

The Asian Crisis: Lessons for the Future

Stanley Fischer¹

Fifth Hong Kong Monetary Authority Distinguished Lecture
May 21, 2002

It is a great honor to have been invited to deliver this lecture at the Hong Kong Monetary Authority, an institution that has shown decisiveness, analytic clarity, and courage in the years since the inauguration of the linked exchange rate system in 1983, and especially in its actions during the Asian crisis in 1997 and 1998.

Although the start of the Asian financial crisis is generally dated to the devaluation of the Thai baht in July 1997, the crisis sharply intensified following the devaluation by Taiwan on October 17, and the financial attack on Hong Kong a few days later. In that attack, market participants shorted both the Hong Kong currency and the Hong Kong stock market, knowing that the increase in interest rates implied by currency board rules would lead to a stock market weakening. The unorthodox direct intervention by the Hong Kong authorities in the stock market in August 1998, against this same double play, not only successfully defended the currency, it also made money for Hong Kong. And at about the same time, soon after the Russian crisis, the HKMA had the courage to implement technical changes that they believed would strengthen the currency board arrangement – and in this too they were successful.

Despite the title of this lecture, I do not intend to revisit the Asian crisis. That has already been done by many,² including IMF researchers³ and in my Robbins Lectures, “The International Financial System: Crises and Reform”, delivered last October at the London School of Economics, on which I will draw in this lecture.⁴ And it is clear – as could be seen ten days ago at the meetings of the Asian Development Bank in Shanghai – that the region is now ready to move on from its preoccupations with the crisis, to address

¹ Vice Chairman, Citigroup Inc. This lecture is as prepared for delivery as the Fifth Hong Kong Monetary Authority Distinguished Lecture, at the HKMA, May 21 2002. Views presented are those of the author, and not necessarily those of Citigroup.

² See Paul Blustein, *The Chastening*.

³ See in particular two excellent papers by my former IMF colleagues: Jack Boorman, Timothy Lane, Marianne Schulze-Ghattas, Ales Bulir, Atish Ghosh, Javier Hamann, Alex Mourmouras, and Steven Phillips, “Managing financial crises: the experience in East Asia”, *Carnegie-Rochester Conference Series on Public Policy*, 53 (2000), 1-67; and Timothy Lane, Atish Ghosh, Marianne Schulze-Ghattas, Ales Bulir, Javier Hamann, and Alex Mourmouras, “IMF-Supported Programs in Capital Account Crises—Design and Experience”, IMF, 2001.

⁴ These are available on both the IMF website, and on my personal website, which is attached to that of the Institute of International Economics.

the policy issues of the first decade of the twenty first century, not least those arising from the historically unprecedented growth of the Chinese economy.

Accordingly I will focus on four major economic issues, each of great importance for the future performance of Asian economies, on each of which there was some controversy during the Asian crisis. They are:

- Fiscal policy, in good times and bad;
- Financial systems and corporate governance;
- Exchange rate systems; and
- Potential regional economic arrangements for Asia.

I. Fiscal Policy

One of the reactions to the financial crises of the 1990s was the development of codes and standards for different aspects of economic policy and economic infrastructure, such as accounting standards and corporate governance. There are now 11 standards listed on the IMF's website; in all there are over 50 international standards relating to the economy. Among them is an IMF-developed code of fiscal transparency, which lays out standards relating to budget formulation and budgetary data presentation. As of now, 39 countries have subscribed to the code of fiscal transparency.

However the code of fiscal transparency does not set standards for fiscal *policy*, for example, for desirable levels of budget deficits and debt to GDP ratios. What would these standards be? Two main considerations need to be taken into account. First, countries should be in a position to use countercyclical fiscal policy, in particular, to be able to undertake fiscal expansion to combat recession. Second, both the deficit and the debt should be at sustainable levels – there should not be any substantial risk of unsustainable debt dynamics.

