Hanging Together:
On Monetary & Financial Cooperation in Asia*

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I do not claim to be an expert on Asian monetary and financial cooperation. Over the years I've worked more on those issues in the context of Europe and Latin America. At the same time I think it is clear that it is in Asia that the big questions about international monetary and financial cooperation are being debated at the moment. So part of what I want to do today is bring some insights into the prospects and options for monetary and financial cooperation in Asia by looking at them through the mirror that European and western hemispheric cooperation provides.

If you begin to try to do that, you are immediately led to some observations about how Asia is different from these other regions and how those differences have profound implications for the kind of cooperative endeavors that are likely to be productive and that are likely to have a positive effect. These observations are obvious, but they are no less important.

The first one is the extreme heterogeneity of Asian economies. Asian economies differ greatly from one another in terms of per capita income, economic structure, the development of their financial systems, and the importance of the state in organizing economic affairs. They differ from one another much more profoundly in all those respects than the members of the European Union, the members of the North American free trade area, or the countries of the western hemisphere as a whole. So there are real questions about whether such a diverse set of countries can overcome the challenges that their very different economic and circumstances pose for efforts at cooperation.

Asia, it is clear, is not a self contained economic region. In some sense regional initiatives make less sense here than they do in other parts of the world. Trade within the region is more important for NAFTA than it is for Asia.

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Trade within the region is more important for Western Europe than it is for Asia as a whole. Any regional arrangement in Asia should recognize that fact. We need to think hard about the compatibility of a regional arrangement with global institutions of cooperation, and need to pursue initiatives that are not disruptive of those global institutions and global economic interdependencies.

Third, it is clear that there exists no single dominant economic and financial power to play the role that the United States plays in integration in the western hemisphere. There is no obvious bipolar alliance like the Franco-German alliance in Western Europe that has pushed forward the process of economic integration and financial integration there. That process in Asia would have to be based on a much more multipolar set of supports than has been the case in any of the other parts of the world that have attempted to move in that direction.

Fourth, cooperation in Asia is different because of a different Asian mentality. Economists do not use words like that. But political scientists do. Asia has a tradition of consensus decision making and a presumption of non-intervention in national affairs. That's different from the OECD where the tradition has been to issue much more forceful statements about problems of economic and financial policy in other countries. This emphasis on consensus—one of my friends, Richard Cooper of Harvard, refers to it as an emphasis on good manners—does impose constraints on how you could organize peer pressure to encourage effective cooperation.

Finally, there is the fact that east Asian regionalism, or current efforts to promote regionalism here, take place at a stage where many of the economies of the region have reached especially difficult stages in their economic development. Japan has reached a stage where it has to transform its economic system, not something that it's done very successfully in the last decade. China is, as you know, moving rapidly from a state-led to a market-led economy. The crisis of 1997-98 led to profound transformations here and in a variety of other places. In such a state of flux, there is a real question about whether we clearly understand what the economic and financial constraints on cooperation will turn out to be.

It is with those issues in mind that I have—for purposes of my own intellectual satisfaction but also with a commission from the World Bank which is thinking about Asian prospects a decade after its "Asian Miracle" book and wants to think about cooperative aspects—done some research into options for economic and financial cooperation. The background for this will be known to you. There are a variety of efforts underway to build on existing arrangements like the APEC finance ministers process, the executive meeting of east Asian and Pacific central banks, and the so-called Six Markets Group. These are existing efforts at cooperation, all of which are focused on extending technical assistance and strengthening monetary policies and financial markets. They are all modest efforts to move further in the direction of promoting monetary and financial cooperation.

There is a second set of more ambitious proposals advocating systematic monetary and exchange rate cooperation in the region. These would move toward a system of collective pegs. It is fair to say that the dominant version of these proposals focuses on the desirability of collective basket pegs where each currency would have a weight attached to the dollar, yen and euro at a minimum.

