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## Global Financial Turmoil, the IMF, and the New Financial Architecture

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## **ABSTRACT**

This report focuses on the global financial turmoil in 1997-2000 that spread from Thailand, through Southeast Asia, up the coast to South Korea, and eventually battered Russia, and hit Brazil and the policy issues it has raised. It briefly reviews the problem and examines a number of the major policy responses taken or being considered. The policy options under consideration include economic and regulatory policy, new financial architecture, and International Monetary Fund reforms. Other CRS products on this topic include: CRS Report RL30467, *IMF and World Bank Activities in Russia and Asia: Some Conflicting Perspectives*; CRS Report RL30467, *the Asian Financial Crisis and U.S. Foreign Policy Interests*; CRS Report RL30394, *Russian Capital Flight, Economic Reforms, and U.S. Interests: an Analysis*; CRS Report 98-987, and *Brazil's Economic Reform and the Global Financial Crisis*. This report will be updated as circumstances warrant.

# Global Financial Turmoil, the IMF, and the New Financial Architecture

## Summary

How does a financial problem in Thailand — of seemingly minor dimensions — trigger financial turmoil of global consequences, destroy billions of dollars in wealth, throw 20 million people into poverty, become a major factor in the fate of certain political leaders, and eventually threaten the health of the robust U.S. and European economies?

Trade and capital flows along with global price competition constitute the major links that tie the United States to the economies of the world. Underlying these links are markets for currency, capital, securities, goods, and services. Behind these links are markets and a communications and financial infrastructure that allows news to travel and transactions to occur at faster and faster speeds. Currency crises tend to flow along international trade paths. They first are regional, although they also spread to countries with macroeconomic conditions similar to the countries in crisis because of the actions of speculators and investors. A new factor has been the activity of hedge funds that are able to accumulate huge leveraged (borrowed) positions that can threaten world financial stability if those positions are reversed too quickly.

Congressional interest in this issue is related to: (1) the effects of the global economic turmoil on the U.S. economy, (2) the operations of the International Monetary Fund, and (3) proposals to create a “new financial architecture.”

In seeking a new world financial architecture, policymakers are trying to improve the international monetary and financial system, to reduce the risk that systemic crisis will recur, and to ensure that, when isolated country crises do happen, there are early warnings, effective policy tools, adequate resources, and broad support to help nations withstand difficult external conditions. These policy discussions are still ongoing. Meanwhile, some countries, such as Malaysia, have taken measures to protect themselves from volatile, short-term capital flows.

Several studies have examined the role of the IMF and other international financial institutions in the financial crisis. The IMF, itself, also has been reviewing its policies and operations in light of severe criticism from various quarters. It has begun to take more preventative measures, such as it did with a loan package for Brazil in December 1998. The 105<sup>th</sup> Congress also conditioned the funds it appropriated to increase the IMF's quota and borrowing authority upon certain reforms by the IMF.

The 106<sup>th</sup> Congress is considering legislation dealing with hedge funds, the sale of gold and other operations of the IMF, and IMF reform.

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# Global Financial Turmoil, the IMF, and New Financial Architecture

The global financial turmoil that began in July 1997 as a potential default on loans by financial companies in Thailand rapidly spread to neighboring countries in Asia — engulfing Indonesia, Malaysia, and the Philippines — and compelling South Korea to join Thailand and Indonesia in asking the International Monetary Fund (IMF) to coordinate a package of emergency loans to help them repay short-term foreign debts. For the first year of the crisis, most economic experts seemed confident that the “Asian flu” could be confined primarily to countries in east and southeast Asia. Countries in Eastern Europe and Latin America did allow the values of their currencies to depreciate and interest rates to rise, but the scope of the problem seemed to fall within manageable proportions. During the summer of 1998, however, economic turmoil in Russia caused the ruble to fall in value, capital to flow into foreign currencies, and a government default on its foreign debt. Even though this was caused as much by problems internal to Russia as by international factors, the Russian crisis triggered a drop in equity markets world wide and caused huge losses for banks and securities companies. Brazil’s currency also came under pressure, and the IMF had to coordinate a loan package from private banks in order to stop the contagion.

In September 1998, the U.S. Federal Reserve facilitated a \$3.625 billion rescue of Long Term Capital Management (LTCM) and its hedge fund by a consortium of banks and investment houses. This triggered new doubts among investors about the value of their holdings of equities. A rush out of equities into U.S. government bonds and other more stable investments caused further declines in stock markets worldwide despite an easing of interest rates by the U.S. Federal Reserve.

At the International Monetary Fund’s annual meetings in October 1998, the threat of global recession loomed over the world. As 1999 progressed, however, world stock markets recovered significantly and surprisingly strong economic growth reports came out of South Korea, Japan, and other countries that had been in recession. Equity markets also continued to recover or grow strongly, albeit with considerable volatility. By early 2000, economic observers were declaring the global financial crisis to be over, although serious financial imbalances and economic problems remained in many countries. As the threat of global recession receded, calls became stronger for reforms in the IMF and the international financial system.

The world economic outlook for 2000 is for rising world growth including in the United States, although there are some concerns about the robust American economy. The global slowdown in 1998 that arose from the Asian financial crisis turned out to be the mildest of four downturns in the last three decades. In essence, the strong U.S. economy with its liberal import and capital markets had carried the rest of the world through the financial crisis. In 2000, the major threat to world prosperity turns out

to be rising energy prices, a volatile U.S. stock market, and a possible downturn in the U.S. economy.<sup>1</sup>

Congressional interest in this issue is related to: (1) oversight and regulation of U.S. financial institutions, (2) effects of global economic turmoil on the U.S. economy, (2) operations and financing of the International Monetary Fund and World Bank, and (4) proposals to create a “new financial architecture” for the international monetary and financial system. In the 106<sup>th</sup> Congress, bills have been introduced to reform the IMF and limit its ability to make loans for long-term, structural adjustment (H.R. 3750, Saxton, and H.R.1203, Saxton) or to abolish it altogether (H.R.1147, Paul). The foreign aid authorization bill also contains provisions dealing with IMF gold authorization and IMF (and World Bank) reforms.

In March 2000, the International Financial Institution Advisory Commission released a report recommending that IMF lending be restricted to short-term liquidity loans and that the IMF end longer-term lending for other purposes.<sup>2</sup>

This report first examines the sources of the global financial instability and the mechanisms by which the economic problems are transmitted from one country to another. It then reviews some major proposals to revamp the international financial system. This report addresses economic aspects of the problem. Other information and analysis are available in CRS Report RL30467, *IMF and World Bank Activities in Russia and Asia: Some Conflicting Perspectives*; CRS Report RL30467 and *The Asian Financial Crisis and U.S. Foreign Policy Interests*; CRS Report 98-987. Specific information on the IMF’s quota increase is in CRS Report 98-56, *The International Monetary Fund’s (IMF) Proposed Quota Increase: Issues for Congress* and CRS Issue Brief 97038, *The International Monetary Fund’s “New Arrangements to Borrow” (NAB.)*. Previous versions of this report with more detail on certain issues are: CRS Report RL30012, *Global Financial Turmoil: Contagion, Effects, and Policy Responses* and CRS Report 98-434 and *The Asian (Global?) Financial Crisis, the IMF, and Japan: Economic Issues*. Information on Russia is found in CRS Report RL30394, *Russian Capital Flight, Economic Reforms, and U.S. Interests: an Analysis* and CRS Report 98-578, *The Russian Financial Crisis: An Analysis of Trends, Causes, and Implications*. Information on Brazil is in CRS Report 98-987, *Brazil’s Economic Reform and the Global Financial Crisis*. This report will be updated as circumstances warrant.

## Contagion of Financial Crises

How does a financial problem in Thailand — of seemingly minor dimensions — set off global consequences, destroy billions of dollars in wealth, throw 20 million people into poverty, and become a major factor in the fate of certain political leaders?

The global economic turmoil can be traced to many factors. First were foreign exchange rates in Asia tied to the appreciating U.S. dollar and too inflexible to adjust

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<sup>1</sup>Behraves, Nariman. The Global Economy: A Multi-Speed, Multi-Risk World. In World Market Economic Outlook, Fourth Quarter, 1999. Standard & Poor’s DRI.

to changing trade and capital flows. Second were bankers and corporations in Asia who borrowed short-term on international markets to finance long-term investments – some of dubious value – in booming local economies. Third were emerging markets without developed financial infrastructure and with insufficient regulation and market discipline in which the allocation of capital and resources was influenced excessively by personal connections and politics (cronyism). Fourth were highly confident businesses that overbuilt manufacturing capacity and office buildings in Asia and began to default on bank loans. Fifth were real estate and stock market bubbles by which excess liquidity was poured into land and corporate equities creating a euphoria as prices rose but also generating huge losses as prices fell.

These five factors were magnified by one theme: globalization. Financial markets today are international in scope, global in nature, and connected by high-speed data systems. They are more linked, volatile, leveraged, and larger than at any time in modern history. This globalization implies that the economies of the world have become more interconnected not only through trade in goods and services but through flows of investment capital, speculative financial activities, and bank loans. These extensive linkages have combined with rapid communications to make currency and stock markets more volatile and easily influenced by events and economic conditions in other countries. Financial investments also have become more leveraged with borrowed funds. When markets suddenly turn, these highly leveraged positions can generate enormous losses (or gains).

The magnitude of the flows of capital among countries also has become huge and unprecedented. A study by the Bank for International Settlements indicates that the volume of foreign exchange transactions in 43 markets has exploded to an estimated \$1.5 trillion per day (after making corrections for double counting) — or about 60 times as great as world trade in goods and services.<sup>3</sup> Private capital flows have grown to the extent that many countries no longer can maintain adequate foreign exchange reserves to handle sudden outflows or keep such outflows from pushing down exchange rates.

