Why the Interest in Reform? Discussion

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I very much enjoyed reading the paper by Jane Little and Giovanni Olivei. It is good analytical work, and their exhaustive commentaries on the various views on the subject are pointed and noteworthy. They approach the question in the title of this conference from four directions, namely, the exchange rate regime, the treatment of capital flows, international lender of last resort facilities, and policy coordination. This is appropriate, because these four aspects encompass the most important elements that now compel us, in the aftermath of recent crises, to seriously reconsider any previous consensus about the international monetary system.

However, their conclusion that economists and policymakers still have a good deal of work to do before they can come up with the right prescription and a practicable work program is on the pessimistic side. That verdict leaves me feeling somewhat helpless. Crisis-ridden countries and regions urgently need a composite package of specific measures now, in order to cope with their problems in these four key areas. Many of the problems are of a universal nature, but some of them are country-specific or region-specific. The important need is to devise specific measures that are compatible with the orientations of different countries and regions within the globalized economy.

Rethinking the international monetary system has become a focus of global interest mainly as a result of the synchronized crises of 1998, which stemmed from the instability brought about by the East Asian Crisis of 1997. I would like to review briefly some relevant features of the four topics mentioned above in the context of the East Asian crisis, and to

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discuss some of the specific measures that, in my view, policymakers need to think about.

Exchange Rate Regime

It is fair to argue that in many crisis-ridden economies in East Asia, the rigidity of the exchange rate regime provided a feeding ground for distortion. Also, the sudden collapse of this rigidity resulted in an exaggerated disintegration of the economy concerned. The rigidity of the exchange rate regime inadvertently encouraged the influx of excess foreign capital, as it created the false impression of a government guarantee against exchange risk. It also left the economy concerned unprotected against changes in price competitiveness. It is now almost a consensus that the so-called "dollar peg," followed by many economies in the region, was the culprit causing the rigidity and is therefore to be blamed. And it is true that the "dollar peg" of crisis-hit economies worked to damage the economies concerned, as described above.

However, we have to recognize that the real culprit was not the "dollar peg" per se; rather, it was the factors that made the "dollar peg" a villain. I can cite two major factors. One is the internal disequilibrium of the economy concerned, and the other is the volatility of the dollar-yen exchange rate. Even under the fixed-exchange-rate Bretton Woods regime, a country was asked to alter its parity when there was a fundamental disequilibrium in its economy. Many crisis-hit economies in East Asia were experiencing disequilibrium, as demonstrated in a savings-investment gap, an inflation gap, or an interest rate gap, thus justifying greater flexibility of exchange rates. Unfortunately, those economies underestimated the dangers of rigidity, as they considered that the benefits of rigidity could outweigh the risks. At the same time, since countries in the region had to use two currencies, the dollar and the yen, they were faced with a wild fluctuation of the dollar-yen exchange rate that tended to induce sudden and involuntary changes in their competitiveness, thus exacerbating their disequilibrium. The dollar-yen exchange rate is primarily a bilateral issue between the United States and Japan. Some Americans even argue that it is a Japanese problem, because the dollar-yen exchange rate has much less importance for the United States than it has for Japan. However, I must point out that, at least until recently, it was the United States that tended to use the exchange rate, together with the threat of protectionism, as a tool of bilateral bargaining.

Therefore, I would argue, first of all, that small and open economies in the region have to be prepared to remain flexible in their exchange rate arrangements if incurable disequilibria are present in their economy. Equally important, the United States and Japan need to cooperate more seriously to achieve greater stability and predictability of the dollar-yen exchange rate. The so-called "basket approach" may ameliorate the damage of dollar-yen volatility, but the technical difficulty is significant and this approach will never entirely eliminate the damage.

Treatment of Capital Flows

The most immediate cause of the East Asian crisis was the sudden and massive reversal of capital flows. This distinguished the East Asian crisis as a "capital-account crisis" as opposed to a "current-account crisis." Of course, in order to understand the whole process of the crisis we have to explore why, in the first place, such a massive inflow of capital occurred, how the inflow distorted the internal macroeconomic balance, and what has triggered the reversal.

Yet we cannot deny that if capital flows had been better managed than they were, the severity of the crisis could have been greatly lessened. In this respect I have to note that industrial economies, including policymakers, business, academia, and the media, were too reluctant and too slow to recognize the importance and relevance of this issue. We should not easily forget the vicious accusations and the cynical mockery directed toward the Malaysian Prime Minister when he announced a capital embargo for his country, in a desperate effort to protect it from speculative capital flows. While I recognize that many doubts about the smooth recovery of the Malaysian economy remain, I must point out that Malaysia has managed to survive the wave of contagion without help from the International Monetary Fund, and it has already succeeded in coming back into the international capital market.

