The Economic Case for the Asian Monetary Fund

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ABSTRACT

The inadequacy of the IMF to cope with today’s international financial problems has become increasingly evident. Its governance system is also antiquated since it primarily reflects the economic reality of the world some sixty-five years ago towards the end of World War II. Furthermore, the IMF’s resources alone are no longer sufficient in coping with new types of international financial crises that have afflicted the global economy in recent decades and that are likely to erupt in the future as well. As many Asian countries have realized that the IMF does not really possess adequate financial resources to assist them in the event of another Asian financial crisis, they have had to resort to massive accumulation of foreign exchange reserves themselves. Since the Asian financial crisis, the world foreign exchange reserves have increased from $1.8 trillion in 1997 to $8 trillion in 2008. The bulk of the increase was accounted for by Asian countries whose combined foreign exchange reserves increased from $900 billion in 1997 to $6.2 trillion in 2008. Foreign exchange reserves are a form of self-insurance of a country against a potential future international financial crisis and, as such, they are very expensive due to their substantial negative carry cost. Another economic cost of huge foreign exchange reserves held by Asian countries could result from a potential depreciation of the U.S. dollar.

Key Words: Asian Monetary Fund, Chiang Mai Initiative (CMI), International Monetary Fund, Foreign Exchange Reserves, Financial Resources of IMF, International Financial Architecture, Asian Financial Crisis
Introduction

During the past two and a half decades, the International Monetary Fund (IMF) has often been criticized for its harsh and inflexible economic measures as, for example, when it tried to cope first with the LDC debt crises in the 1980s and then with a series of international financial crises that plagued the global economy starting in the early 1990s, such as the 1994-95 Mexican peso crisis, the 1997-98 Asian financial crisis, the Russian and Brazilian financial crises in 1998-99, and the Argentine and Turkish financial crises early in the 21st century. In addition, the governance structure of the IMF has been heavily skewed in favor of American and Western European countries at the expense of many important Asian and other emerging market countries. The manner in which the head of the IMF is chosen has also been criticized by many observers and especially by those from Asia, injecting further doubt into the policy neutrality of the IMF in today’s global financial system and the relevance of the IMF to Asia in particular. By tradition, the job of the IMF managing director goes to a European while the presidency of the World Bank is occupied by an American, leaving no place for an Asian ever to head either of the two premier Washington-based international finance institutions.

Nevertheless, Asian countries have an important stake in the proper running of the international financial system, as they suffered heavily from both the Asian financial crisis of 1997-98 and its aftereffects connected with IMF conditionality packages accompanying IMF financial assistance to Asian countries. As the international monetary and financial architecture now stands, the two most important international finance organizations, the World Bank and the IMF, are dominated by the Western powers of North America and Europe. The voice of Asia in the twin Washington-based institutions has been marginalized during the past sixty-five years of their entire existence, and there is no likely prospect that this situation will fundamentally change in the foreseeable future despite some self-serving assurances and several cosmetic gestures by the Western powers in the running of these important organizations.

The Decreasing Relevance of the IMF to Asia

Since the IMF and the World Bank were established at the Bretton Woods Conference in 1944, hence known as the Bretton Woods twins, the voice of Asia has always been marginalized in the two international finance organizations. Even though China’s population is the largest in the world and its economy in purchasing power parity terms is the second largest in the world after the U.S., China’s IMF quota is only the 6th among its 185 member countries. It is further troubling indeed that,
in the Bretton Woods twins, India with the 5th largest economy in the world with GDP of $3.3 trillion in 2008 has fewer votes than the Netherlands which is the 21st economy with GDP of only $670 billion, barely one-fifth of India’s GDP. Furthermore, Korea has an economy almost four times that of Belgium but it has fewer votes in the Bretton Woods twins than the small European country. There are so many other examples showcasing the systematic discrimination against Asian countries in favor of Western European countries, even though these Asian countries are far more important in the current global economy than their respective European counterparts in terms of their economic sizes, world trade volumes and populations.

