongoing financing subject to Chapter 11 in the United States, this might be a further small contribution to improvements in how such sovereign liquidity crises are currently managed.

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Appendix

List of Participants in the Conference on "The Role of Regional Financial Arrangements in Crisis Prevention and Management: The Experiences of Europe, Asia, Africa and Latin America", held at the Czech National Bank in Prague on 21-22 June 2001.

Mr. Amar Bhattacharya	Senior Adviser, Poverty Reduction and Economic Management Network, The World Bank, Washington D.C.
Mr. Xavier Cirera	PhD in Economics Candidate, Globalisation Team, Institute of Development Studies, Brighton, Sussex
Mr. Oldřich Dědek	Vice Governor, Czech National Bank, Prague
Mr. Zdeněk Drábek	Senior Adviser, Economic Research and Analysis, WTO, Geneva
Mr. Heiner Flassbeck	Senior Economist, Division on Globalization and Development Strategies, UNCTAD, Geneva
Mr. Jan Frait	Member of the Board, Czech National Bank, Prague
Ms. Stephany Griffith-Jones	Professorial Fellow, Institute of Development Studies, Sussex University
Mr. Daniel Heymann	Coordinator, Area of Macroeconomic Analysis, ECLAC-Argentina, Buenos Aires
Mr. Miroslav Hrnčiř	Head of Economic Research Unit, Czech National Bank, Prague
Mr. Paul Jenkins	Chief, Finance Ministers' Meetings Policy Secretariat, International Trade and Finance Branch, Department of Finance, Ottawa

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Mr. Brian Kahn	Deputy Chief Economist and Head of the Monetary Policy Research Unit, South African Reserve Bank, Pretoria
Mr. Leslie Lipschitz	Deputy Director, Policy Development and Review Department, International Monetary Fund, Washington D.C.
Mr. Manuel Montes	Program Officer, The Ford Foundation, New York
Mr. José Antonio Ocampo	Executive Secretary, ECLAC, Santiago de Chile
Mr. Yung Chul Park	Ambassador for International Economy and Trade of the Korean Government, Professor of Economics at Korea University, Seoul
Mr. Jan Joost Teunissen	Director, Forum on Debt and Development, The Hague
Mr. János Vincze	Senior Economist, Research Department, National Bank of Hungary, Budapest
Mr. William White	Economic Adviser and Head of the Monetary and Economic Department, Bank for International Settlements, Basel
Mr. Charles Wyplosz	Professor of Economics, Graduate Institute of International Studies, and CEPR, Geneva

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