This world of increased global contagion generates two major policy questions: what can the United States do to insulate its economy from drastic gyrations in world financial and economic markets and what changes might be implemented in the world financial system and International Monetary Fund to bring more stability into the system? In order to understand where actions can be taken, we first examine some sources of volatility in currency markets.

An unanticipated consequence of the global economic slowdown in 1998-99 has been the resurgence of cohesion among the oil exporting nations (OPEC). As the Asian financial crisis depressed demand for petroleum, prices dropped to \$12 per barrel in 1998 before they began to recover to \$17.50 per in 1999. The low prices caused huge reductions in oil revenues for the oil exporting nations and galvanized them into cooperating on reducing supply. The oil exporting nations constricted supply by about 6.7% in 1999. This, combined with a relatively cold winter, a booming economy in the

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<sup>3</sup>Bank for International Settlements. *Central Bank Survey of Foreign Exchange and Derivatives Market Activity 1998*. May 1999. P. 1-4.

United States, and faster than anticipated economic recovery in Asia caused the price of crude petroleum to shoot up to more than \$30 per barrel (for West Texas intermediate crude) in early 2000.<sup>4</sup> During the coldest part of the winter of 1999-2000, home heating oil in New England jumped to more than \$2 per gallon and the price of gasoline in 2000 is expected to settle at about \$1.50 per gallon.

In the 106<sup>th</sup> Congress, H.R.4102 (Saxton) would direct the Secretary of the Treasury to instruct the United States Executive Director at the IMF to oppose any new loans to a country that is acting to restrict oil production to the detriment of the United States economy, except in emergency circumstances.

## Volatility in Currency Markets

Currency markets play a large role in both capital and trade flows. Most international transactions require converting currency from that of one country to that of another using an exchange rate. Until the early 1970s, most nations maintained foreign currency regimes in which their exchange rate was fixed with respect to another currency or to gold. Since March 1973, most major currencies have been allowed to float according to demand and supply with occasional intervention by monetary authorities. Experts on exchange rate systems generally recommend that currencies either be allowed to float freely or be fixed with respect to the dollar, Euro, or other major currency. If a government opts for a fixed rate, however, it must maintain the rate by intervening into exchange markets or by altering domestic fiscal and monetary policies. In order to alter demand and supply for its currency, the government may buy or sell foreign exchange as well as raise or lower interest rates to adjust international capital flows to and from their economies.

A pegged exchange rate that is neither fixed nor floating is usually not recommended because such a regime tends to attract speculators who seek to benefit from a revaluation. Adjustment under a pegged rate occurs in large steps rather than as a continuous process. This opens opportunities to speculate on future currency devaluations while taking market positions to both induce such actions and to benefit from them. A fixed rate, however, also can attract speculators. During the Asian financial crisis, Thailand was not able to maintain its fixed exchange rate in the face of massive capital outflows. Hong Kong and China, however, were able to do so.

The values of national currencies are quoted in terms of U.S. dollars, Euros, or special drawing rights of the International Monetary Fund. A change in one exchange rate affects the rate at which all other currencies trade with respect to that currency but may or may not affect cross exchange rates. For example, a depreciation in the Thai baht with respect to the U.S. dollar changes the baht-dollar exchange rate but may not affect the cross rate at which U.S. dollars are exchanged for euros or yen.

**Figure 1** shows the value of the Thai baht, Indonesian rupiah, South Korean won, Japanese yen, Brazilian real, and Russian ruble relative to the U.S. dollar. The currency depreciation that began in Thailand in July 1997 rapidly spread across southeast Asia and affected other currencies as well. Some (such as the Hong Kong dollar and Chinese renminbi) proved quite resilient to this “Asian flu,” but other currencies

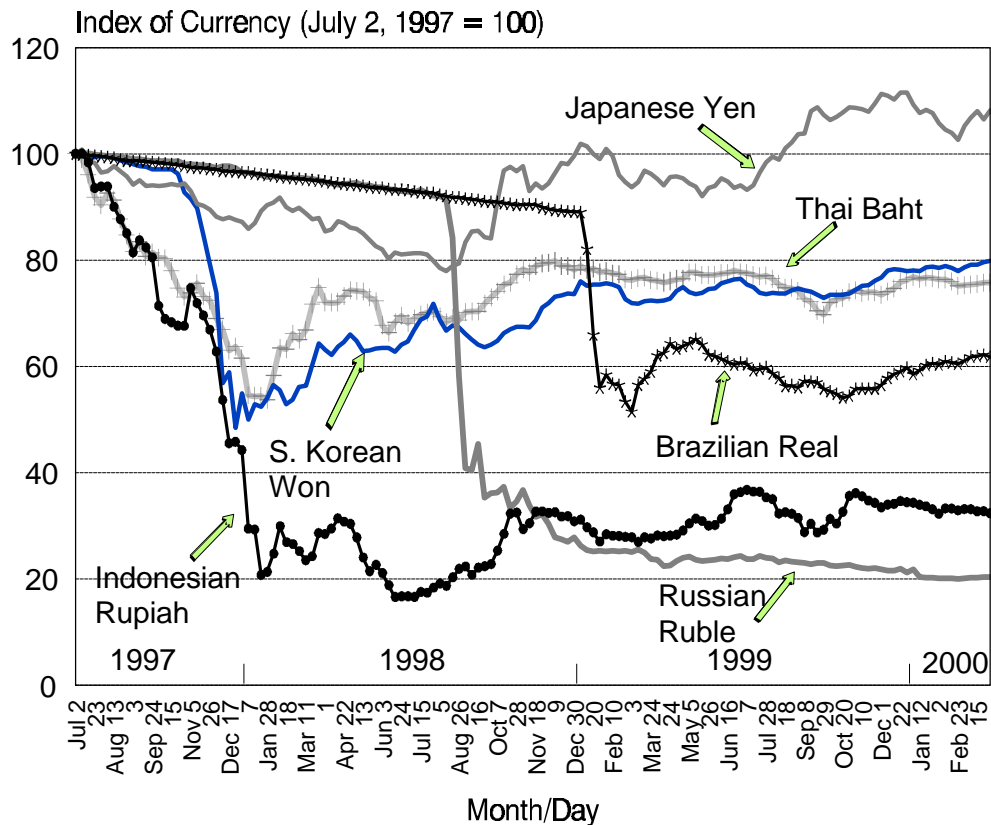
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<sup>4</sup>Standard & Poor’s DRI. *Oil Market Outlook, Long-term Focus*. January 2000.



likewise fell. The dramatic fall in the value of the ruble did not occur until August 1998. By March 2000, the South Korean won and Thai Baht had recovered to about 80% and the Brazilian real to about 60% of its pre-crisis value. The Indonesian rupiah was at about 32% and the Russian ruble at about 20% of their 1997 values, while the Japanese yen had appreciated to a level higher than its pre-crisis level.

**Figure 1. Exchange Values of the Brazilian Real, Indonesian Rupiah, Japanese Yen, South Korean Won, Thai Baht, and Russian Ruble  
July 1997-March 2000**



Source: Data from PACIFIC Exchange Rate Service

What is the mechanism by which weakness in one currency drives down the values of other currencies? In order to understand the process, one must recognize that trade flows no longer dominate foreign exchange markets. In times past, foreign exchange was bought primarily for use in foreign trade transactions — for the international buying and selling of goods and services. Now non-trade transactions dominate foreign exchange markets. Capital flows completely overshadow trade flows in value and effect on exchange rates. Foreign currencies are bought by investors seeking higher rates of return, by wealth-holders seeking safety from political or economic instability, by multinational corporations building manufacturing or distribution facilities abroad, by speculators betting on movements in exchange rates, and by others for a variety of reasons. Trade flows remain important, but they are only one factor in determining foreign exchange values.

Because currencies play such a variety of roles in the world financial system, their value fluctuates as underlying financial conditions, macroeconomic variables, investor expectations, and actions of central monetary authorities change. Like stock markets, there is no sure method of predicting short-term movements in exchange rates. Many economists have concluded that, while underlying financial and macroeconomic conditions — such as interest rates, trade deficits, and economic growth rates — influence exchange rates over the long run, in the short run, fluctuations are more random and unpredictable in nature.<sup>5</sup>

Even though trade flows do not determine currency movements, they play a large role in determining the path through which currency crises spread. Over the past three currency crises — the European crisis in 1992, the Mexican Peso crisis in 1994, and Asia financial crisis in 1997 — the best predictor of the path of contagion has been along trade lines. Currency crises have tended to be regional — among those countries that trade the most with each other or trade with similar markets.<sup>6</sup> The major reason that currency crises spread along trade lines is that once a country devalues its currency, its neighbors suffer a competitive disadvantage in export markets and in selling to that country.

For example, once Thailand allowed the value of its currency to fall, Malaysia, the Philippines, and Indonesia — neighboring countries that compete in similar export markets — suddenly found their exports significantly more expensive than those of Thailand. Not did this affect their balance of trade, but speculators and other buyers of foreign exchange placed financial bets that those other countries would have to allow their currencies to depreciate also. This unleashed tremendous downward pressures on exchange rates in these countries. In the Asian financial crisis, the lines of transmission led from Thailand to Malaysia, the Philippines, and Indonesia, then later to Hong Kong and South Korea. After that, the problem became more global as it spread to Eastern Europe, Russia and Brazil.