Given the desirability of countercyclical fiscal policy, what is required is a *rule* to determine the deficit, rather than a single number. In principle, it should be possible to work out analytically an optimal fiscal policy rule for an economy. Such an analysis would have to tie together the deficit and the debt, using the standard debt dynamics equation:

$$\dot{d} = -x + (r - g)d$$

where d is the debt-to-GDP ratio, x is the primary (non-interest) budget surplus relative to GDP, r is the interest rate, and g the growth rate of GDP.

Although I am not aware of such an analysis having been undertaken, it is likely that any analytically based fiscal rule would reflect the structure of the economy, for example the age structure, the private saving rate, the economy's growth rate and its variability, the real interest rate and its variability, and the size of the national debt.

The best-known fiscal rule⁵ is defined in the European Stability and Growth Pact, which sets 60 percent of GDP as an upper bound on the national debt, 3 percent as an upper bound on the budget deficit, and the requirement that the budget should on average be close to balance over the cycle. The SGP leaves room for countercyclical fiscal policy by targeting a budget that is balanced on average over the cycle, but that is permitted to rise as high as 3 percent of GDP.

During the recession of 2001, the SGP was sometimes criticized for not permitting European countries to use countercyclical fiscal policy. However the problem was not with the SGP, but rather with the failure of those countries to reduce budget deficits sufficiently in good times to permit them to be increased in the recession.

Theory has not provided a great deal of guidance about an optimal debt to GDP ratio. The issue was discussed in the United States during the period, not so long ago, when it was believed the government debt was about to disappear. The Maastricht upper limit of 60 percent of GDP seems to have gradually gained status as a norm, to the extent that one often hears it argued that a particular country's debt cannot be excessive because it meets the Maastricht 60 percent of GDP criterion.⁶

Interest rates paid by emerging market governments are not only typically higher, but also vary a great deal more, than those paid by industrialized country governments. For instance, over the period 1995 to 2000, during which the real interest rate paid by the United States and United Kingdom governments had a standard deviation of 0.86 percent per annum, the standard deviation for Korea was more than double that, and that for Mexico and Brazil – which averaged 4.2 percent per annum⁷ – greater by a factor of five. If a country that is otherwise managing itself reasonably faces a change in its borrowing cost of 400 basis points within a year, then it can suffer a very large fiscal shock if its debt to GDP ratio is around 60 percent.⁸ Further, the costs of borrowing are likely to be non-linear as a function of the debt-to-GDP ratio, which means that the penalty for having a larger debt will increase more than proportionately with the size of the debt.

⁵ Several countries, and subnational governments, are subject to the simpler fiscal rule of a balanced budget. The SGP is more sophisticated in allowing for the operation of countercyclical fiscal policy.

⁶ In practice, a host of budget accounting issues arises about how to treat different aspects of government activity, for instance the provision of explicit and implicit guarantees. These need to be resolved in defining the fiscal rule, as do issues about what measure of the debt to use, for instance net or gross, and if net, net of what. Whatever concept of the debt is used, the measure of the deficit needs to be consistent with the debt definition.

⁷ The underlying data for standard deviations of real interest rates (quarterly data) are 0.88 for the US, 0.92 for the UK, 1.88 for Korea, 3.66 for Mexico, and 4.71 for Brazil.

