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Neil Dias Karunaratne*

Revisiting Capital Account Convertibility in the Aftermath of the Currency Crises

While there are a number of theoretical arguments in favour of capital account convertibility, or free cross-border capital mobility, in the real world cross-border trade in financial assets can in fact reduce welfare due to the effects of domestic distortions. The following paper examines the causes of the Asian financial crises of the late 1990s in this light and presents some of the lessons that would be instructive for a more effective implementation of capital account convertibility.

The Articles of Agreement of the International Monetary Fund (IMF) establishing the Bretton Woods System (BWS), a fixed exchange-rate regime, in 1944 guaranteed foreign exchange for the conduct of free trade in goods and services or current account convertibility (Article VIII). However, it permitted IMF member countries to impose capital controls to achieve balance of payments and internal stabilisation objectives (Article VI). Rapid globalisation or the integration of the world's economies through the symbiotic processes of trade liberalisation or freer cross-border trade in commodities, communication via new high-speed telecommunication and information technologies, and financial integration or freer cross-border trade in financial assets, has created pressures to remove restrictions on international capital mobility. The IMF has spearheaded the move to amend the BWS articles "to make promotion of capital account liberalisation a specific purpose of the Fund and give the Fund appropriate jurisdiction over capital movements" (Interim Committee of the IMF, 28th April, 1997). However, in mid-July 1997 a sudden reversal of capital inflows reduced overnight the East Asian economies that had been growing at miracle growth rates to recession economies. This dented somewhat the enthusiasm of the Fund for promoting rapid capital account convertibility among developing countries (DCs). In this paper the issue of capital account convertibility will be revisited, highlighting the lessons learnt from the aftermath of the recent financial crises, especially the Asian currency crisis.

The process of globalisation has witnessed a surge of capital flows to the emergent market developing countries. The total capital flows increased from an annual average of US\$ 30.5 bn in 1977-82 to a peak of US\$ 240.8 bn in 1996. The composition of the capital flows also changed and bank lending, which had dominated capital flows, was replaced by dominant flows of net foreign direct investment and portfolio capital flows. Furthermore, the regional distribution of capital flows shows that in the mid-1990s before the Asian crisis the Asian region emerged as the main magnet for global capital flows (see Table 1).

These capital inflows fuelled the miracle growth rates of the East Asian economies. Some of these emergent economies were converging or catching up with the per capita income levels of the advanced countries as predicted by neoclassical growth theory¹ but on the other hand low-income countries were diverging or lagging behind. The process of financial globalisation has also increased the frequency of financial crises and speeded up crisis contagion or the spillover of adverse effects to other countries in the region. Regional crisis contagion poses a threat to the systemic stability of the world financial system. Therefore, some have argued that the process of financial globalisation should be reversed: "...we will have to turn the clock at least part of the way back: to limit capital flows to countries that are unsuitable for

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¹ R. Solow: A Contribution to the Theory of Economic Growth, in: Quarterly Journal of Economics, February 1956, pp. 65-94.

Table 1
Anatomy of Capital Flows to Emerging Markets
(Annual averages, US \$ billion)

	1977-82	1983-89	1990-94	1995	1996	1997
Total capital flow	30.5	8.8	120.8	192.0	240.8	173.7
Composition of capital flows						
Net foreign direct	11.2	13.3	46.2	96.0	114.9	138.2
Net portfolio	-10.5	6.5	61.1	23.5	49.7	42.9
Other (bank lending)	29.8	-11.0	13.5	72.5	76.2	-7.3
Regional distribution of capital flows						
Asia	15.8	16.7	40.1	95.8	110.4	13.9
West	26.3	-16.6	40.8	35.7	80.5	91.1
Other	-11.6	8.7	39.9	60.5	50.0	68.8

Sources: IMF: World Economic Outlook, October 1995 and May 1998.