Those proposals have gained prominence as the result of a discussion paper that was prepared by officials from the French and Japanese governments for the third Asia-Europe finance minister's meeting last year. In addition, there have been a variety of academic and quasi-academic versions of this proposal. John Williamson, for example, has a well thought out relatively complete paper on how this would work.

Finally, there are the initiatives that flowed out of the proposal in 1997 for an Asian monetary fund. That went nowhere in the short run as you all know. But in the long run I think it did impress many people in the region with the need for systematic monetary cooperation framed in a way that was consistent with IMF conditionality and other existing multilateral constraints. From that has come the Chiang Mai Initiative (CMI) of central bank swap arrangements in the ASEAN+3 economies. Now, indeed, a growing network of swaps have been successfully negotiated, or evidently are about to be successfully negotiated.

What will come of all this? What does it really bode for the future? There are many attempts to move in the direction of more systematic and extensive cooperation. What exactly will be the results?

In order to address that issue you need to step back and ask some questions. Is it realistic to create a zone of financial stability in Asia by building self-standing institutions of Asian monetary and financial cooperation? Is it really impossible to pursue these issues at the regional level because financial markets are global, the problems are global, the constraints are global and it is at the global level that it makes sense to proceed?

Another way of looking at it would be to say that, yes, regional arrangements do make sense, but we have to design them in a manner where they dovetail and are consistent with the global nature of financial markets and the global nature of other institutions.

Does that mean, then, that Asia can solve this problem like Europe has? By asking that, I come back to my own knowledge and to my earlier theme. Europe has created economic and financial institutions for continent-wide cooperation that are at the same time regional but linked to their global counterparts. Can that be done in Asia, given all the special constraints and special circumstances I described before? How might Asian countries go about it?

In a nutshell, my argument is that, yes, it does make sense to proceed with closer cooperation and institution building at the regional level in Asia. But it does not make sense to have a system of collective currency pegs as the center piece, the focus, of those cooperative efforts. Decades of experience have shown that currency pegs are fragile, crisis prone and difficult to defend, even by a set of governments with vary large international reserves. This is because of the even greater liquidity of the international financial markets. Governments face the fundamental constraints of defending currency pegs. Political democracies have to weigh the competing claims of different groups and cannot always simply subordinate all other important policy issues to the overarching imperative of defending a currency peg.

Not even the vastly expanded system of swap arrangements growing out of the CMI would suffice to enable Asian countries to defend a system of collective currency pegs. Indeed, trying to establish one could be a costly mistake. A great investment would go into its establishment and it would then collapse in the face of market pressures. This would tarnish the arguments from those who were making a case for the benefits of international cooperation. Focusing on exchange rate cooperation would be a diversion from the task at hand.

The task at hand is not to stabilize exchange rates in and of itself. Rather, the fundamental task is to strengthen financial institutions and to promote the development of financial markets in countries where equity markets are underdeveloped and in countries where debt markets in domestic currency denominated assets and liabilities are underdeveloped.

What Asia really wants is a zone of financial stability. The way to get a zone of financial stability is not to focus on the exchange rate, but focus on the weaknesses and the underdevelopment of the financial markets.

As I pondered this point I was led to believe that the focus for economic and financial cooperation in Asia could be something that I call, for lack of another name, an Asian financial institute (AFI) that would not focus on exchange rate cooperation but would focus on financial market strengthening and financial market development.

That institute would have the power to set standards for financial market regulation. It would identify policies for promoting financial market development. It would help to coordinate the initiatives of different countries to strengthen, stabilize and develop their financial markets. It would monitor the compliance of countries with their joint recommendations. And it would apply the appropriate diplomatic incentives—the carrots and sticks—needed to encourage countries to move down that road.

ASEAN+3 with China, South Korea and Japan, would be the logical basis on which to build this Asian financial institute. That is my core argument. But given the time constraints, I will be brief on negative prospects for exchange rate issues and I will try to focus on what I think the positive contributions of this argument are and the need for an Asian financial institute.

As I said, there are a number of scholars who have said that Asia should explore collective solutions to its monetary problems. They argue that Asia needs stable exchange rates, that Asian economies are very open both to international trade and to international financial flows. That means that exchange rate volatility is even more disruptive in Asia than it is in other regions where the typical economy is more closed to international transactions.