Since underlying macroeconomic conditions affect the long-run exchange rate of a country, speculators and investors may target certain currencies for devaluation if their countries exhibit macroeconomic and financial features similar to the country that has devalued its currency. For example, since Thailand's main problems were its weak banks, a rising current account deficit, and an accumulation of short-term foreign currency loans, countries with similar macroeconomic and financial conditions were targeted by speculators. This is one of the reasons that countries with scanty trade ties with a country in crisis also can find themselves subject to currency speculation or capital flight by their own citizens seeking a safe haven to store their wealth. In 1997, for example, as Hong Kong's currency came under attack, speculators also descended upon Estonia's currency. Like Hong Kong, Estonia also has a currency board. In South Korea's case, its currency came under attack because it too had a weak banking

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<sup>5</sup>Frankel, Jeffrey A. and Andrew K. Rose. Empirical Research on Nominal Exchange Rates. In *Handbook of International Economics*, Vol. III, Edited by G. Grossman and K. Rogoff. Amsterdam, Elsevier, 1995. Pp. 1690-91.

<sup>6</sup>How Do Currency Crises Spread? *Federal Reserve Bank of San Francisco Economic Letter*, August 28, 1998. On the Internet at <<http://www.frbsf.org/econsrch/wklyltr98/el9825.html>>.

system, an accumulation of short-term international loans, and other economic conditions that resembled those of the countries of Southeast Asia.

## IMF Support Packages

During the global financial turmoil in 1997-1998, the IMF arranged support packages initially for Thailand, Indonesia, and South Korea and augmented a credit to the Philippines to support its exchange rate and other economic policies. Later, the IMF extended support to Brazil and Russia. The five support packages are summarized in **Table 1**. The total amounts of the packages are approximate because the IMF lends funds denominated in special drawing rights (SDRs), and because pledged amounts may change as circumstances change. The initial support package for Thailand was \$17.2 billion, for Indonesia about \$43 billion, and for South Korea \$57 billion. The United States pledged \$3 billion for Indonesia and \$5 billion for South Korea from its Exchange Stabilization Fund (ESF) as a standby credit that may be tapped in an emergency. The U.S. Treasury lends money from the ESF at appropriate interest rates and with what it considers to be proper safeguards to limit the risk to American taxpayers.

**Table 1. Financial Support Packages**  
(Amounts in U.S.\$Billion)

	Thailand	Indonesia	S. Korea	Russia	Brazil
Date Initially Approved	Aug. 20, 1997	Nov. 5, 1997	Dec. 4, 1997	July 20, 1998	Dec. 2, 1998
Total Initially Pledged	\$17.2	\$43.0	\$57.0	\$22.6	\$41.5
IMF	\$3.9	\$18.6	\$21.0	\$11.6*	\$14.7
World Bank	\$1.5	\$4.5	\$10.0	\$2.3	\$4.5
Development Bank	\$1.2 (ADB)	\$3.5 (ADB)	\$4.0 (ADB)		\$4.5 (IDB)
Bilateral	\$10.6	\$24.0	\$22.0	\$1.0	14.5
IMF Disbursements	\$3.4	\$10.1	\$19.5	\$5.4*	\$11.1

Note: ADB = Asian Development Bank. IDB = Inter-American Development Bank. Actual amounts disbursed by the IMF's are in SDR's. Development bank figures are for structural adjustment and exclude funds for customary projects.

\*The IMF cancelled the 1998 program after disbursing \$4.8 billion. In July 1999, it announced a new program worth \$4.5 billion to be paid in tranches of about \$640 million each. The first was distributed immediately, but the others have been delayed.

Source: IMF, World Bank, ADB, IDB. IMF disbursements are as of Dec. 31, 1999.

The support packages are initiated by a request to the IMF from the country experiencing financial difficulty. This request then requires an assessment by IMF officials of the conditions in the requesting nation. If a support package is approved,

the IMF usually begins with an initial loan of hard currency to the borrowing nation. Subsequent amounts are made available (usually quarterly) only if certain performance targets are met and program reviews are completed. The support packages were designed to restore investor confidence — both international and domestic — in the economies of the recipient nations. The packages constituted a three-pronged approach to the problems: (1) immediate efforts to restore liquidity in currency markets, (2) structural reforms aimed at strengthening financial sectors, and (3) governance issues underlying the crisis which included improving the efficiency of markets, breaking the “crony capitalism” links between business and government in several of the distressed countries, liberalizing capital markets, and providing for more transparency (in disclosing data on external reserves and liabilities). Russia faced many particular problems that the other market-oriented economies did not.

The IMF assessments and the policies the borrowing country intends to implement which are reported in letters of intent are now being made public (with permission of the borrowing country) and posted on the IMF’s Internet site.<sup>7</sup> The IMF has faced severe criticism that the monetary and fiscal policies it required of the Asian countries as a condition of support were too severe and were instrumental in plunging their economies into recession.<sup>8</sup> However, as recessions did develop, the IMF eased its requirements and allowed more expansionary fiscal and monetary policies by the troubled countries.

In addition to IMF support, recipient countries have tapped funds pledged by the World Bank, the Asian Development Bank or, in the case of Brazil, the Inter-American Development Bank, and by certain industrialized nations. The World Bank, in particular, has played a key role in attenuating the negative effects of the financial crises on the poorer people who are less able to shield themselves from the recessions. In 1998, the World Bank created a Special Financial Operations Unit (SFO) to help the Bank respond to financial sector crises. Working closely with the country departments, the SFO’s mandate is to provide immediate support to governments to help them stabilize their financial systems, followed by support for structural reforms and resolution of nonviable financial institutions.<sup>9</sup>

In 1997, the World Bank pledged \$1.5 billion in support of Thailand and, as of June 30, 1999, had approved loans of \$1.3 billion. For Indonesia, the World Bank initially pledged in October 1997 a sum of \$4.5 billion to be disbursed over a three-year period. In July 1998, this was raised to \$5.5 billion. By the end of 1997, the Bank had loaned \$619 million to Indonesia, much of which was for traditional economic development projects. By June 1999, the loan total had risen to \$2.74 billion, although much of the lending was for traditional projects not necessarily occasioned by the financial crisis. For South Korea, in December 1997, the Bank committed up to \$10 billion for financial support. In December 1997, the Bank approved a \$3 billion loan for Korean financial reconstruction and in 1998 a total of

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<sup>7</sup>On Internet at: <<http://www.imf.org/external>>.

<sup>8</sup>See, for example, Sachs, Jeffrey. Fixing the IMF Remedy. *Banker*, v. 148. February 1998. Pp. 16-18.

<sup>9</sup>The World Bank. The Special Financial Operations Unit. 1998. On Internet at <<http://www1.worldbank.org/finance/html/sfo.html>>.

\$4 billion in loans for structural adjustment and \$48 million for financial and corporate restructuring.<sup>10</sup>

Japan has a special interest in the Asian financial crisis since it occurred within its region and not only affected its close trading partners and competitors but also threatened bank loans and investments by Japanese companies in the region. Japan has been providing financial assistance under what it terms the Miyazawa Initiative (named after their Finance Minister). It includes \$30 billion in loans to Thailand, Malaysia, the Philippines, Indonesia, and South Korea. This was augmented in 1999 with a commitment by Japan to assist Asian nations to mobilize another 2 trillion yen (about \$17 billion) in domestic and foreign private-sector funds for Asia.<sup>11</sup>

Japan, in conjunction with the United States, World Bank, and Asian Development Bank, has announced an Asian Growth and Recovery Plan which has a target of raising \$5 billion in bilateral and multilateral support. The purpose of the initiative is to accelerate the pace of corporate and bank restructuring in the region, mobilize new private sector financing, and promote restoration of economic growth.<sup>12</sup>

As a result of the Group of Seven Industrialized Nations (G-7) meeting on February 21, 1997, the U.S. Export-Import Bank has coordinated support among 18 export credit agencies from 11 countries to provide trade financing support to Asia. At the time, the U.S. Export-Import Bank stated that it could commit up to \$3 billion in additional short-term financing in the support of American products sold to South Korea, Thailand, and Indonesia. In January 1997, the Bank also decided to expand the short-term insurance capacity for commercial banks in South Korea.<sup>13</sup> In July 1998, the U.S. Ex-Im Bank established a \$2 billion medium-term loan facility for South Korea and, for example, in June 1999 financed \$796 million for Korean purchases of U.S. aircraft.<sup>14</sup>

The funds borrowed by the recipient country from the IMF usually go into the central bank's foreign exchange reserves. These reserves are used to supply foreign exchange to buyers, both domestic and international. They normally are not loaned directly to private companies, although those companies can purchase the foreign exchange on the open market. The foreign exchange borrowed from the IMF often is used to repay short-term obligations denominated in foreign currencies. A common criticism of the IMF is that its funds end up being used to repay bank loans. Foreign

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<sup>10</sup>The World Bank Group. World Bank Financial Support to East Asia Since July 1997. Factsheet. On Internet at <

<sup>11</sup>Japan. Ministry of Finance. Resource Mobilization for Asia: The Second Stage of the New Miyazawa Initiative. May 15, 1999. On Internet at <<http://www.mof.go.jp>>.

<sup>12</sup>Japan. Ministry of Finance. Asian Growth and Recovery Initiative. On Internet at <<http://www.mof.go.jp>>.

<sup>13</sup>U.S. Export-Import Bank. Ex-Im Bank Working in Support of 18 Country Export Credit Agency Trade Finance Initiative to Stabilize Asian Markets. Press Release. February 23, 1998. On Internet at <<http://www.exim.gov>>.