either currency unions or free floating".² The same sentiments were echoed earlier when advocating "throwing sand on the wheels of international finance" or the imposition of transactions tax to limit short-term capital inflows and outflows.³ This type of "simple one parameter tax would automatically penalise short-horizon round trips, while negligibly affecting incentives for commodity trade and long-term capital investments".⁴ Furthermore, it is contended that such a tax would reduce exchange-rate volatility by favouring Fundamentalists rather than the short-term extrapolative speculative activities of the Chartist.⁵

DCs that open capital accounts will have to manage short-term capital inflows which have a tendency to reverse rapidly generating severe economic disruption. Thus while financial globalisation has increased the pressures for opening up capital accounts, the recent financial crises have brought home the lesson that capital account liberalisation should be sequenced by other structural reforms in the domestic economy and also by reforms in the international financial architecture so as to reduce the frequency of financial crises and the virulence of crises contagion.⁶

The collapse of BWS in 1971 and the surge of short-term portfolio capital flows to developing countries (DCs) particularly in the 1990s, where

capital flows trebled from \$50 billion to \$150 billion in a short span of five years up to 1996 resulted in benefits and also created challenges for DCs. The rapid capital inflows resulted in the miracle growth rates of the high performance Asian economies.⁷ But at the same time the currency crises such as the ERM crisis (1992), the Mexico crisis (1994) and the Asian crisis (1997) revealed that capital inflows can dramatically reverse, plunging miracle growth economies into recession economies overnight. The increasing volatility of capital flows and the virulence of crises and contagion effects due to sudden capital flow reversals has revived the debate on the need to control cross-border capital flows to DCs and reduce their disruptive effects and rapid contagion.

This paper examines the phenomenon of increasing cross-border capital flows and analyses the case for and against capital account convertibility. It reviews the pros and cons of capital account convertibility by reviewing the theoretical arguments for the first-best case for capital account liberalisation and comparing it with the second-best case for capital controls. The issue of sequencing and speed of capital account liberalisation and the pre-conditions that have to be met to achieve sustainable capital account convertibility are reviewed. We then provide a typology of currency crises that have occurred in the 1990s in terms of generation models. This typology will identify the proximate causes that

² P. Krugman: A model of balance of payments crises, in: *Journal of Money, Credit and Banking*, Vol. 11, 1998, pp. 311-325.

³ J. Tobin: A Proposal for International Monetary Reform, in: *Eastern Economic Journal*, Vol. 4, 1978, pp. 153-59.

⁴ J. Tobin: Prologue, in: M. ul Haque, I. Kaul and I. Grunberg (eds.): *The Tobin Tax: Coping with Financial Volatility*, Oxford University Press 1996, pp. xiv-xviii.

⁵ J. Frankel: How Well Do Foreign Exchange Markets Function: Might A Tobin Tax Help?, NBER Working Paper No. 5422, 1996.

⁶ S. Fischer: Reforming the International Financial System, in: *Economic Journal*, Vol. 109, November 1999, pp. F557-567.

⁷ World Bank: *The East Asian Miracle: Economic Growth and Public Policy*, New York 1993, Oxford University Press.

have triggered the various generations of currency crises unleashing regional contagion and posing systemic threats to the stability of the global financial system. The paper focuses next on links between the financial and corporate sectors that caused the Asian financial crisis and underscores the need for setting up sound prudential regulation frameworks to overcome financial sector fragility. We discuss the need for more appropriate IMF policies for responding to financial crises in the context of globalisation and the issues relating to the reform of the global financial architecture, in order to address issues related to capital flow reversals and resulting crises. In conclusion, some of the lessons that would be instructive for the effective implementation of capital account convertibility are presented.