These authors observe that exchange rate stability has played an important role historically in export led economic growth in the region. They say Asia has had difficulties since the middle of the 1990s in resuming and sustaining growth because of the exchange rate problem. Now we are about to see that again, they complain, due to the depreciation of the yen. This is a problem that needs to be fixed, the argument goes, and it can best be fixed through the negotiation of an agreement growing out of the Chiang Mai Initiative to agree on a set of exchange rate pegs with bands around them. It would include the same weights in each peg and the use of swap lines and dedicated funds to provide support for weak currencies that are attempting to participate.

There are a number of issues that appear to be mainly technical about the design of that kind of system. They actually raise quite profound issues about whether it would work to the satisfaction of all participating countries. That, in turn, raises the issue that if some countries are dissatisfied because the structure of that exchange rate system doesn't meet their needs, would they really commit vast resources? Would they really subordinate their other policy objectives to the maintenance of a system that didn't satisfy their domestic economic needs?

John Williamson and the team of French and Japanese officials say it would be very simple for Asian countries to agree on what the weights of the yen, the dollar and the euro should be in this currency basket to which all other countries would agree. In practice though, it is not so simple. Economic structures, the direction of exports, and the relative importance of the U.S., Japanese and European markets differ. As economic development continues and specialization proceeds apace, those differences and the direction of exports and the desired weights in this currency basket may grow even greater in the future than they are now.

People who propose collective currency pegs say that in the past they have not worked because governments have not recognized the need to change the peg when circumstances change. The new system that we propose, they say, will be more robust. It will operate better because it will encourage countries to adjust the peg when circumstances change.

I think that is wishful thinking. It would be nice if governments could be encouraged to behave in that way. But in practice when governments commit to a currency peg they are extremely reluctant to adjust it. In order to convince the markets that you are committed to a peg you have to tell them every morning the currency is pegged and we are committed to the peg. It then becomes extremely embarrassing and the government looses face if it says, "Well, we meant it yesterday but today circumstances have changed and it is necessary to alter the peg."

Governments put off the need to adjust the peg beyond a reasonable point in time not because they are simply stubborn or they do not appreciate the issues but because they face this fundamental dilemma. We saw it again in Argentina last year when, for most of us, it became patently clear that the exchange rate needed to be altered to begin to restore the competitiveness of the economy. But the government said no and refused to even contemplate that idea. When it finally did, the economic fallout was disastrous.

Every system of currency pegs that we have seen, even those that were designed to provide for flexibility, become increasingly rigid over time. The Bretton Woods system from 1945 to the early 1970s was supposed to be an adjustable peg. The peg was almost never adjusted for these same reasons: that doing so was politically embarrassing and financially disruptive. The idea of a system of collective pegs that was also flexible, where the pegs were adjusted in response to changing circumstances, is an illusion. Pegs don't work that way.

What that implies is that a system of pegs in Asia would become increasingly rigid and therefore brittle over time. Pressure would build up in the system and what at first looked to be ample reserves in the coffers of the participating central banks and governments would soon begin to look like very small reserves compared to the massive amounts of liquidity that the financial markets could bring to bear.

All of that makes me skeptical about a collective peg for Asian countries. The fundamental problem is the belief that Asia should use a collective peg as the focus of its cooperation. This neglects the fact that Asian countries are really very different in terms of their structure and what kind of exchange rate regime and monetary system is appropriate for them.

There is a group of Asian countries led by Korea that have better-developed financial systems and stronger institutions that can run a system of inflation targeting that allows the exchange rate to move as it should in response to changing economic conditions by running low inflation and a monetary policy that is consistent with financial stability. Inflation targeting is a happy state of affairs for such a country. We can all run lists of other middle- and high-income countries in Asia which could follow an inflation targeting regime as well. Some of them, like Thailand, have begun. Others, including the Philippines, will soon begin.