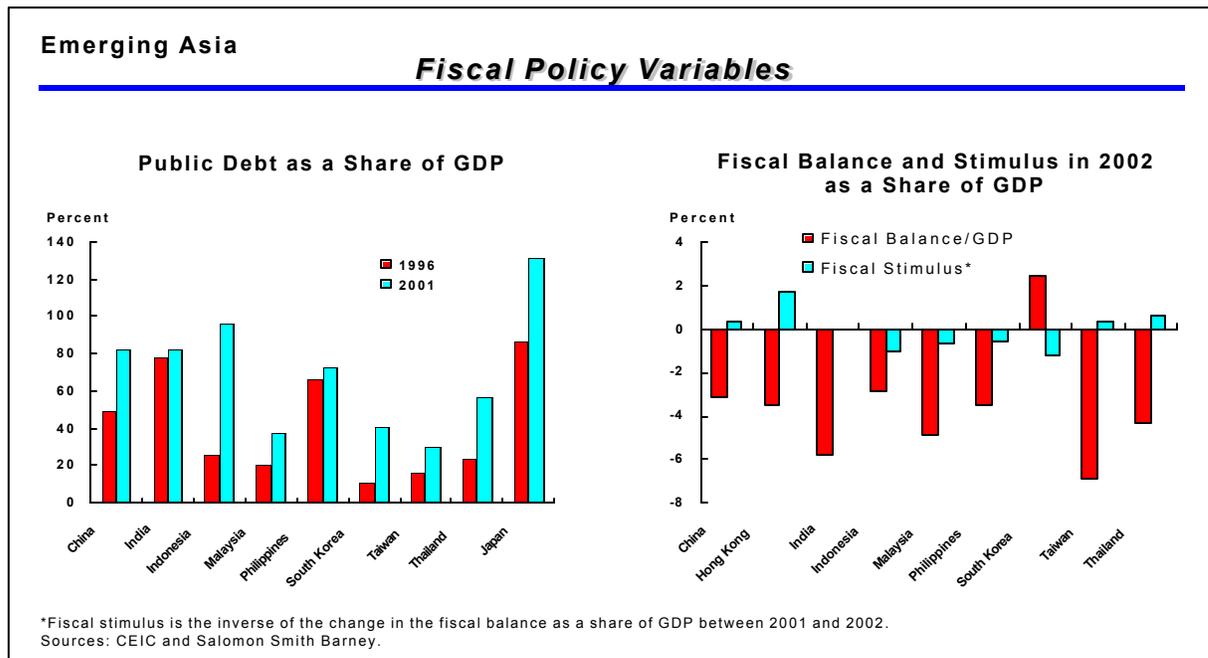
⁸ The extent of the shock would of course depend on the maturity of the debt; if the debt were very long-term, a change in the market interest rate would not have much fiscal consequence for some time.

Accordingly, if 60 percent is a safe norm for an industrialized country, the safe level for an emerging market country is very likely to be lower – even if the case can be made that the needs for budget spending in most developing countries are proportionately larger than those in industrialized countries.

One other aspect of debt dynamics needs to be emphasized: the sensitivity of the behavior of the debt to the relationship between the interest rate and the growth rate of the economy. If the growth rate exceeds the real interest rate – and that may well happen in a rapidly growing economy – then the economics of budget deficits appears benign.⁹ In essence, the impact of growth in reducing the debt to GDP ratio outweighs the impact of the interest on the debt, which tends to increase the debt to GDP ratio.

This sounds abstract, but consider an example of an economy with a debt to GDP ratio of 50 percent, a primary (non-interest) budget in balance, a growth rate of 6 percent, and a real interest rate of 4 percent. One year later the debt to GDP ratio would be a little over 49 percent, with the effect of growth in reducing the debt ratio outweighing the effect of interest payments in increasing the debt ratio. Suppose instead that growth had been zero: then the debt one year later would be 52 percent of GDP rather than 49 percent. And if growth stayed at zero for another two years, the debt to GDP ratio after three years of no growth would be more than 56 percent, 9 percentage points of GDP higher than it would have been had growth remained at 6 percent – and rising rapidly rather than declining relative to GDP. The three years of recession in Argentina from 1999 to 2001 provided an essential part of the mechanism that led to the rapid and unsustainable build-up in that country's debt ratio.

Chart 1 shows debt and budget deficits data for selected Asian countries.



⁹ The golden rule of capital accumulation states that it is dynamically inefficient for an economy to have so much capital that the growth rate exceeds the real interest rate.

In several countries in the region, but not Hong Kong (which has fiscal reserves), debt ratios are high by international standards, largely a result of the financial crises of 1997-98. In 2001, in the face of the recession, most economies increased their fiscal deficits to soften the recession; Hong Kong's deficit exceeded 5 percent of GDP, an increase of 4.6 percent of GDP relative to 2000. Most countries are tightening fiscal policy a bit this year, but it remains important to ensure that medium-term fiscal sustainability is assured, and in the case of Hong Kong, that the fiscal adjustment program designed to bring balance within four years be carried out. Korea stands out as the only country in the chart running a surplus. The message from the chart is that the fiscal situation in most economies in the region is reasonable, but that the situation requires careful watching – either because the current debt (which should include implicit liabilities) is large, or because the deficit is large and not being adjusted.