<sup>14</sup>U.S. Export-Import Bank. Ex-Im Bank Finances \$796 Million for Korean Aircraft Purchase. Press Release. June 25, 1999. On Internet at <<http://www.exim.gov>>.

banks, therefore, tend to recover more of their assets than investors in equities or other liquid assets in time of financial crisis.

Funds from Export-Import banks are used to finance imports or exports and tend to be self-serving for the lending country. They generally are used to help finance the lending country's own exports.

Funds from the World Bank and regional development banks usually provided for specific projects. During the financial crisis, however, they were provided to countries for general purposes such as strengthening the borrowing country's financial sector and structural adjustment. In this case, they tended to go into the same central bank foreign exchange accounts as the funds from the IMF. In the cases in which the funds went for specific projects, the funds might have been used to pay specific companies involved in the project.

## Securities Markets

Fluctuations in currency markets also affect stock and securities markets. The process is two-fold. First, when a currency depreciates it also reduces the value of any asset denominated in that currency such as stocks and bonds. If investors (both foreign and domestic) in national equity markets anticipate a currency depreciation, they may sell their stocks and convert the proceeds into a foreign currency before the depreciation or before the currency depreciates further. Second, when a country is facing a rapidly declining currency, the country's monetary authorities may raise interest rates (to stem capital flight) and adopt restrictive fiscal policies (to raise savings and reassure investors) which may slow economic growth, reduce corporate profits, and raise the return on bonds or money market accounts relative to stocks. Both higher interest rates and lower profits tend to reduce equity values. As funds are moved from a troubled economy to a safer haven (such as the United States or Europe), equity values or bond prices may well be bid up in those safe-haven countries.

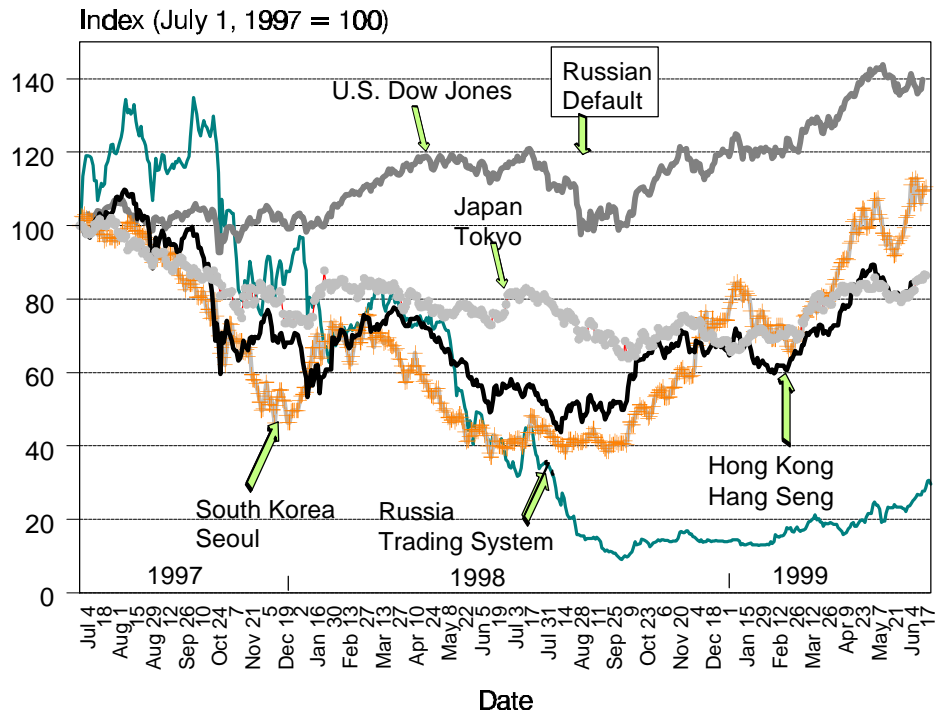
During the Asian financial crisis, values on equity markets fluctuated almost as much as currency values. **Figure 2**, shows indices of stock market values on exchanges in the United States, Japan, South Korea, Hong Kong, and Russia over the period of the worst of the financial crisis – from its onset in July 1997 to June 1999. The similar behavior of the Asian markets as well as both the positive and negative effects on the U.S. stock market as measured by the Dow-Jones index is apparent. The market that has recovered the least is the Russian.

## Speculation and Leverage in Financial Instruments

In assigning blame for the Asian currency crisis, some have pointed the finger at speculators — even though speculators certainly were not to blame for the underlying economic conditions that contributed to the perceived overvaluation of the currencies in the first place. Speculators, often managers of large international investment funds, generate gains by taking advantage of perceived weaknesses in exchange rates. They place financial bets on depreciation (or appreciation) based on their perceptions of underlying forces of demand and supply. They also combine currency speculation with financial maneuvering in derivatives, stocks, securities, and money markets. For smaller emerging markets, these financial actions may trigger currency crises and may

be paralleled by similar maneuvering by other investors and businesses engaged in currency transactions.

**Figure 2. Stock Market Indices in the United States, Japan, Indonesia, South Korea, and Hong Kong, July 1997-January 1999**



Source: Trendlines, Seoul Composite, Tokyo Nikkei 225, Hong Kong Hang Seng, Russia Trading System & Dow Jones Industrial Indices

The mechanics of currency speculation are complicated. Essentially the process involves currency buyers and sellers generating profits from fluctuations in exchange rates by using spot markets (markets for current delivery of foreign exchange), forward or futures markets (markets for future delivery), currency swaps, loans, and other financial maneuvers. The key to this process is that when speculators expect a depreciation in a local currency, they begin short sales (without the currency in hand) of forward or future contracts to deliver that currency at a future date in the hope that they will be able to buy the currency at a lower price before they have to deliver it. They also can speculate in stock market futures by amassing holdings of a currency to dump on the market in order to elicit a response from monetary authorities who often will raise interest rates in order to maintain the exchange rate. The higher interest rates, in turn, cause equity values to fall.

Once a currency begins to show signs of weakening, astute investors and speculators who profit from volatility in exchange markets take actions to minimize losses and maximize gains. The ensuing flight from the local currency pushes its value down even further until it often overshoots what would be considered an equilibrium rate. Recovery may be slow.

## Hedge Funds and Speculation

A recent force in stock and securities markets has been the rise of hedge funds. These funds normally engage only large investors (including banks) and are highly leveraged. Perhaps the best known of these is the fund managed by Long Term Capital Management (LTCM) of Greenwich, Connecticut. This company worked by spotting unusual differences between the prices of financial instruments with well-established historical relationships — government bonds, fixed-income derivatives, equities, and equity derivatives. The fund would purchase securities with borrowed money and take large financial positions in world securities and derivative product markets. LTCM reportedly had borrowed \$125 billion on its capital of \$4.7 billion (as of December 31, 1997) and had derivatives exposure of \$1.2 trillion.<sup>15</sup> The fund would place large financial bets in such a way that if interest rates and prices converged to their usual patterns, the fund would gain profits. These positions carried a large probability of making a small profit but a small probability of incurring a huge loss. Since the fund's profit margins were small, it worked with enormous sums of investment capital and attempted to reduce risk by diversifying across many interest-rate products, markets, and geographical locations. Most of its activities were in U.S., European, and Japanese markets.

LTCM's computer models and convergence trades enabled the fund to generate huge profits for a time. Its total returns after fees were 45% in 1995, 41% in 1996, and 17% in 1997, but the computer models did not anticipate the Russian default on its government bonds on August 17, 1998, and the subsequent turmoil in global financial markets. In August alone, LTCM reportedly lost about \$2 billion and possibly more than that during the first three weeks of September.<sup>16</sup> By September 23, LTCM's equity position stood at \$600 million but it was supporting balance sheet positions in excess of \$100 billion. The hedge fund's losses on its highly leveraged positions had wiped out 90% of its equity.

The threat to the international financial system of a collapse by LTCM and a forced dumping of its illiquid securities on markets at prices well below their face value was large and threatened to further widen spreads and trigger a massive sell off of securities in markets that were already strained and jittery. On September 23, 1998, the U.S. Federal Reserve Bank of New York coordinated a private bailout of LTCM in which fourteen banks and investment companies agreed to inject \$3.625 billion into the fund. The rescue of LTCM was a type of out-of-court bankruptcy reorganization in which its major creditors have become its new owners. The bailout did stabilize international financial markets, but critics of the action argue that because LTCM was not subject to the Federal Reserve's supervisory and regulatory jurisdiction, it was not appropriate for the Fed to risk its reputation and goodwill by intervening. The action also may have created a moral hazard for institutions not ordinarily regulated or supervised by the central bank or who are highly leveraged. Such institutions might be more inclined to make risky investments if they think the Federal Reserve or other

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<sup>15</sup>Day, Kathleen. Top Regulator Was Aware of Fund's Debt. *Washington Post*, November 18, 1998. P. C11.

<sup>16</sup>Mayer, Martin. Bailing Out The Billion-Bettors. *Los Angeles Times*, October 5, 1998. On Internet at <<http://www.latimes.com/cgi-bin>>.



central bank will help in their rescue.<sup>17</sup> In July 1999, the bankers who oversee the LTCM decided that the financial institutions that rescued the institution will get back \$1 billion of the \$3.625 billion injected into the fund while original investors will receive all the \$300 million they had left in the fund.<sup>18</sup>

In the 106<sup>th</sup> Congress, several bills have been introduced to bring more transparency and discipline into hedge fund activities. These include H.R. 2924 (Baker) which would require unregulated hedge funds to submit regular reports to the Board of Governors of the Federal Reserve System and H.R.3483 (Markey) and S. 1968 (Dorgan) which would amend the Federal securities laws to enhance oversight over certain derivatives dealers and hedge funds.