On the other hand there are the low-income countries in Asia, the new members of ASEAN for example, that will not have the prerequisites for inflation targeting in place soon. They should peg and then use capital controls to support their pegs because their financial markets are relatively underdeveloped. Their structures are very different, as are the exchange rate regimes and monetary policies appropriate for them. Trying to force them all into the same exchange rate box would not be a durable solution.

That outlines some of the negative aspects. Let me now turn to the positive part of my message.

In order to make any monetary regime work smoothly, you need to develop domestic financial markets. Korea can inflation target because it has made progress in recent years in the development of debt markets and equity markets. Deeper and more liquid markets enable a policy like inflation targeting to work effectively. The fundamental desire behind this push for closer cooperation in the region is to create a zone of financial stability. The key thing to achieve in order to do so is to strengthen financial markets, strengthen supervision and regulation, and to deepen financial markets so that they can better govern themselves. That brings me to my proposal for the creation of an Asian financial institute.

Certainly, Asian countries need to develop and strengthen their financial markets. But why can't we let each one do it by themselves? Why do we need cooperation to push that process forward?

There are three or four reasons why progress can occur faster if countries cooperate within the region than if they move individually to simply try to strengthen their financial markets. One is peer pressure. If their neighbors encourage the countries that are slow to move to move faster, you can get faster progress. A sharing of expertise and technical assistance will help and regional cooperation is useful in that regard. There is a reluctance to take necessary steps by countries that fear loosing market share to their neighbors. If countries, say, increase the capital requirements for their banks, they will make it more expensive for their banks to do business internationally. Only if everybody increases capital standards at the same time are you likely to get fast movement. You can make similar arguments for a variety of regulatory measures. You get faster movement when you move together.

There is also the fact that a number of the financial problems in the region are distinctively Asian. Asian countries do understand their neighbors' problems better than Washington, D.C. They share many similar problems, having shared some similar economic policies that led to, for example, heavy corporate indebtedness or state-led banking systems. This was due to a development model that was common to the region in its earlier days.

Those are all reasons why progress would be faster if it occurred cooperatively, and why there is a case for an Asian financial institute to organize that cooperation. I have in mind an institute that would have an explicit mandate to coordinate initiatives for promoting financial stability and development in the region. It would provide technical assistance to its members. It would run training programs for bank inspectors, securities commissioners and accountants. It would provide central banking services like the ones the Bank for International Settlements provides to its members. It would allow its members to negotiate common agreements on capital and liquidity requirements, and standards for information disclosure, securities listing and corporate governance. All these things that Korea has been remaking and moving forward on could be negotiated and designed at the regional level under the umbrella of this Asian financial institute.

This body would then monitor member countries' compliance with the standards and regulations that they have agreed to. It would use public announcements and peer pressure to encourage countries that were not complying to upgrade their domestic arrangements. It would encourage the coordination of monetary, fiscal and regulatory policies so that financial reform would grow uniformly across the region. Under exceptional circumstances, where one of the countries attempting to upgrade its financial arrangements ran into a financial problem, there could be swap lines and inter-regional financial support to help it overcome that disruptive event.

That is what leads me to think that ASEAN+3 is the logical platform for this kind of initiative. Any other grouping either excludes some of the critical participants or does not represent the region. ASEAN alone would not include the three biggest economies in the region. APEC would include the United States and various Latin American countries which have different economic circumstances and problems. The Asian Development Bank would not be an appropriate platform because the U.S. and various micro-states in the Pacific are members, and also it has a different mandate to help the poor countries in the region, not to promote financial development.

Finally, ASEAN+3 is the appropriate platform for this because it is already the platform for the Chiang Mai Initiative. Through the CMI, there is already a surveillance procedure being put in place and there is already a system of financial supports. Were the CMI to become the basis for the creation of an Asian financial institute, it would then be clear for what those swap lines and dedicated funds would be used. They would not be used to peg exchange rates, which, as I've already tried to convince you, would only be dangerous. They would be used to promote the upgrading of financial regulation and the developing and deepening of financial markets. This is what Asia really needs.