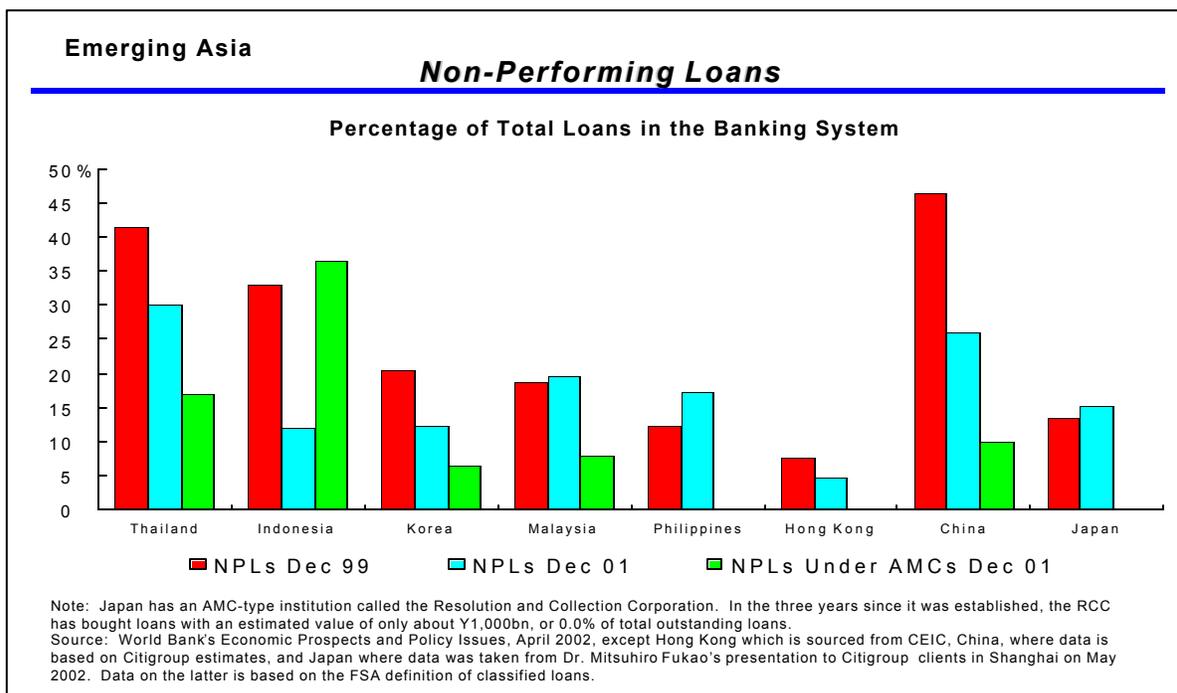
So what is the message on fiscal policy? It is to run sufficiently conservative policies in normal times to make it possible to use expansionary fiscal policy in recessions. And it is to pay attention to the level of the debt, for the higher the debt ratio, the greater the potential instability arising from a decline in growth or an increase in the real interest rate. It is also to run debt dynamics scenarios, under different assumptions about growth and real interest rates, to be sure that the debt dynamics is sustainable – and if not, it is to adjust fiscal policy appropriately. And if a 60 percent debt ratio is an appropriate upper limit for an industrialized country, the limit for most developing countries should be significantly lower, say around 40 percent.¹⁰

II. Financial Systems and Corporate Governance.

The Asian crisis had a devastating effect on financial institutions in the crisis countries. This was a result both of poor lending practices before the crisis, and of the size of the macroeconomic shock. Although no financial system that lends on a large scale to the private sector can be strong enough to withstand a prolonged period of severe macroeconomic weakness, the impact of the macroeconomic shocks on the crisis countries was intensified by preexisting weaknesses in both the financial sector and corporate governance.

¹⁰ As noted earlier, there is not yet an analytic basis for these estimates.

Chart 2 shows the current extent of non-performing loans (NPLs) in the crisis countries and in China and Japan.