At the same time, the current financial resources of the IMF are woefully inadequate to cope with another Asian financial crisis similar in size of that in 1997-98. The total IMF quotas as a percentage of world imports have declined from 58 percent in 1944 to just 2 percent in 2008, largely because the influential Western industrialized countries, which have not borrowed from the IMF in the last 30 years, have become reluctant to agree to increased IMF quotas commensurate with the increased volume of world trade and international financial flows. As a result, the ability of the IMF to handle major international financial crises has declined drastically. As of mid 2009, the total usable IMF resources amounts to only $220 billion, compared to over $4 trillion of foreign exchange reserves held by just six Asian countries (or “economies”), of Japan, China, India, Taiwan, South Korea and Hong Kong. Since the IMF has already lent out much of $220 billion to its member countries, a more appropriate measure of the IMF’s true capacity to assist any future borrowers is known as the “one-year forward commitment capacity” (FCC). It takes into account that some of the IMF’s available resources have already been committed and that a prudent balance is also needed to safeguard the liquidity of creditors’ claims on the IMF and guard against any potential erosion of the IMF’s base of available resources as well as any amounts that are projected to be repaid to the IMF over the coming 12 months. The IMF’s one-year FCC stands at only $50 billion as of mid 2009, which is far less than one-third the foreign exchange reserves of Hong Kong at $180 billion.

After the bitter experience of many Asian countries with IMF loans with unrealistic and unusually harsh conditionality during the 1997-98 Asian financial crisis, Asian countries have intentionally stayed away from the IMF for any further borrowing. Only Pakistan and Mongolia have outstanding loans from the IMF among Asian countries, with Mongolia accounting for only 0.2% of IMF’s outstanding loans. Out of the total outstanding IMF loans of $32 billion as of early June 2009, just
four countries of Hungary, the Ukraine, Romania and Pakistan account for 87 percent, exhibiting a severe concentration of the IMF’s credit risk exposure to a handful of former Eastern European countries. Since the Asian financial crisis, the IMF has been at the mercy of mostly non-Asian borrowers. Early in the 21st century, the IMF was over-exposed to the Latin American countries of Brazil with $28 billion loans and Argentina with $16 billion. Its mistake in granting huge loans to Argentina in 2001 was skillfully manipulated by the Argentine government in March 2004, when the IMF was forced to roll over its maturing Argentine loans despite the largest default in history by the Argentine government of $107 billion on its private creditors.

Role of the U.S. and the IMF in Disorderly Financial Liberalization in Asia

Many economists have argued, and even some key former officials of the Clinton Administration now admit, that both the U.S. government and, by extension, the IMF pushed the developing countries, especially the Asian emerging market countries, too hard for financial liberalization and freer capital flows in 1990s, allowing foreign capital to stream into Asia. The booming Asian economies of the early and mid 1990s were a tempting target for foreign investors from industrialized countries. The U.S. government wielded its enormous influence in Asia both directly and through the IMF to open up Asian financial markets, hailing the virtue of free capital flows but neglecting to make them safer. Encouraged by Western scholars and journalists who acclaimed the bright future of Asian emerging markets and the coming “Asian Century”, Western portfolio investors and bankers in the 1990s were too happy in pouring investment capital into Asia. Much of these foreign capital inflows was used by Asian businessmen for speculative real estate developments and other ambitious projects without due consideration of sound investment criteria.

Although the U.S. government has traditionally encouraged financial liberalization of developing countries as highly desirable for their own sake, it has also been reported that the Clinton Administration pushed especially hard for free capital flows in part because this was what its supporters in Wall Street and the U.S. banking industry wanted. Quoting a number of key Clinton aides, a *New York Times* article reported that the push for financial liberalization was directed at Asia in particular, largely because it was seen as a potential gold mine for American banks and brokerage houses. The idea was to press Asia to ease its barriers to American financial services and products, “helping Fidelity sell mutual funds, Citibank sell checking accounts and American International Group (AIG) sell insurance.”
A case in point was the U.S. negotiation strategy on Korea’s entry into OECD during the 1990s. The New York Times quoted a senior OECD official, who stated that “To enter OECD, the Koreans agreed to liberalize faster than they had originally planned. They were concerned that if they went too fast, a number of their financial institutions would be unable to adapt.” The same New York Times article also cited a U.S. Treasury Department memorandum dated June 20, 1996, which specified the U.S. Treasury’s negotiating position, listing priority areas for further financial liberalization in Korea. These included letting foreigners buy domestic Korean bonds, letting Korean companies borrow abroad both short term and long term, and letting foreigners buy Korean stocks more easily, all of which were “of interest to U.S. financial services community,” according to the memo. In the end, Korea opened up its financial markets the wrong way by keeping restrictions on long-term foreign investments in Korea but freely allowing short-term overseas borrowing by Korean firms, even though short-term capital flows are far more volatile than long-term investments as the subsequent event in Korea during the Asian financial crisis proved.