Pros and Cons of Capital Account Convertibility

In a domestic distortion free, first-best world, free capital mobility or capital account convertibility (KAC), like free trade, would lead to the efficient allocation of resources and would be welfare maximising. Some trade theorists contend that the theorems on the gains of free trade in commodities are also valid for the inter-temporal trade in financial assets.⁸ But others argue that information asymmetries and other distortions undermine the validity of gains from trade theorems in relation to trade in financial assets or capital mobility because they create welfare-reducing moral hazard and herding behaviour.⁹

Nonetheless, on a theoretical plane several arguments can be tendered in favour of capital account convertibility or free cross-border capital mobility:

- ☐ Free capital mobility or KAC will lead to allocative efficiency that would in turn maximise the welfare of the asset trading nations in a manner analogous to free trade and is the best proposition amongst nations that conduct free trade in goods and services.
- ☐ KAC will also facilitate the access to the global pool of savings by savings-constrained DCs, thus bridging the savings-investment or the resource gap and contributing to increased investment and growth.

☐ KAC promotes risk-spreading and maximises the risk-adjusted returns by the international diversification of asset portfolios.

☐ KAC allows inter-temporal consumption smoothing in the context of the business cycle.

☐ KAC exposes the economy to the discipline of the international markets by censoring imprudent policies by rapid capital inflow reversals. Relevant surveys of the first-best case for KAC are found in the papers by Dooley¹⁰ and Fischer.¹¹

The real world cross-border trade in financial assets is riddled with market failure or domestic distortions. In such a second-best world, free capital mobility or KAC can reduce welfare due to the effects of domestic distortions. These distortions could be classified broadly into distortions due to information asymmetries and non-information factors.

Unequal access to information or information asymmetry creates several distortions and manifests itself in capital account transactions. These distortions are:

☐ Adverse selection because borrowers have more information about the viability of a project than lenders and this leads lenders to select inferior projects, resulting in sub-optimal investment decisions.

☐ Moral hazard problems where investors engage in risky behaviour and pass on the cost of failure to third parties such as the tax-payer.

☐ Herding or panic behaviour as some investors ignore fundamentals and blindly follow market leaders on the premise that they have superior information, although asymmetric information is an intrinsic characteristic of financial transactions.¹²

Nonetheless the adverse welfare effects of these information asymmetries can be mitigated by designing institutional mechanisms that require the implementing of prudential supervision, transparency in decision-making, best practice accounting and good corporate governance of the intermediaries engaged in financial transactions.

The non-information distortions that would caution against KAC in a second-best world are :

⁸ M. Obstfeld and K. Rogoff: *Foundations of International Finance*, 1996, MIT Press.

⁹ J. Bhagwati: *The Capital Myth: The Difference Between Trade in Widgets and Trade in Dollars*, in: *Foreign Affairs*, Vol. 77, 1998, pp. 7-12; R. N. Cooper: *Should capital account convertibility be a world objective?* in: *Should the IMF pursue Capital Account Convertibility : Essays in International Finance*, No. 207, Princeton University, 1998, Princeton University.

¹⁰ M. P. Dooley: *A survey of the literature on controls over international capital transactions*, in: *International Monetary Fund Staff Papers*, Vol. 43, 1996, pp. 639-87.

¹¹ S. Fischer: *Capital account liberalization and the role of the IMF*, in: *Should the IMF Pursue Capital Account Convertibility*, op. cit.

¹² B. Eichengreen et al.: *Capital Account Liberalisation. Theoretical and Practical Aspects*, Occasional Paper 172, International Monetary Fund, Washington DC 1999.

- ☐ Fiscal distortions such as high taxes that would result in capital flight from the domestic economy in search of higher returns abroad.
- ☐ Legal distortions due to the absence of well-defined property rights, again encouraging capital flight in search of better overseas pastures.
- ☐ Trade distortions where free capital mobility may encourage the adoption of inappropriate capital intensive techniques in labour-abundant DCs.
- ☐ The provision of a breather to implement structural adjustments leading to the reduction of distortions.
- ☐ In the context of multiple equilibria, capital account controls could also be shown to be a first-best response.¹³

These second-best arguments for capital account controls due to non-information distortions are discussed further in Dooley.¹⁴