Obviously, banking system problems in several countries are far from resolved. For some countries, in particular Indonesia, a large proportion of the NPLs have been moved off bank balance sheets into asset management companies (AMCs). This represents progress, but whether it ultimately resolves the NPL problem depends on how well and how rapidly the NPLs are dealt with. Chart 2 makes it clear how strong is the banking system in Hong Kong, one of the sources of the strength of the economy, a testimony not only to the HKMA, but also to standards of corporate governance in the SAR.

Beyond the crisis countries, financial institutions in both China and Japan suffer from substantial difficulties. In China, NPLs of the major banks are estimated to have totaled more than 40 percent, before about 10 percent of total loans were transferred to AMCs. The government has now instructed the banks that the NPL ratio should be reduced by 2-3 percentage points per year. The main source of the NPLs is policy lending, i.e. directed lending to particular sectors or firms. But underlying the fact that policy lending leads to NPLs is the poor state of corporate governance among the recipient companies. And that in turn makes it clear that one key to reducing the proportion of NPLs is to stop making loans to companies that will not be able to repay them – that is, dealing with the stock problem of existing NPLs is only one half of what needs to be done, the other half is to deal with the flow problem, by severely reducing the flow of new NPLs.

The problems of the Japanese banks are well known, and a variety of reform plans and measures have been put in place. Nonetheless, a substantial NPL problem remains; private sector estimates of its extent are typically larger than the estimates of the authorities, and in most cases so far, the private sector analysts have proved to be more accurate. The problems of the banking sector have been evident for at least six years, maybe a decade, but they have been extremely difficult to deal with decisively. The political economy of such reforms is complicated, for the measures that need to be implemented tend to be recessionary in the short run; accordingly there is a strong temptation to delay reform, in the hope that future growth will deal with the problem. That cannot be ruled out, but in the meantime Japan is suffering from a prolonged period of low growth, with three recessions in a decade, the low growth itself being a result in part of the problems of the financial sector (and vice versa).

In the Japanese case, too, financial sector problems interact with those of corporate governance. As a policy matter, the government is reluctant to move too quickly on the banks, for fear that excessively aggressive action on NPLs will lead to corporate bankruptcies and unemployment. And individual banks would rather gamble for redemption by making new loans to corporations than recognize losses that have already been incurred.

What does it take to create a good financial system? In brief: banks that are commercially oriented, well capitalized, well managed, especially in controlling risk, and well supervised. In this regard, I have been struck in my new job by how pervasively the potential actions of regulators are present in the deliberations and decisions made inside our bank – the regulators matter a great deal, for good or ill.

It also takes good corporate governance, for without adequate information about the activities of borrowers, and without the assurance that the borrowers will be well managed in a strong and predictable legal system, lenders simply cannot operate effectively.

Alan Greenspan has argued – in the context of discussions about the Asian crisis – that a financial system is strengthened by having a diverse array of financial institutions. The logic is that if one set of institutions gets into trouble, another part of a well-diversified system can pick up the slack. For instance, if the banks have problems, firms can turn to the commercial paper market for funding; and if the commercial paper market has problems, they can try to borrow longer or even issue equities. The argument is persuasive, but the extent to which a given economy can support a diversity of institutions must depend on both its size and stage of development. However, by being open to the presence of foreign institutions, a small economy can have access to a wider array of services than if it remains closed to the operation of foreign financial institutions.

What should be done when the financial system or institutions in it are in trouble? As an economic matter, it may be possible to construct an argument for regulatory forbearance at the worst parts of the cycle – provided the problem the economy is facing is not one caused by the financial system's weaknesses. In the latter case, it is probably

regulatory forbearance that created the problem, and without corrective action the situation will not improve. By contrast, political economy considerations generally suggest moving faster rather than slower, for it is only during crises that difficult problems of this nature are likely to be addressed comprehensively. In making this argument, I distinguish between the need for rapid decisions and rapid initiation of actions, and speed in completing the cleanup – for the simple fact is that the cleanups are generally complex and take time to complete. In thinking through these issues, it is useful to recall Marshall Lyautey's gardener,¹¹ who responded to a request to plant a particular species of trees by saying there was no rush, for they took 150 years to mature. He was told that was all the more reason to plant them as soon as possible.