In a separate action, the Hong Kong Monetary Authority also intervened to affect market speculation. In August 1998, the Hong Kong Monetary Authority spent about \$15 billion buying stocks on the Hong Kong market in order to prop up the Hang Seng index (of stock market values) and deter speculators. The Hong Kong government purchased about 7.3% of the 33 companies that make up the Hang Seng index and used the equivalent of \$2,500 for every person in Hong Kong for the operation. Eventually, those stocks are to be sold.<sup>19</sup> This market intervention was quite a departure for a government that prided itself in its free-market approach to its economy, but it illustrates one method of thwarting speculation.

Malaysia has pursued a different approach to speculation and short-term capital flows. It has taken measures to prohibit trading in its currency, the ringgit, and in its stock market by foreign parties. As of September 1, 1998, Malaysia made the ringgit acceptable as a currency only in Malaysia. After a short grace period, re-entry of offshore ringgit was prohibited. The currency became no longer accessible to currency dealers and can be traded for foreign exchange only in Malaysia. All stock trading not conducted on the Kuala Lumpur Stock Exchange is no longer recognized (particularly that previously done in Singapore).<sup>20</sup>

Analysts view the Malaysian currency controls as quite drastic, but acknowledge that the measures have allowed the country to re-peg its currency to the U.S. dollar

<sup>17</sup>International Monetary Fund. *World Economic Outlook and International Capital Markets, Interim Assessment*. December 1998. P. 136. On Internet at <<http://www.imf.org/external/pubs/ft/weo/weo1298/index.htm>>. Eleven of the 14 financial institutions took equity stakes of \$100 to \$300 million in LTCM.

<sup>18</sup>Pacelle, Mitchell. Long-Term Capital to Return Money to Bailout Group. *The Wall Street Journal*, July 7, 1999. P. A4.

<sup>19</sup>Hong Kong. Fair Shares. *The Economist*, October 31, 1998. On Internet at <<http://www.economist.com/archive>>.

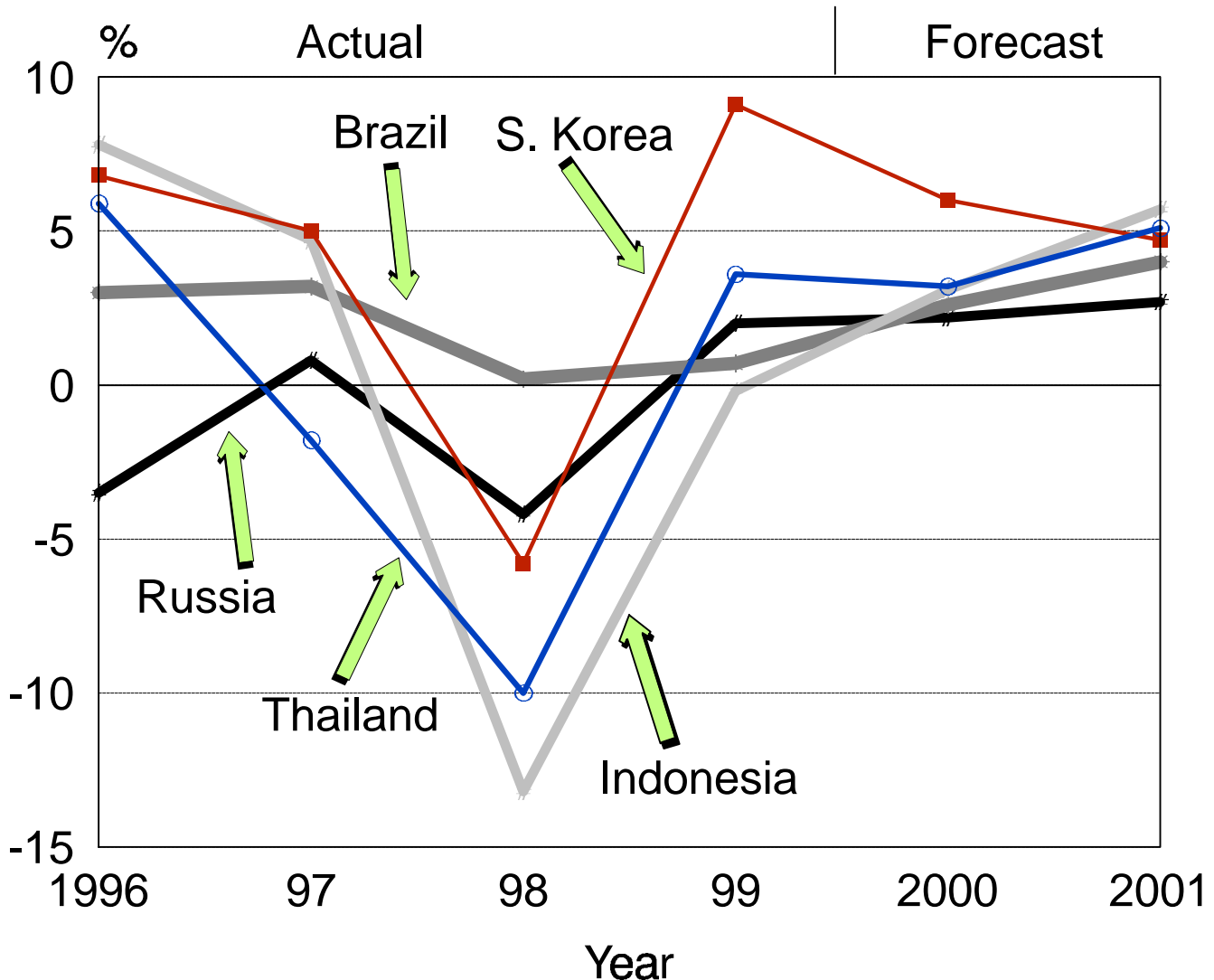
<sup>20</sup>The major changes in Malaysia's exchange control rules were: (1) approval is required for ringgit funds transferred between or withdrawn from external accounts; (2) all purchases and sales of ringgit financial assets can be transacted only through authorized depositary institutions; (3) all settlements of exports and imports must be made in foreign currency, and (4) limits are placed on the amount of ringgits carried by resident and non-resident travelers. Malaysia Ministry of Finance. *Economic Report 1998/99*. December 1998. P. 4 of Overview. On Internet at <<http://www.treasury.gov.my/er9899/er9899.htm>>.

and have brought stability back into the value of the ringgit. Whether these policies will hurt the ability of Malaysia to attract the foreign capital and industry important to its long-term economic growth is an open question.

## Outlook for Countries in Turmoil

As shown in **Figure 3**, for the five countries that received IMF support packages, South Korea seems to be recovering the most quickly. After dropping 5.8% in 1998, growth in Korean real gross domestic product rebounded to 10% in 1999 and is expected to continue to grow at about 7% in 2000. A strong fiscal boost (a fiscal deficit of 4% of GDP in 1999) plus strong consumer spending and rising exports are helping the economy. The economy is now operating at pre-crisis levels. Private sector reform, particularly of the *chaebol*, or industrial conglomerates, is progressing only haltingly and improving economic conditions are decreasing the urgency of the task.

**Figure 3. Growth in Real Gross Domestic Product for Thailand, Indonesia, South Korea, Brazil, and Russia, 1996 to 2001 (forecast)**



Source: Standard & Poor's DRI

The Thai economy also is recovering. Output shrunk by 10.4% in 1998, with investment down by 36% and private consumption down by 13%. In 1999, the economy began to recover and grew by 5% – helped by a large government stimulus package. In 2000, the economy is expected to expand by 6%. The Thai trade balance remains positive, and foreign exchange reserves have risen.

Indonesia still faces difficult economic times. In 1998, real GDP dropped by 13.2% and grew by a paltry 0.1% in 1999 and is expected to grow by about 3.5% in 2000. In 1998, investment fell by 46%. New investment also was discouraged by riots and the destruction of buildings and equipment. The value of the Indonesian currency remains at about a third of its pre-crisis level, although a certain normalcy has returned to most parts of the country. Food prices have decelerated as production of basic commodities has resumed. Still, rising poverty and joblessness abound. Parliamentary elections in 1999 brought a legitimately elected government led by President Abdurrahman Wahid and a relatively smooth transfer of power in October 1999. In the Aceh province, however, secessionist demands are yet to be resolved.

On February 4, 2000, the IMF approved a three-year, \$5 billion Extended Fund Facility to support Indonesia's economic and structural program. The World Bank, Asian Development Bank, and nations (particularly Japan) also pledged up to \$4.7 billion in additional support for Indonesia in fiscal year 2000.<sup>21</sup>

The Brazilian economy is recovering from a sharp slowdown in which economic growth dropped to 0.2% in 1998 and 0.7% in 1999 following the devaluation of the currency from an average of 1.17 reals per dollar in 1998 to 1.81 reals per dollar in 1999. For 2000, growth is projected to rise to about 2.6%. A major concern is the huge fiscal deficit of about 11% of gross domestic product and a growing trade deficit.<sup>22</sup>

Russia dropped back into recession in 1998 with negative growth of 5% (similar to the negative growth through most of the 1990s) but has been recovering in 1999 with the economy expanding by about 3%. Between 1992 and 1999, the Russian economy had contracted by more than 30%. Inflation remains a problem, although it declined from 84% in 1998 to 36% in 1999. Interest rates remain at about 45%. Russia's trade balance continues to improve (about \$30 billion in 1999), although this stems mainly from a drop in imports rather than an expansion of exports. In July 1999, Russia and the IMF agreed to a \$4.5 billion standby credit, although the funds primarily were just shifted from one IMF account to another. With the election of a new Russian President in March 2000, the hope is for the country to turn its attention toward resolving economic problems and the situation in Chechnya.<sup>23</sup>

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<sup>21</sup>International Monetary Fund. IMF Approves US\$5 billion Extended Arrangement for Indonesia. Press Release No. 00/4, February 4, 2000.