What we need now is international endorsement of a formula of sequenced capital liberalization, together with a package of emergency capital control measures. Market-friendly measures such as additional reserve requirements or differentiated interest rates would certainly be a preferable approach. Also, industrial economies can provide valuable advice derived from their own experiences. After all, however, it is the capital-importing country that must ponder the balance between merits and demerits of capital controls.

International Lender of Last Resort

When the crisis hit the East Asian countries, the first symptom was the acute shortage of foreign currency liquidity. Official reserves were depleted as the result of futile interventions. A sharp depreciation of the local currency swelled the debt service burden of banks and business firms enormously with unhedged foreign currency debt, thus seriously damaging their balance sheets. Currency crisis and banking crisis reinforced each other. Industries could not finance imports of vital materials, parts, and capital goods. Exporters could not obtain letter-of-credit facilities. Bankruptcies soared. In other words, the real sector of the economy crumbled.

When an economy encounters the onset of such a crisis, the most needed medicine is the ample and quick injection of liquidity in both foreign and local currencies. The national central bank is naturally expected to play the role of lender of last resort in local currency. The more difficult question is who should provide foreign currency liquidity. In the Mexican currency crisis of December 20, 1994, an international rescue package of $50 billion was in place by January 31, 1995. Unfortunately, however, in the case of the East Asian crisis such a rescue package did not materialize.

And I believe that it is unrealistic to expect that a Mexican-type rescue will always be available in future crises. Since that is the case, the remaining alternative is to establish a credit facility financed mainly by countries in the region, which have close ties of interdependence and thus a shared interest. Such a facility could well be a regional vehicle of the IMF, provided that regional members make majority contributions and hold majority voting rights to ensure a high degree of maneuverability, the key to the success of such a facility. Considering the $600 billion in official reserves held by countries in East Asia, I believe that East Asia could be a suitable place to try such an idea.

Policy Coordination

Nobody could have anticipated the onslaught of the East Asian crisis. In hindsight, we can argue that plenty of signals indicated the growing risks and worsening distortions in many countries. Nevertheless, there was no collective sense of concern to prompt preventive or corrective measures. It is indeed a painful reflection for all East Asian countries. Lack of reliable information and lack of transparency were certainly present. However, the major shortcoming was the lack of a forum where countries sharing common interests could conduct continuous economic surveillance and exchange among themselves fair and frank advice, with the aim of applying peer pressure where needed.

The G-7 countries have long endeavored to establish a framework of mutual surveillance and policy coordination. The experience of the East Asian crisis, however, has revealed that East Asia needs an additional forum, where dialogues more focused and more relevant to the situation in the region can be conducted. Such a forum could be established within the IMF as a subgroup of its Board of Governors or its Board of Executive Directors. International financial institutions and regional institutions could also participate. Such a forum could be assigned the study of how best to devise appropriate exchange rate arrangements, consolidate and improve settlement systems, and maintain healthy balance sheets at banks and business firms.

The Role of the International Monetary Fund

Last but not least, improving the functioning of the IMF is a particularly relevant issue when we discuss the reform of the international monetary system. Fifty years ago, the IMF was established as the guardian of the Bretton Woods regime. Its mission was clear. The IMF was to seek after exchange rate stability and balance of payments equilibrium. When the Bretton Woods regime collapsed and when exchange rate fluctuations and the free flow of international capital became facts of life, the original role of the IMF became irrelevant. In hindsight, we should have had a fundamental reappraisal and redefinition of the roles and responsibilities of the IMF at that time. Instead, under the pressures of urgency created by a series of events such as oil shocks, currency crises, the demise of the Cold War structure, and the like, the roles and responsibilities of the IMF have evolved through an incremental process, without a clear-cut redefinition. Now the IMF is functioning as a sort of all-purpose troubleshooter.

It can be argued that this was an inevitable development given the rapidly changing circumstances. However, it is also true that a sense of uneasiness has been growing about the lack of a clear definition of the IMF's role in the global economy. The uneasiness was intensified as the result of recent mistakes made by the IMF in its dealings with certain situations in crisis-hit countries. The lack of transparency and accountability on the part of the IMF has also been criticized.

My own conclusion is that this is not the right moment to try to overhaul the IMF, because we do not have even a sense of the direction in which the exercise should move. Having said that, I believe it is important, and also possible, for major shareholders to become more involved in the effort to improve the organization and functioning of the IMF, so that it can be more cognizant of the situations of member countries and can provide more effective services to them.