Would this kind of Asian financial institute work, given the Asian approach to surveillance? It would require forceful peer pressure. It would require countries to name names when one of its neighbors was not doing what was necessary to upgrade domestic supervision and regulation, in order to provide a framework for financial development. Would countries in the region be willing to point to their neighbors and say that they were not doing what is necessary, and that they need to shape up and change their policies?

A second question is whether the distinctive Asian approach to financial regulation—different only because the Asian development model was different—would be as vigorous as global standards and regulations. We don't want this Asian financial institute to adopt a lax, less-rigorous approach to supervision and regulation. How could we build a set of regional arrangements to ensure rigor of design and enforcement?

Are global standards for accounting, financial market development, and prudential supervision and regulation really incompatible with the Asian model? Is the Asian approach to economic growth really so different that it requires a different set of standards and regulations that cannot be accommodated by the global approach to setting standards?

Those are the big unanswered questions that need to be addressed if there is a desire in the region to press ahead with financial cooperation.

Questions & Answers

Q: Your speech this morning is very encouraging. But I think your idea for the establishment of an Asian financial institution would take a long time. The establishment of the Inter-American Development bank took over a hundred years and the EMU, starting with the European common market, took more than 50 years.

Also, there is already the Asian Development Bank to act as a regional framework for financial organization. There is also the North East Asia Development body, led by the North East Economic Forum at the East West Center in Hawaii, which has been holding discussions for the past ten years.

Under these circumstances, without a central bank's coordinating activities, do you really think an Asian financial institute would be strongly supported by the U.S. government because it would be a sub-regional system? Do you think there would be a foreseeable conflict between a Japanese yen block and an emerging Chinese yuan block?

A: It is true that there are many cooperative initiatives already underway in the region. But none of them focus completely on strengthening financial supervision and regulation. They do not try to build financial markets. They do not combine technical assistance with the development of a set of standards for building financial markets and regulating them. They do not provide the serious financial assistance needed when countries hit a pothole. So I do think there is a case for an institution dedicated to those tasks.

Would the U.S. government support it? That is a very good question. I think the strong negative reaction to the Asian Monetary Fund from the Clinton administration was motivated by the view that this initiative might be incompatible with global efforts along similar lines. I think an Asian financial institute could be designed in a way that allowed Asian countries to develop standards and regulations that were somewhat different from global standards, but were not viewed as incompatible with the global standard setting and regulatory effort.

Would China and Japan work together in the development of such an arrangement? I would agree with you that that is the big challenge for any cooperative initiative in Asia going forward. There is a role for Korea, obviously, as a sort of mediator, an interlocutor, between these two powers.

But it really is the big countries that will have to agree in order for such a thing to move forward.

Q: If you look at successful, regional cooperation, Europe and North America are really the two most successful examples. Neither, though, started with a regional consensus. The EU started with a bipolar arrangement between France and Germany that then gradually expanded. NAFTA started with Canada-U.S. cooperation and then gradually expanded. Maybe a similar model would work for Asia. From my own experience in Asia, getting many Asian countries to agree on anything is pretty much hopeless, rather like herding cats. So there is a very strong case to be made for South Korea and China to work on a bipolar, bilateral economic cooperation agreement, rather like that originally between Canada and the U.S. When this is successful, the rest of Asia, country by country, step by step, can join into that arrangement. What do you think?

A: Bilateral approaches to these matters makes sense for trade and makes sense for direct foreign investment. Bilateral liberalization around those issues can be quite useful. But for something like building a regional financial market I think it makes more sense to try to proceed as a group rather than simply as a pair.

Q: Have you elaborated on your concept of an Asian financial institute proposal in the form of a paper somewhere? I would be very eager to get hold of that.

Secondly, you are very pessimistic about the prospects for monetary integration in East Asia. But you did not indicate any length of time. If I give you 50 years, would you still say the same thing? In the European case, it took just about that long. If the time horizon lengthens are there prospects for such integration?