<sup>22</sup>Standard & Poor's DRI. *World Markets Report, Brazil*. January 2000.

<sup>23</sup>Standard & Poor's DRI. *World Markets Report, Russia*. October 1999

## U.S. Links to the Global Turmoil

Trade and capital flows along with global price competition constitute the major links that tie the United States to the economies of the world. Underlying these links are markets for currency, capital, securities, goods, and services. Behind these links are markets and a communications and financial infrastructure that allows news to travel and transactions to occur at faster and faster speeds.

Global financial turmoil affects the United States economy through the trade deficit, interest rates, stock values, and commodity prices. These variables affect U.S. economic growth, rates of unemployment, and the health of various industries, which, in turn, may seek assistance from Washington or protection from import competition.

Three industries have been particularly affected by the financial turmoil. The first is the steel industry. In 1997, Southeast Asia was the world's largest steel import market with 75 million tons imported (as compared with 30 million tons imported into the United States). The Asian financial crisis along with severe recessions in the countries of the region (except for China) caused steel import demand to fall, and more production from Asian steel mills to be diverted to other markets (including those in the United States). Asian mills have more than 300 million tons in steel making capacity (counting the capacity in Japan and South Korea). Also, European producers who previously exported to Asia, diverted some of their product to the United States. Between August 1997 and August 1998, steel imports into the United States increased almost 80%. U.S. production suffered, and total employment in the industry dropped by about 10,000 workers. This brought anti-dumping petitions from the U.S. steel industry with respect to imports of hot rolled steel from Japan, Brazil, and Russia. On April 29, 1999, the Department of Commerce found that Japan was dumping hot-rolled steel in the United States and assigned duties ranging from 17.86% to 67.14%. In February 2000, The White House decided to impose import curbs on wire rods and line pipes.<sup>24</sup>

The second industry particularly hurt by the financial turmoil is U.S. agriculture. Falling exports, lower U.S. prices, and a drop in farm income were among the reasons the Secretary of Agriculture has announced several food aid measures to boost U.S. agricultural exports. In 2000, the U.S. agricultural trade surplus is forecasted to drop to around \$11 billion, the lowest level since 1986. Behind the continued low export levels are the slow economic recovery in East and Southeast Asia, the strength of the dollar, and increased competition in world corn, wheat, and soybean markets.<sup>25</sup>

The third industry is crude petroleum, particularly those U.S. companies involved in extraction and in servicing the oil drilling industry. The drop in crude oil prices caused primarily by the recession in Asia placed oil producers in a profit squeeze. The subsequent revival of the OPEC cartel and the hike in crude oil prices in 2000 have

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<sup>24</sup>U.S. Grants Minimal Relief on Wire Rod; More on Line Pipe in 201 Cases. *Inside U.S. Trade*. February 18, 2000.

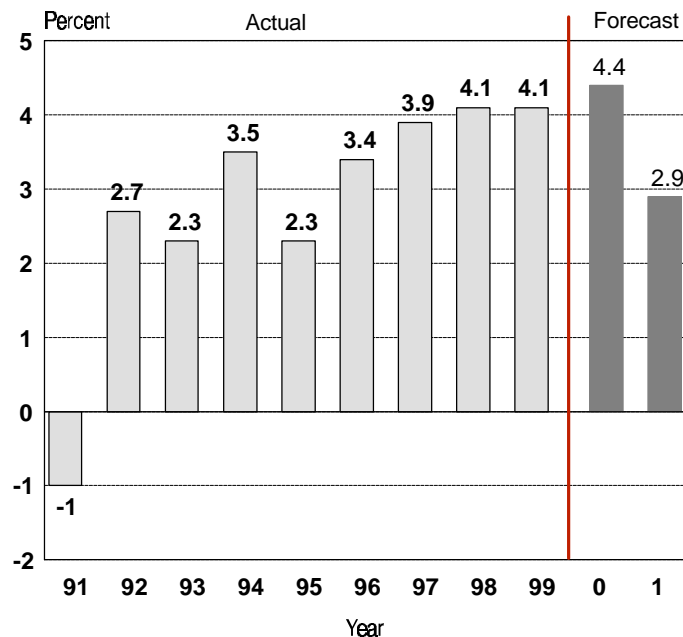
<sup>25</sup>See: CRS Issue Brief 98006, *Agricultural Export and Food Aid Programs*, by Charles Hanrahan.

offset some of the losses, but for some companies, the recovery has been too late. The high prices, in turn, have hurt the users of petroleum products (particularly gasoline, diesel fuel, and home heating oil) who had benefitted from depressed prices in 1998-99.

## Effects on U.S. Economic Growth

The U.S. economy in late 1998 shook off the effects of the slump in Asian and other foreign economies. A rising trade deficit was largely offset by capital inflows seeking safety and a more accommodating Federal Reserve which lowered interest rates three times during the worst of the global turmoil. U.S. economic growth in real gross domestic product reached 4.1% in 1998, up slightly from 1997 and the 3.4% in 1996. In 1999, the economy remained strong with a 4.1% growth rate and is expected to log a similar high rate in 2000.<sup>26</sup> (See **Figure 4.**)

**Figure 4. U.S. Economic Growth Rate  
1991-2001 (forecast)**



Sources: Standard & Poor's DRI, U.S. Dept. of Commerce

Standard & Poor's DRI, an econometric forecasting service, explains that the U.S. economy continues in its record-breaking expansion – even as higher interest rates and oil prices threaten to stop the expansion. International trade remains the major imbalance in the economy as the merchandise deficit continues to set new records. Imports are rising faster than exports, but foreigners seem willing to invest in U.S. assets to fund the current account deficit.<sup>27</sup>

## Policy Proposals and the New Financial Architecture

The commonly accepted vision for international capital markets is that they should operate at least as well as the better domestic capital markets. While volatility and

<sup>26</sup>Standard & Poor's DRI. *The U.S. Economy*, 3/2000. P. 10.

<sup>27</sup>Standard and Poor's DRI. *The U.S. Economy*, 2000/3. P. 6.

contagion cannot be eliminated, at a minimum, the frequency and intensity of market financial crises and the extent of contagion should be reduced.

The policy proposals that have arisen take three broad tracks. The first is economic and regulatory policy — both by the United States and by other nations to reform their domestic economies. The second is what is being termed a new financial architecture, and the third is in the activities of the International Monetary Fund. The reforms seek to accomplish certain goals. They include: (1) promoting the more orderly working of the international monetary and financial system, (2) minimizing the risk that systemic crisis will recur, and (3) ensuring that, when isolated crises do happen, there are early warning mechanisms, effective policy tools, adequate resources, and broad support to help countries withstand difficult external pressures and conditions.

### **International Financial Institution Advisory Commission**

On March 8, 2000, the congressionally mandated International Financial Institution Advisory Commission submitted its report to the Congress and U.S. Treasury.<sup>28</sup> The Commission considered the future roles of seven international financial institutions: the International Monetary Fund, the World Bank, three regional development banks, the World Trade Organization, and the Bank for International Settlements. With respect to the IMF, the Commission made the following recommendations:

- The IMF should be restructured as a smaller institution with three major purposes: (1) to serve as a quasi lender of last resort (standby lender to prevent panics) to emerging economies, but its lending operations should be limited to the provision of liquidity (short-term funds) at penalty interest rates (above the borrower's recent market rates) to solvent member governments when financial markets close; (2) to collect and publish financial and economic data from member countries and disseminate those data in a timely and uniform manner; and (3) to provide advice (but not impose conditions) relating to economic policy as part of regular consultations with member countries.
- The IMF should be precluded from making other than short-term loans to member countries, particularly long-term loans in exchange for compliance with conditions set by the IMF.
- The IMF's Poverty and Growth facility should be closed and its long-term assistance to foster development and encourage sound economic policies be the responsibility of a reconstructed World Bank and regional development banks.

The Commission listed four “pre-conditions” for a country to qualify for IMF assistance: (1) a competitive banking system that allows a greater presence for foreign

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<sup>28</sup>International Financial Institution Advisory Commission. *Report of the International Financial Institution Advisory Commission*. Allan H. Meltzer, Chairman. March 8, 2000. The members of the commission included Allan H. Meltzer, C. Fred Bergsten, Charles W. Calomiris, Tom Campbell, Edwin J. Feulner, W. Lee Hoskins, Richard L. Huber, Manuel H. Johnson, Jerome I. Levinson, Jeffrey D. Sachs, and Esteban Edward Torres.

financial institutions; (2) the regular publication of information regarding that nation's outstanding debts and liabilities; (3) commercial banks that are adequately capitalized, and (4) proper fiscal policy. The Commission suggested that these rules be phased in over a five-year period and that they be suspended if necessary for global stability in the event of a major crisis.

Several members of the Commission dissented from the recommendations of the report. The dissent with respect to the IMF centered on the constraints placed on the IMF in combating financial turmoil and on who would qualify for assistance. The four dissenters, for example, argued that the suggested pre-conditions for crisis loans would ignore the macroeconomic policy stance of the country in turmoil, because the IMF would not be authorized to negotiate policy reform. In short, the IMF might end up supporting countries with runaway budget deficits and profligate monetary policies. The pre-qualifying conditions also might preclude support for countries that are critical for global financial stability.<sup>29</sup> Other objections by commission members were that it did not address worker rights or sustainable development issues and that it might undercut the fight against global poverty.