The pros and cons of KAC point out that there are benefits and costs from liberalising cross-border capital flows. At the practical policy level the issue of KAC rests on establishing pre-conditions that will maximise net benefits from implementing full convertibility and these require the establishment of a sound financial system and the pursuit of sound macroeconomic policies. KAC under a fragile financial system can lead to over-borrowing and build up short-term debt in terms of unhedged foreign currency liabilities. It can also result in the channelling of these borrowings to risky projects when the financial system lacks prudential supervision and is plagued by connected lending or crony capitalism. The pursuit of imprudent macroeconomic policies can lead to the provision of implicit guarantees under a fixed exchange-rate regime which can lead to a lending boom and investment in risky projects. This would also render the economy highly vulnerable to exogenous shocks such as devaluation. A devaluation could erode its creditworthiness or rating due to the increased cost of its external liabilities denominated in local currency. The recent currency crises which will be discussed below reveal that KAC in the absence of the pre-conditions provided a fertile ground for breeding a financial crisis.

At the practical policy level, when implementing KAC the issues of sequencing and the speed of liber-

alisation have to be addressed.¹⁵ It has been argued that because asset markets react more speedily to liberalisation than commodity markets if KAC preceded current account convertibility (CAC) then the inflow of capital would cause an appreciation of the real exchange rate to undermine the trade liberalisation of the CAC process.¹⁶ However, others contend that KAC would lead to inflows of resources that could facilitate adjustment in such manner that will neither be inflationary nor lead to the appreciation of the real exchange rate resulting in the loss of the country's international competitiveness.

In the contemporary globalised financial world countries that adopted open capital accounts or KAC such as the advanced countries or the OECD countries and East Asian economies experienced miracle growth rates, whilst countries in South Asia and other DCs that had capital controls stagnated. Capital inflows through transnational corporations (TNCs) transferred to DCs the magic package of scarce capital, technology, managerial skills and other firm specific assets that were needed to ignite the process of rapid investment and growth. The Asian growth miracle is arguably attributable to the adoption of KAC by East Asian economies to finance and implement their export-led growth strategies, whilst other DCs that adopted capital controls and inward-looking import substituting industrialisation strategies stagnated.

The main types of capital controls have been either exchange-rate controls, dual exchange rates and taxes on short-term capital flows or non-interest bearing deposit requirements for short-term capital flows. These controls have been justified on the grounds of redressing disequilibria in the balance of payments, the need to retain domestic savings, the need to prevent the erosion of the domestic tax-base and in order to avoid jeopardising stabilisation and structural reform programmes.¹⁷

The countries with open capital accounts also exposed themselves to risks of currency crises caused by massive short-term capital flow reversals due to sudden changes in market sentiments. The

¹³ S. Fischer, *op. cit.*

¹⁴ R. McKinnon: The Order of Economic Liberalization: Lessons from Chile and Argentina, in: K. Brunner and A. Meltzer (eds.): *Economic Policy in a World of Change*, Carnegie-Rochester Conference Series on Public Policy, Amsterdam 1982, North-Holland, pp. 159-71.

¹⁵ D. J. Mathieson and L. Rojas-Suarez: *Liberalization of the Capital Account. Experiences and Issues*, in: International Monetary Fund: Occasional Paper No. 103, Washington, DC 1993.

¹⁶ M. Obstfeld: Models of currency crises with self-fulfilling features, in: *European Economic Review*, Vol. 40, 1996, pp. 1037-1047.