But before that, we must take the first step. The first step, which you did not emphasize in your lecture, is policy dialogue and peer pressure on macro-management. East Asian countries would benefit very much, for example, if they got together and discussed the situation in Japan and how to get it out of recession. Those discussions would be a first step toward, say, greater exchange rate flexibility. If we begin with something small like this, it is tangible and workable. Then we can build upon it. If we visualize a very long time frame, and approach the process step by step, there is a future for monetary integration in East Asia.

When you posed your last two questions I felt that you were probably very much intimidated by what you perceive as the Asian way, or an Asian attitude. Let me say that the East Asian financial crisis really had an impact on our mentality and perspectives. We have begun to give less and less credence to what we used to think of as an Asian way. I would not be as concerned as you about Asian ways.

For example, there are a number of initiatives in East Asia already underway. You mentioned Chiang Mai, but there is also the meeting of central bankers and the Manila framework group, which acts as a sort of incipient surveillance process. Given this progress, do you see any tangible regional financial agreements in discussion among Latin American countries?

A: What do I think Asia's monetary and financial architecture will look like 50 years from now? That's too far down the road for me to clearly say. But I do think that the political starting point in Asia is very different than in either Europe or North America. I could imagine a North American single currency, with apologies to my Canadian friends, before I could see a single currency for an Asia including Japan, Korea and China. The political starting point is very different.

The pressures, however, pushing toward a single currency will be stronger than they were in Europe over the past 50 years. The financial markets are bigger, they're going to grow bigger still, and the amount of volatility you could get if things went wrong will be bigger. Therefore the desire for a single currency as insulation will be correspondingly stronger.

Talk in Latin America of a single currency for the South American countries, predictably, is back on the table and back in the newspapers after the Argentine crisis. It's revealing to reflect on why. Whenever you have a crisis, people think the exchange rate is the problem and a single currency is the solution. I don't think the exchange rate was fundamentally the problem in Argentina. Weak political institutions and bad structural policies were the problem. The solution doesn't lie in moving toward a single currency.

Having said that, some of my friends in Latin America think that talking about a single currency is useful. It continually allows the countries in good economic shape to remind the others that if they want to move toward integration with a single currency, the countries with problems have to shape up and move faster to fix their structural and political problems. So the Brazilians think this is useful talk because it increases the pressure on the Argentines to do what the Argentines need to do anyway.

Finally, is there a paper? There is a paper on my website about this topic. It has the title *Hanging Together?*, with the question mark, and is about monetary and financial cooperation in Asia. It brings to mind the old American proverb about those who do not hang together will hang separately.

Commentary: One of the important lessons we learned from the recent Asian financial crisis is that when liberalizing capital accounts, sequencing is very important. Unless you have a very sound domestic financial sector, with a very sound and prudential supervisory and regulatory framework, it is very dangerous to open capital accounts, particularly in the short-term. You should go from long-term to short-term. Korea made a very big mistake by going from the short-term to the long-term.

In your presentation you pointed out the importance of sequencing when it comes to economic cooperation. In the same manner, countries should go from financial cooperation to monetary cooperation, in that order. That is why I would like to see the Chiang Mai initiative further institutionalized so that it can become the sort of institution you are talking about.

Conditionalities are required if you are to have some sticking power. You have to have incentives and give something in return, like the IMF does by providing loans with conditionalities. Without those, you cannot enforce the standards and requirements.

I would like to see this Chiang Mai initiative further institutionalized so that it may become an institution. It may not be called an "AMF", as the "AMF" carries a bad image. It can be called something else.

For example, many Koreans do not understand the U.S. psychological change after Sept. 11. I know some of my friends in the U.S. who last Christmas were reluctant to even send Christmas cards because of this anthrax scare. That kind of psychological change is exactly what people living here experienced in 1997-98. The Asian financial crisis changed our psychological make-up. Look at the summit meeting between Korea and Japan where the two heads-of-state talked about a free trade area. This would have been unimaginable before the Asian financial crisis. The Asian financial crisis changed our psychological make-up. This type of cooperation will go on much faster than if there had not been a crisis.