In a response to the report, House Majority Leader Dick Armey stated that the report would help reverse years of IMF mission creep and that it will form the bipartisan basis for legislative action in 2000.<sup>30</sup> In a Senate Banking Committee hearing, Senator Phil Gramm stated that his inclination was to study the report and to use the legislation for debt relief for certain highly indebted poor countries to implement necessary reforms of the IMF and World Bank.<sup>31</sup>

As for the Clinton Administration, in a March 2000 hearing of the House Banking Committee, Treasury Secretary Summers stated that the ongoing reform of the global financial architecture had produced some important achievements, including, more recently, the creation of the G20 (Group of Twenty nations) which is to be a permanent informal mechanism for dialogue on key economic and financial issues among industrial and emerging market economies. In addition, the IMF has changed the terms of the exceptional financial support that the international community provides by creating a Supplementary Reserve Facility and has been working to reduce problems of moral hazard by charging premium interest rates. The IMF also has provided increased incentives for countries to pursue sound policies before financial crisis strikes. The IMF also has found new ways to involve the private sector in the resolution of crises - most notably in the cases of Korea and Brazil. The Administration also claim that there has been a sea change in transparency and accountability at the IMF and World Bank, a new emphasis in program content with substantial changes in the scope and nature of the conditionality for IMF (and World Bank) support that places greater emphasis on the importance of market opening and liberalization of trade, focuses more on the development of the institutions and policies

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<sup>29</sup>C. Fred Bergsten, Richard Huber, Jerome Levinson, and Esteban Edward Torres. Dissenting Statement (to the International Financial Institution Advisory Commission report). c. March 6, 2000.

<sup>30</sup>Office of the House Majority Leader. Press Release. March 8, 2000.

<sup>31</sup>Senate Banking Committee. Gramm Plans Legislation to Implement Reforms of International Monetary Fund, World Bank. Opening Statement. March 9, 2000.

that will allow markets to operate, takes better account of the impact on the poor of economic adjustments; increases national ownership and participation in reforms, and incorporates environment, social and labor issues into program design, as appropriate.<sup>32</sup>

## **G7 and Other Recommendations**

Other studies in the aftermath of the global financial crisis have made similar recommendations. In June 1999, the finance ministers of the G7 (Group of Seven Industrial Nations) recommended reforms in six priority areas:

- strengthening and reforming the international financial institutions and arrangements;
- enhancing transparency and best practices;
- strengthening financial regulation in industrialized countries;
- strengthening macroeconomic policies and financial systems in emerging markets;
- improving crisis prevention and management, and involving the private sector, and
- promoting social policies to protect the poor and most vulnerable.<sup>33</sup>

In February 1999, the G7 established the Financial Stability Forum which has endorsed a broad range of concrete policy actions to address concerns related to highly leveraged institutions, volatile capital flows, and offshore financial centers. The Forum aims to promote international financial stability through enhanced information exchange and co-operation in financial supervision and surveillance. It comprises national authorities responsible for financial stability in significant international financial centers, international financial institutions, international supervisory and regulatory bodies, and central bank expert groupings. The Forum is chaired by Andrew Crockett, General Manager of the Bank for International Settlements. For hedge funds and other highly leveraged institutions (HLI), the Forum recommended strengthened risk management practices, enhanced regulatory oversight of HLI credit providers, enhanced public disclosure, guidelines on good practices for foreign exchange trading, and building a firmer market infrastructure.<sup>34</sup>

A separate study by the Council on Foreign Relations chaired by Carla Hills and Peter Peterson makes recommendations aimed at altering the behavior of emerging-market borrowers and their private creditors in ways that would reduce vulnerabilities in the exchange rate systems of emerging economies; inducing private creditors to accept their fair share of the costs of crisis resolution; reforming the IMF's

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<sup>32</sup>Summers, Lawrence H. Testimony before the House Banking Committee. March 23, 2000.

<sup>33</sup>G7 Finance Ministers. *Strengthening the International Financial Architecture*, Report of the G7 Finance Ministers to the Köln Economic Summit, Cologne, June 18-20, 1999.

<sup>34</sup>Financial Stability Forum (Basle, Switzerland). Financial Stability Forum Endorses Policy Actions Aimed at Reducing Global Financial Vulnerabilities. Press release No. 7/2000E, March 26, 1999.



lending policies; and refocusing the mandates of the IMF and the World Bank on leaner agendas.<sup>35</sup>

## IMF And World Bank Actions

The IMF, itself, along with the World Bank and member governments have been addressing the problems in the international financial system. The IMF has outlined the reform proposals as summarized briefly below.<sup>36</sup>

### I. Inadequate Financial Data, Standards, and Surveillance

**Problem:** In the countries that experienced financial crises, banks, lending companies, and other financial institutions had incurred extensive short-term debts in foreign currency while lending long-term for arguably uneconomic purposes in domestic currencies. True risks were not disclosed, and reliable data often were not available.

#### 1. Transparency in IMF and Country Operations

**Problem:** Insufficient information was available to the public to protect their investments and lessen the risks involved when investing or conducting business in the countries that experienced financial crises, even though some of this information had been gathered by the IMF. Insufficient information was available on IMF analyses and operations.

**Objective of Proposals:** Help foster better decision-making and economic performance by further improving transparency in the policies and practices of countries and international institutions without compromising the candor of the dialogue with members that has characterized the IMF's role as a confidential policy advisor.

#### Proposals:

- A. Make available more information on IMF surveillance of member countries and analyses of policy issues.
  - The IMF agreed in March 1999 that it should continue to actively encourage the release of Public Information Notices following Article IV consultations. (About 80% of them have been released.)
  - In April 1999, an eighteen-month pilot project for the voluntary public release of Article IV staff reports was established with 45 countries agreeing to participate.
  - On June 3, 1999, the IMF decided to release statements of the Chairman of its Executive Board summarizing the board's views following discussions of a member's use of Fund resources. At the same

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<sup>35</sup>Council on Foreign Relations. *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture*. 1999.

<sup>36</sup>Proposals are summarized in: International Monetary Fund. *Report of the Managing Director to the Interim Committee on the Progress in Strengthening the Architecture of the International Financial System*. September 24, 2000.

time, the IMF established a presumption that the relevant Letters of Intent, Memoranda of Economic and Financial Policies, and Policy Framework Papers, if any, would be published (with country permission) in use of Fund resources cases (to September 1999, 26 out of 31 had been published).

– Key IMF documents are being released including various policy papers and related summaries, external evaluations of the IMF's surveillance and economic research activities, the staff's statements on the findings of these studies, and summaries of the Executive Board discussions.

- B. In July 1999, an independent, external evaluation of IMF surveillance recommended that with respect to scope, the IMF concentrate on its traditional areas of surveillance while giving increased attention to the international and regional aspects of surveillance and more explicit attention to vulnerability issues including enhanced analysis of the capital account, the financial sector, and the treatment of contagion. With respect to organization and governance, the report made several proposals with a view to (i) making the Executive Board's oversight more focused; (ii) enhancing ownership of the surveillance process by the Board; and (iii) ensuring that consultations cover the most important issues. The IMF noted that over the past two years, it had already focused more on several of the issues raised in the report. This included greater attention to financial sector vulnerabilities, capital account issues and sustainable exchange rate regimes, debt and reserve management practices, as well as developing early warning systems to signal potential problems.

## 2. International Standards

**Problem:** Financial data available to investors and policymakers on economic and business activities in the countries in turmoil often has not been based on internationally accepted standards. Newly industrialized countries often lack good practice standards for economic and financial activities and social safety nets to cope with severe recessions..

**Objective of Proposals:** Foster the development, dissemination, and adoption of internationally accepted standards or codes of good practice for economic, financial, and business activities and governmental monetary and fiscal policies.

### **Proposals:**

- A. Strengthen the IMF's Special Data Dissemination Standard.  
—By March 2000 all SDDS subscribers are required to conform to the IMF's comprehensive template for disseminating data on international reserves and related liabilities.
- B. Implement the "Code of Good Practices on Fiscal Transparency — Declaration of Principles" that was adopted by the IMF's Interim Committee. A Code of Good Practices on Transparency in Monetary

and Financial policies was approved by the IMF's Executive Board and awaits approval by the Interim Committee.

- C. Improve the quality of banking supervision internationally.  
— Address the gaps in existing standards on banking supervision.
- D. Complete work in other standard-setting bodies on developing standards relevant for the functioning of financial systems, including accounting and auditing, bankruptcy, corporate governance, insurance regulations, payment and settlement systems, and securities market regulation.
- E. Strengthen social policies as an essential complement to the reform of the international financial system.  
— Assist countries in establishing social safety nets.  
— World Bank to develop principles of good practice in social policy.

### 3. Surveillance and Enforcement of International Standards

**Problem:** Monitoring and regulation of banks and other financial institutions are done by national governmental organizations according to national regulations. Even though many financial institutions had been operating within allowable national standards, those standards did not rise to the level of international standards. The extent to which national regulatory authorities enforced international standards also was not clear.

**Objective of Proposals:** To induce countries to adopt international financial standards and monitor the extent to which countries observe them.

