

# IS THERE A CASE FOR AN ASIAN MONETARY FUND?

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## 1. INTRODUCTION

The East Asian financial crisis has spawned a number of proposals for institutional reform. Some of these envisage reforming existing institutions, particularly the International Monetary Fund (IMF), while others suggest that new institutions are needed either to stand alongside the IMF or to replace it.

Just as multilateral trade reform and multilateral trade institutions have been joined by an increasing array of regional trading arrangements, so it has also been suggested that regional financial crises may be better handled by regional monetary funds. Specifically, the Asian financial crisis has focused attention on the idea of establishing an Asian Monetary Fund (AMF). In general terms, this idea raises many of the issues associated with the debate over *regionalism* versus *multilateralism* in the trade arena. Are the two approaches inconsistent or mutually re-enforcing? Could regional arrangements act as “stumbling blocks” in the way of multilateral reform or as “stepping stones” towards it? Will regional monetary “blocs” encourage aggressively “beggar-thy-neighbor” policies and generate conflict between regions as compared with the consensus approach of multilateral institutions? Would an AMF give member countries a louder voice in international monetary reform? What could an AMF do that the IMF could not?

These issues are difficult to resolve definitively since they are affected by a complex combination of economic and political factors. Just as some claim that regional trade arrangements, such as the European Union (EU) and the North American Free Trade Agreement (NAFTA), are fundamentally about politics, it is difficult to imagine that

politics are not also involved in the arguments for and against monetary and financial regionalism.

However, to evaluate any policy proposal it is necessary to have a clear understanding of the underlying economic issues involved. This article sets out to identify and assess the arguments for and against establishing an AMF in particular and regional monetary funds in general.

The lay out is as follows. Section 2 provides the background to the proposal for establishing an AMF, and briefly discusses the variations that there have been on a similar theme. Section 3 identifies and assesses the basic issues that underlie the idea. Section 4 attempts to delineate a specific role for an AMF in the context of current international monetary reform. Section 5 briefly assesses the logical justification for a regional approach to currency crises prevention. Section 6 offers a few concluding remarks, touching on the relationship between an AMF and the IMF.

## **2. THE BACKGROUND**

Proposals for institutional reform generally reflect the perception that existing arrangements are not working satisfactorily. The proposal to establish a regional monetary fund in Asia reflects dissatisfaction with the way in which the IMF handled the East Asian financial crisis. Elements of this dissatisfaction include the claim that the IMF misdiagnosed the causes of the crisis and came up with an inappropriate set of policy prescriptions. The essence of the argument is that the Fund laid too much blame at the

door of the so-called “Asian development model” (though this model has never been precisely defined), and, as a consequence, called for excessively far reaching reforms covering a wide range of economic activity. It is also claimed that the IMF enhanced the recessionary consequences of the crisis by treating an unconventional (capital account) balance of payments crisis with conventional macroeconomic management measures (particularly fiscal retrenchment). On top of this, critics charge that the IMF moved too slowly in terms of organizing and disbursing financial assistance to the crisis-hit economies<sup>1</sup>.

More generally, and at a systemic level, critics of the IMF have argued that, during the 1990s, it has been ineffectual in helping to prevent crises, it has been unable to deal adequately with the problem of capital volatility, and it has exploited its monopoly position to both widen and deepen its conditionalities in ways that may be counter-productive, since excessive conditionalities undermine a government’s ownership of and commitment to the reform of economic policy.

Where the IMF has put together large financial packages, these have drawn in the main on non-IMF money and have relied on contributions from other sources which have a specific regional interest - the US in the case of the Mexican peso crisis of 1994-95 and Japan and other East Asian economies in the case of the East Asian crisis. Critics perceive such arrangements as ad hoc, unreliable and sub optimal.

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<sup>1</sup> For an elaboration of these criticisms of the IMF, see, for instance, Martin Feldstein, “Refocusing the IMF”, Foreign Affairs (March/April 1998) and Jeffrey Sachs, “The IMF: A Power unto Itself”, Financial Times (December 11, 1997) and “The Wrong Medicine for Asia”, The New York Times (November 3, 1997).