In Asia, there is a strong suspicion that the IMF was also used by the U.S. government in its efforts to pursue aggressive financial liberalization. An example was the April 1997 meeting of G-7 finance ministers chaired by U.S. Treasury Secretary Robert Rubin, a former Wall Street banker himself, which issued a statement “promoting freedom of capital flows” and urged that the IMF charter be amended so that the Fund could lead the charge for capital account liberalization. The record shows that the IMF, characterized by The New York Times as “an extension of American policy” and by The Wall Street Journal as “a subsidiary of the U.S. Treasury Department”, was actively promoting financial liberalization in Asia before the Asian financial crisis, for example praising in 1996 the accelerated capital account liberalization in both Indonesia and South Korea.

**Doubt on the Effectiveness of the IMF Policy Measures to Cope with the Asian Crisis**

The key ingredients of the IMF programs dealing with the Asian financial crisis of 1997-98 were a tight macroeconomic policy and structural adjustment. High interest rates and tight monetary policies, mandated for the Asian crisis countries in the IMF programs of 1997-98, were claimed by both the IMF and the U.S. Treasury Department to be necessary or inevitable, at least in the short run, for the stabilization of the exchange rate. High interest rates were supposed to help not only stabilize the exchange rate by discouraging capital outflows (and equally, encouraging capital inflows) but also facilitate much needed corporate
sector restructuring. Nevertheless, this textbook prescription needed to be reevaluated in light of the financial panic situation since high interest rates were not effective in reversing massive capital outflows from Asia. Furthermore, given the heavy reliance on corporate debt in Asia resulting in high leverage, the sky-high interest rates mandated by the IMF for the Asian crisis countries at that time imposed crushing financial costs on Asian firms, and hence, significantly increased the risk of corporate bankruptcies. Widespread corporate bankruptcies and sharp increases in non-performing loans on the books of Asian banks further discouraged capital inflows into Asia, offsetting any possible positive effects on capital inflows of high interest rates there.

The main components of the IMF conditionality for the affected Asian countries during 1997-98 period were born originally in the 1980s when the IMF was called upon to deal with the LDC foreign debt crisis that was first triggered by Mexico in 1982 and then spread to other developing countries in Latin America, Africa and Eastern Europe. The common economic characteristics of those heavily-indebted LDCs in the 1980s were large fiscal deficits, over-valued currencies, high inflation rates in the double or even triple digits, and heavy government subsidies to bloated public sectors and parastatals. It was natural, therefore, for the IMF to adopt its loan conditionality primarily focused upon the tight aggregate demand management.

The IMF demonstrated its tendency to continue this policy inertia for the Asian countries facing the 1997-98 financial crisis as well. However, such IMF conditionality was ill suited to the Asian crisis, where the countries affected had quite different macro-economic parameters than those LDCs assisted by the IMF in the 1980s. Inflation was not a serious problem for the affected Asian countries, and their budget deficits were either negligible or non-existent unlike many Latin American countries facing foreign debt crisis in the 1980s. In this case the IMF should have refrained from its traditional obsession with the aggregate demand management through tight fiscal and monetary policies. Instead, it should have focused upon economic structural reforms such as liberalization, deregulation, privatization of state enterprises, downsizing of government agencies, financial sector reforms, the strengthening of a prudent financial supervisory infrastructure, promotion of competitive business practices through stringent monitoring of insider trading and cross-guarantee of affiliates’ debts, ensuring business transparency with the adoption of international accounting standards, the modernization of corporate governance, and labor market flexibility. In the immediate aftermath of the Asian financial crisis, however, the IMF stubbornly insisted on tight aggregated
demand management policies, despite their obvious irrelevance to the Asian countries then in crisis, thus drastically exacerbating their economic hardships during the crisis.