But even with this willingness to debate the subject, I do not think that monetary cooperation will go quickly. That is not desirable. We have to have a leading currency that is fully internationalized for such integration to work. We don't have that as the yen is not fully internationalized. Without the yen as a key currency in the region, how can we have these currency pegs or even a basket pegs? This is one of the reasons why we should push for financial cooperation and then monetary cooperation. The proper sequencing is very important.

Q: What countries will be members and major investors in this Asian monetary fund? Also, how soon do you think this "AMF" will be realized and how effective will it be? What will be the relationship between this "AMF" and the IMF, IBRD and ADB? How will they cooperate and coordinate with each other in terms of lending and other activities?

A: Who should be the members of an Asian financial institute? Well, labels and terminology are very difficult. I don't call it an Asian monetary fund or an Asian monetary institute, so as to distinguish it from the 1997 proposal of the Japanese government and to try to make clear that the focus is on finance and not on monetary policy or exchange rates.

The logical members are the ten ASEAN countries plus China, South Korea and Japan. I think it would be possible to establish such an Asian financial institute very quickly.

What would be the relationship between this regional institute and the International Monetary Fund, the Basel Committee of Banking Supervisors and the Bank for International Settlements? Clearly they are going to have to work together and it would be useful if there were regular meetings between any regional institute and global ones.

This comes back to the earlier issue of whether the Asian model is different from the global model of economic and financial development, or whether I am just overly impressed by old fashioned arguments that Asia is different.

Let us assume for the sake of argument that Asia is different. One way it is different is that banks play an important role in industrial development and that individual banks develop very close connections with large individual industrial firms or conglomerates. This implies that banks often have very large portfolio concentrations in their holdings with claims on particular companies and sectors. Those kinds of portfolio concentrations are incompatible with Basel and international standards concerning prudential bank supervision. Banks should not be heavily exposed to the fate of one company by having a concentrated portfolio heavily dominated by claims on that one company.

Now an Asian prudential standard could say that that is permitted if at the same time the bank is required to hold more capital as protection against problems in that particular company. It may have a more volatile portfolio, but it can protect itself against that volatility by holding a bigger buffer of capital. An Asian financial institute could explain to the committee of banking supervisors that this is not really a different approach to prudential supervision, but a different combination of the elements. We are looser in one element (portfolio concentrations) but tighter in another (capital requirements). They balance each other. Our regulation is different from yours, but it's equally strong. You need the two parties working hand in hand in order for that to make sense and to work effectively.

Q: What about the relationship between a free trade area in the region and an Asian financial institute? For example, last January Singapore and Japan formed an FTA. How does this fit with the proposed Asian financial institute?

Also, what about investor behavior during a financial crisis? You argued that during the peso crisis of 1994-5, domestic investors in Mexico played a key role in shaping the outcome of that crisis. How do you view their role in this Asian financial institute?

A: The ASEAN free trade area and the commitment to freer trade within APEC by 2010 raise the issue of whether or not the creation of a free trade area—and maybe eventually a customs union—can be the basis for closer cooperation in the region. That was the European model. They started with a free trade area and then moved from there to free investment, and finally ended up with monetary cooperation and a single currency.

Could Asia do it the same way? Perhaps. But I think the desire in Asia is different. It is not so much for a free trade area but for a zone of financial stability. If Asia is going to move quickly down this road, financial cooperation is the logical place to start. Not FTAs.

Q: Up until now the IMF, particularly the U.S. Treasury, insisted on the "two corner option" for exchange rate regimes for any single country. They said that countries must either choose a hard fix and the virtual dollarization and currency board that goes along with it, or a fully floating exchange rate. They did not encourage any intermediate regime. What is your view on this issue?

Unless you have stable exchange rates between key currencies—the dollar, euro and yen—emerging market exchange rates can be extremely vulnerable. Now, there are minority dissenting views, among them Paul Volcker, Fred Bergsten and George Soros, who said that discussing international financial architecture without discussing key currency exchange rate stability is like watching Hamlet without the prince. But many people do not believe in this and, to be frank, the feasibility of such a scheme is extremely low. I would like to know your stand on this.