To criticize the IMF is of course not necessarily to advocate an AMF. To make this transition it has to be believed that the perceived deficiencies of the IMF are unlikely to be corrected by internal reform of the organisation and that they would be better overcome by establishing an AMF. Advocates of this solution might suggest that the domination of the IMF by industrial countries mitigates against any reforms other than those that are seen as having a fairly direct pay-off for the richer economies of the world. Indeed, the spread of conditionalities have sometimes been presented as serving the interests of the industrialized countries that are anxious to gain improved access to markets in emerging economies and to exploit investment opportunities world wide, rather than the interests of client countries in which the reforms are pursued.

Moreover, a global institution such as the IMF is only likely to be reformed if there is a global crisis and if there is a reasonable consensus about the lessons that may be learned from it. While the East Asian crisis did threaten to turn global, in actuality it did not. A resident of Thailand, Korea, Indonesia or Hong Kong would therefore regard the East Asian crisis in a very different way than a resident of the US or the EU. From an industrialized country perspective the East Asian crisis was a crisis that was by-passed; so why reform the IMF? From an Asian perspective the crisis occurred head on. But it is the very containment of the crisis that reduces the probability of reforming the IMF and thereby increases the appeal of an AMF (at least for as long as the crisis is reasonably fresh in the Asian memory).

Although early proposals for an AMF, coming from the Japanese government in September 1997, were opposed strongly by the US and appeared to have been dropped, the proposal re-emerged at the East Asian Summit organized by the World Economic Forum in Singapore in October 1999. In November 1999, ASEAN ministers discussed the idea at an informal summit in Manila. A view that little progress has been achieved in reforming the international financial architecture has further re-ignited the debate about an AMF<sup>2</sup>.

The precise form that an AMF would take varies across the specific proposals. The original Japanese proposal envisaged its role as being one of making available a pool of funds that would be disbursed quickly to provide emergency balance of payments support to countries in crisis. A related proposal by Malaysian prime minister, Mahathir Mohamad, envisages a wider role. Here an AMF would be a:

a small compact wholly regional funding organisation which would be deeply and constantly engaged in East Asian monetary co-operation and problems on a daily basis<sup>3</sup>.

### **3. EXAMINING THE CASE FOR AN AMF: UNDERLYING ISSUES**

What comparisons might be made between an AMF and the IMF? Clearly an AMF would not have a systemic role, although it might still contribute to systemic stability. Instead its role could, in principle, be to fulfil a regional financing and adjustment function. By holding, or being able reliably to mobilize a pool of resources, it

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<sup>2</sup> For progress to date – or lack thereof – of steps towards reforming the international financial architecture, see Barry Eichengreen, “Strengthening the International Financial Architecture”: Where do we Stand”, paper prepared for the East-West Center Workshop on International Monetary and Financial Reform, Honolulu (October 1-2, 1999).

could provide more predictable support to countries in crisis. Uncertainty about the availability of financing could be reduced and this could help contain crises by creating confidence. In the cases of both the recent Mexican and East Asian crises, the IMF was able to orchestrate packages of financial support, but these were put together in the midst of each of the crisis. The financing was not in place before the event<sup>4</sup>. The related uncertainties contributed to instability

Moreover, a system that relies on a series of ad hoc measures tends to involve high transactions costs. Although there might exist a moral hazard problem with any more formal set of arrangements (such as that envisaged in an AMF proposal), this needs to be assessed against the costs of crises of confidence and the instability they generate. Any lender of last resort (LLR) faces a moral hazard problem. But domestic financial systems incorporate an LLR role because the maintenance of confidence is seen as being more important.

Another potential danger with an AMF may also be over-estimated. With any proposal for a new lending agency, there is the question of “additionality”. Will financing that was previously channelled through the IMF now simply be redirected through the AMF? It is much more likely in the near term that an AMF will redirect supplementary resources rather than replace IMF credits. The existence of an AMF in the longer term could, in principle, adversely affect the willingness of industrial countries to provide additional

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<sup>3</sup> See the World Economic Forum [Press Release](#) (October 19, 1999).

<sup>4</sup> In contrast, the IMF’s assistance to Brazil in 1999 was negotiated before the Brazilian peg was broken, suggesting some degree of institutional learning.

resources to the IMF. But even here, it may be recalled that attention has turned to the idea of an AMF because of the perceived inability of the IMF to provide adequate and rapid liquidity support through its conventional channels.