¹⁷ M. P. Dooley, *op. cit.*

casino economy generated by the sudden capital flow reversals has been highly disruptive from both growth and social welfare standpoints. Nonetheless, the countries with KAC experienced faster growth rates and achieved higher living standards than their counterparts that closed the doors to capital inflows and experienced relative stagnation. In this context the empirical studies which find that countries which adopted capital controls did not experience adverse macroeconomic performance¹⁸ are somewhat puzzling, and their results could be attributed to the use of simple dummy variables that do not capture the true nature of the intensity of capital controls.¹⁹

A Typology of Models

A study of the anatomy of recent currency crises could shed light on the factors that precipitate speculative attacks causing the collapse of the currency peg and unleashing domestic financial turmoil and regional crisis contagion. The models of currency crises that occurred in the 1990s could be classified into three generation models following the classification of Flood and Garber.²⁰

The first-generation, or canonical, model of currency crises is based on the experience of the Latin American countries during the late 1970s. The currency crises were precipitated by expansionary fiscal policies that resulted in massive budget deficits. The monetisation of the deficits led to an exhaustion of foreign exchange reserves and precipitated a collapse of the exchange-rate peg.²¹ The first-generation model focuses on deteriorating macroeconomic fundamentals leading to a sudden reversal of capital and a collapse of the exchange-rate peg. The macroeconomic fundamentals in East Asia were sound and these countries were managed prudently and therefore the first-generation models do not explain the occurrence of the East Asian financial crisis.

The second-generation models abstract from the experience of the Exchange Rate Mechanism (ERM) crisis (1992) and the "tequila crisis" that originated in Mexico (1994). The collapse of the peg is linked to

rational self-fulfilling expectations that result in multiple equilibria. Such multiple equilibria models are analogous to bank-run models where self-fulfilling expectations switch a good equilibrium (no bank run) into a bad equilibrium (bank run) or vice-versa due to changes in market sentiment.²² In these second-generation models the policymakers compare the benefits of maintaining the peg with the costs of a devaluation and abandon the peg for short-run macroeconomic policy gains. Often self-fulfilling actions facilitate the switch from one equilibrium to another as explained in the self-fulfilling multiple equilibria models.²³ Nonetheless, these self-fulfilling expectations multiple equilibria models of speculative attacks fail to explain the events that underpin the Asian currency turmoil that occurred in mid-1997.

Third-generation models attempt to stylise the causal mechanics precipitating the Asian currency crisis that began with the collapse of the Thai bhat in mid-1977. In the first version of the third-generation model, it is postulated that implicit government guarantees encouraged moral hazard behaviour by financial intermediaries who engaged in "Panglossian over-borrowings" in unhedged foreign currency. These borrowings were facilitated by connected lending due to the operation of crony capitalist links between banks and industry. The investments were channelled into risky real estate and asset purchases, fuelling an asset price bubble that was destined to burst and trigger a massive capital inflow reversal.²⁴ This moral hazard behaviour exhibited by international investors was tantamount to organised theft.²⁵

In a second version of the third-generation model, capital inflows under implicit guarantees are channelled into risky projects in the absence of prudential regulation by the banking and financial system. A sudden liquidity crisis, caused by an exogenous shock, triggers panic and herd behaviour among lenders as they scramble to recall their short-term loans by refusing to roll over their debts. This converts a liquidity crisis into an insolvency crisis and

¹⁸ D. Diamond and P. Dybvig: Bank Runs, Deposit Insurance and Liquidity, in: *Journal of Political Economy*, Vol. 91, 1983, pp. 401-409.

¹⁹ M. Obstfeld, *op. cit.*

²⁰ P. Krugman: What happened in Asia?, mimeo 1998. <http://web.mit.edu/krugman/www/DISINTER.html>.

²¹ M. P. Dooley: Are Recent Capital Inflows to Developing Countries a Vote for or Against Economic Policy Reform?, in: P. Agenor, M. Miller, D. Vines and A. Weber (eds.): *The Asian Financial Crisis. Causes, Contagion and Consequences*, Cambridge 1999, Cambridge University Press, pp. 112-123.

¹⁸ D. Rodrik: Who Needs Capital-Account Convertibility, in: *Should the IMF Pursue Capital Account Convertibility*, *op. cit.*, pp. 55-65.