Finally, what about Anne Krueger's international workout scheme? I know there are many technicalities involved, but there is a need for private sector involvement. Whether this workout scheme will be accepted by the IMF board or the U.S. treasury is another question. But I would at least like to know your opinion on private sector involvement.

A: I have a considerable personal stake in the exchange rate issue. In 1994 both Andrew Crockett, in an article written for the Kansas City Federal Reserve Bank, and I, in my little book "International Monetary Arrangements for the 21st Century," expressed our views on this issue. We both said that with increasingly liquid financial markets and conflicting political pressures, pegging would not be feasible. Countries were going to have to pick between a freer float and some kind of very hard peg, and that nothing in between would be feasible.

Over the intervening years I have been on podiums around the world debating with Fred Bergsten and John Williamson and others who are of the opposite opinion. But history has worked in my direction.

All the crises of the intervening decade have pointed out that pegging is increasingly difficult in our modern world. The data show that more and more IMF member countries, emerging markets in particular, have moved away from pegs. There are a few cases of dollarization, like El Salvador or Ecuador, or where governments have adopted similarly strong pegs, for example in Eastern Europe where they are moving toward membership in the Eurozone. But the vast majority of them have gone the other way toward a freer floating currency, as Korea has done.

The mistake made in my book was that I said the choices were between a very hard peg and a very free float. I should have been more clear. I did not mean that the exchange rate can be ignored and be allowed to move wherever it wants to. What I really should have made clear was that if a country wants to eliminate the exchange rate peg, it needs to develop a different anchor for monetary policy, like inflation targeting. It would then explain what the role of foreign exchange market intervention would be within that inflation targeting regime. That is what the Bank of Korea has begun to do. This is an example of what freer floating means in our modern world.

When I wrote that book in 1994, I described how country circumstances differ. Some of them want to move toward a freer float and others want to move toward a very hard fix. I now believe that the ones for whom a hard fix will work are even fewer than we would have thought back then.

A hard fix works for Estonia and Bulgaria because they have a destination, namely they will become members of the European Central Bank in four years. In addition, both countries will be in the European Union in two years. That anchors and stabilizes expectations and financial markets and makes the hard peg work. On the other hand, very small economies that trade almost entirely with the United States, like El Salvador, or countries and provinces in very special economic and political circumstances, like Hong Kong, can make a peg work. But Argentina and Venezuela, for example, cannot. I think we have learned that the kind of countries for whom a hard peg can work are few and far between.

I have always disagreed with Fred Bergsten about the role of dollar-yen-euro fluctuations in the Asian crisis. I do not think a strong dollar was one of the top three factors in setting the stage for the Asian crisis. And since then, we have seen Asia hold up remarkably well in the face of a lot of pressure from a weakening yen. Now, it certainly does not help that the dollar, yen and euro fluctuate against one another. It makes life more difficult. But one can develop methods to cope with this by strengthening financial markets. I do not see this changing any time soon.

Finally, on the Krueger proposal, I was completely surprised when Anne Krueger made her speech in November saying that we need to change the way we deal with sovereign debt crises. I did not see the IMF initiative coming and I think we should applaud the initiative. We can almost thank the Argentines for making so clear that the IMF needs to change the way it does business.

I think the Krueger proposal is a very positive step. It has identified what the problem is precisely and correctly, that restructuring debt is messy, difficult and unpleasant. Because of this, the IMF has an incentive to lend more rather than encouraging restructuring. This creates moral hazard, which undermines the stability of financial markets.

She has identified the problem correctly and she has correctly identified the class of solutions. In order to take pressure off the IMF to lend and lend again, we need to make debt restructuring more public and less uncertain. I have some disagreements and quibbles about the technicalities of her proposal, but because of lack of time and because I don't think we should lose sight of the fact that this is important progress in the right direction, I won't even elaborate.