**Need for an Asian Monetary Fund to Better Manage Future Asian Financial Crises**

The Asian financial crisis of 1997-98 has taught Asian countries many valuable lessons. One of them is the urgent need to establish their own monetary fund that can better adjust their assistance packages suitable to Asia with the right policy mixes appropriate for Asia rather than being manipulated to the advantage of non-Asian economic and financial interests. Such a fund could function to complement but not necessarily to replace the IMF in Washington. The World Bank in Washington has worked quite well in synergy with regional development banks such as the African Development Bank, the Asian Development Bank, the European Bank for Reconstruction and Development, and the Inter-American Development Bank. The IMF should not insist on its monopoly role as “the” world monetary fund but instead should cooperate with any new regional monetary funds that might be established in the future, such as African, Asian, Eastern European and Latin American Monetary Funds.

In 1997 and early 1998, during the height of the Asian financial crisis, when many Asian countries needed massive emergency funds to cope with panicky capital outflows from the Asian region, there were serious discussions among some Asian countries on establishing an Asian Monetary Fund (AMF) in order to supplement the Washington-based IMF. The Japanese government, for example, was willing to make a major contribution of up to $50 billion to the new AMF that might have an initial capital resource of about $100 billion, with the rest of its capital to be contributed by China, Hong Kong, Taipei and Singapore. The proposal for an AMF was strongly supported by other Asian countries such as Malaysia and Thailand as a way to supplement dwindling IMF resources. Australia also showed its support for an AMF and even its willingness to join. Unfortunately, but predictably, the idea of a new AMF was bitterly opposed by both the U.S. government and the IMF, which were afraid of the presumed erosion of their traditional monopolistic influence on Asian economic policy making. Opponents of the AMF argued that a regional fund such as an AMF would unnecessarily duplicate IMF’s activities and lead to moral hazard problems. However, the moral hazard problem associated with mutual liquidity provisions by both the IMF and an AMF to an Asian country in financial crisis could be addressed by policy harmonization between the two institutions similar to the harmonization of loan covenants between
the World Bank and regional development banks such as the Asian and Inter-American Development Banks.

In hindsight, a growing number of observers believed after the Asian financial crisis that such a regional fund as AMF would make a lot of economic sense. When the IMF remained the only guardian of the Bretton Woods system of globalized fixed exchange rates during the 1945-73 period, perhaps there was no need for such regional monetary funds. Since the breakdown of the Bretton Woods system in 1973, however, the IMF has evolved from “the” global monetary system guardian into just another development finance agency similar to the World Bank. Under the Bretton Woods system that existed from 1945 through 1973, countries seeking IMF assistance were both developing and industrialized countries. (In fact, such industrialized countries as Britain, Italy and France were among the heaviest borrowers from the IMF in those years while the total volume of IMF loans to developing countries was negligible in comparison.) During the past three and a half decades since the breakdown of the Bretton Woods system in 1973, however, the IMF’s loan clients have been almost exclusively developing and emerging market countries, which are the same client base of the World Bank and other regional development banks. In fact, the IMF has now become another de facto World Bank, catering exclusively to the developing country clientele only, which is quite different from the 1945-73 period. It is no wonder then that some influential voices such as The Economist in London have argued for a merger between the IMF and the World Bank.

Also, the character of the IMF financial assistance has shifted fundamentally from temporary balance-of-payment loans for the exclusive purpose of maintaining the Bretton Woods fixed exchange rate system during the 1945-73 period. Nowadays, the IMF also provides longer-term structural adjustment loans for developing countries, a similar role to that of the World Bank. The main difference now between the loans of the two Bretton Woods twins is that the IMF provides mostly policy-based long-term financial assistance, while the World Bank tends to focus more on project-based long-term lending, even though the Bank’s structural adjustment loans, among its many lending programs, are essentially undistinguishable from the Extended Fund Facility and other long-term structural adjustment loans of the Fund. It is high time, therefore, for each region to work on establishing its own regional monetary fund in order to supplement the Washington-based IMF, similar to the successful arrangements between the World Bank in Washington and various regional developments banks such as the African, Inter-American, Asian, and European development banks.
Economic Rationale for an Asian Monetary Fund

The inadequacy of the IMF to cope with today’s international financial problems has become increasingly evident. Its governance system is also antiquated since it primarily reflects the economic reality of the world some sixty-five years ago at the end of World War II. Consequently, the voting power of Asian countries is disproportionately underrepresented in the IMF compared to the economic size, trade volume and foreign exchange reserves of Asia. Furthermore, the IMF’s resources alone are no longer sufficient in coping with new types of international financial crises that have afflicted the global economy in recent decades and that are likely to erupt in the future as well. Compared to today’s world trading volume and the magnitude of international financial market activities wherein the daily foreign exchange trade volume alone is about $4 trillion, the current size of IMF quotas with total usable resources of barely $220 billion is inadequate to cope with another sizable international financial crisis like that of the 1997-98 Asian financial crisis or the current global financial crisis.