¹⁹ S. Edwards: How Effective Are Capital Controls?, NBER Working Paper 7413, 1999.

²⁰ P. Flood and N. Marion Garber: Perspectives On The Recent Currency Crisis Literature, NBER Working Paper No. 6380, 1998.

²¹ P. Krugman: A Model Of Balance Of Payments Crisis, in: *Journal of Money, Credit and Banking*, Vol. 11, 1979, pp. 311-323.

results in a sudden reversal of capital inflows precipitating a full blown financial crisis.²⁶

The exogenous shocks that converted a liquidity crisis to an insolvency crisis that led to the collapse of the currency peg in the East Asian economy manifested itself in several forms such as: an appreciation of the US dollar to which the Asian currencies were pegged; the depreciation of the yen and the recession in Japan; the entry of China into the world market as an export competitor; and the oversupply of electronic goods – leading to the erosion of competitiveness and loss of export volume and revenue by the Asian economies in the build-up to the crisis in 1997.²⁷

The Asian financial crisis was not the upshot of the weakening of macroeconomic fundamentals due to policies that were inconsistent with the currency peg, as assumed in the first-generation models; nor was the crisis the result of self-fulfilling expectations converting a no-run equilibrium to a run equilibrium, but rather it was due to speculative attacks on the currency peg that brought about a sudden reversal of

capital flows due to financial sector fragility as highlighted in the third generation models.

Financial and corporate sector weaknesses played a critical role in precipitating the Asian crisis in 1997. These weaknesses increased the vulnerability of financial institutions to exogenous shocks. The existence of information and non-information distortions contributed to the magnification of the adverse effects of these shocks leading to panic behaviour among foreign lenders. They withdrew their funds regardless of the state of the fundamentals and the massive capital flow reversals led to the regional contagion of the crisis and threatened the stability of the global financial system.

Need for Structural Reforms

The recent currency crises offer a number of lessons for policymakers committed to reducing of the frequency of financial crises in order to mitigate the adverse effects of regional crisis contagion.

The need for structural reforms in the domestic financial and corporate sectors and the pursuit of sound macroeconomic policies are fundamental if a country is to open its capital account and benefit from capital inflows. Structural reforms should include the phasing out of nonviable financial institutions, and establishing procedures for recapitalising and reinforcing viable institutions. Besides, the corporate sector needs to be restructured by improving

²⁶ S. Radlet and J. Sachs: The East Asian Financial Crisis: Diagnosis, Remedies and Prospects, in: *Brooking Papers on Economic Activity*, 1998, No. 1, pp. 1-90.

²⁷ J. Corbett and D. Vines: The Asian Crisis: lessons from the collapse of the financial system, exchange rates, and macroeconomic policy, in: P. Agenor et al., op. cit., pp. 67-110.

Ooi Su-Mei

Globalisation and Security: The Role of International Financial Institutions in Pacific Asian Security

In 1997/98, an unprecedented crisis hit the economies of hitherto prospering East Asian countries such as Thailand, Indonesia, Malaysia, and South Korea. With the exception of Malaysia, the International Monetary Fund (IMF) was called in to offer support. The Fund's rescue packages included severe conditions for both macro-economic and micro-economic adjustment, some of which had far-reaching consequences for economic, legal, and even political systems and have subsequently been criticised in certain quarters for sharpening rather than containing instabilities.

This monograph looks into the impact of IMF (and World Bank) conditionality on the internal and external stability of affected countries as well as on regional cooperation and draws conclusions as to the relevance of security considerations in the context of the reform of international financial institutions.