Corporate governance is very much in the news, with the Enron case and its fallout dominating the headlines. It would only be natural if some in Asia, who smarted under charges of weak corporate governance five years ago, took a small measure of quiet satisfaction from these events. It is nonetheless impressive to see how seriously these problems are being treated in the United States, how much attention they are receiving, and how many suggestions for change there are. It is hard to know what will finally emerge, but we can expect rapid (perhaps too rapid) reactions by legislature, regulators, and shareholders, and improvements in corporate governance.

One reason to expect improvements is that good corporate governance is likely to pay off. On a recent trip to Russia, I was impressed by the improvements in corporate governance that had been made in one company that we visited, Yukos Oil. Then we heard from other companies that they too wanted to “Yukos-ize” – and one reason they gave was that Yukos stock had done relatively better than those of competitors whose practices had not yet improved.

What is needed for good corporate governance? A strong legal system, including effective bankruptcy procedures. Transparency in the form of good accounting and good accounting rules. Serious management, with its responsibilities and accountability clearly defined and implemented. Moving fast to reorganize when firms are in trouble. All this is obvious – and yet, it is extremely difficult, and near impossible in a political and social environment that does not reward those who follow the rules and punish those who do not.

One question that was often raised during the Asian crisis was why corporate governance should be singled out for reform when the practices being criticized had been around for decades of extraordinary growth. It is a good question. Part of the answer must be that rapid growth conceals a multitude of sins that become evident only under stress. In any case, there does now seem to be growing acceptance, in Asia as elsewhere, that good corporate governance matters. And there has been progress in corporate governance, most clearly in Korea, to a much lesser extent in some other countries.

Reforms in both financial systems and corporate governance in Asia have been slow, despite the emphasis placed on them in the IMF crisis programs. That is mainly

¹¹ The story has also been attributed to Louis XIV and others.

because these problems are very difficult to deal with, because they are deeply embedded in the structure of both the economic and political systems. It is also in part because the hardest economic policies to implement are those with short-run costs and benefits that appear only in the long run – and cleaning up banks and corporate balance sheets are both of this nature. The temptation to wait, to gamble for redemption, is natural. Sometimes it works – but not usually. That is why these problems persist in so many countries.

III. Exchange Rate Systems

The financial crises of the last decade showed that adjustable or soft exchange rate pegs are not viable when the capital account is open. Except in the case of Ecuador, every crisis country had some form of pegged exchange rate before its crisis. These crises reinforced belief in the impossible trinity:¹² that an open capital account, a pegged exchange rate, and an independent monetary policy, are not consistent. If the peg is hard, such as a currency board, then consistency is ensured by automatically dedicating monetary policy to maintenance of the peg. But that still may not be enough, for if fiscal policy goes off track, and/or the financial system is weak, monetary policy alone may not be sufficient to hold the peg.

I shall first discuss the operation of monetary policy under a flexible exchange rate, and then turn to some currency board issues. A country with a floating exchange rate has to decide what nominal anchor to adopt, and what exchange rate policy to pursue. For a country with a reasonable rate of inflation – one in the low double digits – experience increasingly supports the use of inflation targeting as the basis for monetary policy.

Turning next to exchange rate behavior: Most of the countries forced to float have been very unhappy about the subsequent behavior of the exchange rate, and policymakers and private sector participants in several countries – among them the Asian crisis countries, and Turkey several months ago – are searching for a middle way, that provides more predictability for the exchange rate. It is hard not to sympathize with this desire, for exchange rates moved far more after the crises than had been expected.

Further, there are good reasons for a country to be concerned about the behavior of both nominal and the real exchange rates. Changes in the nominal exchange rate are likely to affect the inflation rate. Changes in the real exchange rate may have a powerful effect on the allocation of resources, and – especially in countries that are to some extent dollarized – also on the health of the financial system and the distribution of wealth between debtors and creditors.