Moreover, it is not simply a question of the *quantity* of aggregate financial flows, but also a question of their *quality*. Financing that is available more rapidly and that comes with conditions that are generally perceived as appropriate, will be worth more to their recipients than flows that, while equivalent in volume, come after a delay, are surrounded by uncertainty, and are connected to conditionalities that are seen as inappropriate. The fact remains, of course, that any detailed proposal for an AMF must satisfactorily address the question of where its resources will come from.

Another important issue relates to the sort of conditionalities that would be attached to credits from an AMF? Should the AMF simply endorse IMF conditionalities? In this case, negotiating a program - or at least a shadow program with the IMF - would become a precondition for AMF support. The problem here is that some of the potential appeal of an AMF comes from the idea that it may be able to design “better” or “more appropriate” conditionalities than the IMF, because of the former’s supposed superior regional knowledge and its closer geographical proximity to its member countries. An AMF might be better able than the IMF to reach a genuine consensus on policy reform to ensure greater ownership of a programme of reform, and engender greater commitment to it. However - and here is the conundrum - if members of the AMF preferred its conditionalities to those of the IMF, they would, other things being even, turn to it before

turning to the IMF. It would be the IMF that would be regarded as the lender of last resort to be turned to only in emergency and crisis conditions. The AMF would be the lender of *next to last resort*. The costs of operating the AMF would rise since it would have to take on the job of designing and negotiating conditionalities.

What does all this imply? An often-voiced observation of the IMF's dealings with its client countries is that they turn to it too late, when a balance of payments problem has been transformed into a crisis. In terms of its various potential roles, the IMF is perhaps least good at crisis prevention. Contrary to the way in which the proposal has usually been couched, perhaps an AMF ought to focus on this prevention role, encouraging member countries to refer to it early in the evolution of balance of payments difficulties.

However, advocacy of this function depends crucially on the assumption that countries may be more prepared to take advice from a regional monetary fund than an international one, not only because of its content, but also because of the way in which it is offered. This must be in some doubt in Asia, given the historical animosities and current suspicions between some of the countries in the region.

Without a conditionality function, does the case for an AMF rest squarely on the claim that it can rapidly and reliably mobilize resources in addition to those provided by the IMF, and does so in a manner that is superior to the way in which IMF assistance has been augmented in the case of previous financial crises?

#### **4. THE AMF AND CONTINGENT CREDIT LINES**

Is there any other role for an AMF which may overcome the conundrum noted above. Part of the IMF's approach to crisis prevention has been to introduce a contingent credit line (CCL) which seeks to guarantee countries access to financial support should they need it, provided they have met certain conditions. The scheme has come in for considerable criticism. First, to deal with crises of the size encountered in the 1990s, it needs to mobilize quantities of finance in excess of those available under conventional IMF facilities, and this puts pressure on the limited resources of the IMF. Second, while there is little incentive for countries to negotiate a program which merely secures a financing option with strict conditionalities, on the one hand, there is a moral hazard problem with relaxed conditionalities, on the other. Some commentators have already suggested that the CCL should be abolished as being inappropriate for the IMF<sup>5</sup>.

Rather than abandoning the idea of CCLs altogether, their provision could be taken over by an AMF. The AMF could stipulate criteria or standards which would dictate a country's eligibility to such lines of credit in the event of a crisis. There would therefore be some form of conditionalities. However, the conditionalities would not be negotiated case-by-case, thus reducing transactions costs. By encouraging economic and financial good practice, the AMF would minimize the risk of crises; its role would in large measure be crisis prevention. It would thereby be able to circumvent the moral hazard problem. In the event of a crisis, and in circumstances where the country had complied

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<sup>5</sup> See Hills, C., P. Peterson and M. Goldstein, M. and Associates (1999). Report of an Independent Task Force Sponsored by the Council on Foreign Relations Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture, Washington, DC: Institute for International Economics.

with the good practice guidelines, there would be an assured line of credit which would help to alleviate the longevity aspects of the crisis. The finance would be short-term and available only at a penalty rate. The provision of liquidity could forestall the crisis. Where it failed to do this, the country would almost certainly turn to the IMF, where it would encounter more detailed country-specific conditionalities. Liquidity and adjustment would be graduated and phased with IMF conditionalities only being applied in circumstances where the pursuit of good practise combined with a guaranteed source of liquidity had failed to prevent a crisis from occurring.