#### **Proposals:**

- A. Better integrate the use of international standards in IMF surveillance.  
— IMF has completed two rounds of experimental assessments on the observance of standards and codes by member nations.  
— IMF's Executive Board has announced that it would give greater attention to financial sector vulnerabilities, capital account issues, and sustainable exchange rate regimes.  
— Improve members' systems for monitoring of short-term external debt.
- B. Improve financial market supervision by national authorities to include reducing "crony capitalism" lending based more on political or other connections rather than on market discipline.  
— Basle Committee on Banking Supervision (BCBS) is reviewing gaps bank regulation (sponsored by the Bank for International Settlements) and has proposed a New Capital Adequacy Framework to replace the 1988 Basle Accord.  
— National authorities are reviewing their ongoing procedures to enhance oversight of financial sectors, particularly with respect to highly leveraged institutions and offshore operations.

## II. Strengthening Financial Systems.

**Problem:** The international financial system has been evolving and becoming more integrated, while countries are becoming less able to cope with shocks to their exchange rate regimes. Weaknesses in one country's exchange rate may be transferred to other countries, particularly by sudden outflows of short-term capital or by currency speculation.

**Objective of the Proposals:** Reduce the risk of sudden weakness in exchange rate systems — caused especially by rapid outflows of capital or currency speculation — and the risk that a financial crisis in one country will be transmitted to other countries.

### Proposals:

- A. Assess measures related to exchange rate arrangements to improve the functioning of the international financial system.
  - In the course of IMF consultations, provide increasing attention to analysis of financial sector vulnerabilities. IMF to prepare Financial Sector Stability Assessments based on IMF-World Bank Financial Sector Assessment Program launched in April 1999.
  - Countries move toward either more flexible or purely fixed exchange rate regimes, although the IMF has concluded that no single exchange rate regime is appropriate for all countries or in all circumstances. Exchange rate flexibility needs to be accompanied by a credible monetary policy.
  - Adoption of the U.S. dollar as the domestic currency in certain countries (e.g. Argentina) and whether the Federal Reserve discount window or U.S. bank supervision should be extended to such countries.
- B. Have the IMF provide contingent resources
  - In April 1999, the IMF approved contingent credit lines and in early 1999 reviewed and decided to maintain the Supplemental Reserve Facility.
- C. Increase resources available for the IMF to provide to countries in crisis.
  - Already effective are the increase the Fund's quotas and the bringing into force the New Arrangements to Borrow.
  - In September 1999, the IMF decided to sell up to 14 million ounces of gold on the basis of market prices to some central banks of member countries who, in turn, would use the gold to make loan repayments. These transactions would allow the IMF to replace the gold in their reserves (at a value of SDR 35 per ounce) and use the balance from the sale at market prices for its Special Disbursement Account for investments benefitting the Heavily Indebted Poor Countries (HIPC) countries. By keeping the gold transactions out of the market, the price of gold is not affected. The IMF's first gold sale occurred on December 14, 1999, in which slightly more than 7 million ounces of gold were sold to Brazil and accepted it back for payment of an obligation due the same day. Of the proceeds, the IMF invested about \$1.6 billion with the Bank for International Settlements to generate income for the HIPC initiative.

The second sale on December 17 was of 655,000 ounces of gold to Mexico which created about \$152 million which likewise was invested.<sup>37</sup>

### III. Capital Account Issues.

**Problem:** Sudden and large capital outflows contribute to the severity and contagion of financial crises.

**Objective of Proposals:** To reduce the volatility of capital flows.

- A. Consider the role of capital controls.
  - Most IMF directors have concluded that the reimposition of controls on capital outflows was not generally an effective policy instrument in a financial crisis, although some pointed out that such controls could play an important role. Directors also agreed that there is no single approach to securing the benefits of international capital flows while limiting its risks. The IMF Directors also concluded that capital controls cannot substitute for sound macroeconomic policies.
  - Consider measures to raise the cost of short-term cross-border capital flows (such as the taxes on short-term capital inflows [the so-called Tobin tax] imposed by Chile).
- D. Consider how to achieve orderly capital market liberalization.
  - National authorities to pursue orderly integration and liberalization, building on the need for strengthened financial systems and prudential regulation.

### III. Involving the Private Sector in Forestalling and Resolving Crises.

**Problem:** The sheer magnitude of private capital flows into and out of countries in crisis, along with the moral hazard that international financial support packages by the IMF merely encourage risky private sector lending, mean that the private sector needs to be involved in any solution.

**Objective of Proposals:** To better involve the private sector in crisis prevention and crisis resolution, in order to limit moral hazard, strengthen market discipline, and help bring about orderly adjustment processes when crises do occur, while still maintaining international financial flows.

#### Proposals:

- A. In trying to involve the private sector to help finance adjustment programs, the IMF has relied on its catalytic role to mobilize private financing. In recent cases with Ecuador, Pakistan, Romania, and the Ukraine, the IMF has encouraged these countries to approach their creditors for additional financing and to use market-friendly approaches that avoid defaults and disorderly creditor-debtor relations.

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<sup>37</sup>International Monetary Fund. Press Release No. 99/48. Newsbriefs No. 99/84 and 99/86.

- B. Encourage countries to consider changes in the terms of foreign sovereign bond contracts to speed the negotiation process in times of difficulties.  
— The G-22 has consulted with the private sector on model clauses.
- C. Allow the IMF to lend to support government-issue debt in arrears held by private bondholders to support adjustment measures during debt negotiations.  
— The IMF's Executive Board has agreed in principle to extend its 1989 policy on lending into arrears on a case-by-case basis.
- D. Allow the IMF to lend to support non-governmental debt in arrears, arising from the imposition of exchange controls, to support adjustment measures during debt negotiations.
- E. Provide for the imposition of stays on creditor litigation to facilitate orderly non-governmental debt renegotiation.  
— Further consideration required.
- F. Strengthen national insolvency codes and the operation of insolvency regimes.

## **U.S. Economic and Regulatory Policy**

In terms of economic and regulatory policy in response to the global economic turmoil, the United States can pursue monetary, fiscal, regulatory, and trade policies. Monetary policy is primarily in the hands of the Federal Reserve. While Congress plays an important oversight role, actual monetary policy changes are carried out by the Fed in accord with its own assessments. Since mid-1999, as inflation has picked up and labor markets have remained tight, the Fed has raised interest rates several times to ease labor and price pressures and to provide alternative investments to the high-rising U.S. stock market. If, however, the economy slows sharply or drops into recession, there will be pressures both on the Fed to reduce U.S. interest rates and on Congress and the White House to pursue a stimulative fiscal policy — tax cuts and/or additional spending.

As for U.S. exchange rate policy, one question is whether the United States, Europe, and Japan should intervene more regularly to stabilize currencies. In June 1998, the United States and Japan did intervene to prop up the yen,<sup>38</sup> but such action has been the exception rather than the rule.

As for regulatory changes, in the wake of the bailout of Long Term Capital Management (LTCM), several questions have been raised about financial market transparency, internal risk management and control procedures of large financial institutions, and the adequacy of prudential supervision and systematic financial market surveillance. The key issue is how large leveraged positions, such as those held by

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<sup>38</sup>Sanger, David E. U.S. Intervenes in Currency Markets to Support the Yen. *The New York Times*, June 18, 1998.

LTCM, could be built up across a sizable number of financial institutions to the point where systemic risk was raised to dangerous levels.

In response to this issue, the White House organized the President's Working Group on Financial Markets. Some of the world's largest financial institutions also have agreed to try to set their own industry-wide standards in derivatives markets. By setting their own voluntary guidelines, the financial industry reportedly hopes to both prevent recurrences of the problems that have arisen and to keep stricter regulations from being imposed by regulatory authorities. In April 1999, the President's Working Group recommended the following measures:<sup>39</sup>

- to make public more frequent and meaningful information on hedge funds;
- public companies, including financial institutions, to publicly disclose additional information about their material financial exposures to significantly leveraged institutions, including hedge funds;
- financial institutions to enhance their practices for counterparty risk management;
- regulators to encourage improvements in the risk-management systems of regulated entities, and
- regulators to promote the development of more risk-sensitive but prudent approaches to capital adequacy.

The Hedge Fund Disclosure Act, H.R. 2924 (Baker), incorporates the core of these recommendations. It would require hedge funds with over \$3 billion in capital to file quarterly reports which would be made public. The Working Group also noted that regulators need expanded risk assessment authority for the unregulated affiliates of broker-dealers and futures commission merchants. It also recommended that the U.S. Congress enact the provisions with respect to financial contract netting (In the 106<sup>th</sup> Congress, see H.R. 833 [Gekas], H.R. 1161 [Leach], S. 625 [Grassley]) and that U.S. regulators consider stronger incentives to encourage offshore financial centers to comply with international standards.<sup>40</sup>

As for international trade policy, pressures are building in two areas. The first is in the growing size of the U.S. trade deficit. In 1999, the merchandise trade deficit reached a record \$347.1 billion, while the current account also came in at a record \$338.9 billion, up from \$220.6 billion in 1998. While these deficits currently are being matched by inflows of capital into the relatively safe U.S. market, the trade imbalance reflects growing pressures on U.S. industries that export to the troubled economies or compete with imports. The United States continues to encourage Japan to resolve its bad loan problem and to lift its economy out of recession in order that it might lead,

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<sup>39</sup>The President's Working Group on Financial Markets (Department of the Treasury, Board of Governors of the Federal Reserve System, Securities and Exchange Commission, Commodity Futures Trading Commission). *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*. April 1999. On Internet at <<http://www.ustreas.gov/press/releases/archive.htm#june>>.

<sup>40</sup>For a general description of hedge funds, see CRS Report 94-511 E and CRS Report RS20394, *The Hedge Fund Disclosure Act: Analysis of H.R. 2924*, by Mark Jickling.

rather than retard, economic recovery in Asia and take in more exports from Asian nations. For 1999, Japan again reported recessionary economic conditions.