Thus monetary policy in countries with floating exchange rate systems is likely to respond to movements of the exchange rate. While this is rarely if ever the case for the United States, it is more so among other G-7 countries, and for smaller emerging market economies. In countries that pursue an inflation targeting approach to monetary policy,

¹² See my paper, “Exchange Rate Regimes: Is the Bipolar View Correct?” *Journal of Economic Perspectives*, Spring 2001, Volume 15, 2, 3-24.

changes in the exchange rate will be taken into account in setting monetary policy, because the exchange rate affects price behavior.

In the reverse direction, there is an unresolved issue about whether monetary policy in a flexible rate system should be used in the short run to try to affect the exchange rate. This is an area in which from time to time, in one country or another, conflict will erupt between the finance ministry and the central bank. In many respects, the issue is similar to that of how monetary policy in an inflation targeting framework should respond to movements in output and unemployment. Although it has not received much empirical attention, there is almost certainly a short-run tradeoff between the real exchange rate and inflation, analogous to the Phillips curve,¹³ and it is necessary to answer the question of how monetary policy should deal with such a tradeoff.¹⁴

Beyond the use of interest rates, some floaters intervene directly from time to time in the foreign exchange markets to try to stabilize the exchange rate. Interventions from time to time can be useful, *so long as they are not perceived as trying to defend a particular rate*. It is when the central bank commits itself to defending a particular value of the exchange rate that the speculators can have a field day.

Everything I have said so far reflects my belief that there is little room for the monetary authority in an emerging market country to peg the exchange rate, despite the understandable desire of so many to do so. Recognizing the difficulty for an emerging market country of defending a narrow range of exchange rates, John Williamson (2000) proposes alternative regimes. Rudi Dornbusch has named these BBC arrangements: basket, band, and crawl, which describes their essence.

Although I do not see how to make these intermediate regimes work for emerging market countries, it is clear that floating exchange rates do fluctuate a great deal, and that it would be useful if it were possible to reduce the range of fluctuations. The Asian countries are trying to work towards some arrangement to that end, perhaps along the lines of the European Monetary System, which preceded EMU, to which I will return at the end of the lecture. It is also true that it would be desirable to reduce the range of fluctuations of exchange rates among the major currencies, but that does not seem on the cards at present.

I believe that of all the changes in the international financial system that have taken place since 1994, the shift towards flexible exchange rates by emerging market countries is the one that has most reduced the risk of future crises. However, while a flexible exchange rate regime precludes some types of crises, it remains true that external financing crises can still occur in a flexible exchange rate regime, particularly a crisis that arises from the market's conclusion that a country's debt situation is not sustainable.

¹³ Cushman and Zha (1997) contain VARs from which the implied tradeoff can be calculated in the Canadian case.

¹⁴ The literature does include one answer: that monetary policy should only react to the exchange rate to the extent that changes in the exchange rate would affect the inflation rate. This answer seems to me incomplete.

Much as I wish the world were otherwise, I remain bipolar – at least on exchange rates. So let me now turn to the second pole, a currency board. A currency board can succeed – and in Hong Kong the linked exchange rate system has succeeded well – in bringing monetary stability. To work well the currency board needs the support of a strong financial system, a strong fiscal policy, and a flexible economy, which can adjust to shocks without having the exchange rate as a policy tool. That is a demanding set of requirements – but each is in any case desirable in its own right. Having large excess reserves of foreign exchange also helps.

What are the lessons of the collapse of the Argentinian monetary convertibility regime? The main lesson is that absent other adjustment mechanisms – and I include fiscal policy among the adjustment mechanisms – even a hard peg may not be viable. Labor markets in Argentina were not very flexible. The volume of trade is exceptionally small relative to GDP, so that large movements in relative prices would have been needed to equilibrate the balance of payments. And fiscal policy too turned out to be insufficiently flexible. It is often pointed out that until recently, fiscal deficits in Argentina were relatively small. That is true. But Argentina's external borrowing requirements were large, and fiscal policy did not change enough to persuade investors that the demands for foreign funding would decline anytime soon. Under these circumstances, with heavy dependence on foreign financing, the debt was not sustainable, and as a result, neither was the peg.