But why might such CCLs be more appropriate at the *regional* level than at the *global* level?

## **5. REGIONAL CONTAGION, REGIONAL SOLUTION?**

The basic point is that the contagion effects of crises tend to be regional. There are good theoretical reasons to believe that this will be the case both in terms of economic fundamentals and psychological bandwagons, and there is a growing body of empirical evidence to confirm it<sup>6</sup>. If contagion from crises is primarily a regional phenomenon, does it not follow that the liquidity provided in an attempt to forestall the contagion effects of crises should be provided regionally? Asian economies will have a stronger incentive to contribute to an AMF as a way of insuring against suffering contagion from a

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<sup>6</sup> See for instance, De Gregario, J. and R. Valdes, "Crisis Transmission: Evidence from the Debt, Tequila, and Asian Flu Crises", mimeo (October 1999) and M. Krueger, P. Osakwe and J. Page "Fundamentals, Contagion and Currency Crises: An Empirical Analysis", Working Paper No.98-10, Bank of Canada (July 1998).

future regional crisis, than would industrial countries to contribute to a similar global contingent facility where they believe that they would remain unaffected by such crises.

Moreover, to give this role to an AMF is consistent with the principle of “subsidiarity”. Why choose to deal with a problem at the global level when it can be handled adequately and perhaps more effectively at the regional level? By passing the task of creating a CCL to an AMF, the IMF would be allowed to focus on its other activities. By mobilizing Asian capital to support such a facility, the IMF would be able to use its limited resources to better assist low income countries.

By establishing a reasonably clear division of labor between an AMF and the IMF, institutional conflict and overlapping could be minimized. To the extent that there were to be a measure of institutional competition, it is not obvious that this would be a bad thing. Indeed, if the view is taken that IMF conditionalities have become “excessive” – a theme often raised in the context of the Asian financial crisis – there could be advantages from having an AMF that could act as a broker between individual countries and the IMF, and indeed, between individual countries and external creditors in the event of crisis.

## **6. CONCLUDING REMARKS**

It is unwise to assume that all problems can be solved by building new institutions. Much time can be wasted in “re-inventing the wheel”, and in creating inter-institutional conflict. Transactions costs may increase as countries have to negotiate with more institutions and new institutions may not mean more money. It should not simply be

assumed that the East Asian financial crisis and the desire to avoid a subsequent one in itself justifies establishing an AMF. In order to effectively make the case, there has to be a reasonable presumption that an AMF could undertake a necessary function more efficiently than the IMF.

Without delving into the details of its membership and resourcing, and without addressing the politics that would undoubtedly be involved, there is some justification for claiming that an AMF could pass this stiffer test.

The analysis in this article suggests that an AMF would be ill-positioned to fulfil a detailed adjustment function which involves negotiating conditionalities with member countries. This could lead to moral hazard problems and institutional conflict. This role should remain with the IMF. However, an AMF could make a significant contribution by ensuring that member countries comply with certain standards in terms of financial propriety. Such compliance would be a condition for financial support in the event of a crisis, but should, of course, itself reduce the likelihood of such crises. The regional contagion of crises should enhance the ability of an AMF to raise resources that might have been unavailable to the IMF, except perhaps in the very midst of a crisis. The AMF may therefore be better placed to prevent crises than the IMF.

Through the superior mobilisation of contingent credit, and in the event that a crisis occurred, an AMF would be well-placed to respond rapidly by providing needed liquidity. It would therefore only be in cases where this proved inadequate to resolve the

problem that countries would be effectively forced to turn to the IMF. In this way an AMF could filter out crisis countries from the IMF, excepting those that required more fundamental economic reform.

Establishing an AMF might help alleviate some of the financing constraints on the IMF, might help to defuse the criticism that IMF conditionalities are excessive, and might help reduce the likelihood of future Asian financial crises.