Since the IMF has in reality no practical leverage over the Western industrialized countries that have never borrowed from the IMF during the past 30 years, it has exercised its vaunted surveillance function in a rather skewed manner only upon developing countries while exempting major destabilizing economic policies of powerful industrialized countries such as the United States and Germany. Consequently, the IMF represents mostly the Washington consensus in international economic and financial management of developing countries, while being practically helpless in dealing with some genuine concerns of developing countries over the wayward policy stance of powerful Western industrialized countries.

As many Asian countries have realized that the IMF does not really possess adequate financial resources to assist them in the event of another Asian financial crisis, they have had to resort to massive accumulation of foreign exchange reserves themselves. Since the Asian financial crisis, the world foreign exchange reserves have increased from $1.8 trillion in 1997 to $8 trillion in 2008 including Taiwan’s $312 billion. The bulk of the increase has been accounted for by Asian countries whose combined foreign exchange reserves increased from $900 billion in 1997 to $6.2 trillion in 2008, a rise of $5.3 trillion. Now, Asia accounts for almost 80% of the world foreign exchange reserves, a steep increase from 44% of the world foreign exchange reserves in 1997. Such a sharp increase in Asian foreign exchange reserves has been due both to Asia’s huge current account surplus and the strong net capital inflows into Asia over the past decade.
Foreign exchange reserves are a form of self-insurance by a country against a potential future international financial crisis and, as such, they are very expensive due to their substantial negative carrying cost. Such a negative cost is caused by the fact that the cost of capital inflows into Asia significantly exceeds the returns on short-term investments such as U.S. Treasury bills in which the bulk of Asian foreign exchange reserves are held. Another economic cost of huge foreign exchange reserves held by Asian countries could result from a potential depreciation of the U.S. dollar. About 65% of all foreign exchange reserves are held in U.S. dollars, which means that about $4 trillion of Asian foreign exchange reserves are denominated in American dollars. If the dollar, which is viewed as significantly overvalued in light of both the huge current account and budget deficits of the United States, were to depreciate by 20%, the aggregate value losses for Asian foreign exchange reserves would amount to $800 billion, truly a staggering amount.

If such costly self-insurance by Asian countries through the accumulation of excessive foreign exchange reserves can be replaced by a collective insurance system in the form of an Asian Monetary Fund financed by some of these very foreign exchange reserves accumulated by Asian countries but now invested mostly outside Asia in such low-yield instruments as U.S. Treasury bills and Eurodollar CDs, the overall economic benefit to Asia would also be enormous. If the Asian foreign exchange reserves were to be reduced by 50% with the collective insurance mechanism via a new Asian Monetary Fund, the economic benefits to Asia could be the following:

Reduction of Asian foreign exchange reserves by 50%: from $6.2 trillion to $3.1 trillion
Enhanced yield from 0.3% 6-month US Treasury bill rate to 10%
return on direct investment of $3.1 trillion:
\[ 9.7\% \times 3.1 \text{ trillion} = 282 \text{ billion extra returns per year} \]
Avoiding the loss from 20% US dollar depreciation on 65% of
\$3.1 \text{ trillion}: $403 \text{ billion}

An Asian Monetary Fund could thus provide an economic benefit of $282 billion per year for Asia, plus avoiding a potential loss of $403 billion in case of a US dollar depreciation by 20%.

Momentum Toward an Asian Monetary Fund

Already, the first step toward a closer monetary and financial cooperation among Asian countries was taken under the Chiang Mai Initiative (CMI), a framework agreement reached in 2000 on a set of bilateral currency swap arrangements (BSAs) among the 13 Asian countries of the ASEAN+3 group (the 10 ASEAN member countries plus
The CMI was designed to expand the previous ASEAN Swap Arrangement (ASA), by extending its coverage from the original five members to all ten members of ASEAN plus three additional non-ASEAN countries of Japan, China and South Korea, and by increasing the total size of the swap arrangements. ASA was first established by five of the ten ASEAN member countries in August 1997 right after Thailand triggered the Asian financial crisis in early July 1997, and ASA was originally designed to alleviate temporary liquidity shortages among central banks of the five member countries, and the facility was extensively used.