Let me mention one other major lesson from the Argentine crisis. The Argentine banking system was widely and rightly regarded as very strong until about 18 months ago. But as the government's financing difficulties grew, it in effect turned to the domestic financial system for financing, including by changing reserve ratios. All these measures weakened the financial system – and both directly and indirectly, they weakened confidence in the convertibility regime.

The caution is that even a very strong financial system is vulnerable – and rapidly so – to a combination of macroeconomic slowdown and a government's needs for financing.

In sum, maintenance of a currency board arrangement requires strong and consistent macroeconomic and structural policies. Hong Kong has demonstrated that it can meet these requirements.

IV. Regional Arrangements

Regional initiatives are high on the Asian agenda. As in most regions, trade arrangements have developed furthest, particularly among the ASEAN countries, but APEC and other trade agreements may well widen the extent of trade cooperation. There has been a great deal of discussion of regionalism versus multilateralism in trade, and it is easy to show analytically how regional arrangements may increase trade distortions

rather than reduce them. Ongoing integration into the global trading system should be the first priority for Asian (and all other) countries – and here China’s entry into the WTO provides a particularly pertinent example. But in a context of ongoing multilateral trade liberalization, Asian countries are likely to benefit from further regional trade integration.

The rise of China has created anxiety among some of its neighbors, who fear that they will not be able to compete with a country that they claim will have an absolute advantage in every line of activity. Economists brought up on the theory of comparative advantage are not persuaded by this argument, but it is nonetheless likely that China’s growth will cause short-run disruptions for some neighboring economies. These concerns relate to competition on the supply side. But at the same time, China is committed under its WTO agreement to opening its economy, and it will therefore become an increasingly important source of demand for the products of its neighbors.

Beyond the likely growth of regional trade, lies monetary cooperation, and perhaps eventually exchange rate cooperation. The Chiang Mai +3 (also called ASEAN +3) initiative promises to take regional monetary cooperation further, through the provision of bilaterally negotiated swap lines among 13 countries, with China, Japan, and Korea as the likely creditors. Swap arrangements among European countries, and in North America, have existed for some time.

In any such arrangement, the creditors and the debtor may have different interests at the time of a crisis: the creditors want conditionality to assure they will be repaid, the debtors generally believe they are facing a temporary crisis that can mostly be handled by financing. Chiang Mai +3 provides a small part of the credit line unconditionally, but requires an IMF arrangement to draw more than 10 percent of the amount. This means that the initiative will co-operate rather than compete with the global institutions, and as such is a useful model of how regionalism and multilateralism can reinforce each other rather than compete.

It remains to be seen how well such arrangements will work in practice, and in which directions they will develop.

Finally, there is a great deal of sentiment in favor of exchange rate cooperation. This has been a topic of European-Asian economic discussions, with lessons being sought in the development of EMU. It is not obvious that intra-Asian exchange rate fluctuations were the main exchange rate problem in the development of the Asian crisis; rather it was movements in the dollar-yen rate that helped create the trade deficits of 1996. Those problems in turn derived from Asian currencies being pegged against the dollar, which should not now be a problem given that most of the relevant exchange rates are flexible.

If Asian economies become increasingly integrated in the years ahead, then it is likely that there will be attempts to create an exchange rate mechanism to promote greater stability of intra-Asian exchange rates. As that is done, we should not forget that the

various European currency arrangements were crisis prone – these arrangements were not immune to the impossible trinity. Nor should we forget how long it took after the founding of the European Economic Community to achieve a currency union, for to reach that stage, it was necessary first to create both the single market and macroeconomic convergence, each of them a long and difficult process.

Neither should we forget that behind the entire enterprise of European economic integration lay a powerful political impulse: to create, after two devastating world wars, a Europe that would never again engage in internecine warfare. Europe used economic integration to achieve its political goals. That political impulse is not yet evident in Asia, where relationships among three potentially very large economies – Japan, China, and India – are in a state of flux. Without that political impulse, regional integration, and particularly financial integration, in Asia is in practice likely to proceed slowly.

Thank you.