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prudential regulation and supervision and enforcing market discipline.²⁸ Capital account liberalisation "without first strengthening the prudential framework (is) a recipe for disaster".²⁹

The Asian financial crisis was precipitated by the weaknesses in the financial and corporate sectors. The formal and informal currency pegs, which led to unhedged borrowing, fuelled the rapid credit expansion and led to asset price inflation. The inflated asset prices stimulated further capital inflows under weakly supervised non-bank financial intermediaries. The highly leveraged corporate sector and large unhedged short-term debt made these economies vulnerable to sudden changes in market sentiment or changes in interest rates. Besides, weak accounting standards, poor loan valuation and disclosure practices masked the growing vulnerabilities from policymakers. The structural reforms to avoid the recurrence of crises need to address these deficiencies and also the deficiencies in assessing country risk on the part of the lenders. The Asian financial crisis has highlighted the links between financial sector fragility and macroeconomic stability. Highly leveraged corporate sectors with massive unhedged short-term corporate debt denominated in foreign currency exposed the economy to foreign currency risks, especially under pegged exchange rates. The need for prudential regulation to avoid these pitfalls has to be underscored as one of the important lessons from the recent crises.

Exchange-rate Risk

In the Asian currency crisis the foreign investors had misjudged the extent of exchange-risk by effectively presuming that many Asian central banks were bearing the foreign exchange-rate risk by maintaining the pegged exchange rates. For decades preceding the crisis the central banks of the five Asian countries had provided domestic borrowers and foreign lenders alike with a measure of exchange-rate certainty as well as flexibility. As a result capital flows responded strongly to interest-rate differentials and foreign borrowings remained unhedged against the possibility of large currency depreciations. Government ownership of many Asian banks also signalled implicit government guarantees against default. This

encouraged foreign lenders to underestimate the default risk, thus creating a moral hazard problem of too much borrowing and lending. From the foreign lending side there was another moral hazard effect that arose from the expectation that the IMF might bail out creditors in the event of a collapse. The IMF bailouts encourage excessive international borrowing and lending activity and re-enforce the problem of moral hazard because the default risk associated with such an activity may be underestimated by the IMF. Hence the IMF bailout assistance effectively subsidises those foreign lenders with long-term loans who are unable to liquidate their assets quickly and would otherwise have lost funds through careful default action. Moreover, loan default would teach financial institutions such as banks and mutual funds operating globally to assess the fundamentals of foreign economies more carefully.

The Need for Better IMF Policies

The IMF under Article I is empowered to rescue member nations engulfed in a balance of payments crisis by providing a liquidity lifeboat or emergency funding to restore confidence and arrest capital inflow reversals. In the case of the Asian currency crisis the IMF prescribed the orthodox medicine of expenditure reduction or fiscal contraction and expenditure switching or a devaluation to remedy the currency crisis. However, the core issue precipitating the currency crisis lay in the market perception that the Asian economies were in the grip of sovereign insolvency.

The IMF, as lender of last resort during the Mexico crisis (1994), combined with the US Treasury and the G-10 countries to provide a massive bailout package to restore market confidence and reverse capital outflows. However, in the previous Latin American financial crises in the 1970s the partial defaults on sovereign debt and "disorderly" debt workouts had resulted in deadlock and a lost decade of development for Latin America. In the Asian currency crisis, Thailand and South Korea opted to follow the Mexican solution and give blanket guarantees on repaying the foreign debts. However, Indonesia, which had massive unhedged corporate debts to foreign lenders, defaulted. This has inflicted economic chaos and unprecedented social trauma in Indonesia. The Asian experience underscores the need for the establishment of bankruptcy procedures involving standstills on payments to lenders. The injection of liquidity and orderly debt workouts to avoid massive capital inflow reversals has to be addressed. There is a need

²⁸ C. Lindgren, T. J. T. Balino, C. Enoch, A. Guide, M. Quintyn and T. Leslie: *Financial Sector Crisis and Restructuring. Lessons from Asia*, Washington DC 1999, International Monetary Fund.

²⁹ M. Goldstein: *The Asian Financial Crisis: Causes, Cures and Systemic Implications*, in: *Policy Analyses in International Economics*, Vol. 55, Washington, DC 1998, Institute for International Economics.

for a provision such as that of Chapter 11 of the US Bankruptcy Code in the international arena.