Under the CMI, the core objective was to establish a network of BSAs among the 13 Asian countries. So far, 16 bilateral currency swap arrangements amounting to $44 billion have been concluded. Such currency swap arrangements allow the 13 Asian countries to access one another for short-term liquidity support similar to IMF financial assistance. However, the CMI is not independent from the IMF, since 80% of the amounts available under the BSAs would be disbursed only if the borrower country also agreed to an IMF program. Also, activation under the BSAs is not automatic on the request of the borrower. Activation also requires approval by the creditor country which may consider the details of the IMF program that a borrower country has agreed to adopt. In this sense, the CMI is largely a parallel line of defense to IMF financing. It is noteworthy that, despite initial high hopes, none of the BSAs have been activated since its creation.

In recognition of the structural deficiencies of the BSAs, ASEAN plus 3 agreed in 2007 to adopt “multilateralization” by converting a network of BSA bilateral contracts into a single contract informally known as a common fund. Here, multilateralization of the CMI implies collectivization on a regional basis, which is something more than bilateral and less than global. The size of the pooled reserves in the common fund was raised from the initial $80 billion to $120 billion in early 2009, with 20% provided by 10 ASEAN countries and 80% by the Plus Three countries of China, Japan and South Korea. This Multilateralized CMI (known as CMIM) will also have an independent regional surveillance unit in order to facilitate prompt activation of the CMIM and to promote objective economic monitoring and surveillance with the goal of reducing the IMF linkage. As for the reserve pool of $120 billion, however, member countries will still manage their own foreign reserves contributed to the fund, unlike the IMF which has its own funds contributed by its member countries.

Despite its potential, it is doubtful that the CMIM in its present form can be a credible regional lender to its Asian member countries so that it
can act as an effective co-insurance mechanism in a time of financial crisis. First of all, the amount is still negligible with a pool of just $120 billion. During the Asian financial crisis ten years ago, just three Asian countries—Indonesia, Thailand and Korea—borrowed about $100 billion from the IMF-organized funding sources. During the current global financial crisis, South Korea alone had to mobilize additional resources of $76 billion in the form of central bank swaps with the United States ($30 billion), China ($26 billion) and Japan ($20 billion) on top of Korea’s own foreign exchange reserves of $240 billion at the time of the Lehman Brothers bankruptcy in September 2008. Furthermore, the borrowing procedure under the CMIM is rather complicated and tied with the IMF policy conditionality if the borrowing amount exceeds a certain limit.

Therefore, only a full-fledged Asian Monetary Fund can realize the true advantage of co-insurance with the attendant economic benefits to Asia. Without being constrained by the often-counterproductive IMF conditionality in a future financial crisis, Asian countries can pursue under an AMF framework appropriate economic policies that can assist them more directly rather than serving the parochial interests of the Washington consensus forced upon Asia by the IMF and the U.S. Treasury Department. The IMF has not always acted in the best interests of Asia, and it is about time that Asia should exert its economic independence from the Washington consensus by establishing an AMF. Asian countries already possess the financial means to fund an Asian Monetary Fund in view of their huge foreign exchange reserves accumulated so far.

In recent years, Asian economies have become more tightly integrated. Currently, Asian developing countries have sent more than half of their exports to other Asian countries. Asia is also the largest export market for Japan, followed by the U.S. market and the European Union market. In fact, Japan exports now more to China, Hong Kong and Taiwan than to the United States, the first such development in 130 years. Also, China replaced the United States as Korea’s top export market for the first time in the modern Korean history. An Asian Monetary Fund can be a natural outcome of this trend toward closer Asian economic and financial integration. It is high time now for the Asian countries to muster the necessary political will to stand up against the expected opposition from the IMF and its controlling interests in North America and Europe by establishing their own Asian Monetary Fund.
Notes:

4 Ibid.
5 Ibid.
9 The original agreement was signed by Indonesia, Malaysia, the Philippines, Singapore and Thailand.