This requires a revamping of the IMF's role as lender of last resort and collaboration with the World Bank to establish a new financial architecture that will address not only the debt default issues, but also issues related to the frequency and virulence of currency crisis contagion.

Restructuring of the Global Financial Architecture

The sudden and ferocious nature of the Asian financial crises revealed that the IMF had been napping on its Article IV surveillance and crisis monitoring functions. The IMF is now busily engaged in attempts to close the stable door after the steed has bolted. Nonetheless, the initiatives taken by the IMF now will help to mitigate the virulence of inevitable future crises in a world of increasing capital mobility.

Among the attempts to restructure the global financial architecture strengthening the effectiveness of the lender of last resort (LOLR) function is a keystone in the architecture. To this end the IMF has introduced the supplementary reserve facility (SRF) which requires sound macroeconomic policies and the implementation of best practice surveillance standards. Furthermore, a contingent credit line (CCL) has been established to provide quick relief to countries afflicted by crisis contagion.

On a broader front the effectiveness of the LOLR function will depend on the removal of the major weaknesses of the present financial architecture in relation to surveillance, prudential regulation and transparency, and standards and best practice accounting. Furthermore, the establishment of bankruptcy procedures in the case of sovereign default to avoid debt workout deadlocks is imperative as cross-border capital flows are increasingly private rather than public. The involvement of the private sector in debt restructuring and crisis resolution and in the implementation of good corporate governance would contribute to the minimisation of moral hazard due to speculative risk-taking.

The IMF, by providing blanket guarantees to honour sovereign bailouts, may fulfil its role as LOLR at the expense of the tax-payers of the crisis economy. It is imperative that the moral hazard resulting from giving blanket bailout guarantees be countermanded by appropriate institutional reforms, so that the IMF will preserve its integrity as an LOLR rather than become

an international debt collector for the international creditors of DCs.

Lessons for Capital Account Convertibility

The above review of the recent Asian currency crises proffers several lessons that would be useful for the effective implementation of capital account convertibility. First, the fragile domestic financial system should be reformed and placed on a sound basis, so that its capacity to prudentially regulate the large inflow of capital under an open capital account is strengthened. Second, capital account convertibility should be preceded by the establishment of sound macroeconomic fundamentals by pursuing policies of fiscal sustainability and price stability. For example, in the presence of large fiscal deficits open capital accounts present a window for financial intermediaries to engage in external borrowing that would lead to the accumulation of foreign debts. Third, under the exchange-rate flexibility that is inevitable under a liberalised capital account, monetary policy design needs to fill the gap left by abandoning the nominal exchange-rate anchor. In this connection inflation targeting could play a role. It could provide the policy credibility and obviate the need for large interest-rate hikes and exchange-rate devaluations which could turn a good equilibrium into a bad equilibrium and convert a crisis into collapse as was observed in the Asian crisis. Fourth, the IMF should lift its game on surveillance under Article IV and establish a better modelling of crisis vulnerability and early warning systems of impending crises. The IMF in its General and Special Data Dissemination Standards (GDDS and SDDS) is addressing the issue. Furthermore, other institutions such as the Bank for International Settlements (BIS) under the Basle Core Principles (BCP) review the capital adequacy requirements which bias capital flows against long-term maturity flows and in favour of short-term maturity flows. Fifth, the private sector should be involved in debt-restructuring, corporate governance and risk assessment so as to minimise the moral hazard of risky lending under implicit IMF bailout guarantees. Sixth, the Fund should coordinate its micro functions of surveillance and prudential supervision with the macro institution-building functions of the Bank to avoid potential conflicts. Because of the prospect of massive capital inflows after capital account convertibility the gap between the rich and poor in the economy could widen, unleashing political tensions. The issue of equity should therefore be addressed. In this regard the IMF poverty reduction growth facility (PRGF) is a step in the right direction.