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# Lessons from the Asian Financial Crisis: The Role of the IMF and the United States

John W. Head

## I. Introduction

The second half of 1997 proved disastrous for Asia — particularly Thailand, Indonesia, and Korea. The 1997 financial crisis that hit those countries was massive in scale. Here are some representative figures showing the magnitude of the damage:

-The Thai baht, having traded at around 25 to the dollar for thirteen years,<sup>1</sup> lost over half of its value between July 1997 and January 1998, when it was trading at about 55 to the dollar.<sup>2</sup> Thailand's stock market value declined over 60% in that same period.<sup>3</sup>

-The Indonesian rupiah lost about 75% of its value against the dollar between mid-1997 and early 1998.<sup>4</sup> The Indonesian stock market dropped in value even more than Thailand's had — by over 75% in the second half of 1997.<sup>5</sup>

-Korea was in some ways the hardest hit of all — and this is especially significant because of its economic importance in Asia. The won fell in value 70% between mid-October and mid-December 1997,<sup>6</sup> and Korea's stock market lost two-thirds of its value from August to December.<sup>7</sup> Korea's foreign exchange reserves fell by more than 50% in the space of two months.<sup>8</sup> Bonds issue by one of Korea's biggest banks were trading at 60% of face value in December 1997, down from 100% of face value in October 1997.<sup>9</sup>

In response to these economic troubles, the International Monetary Fund (IMF) put together financial "bailout" packages for

Thailand, Indonesia, and Korea.<sup>10</sup> The United States participated in the latter two packages. It is those bailout packages that I examine in this article. Specifically, I focus on a pair of crucial questions: (1) Did the IMF respond properly to the Asian economic disaster? (2) Did the United States do the right thing by supporting the bailouts? My aim is not only to critique past actions, but also to offer suggestions for responding to — or, better yet, preventing — future economic crises.

My discussion of these issues begins with a brief survey of how the disasters unfolded in Thailand, Indonesia, and Korea and how the IMF and other international financial institutions responded. Then I evaluate (in part III) a central element of the IMF "conditionality"<sup>11</sup> that attached to the bailout funding for each of the three countries — the requirement that dramatic changes be made in their national financial (banking) systems. The main proposition I develop there is that a sound financial system depends on a trio of crucial elements: (a) independence of the central bank from short-term political pressures; (b) enforcement of international standards on the operations of commercial banks; and (c) special rules and procedures for closing insolvent banks and restructuring weak ones. Lastly (in part IV), I consider the U.S. participation in the IMF-led bailout efforts in Asia. I conclude that much of the opposition to U.S. participation in the bailout

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of the Asian economies is misplaced because it rests on either (i) a misunderstanding of the financial relationship between the IMF and the United States or (ii) a misunderstanding of how U.S. participation in the IMF-led bailouts serves the national interest of the United States.

### II. The Crisis and the Response

The Asian economic crisis of 1997 supports the old adage that bad things come in threes. The crisis surfaced first in Thailand in July, moved to Indonesia beginning in October, and hit Korea in late November. In each case the IMF reacted with a bailout package. The following paragraphs summarize these developments through February 1998, when this article was written.

#### A. Thailand

Although two of the three countries injured by the economic crisis — Korea and Indonesia — seemed economically strong until mid-1997, Thailand was a different story. From 1993 onward, Thailand's economic progress of the previous decade started to unravel, with external debt reaching 50% of GDP — and 40% of that debt was short-term.<sup>12</sup> Most ominous, in my view, were the weaknesses that started appearing in the financial system, especially banks and finance companies.<sup>13</sup> These institutions borrowed heavily in dollars and used those resources to pump money into the economy.<sup>14</sup> Governmental attempts at banking supervision were fruitless because of the political power of the banks and finance companies.<sup>15</sup>

The IMF was not surprised by the crisis in Thailand. Beginning in 1996, IMF officials had repeatedly warned the Thai authorities

about weaknesses threatening the country's economic health.<sup>16</sup> Once those economic weaknesses became obvious to lenders and investors in the first half of 1997, confidence in the baht dropped quickly, forcing the government in July 1997 to abandon its attempts to keep the value of the baht "pegged" to the U.S. dollar.<sup>17</sup>

In August 1997, after the baht had depreciated another 20% against the dollar in July,<sup>18</sup> the IMF arranged a financial bailout package totaling \$17.2 billion with the following sources and amounts of funding:<sup>19</sup>

- \$4.0 billion from the IMF
- \$1.5 billion from the World Bank
- \$1.2 billion from the Asian Development Bank
- \$4.0 billion from Japan
- \$1.0 billion from each of five other Asian countries
- \$0.5 billion from each of three other Asian countries.

The United States did not participate in the Thailand bailout package, except of course, through its participation in the IMF.<sup>20</sup> The United States was criticized for that move, which seems to have been prompted largely by domestic political considerations.<sup>21</sup>

The IMF loan, technically referred to as a stand-by credit,<sup>22</sup> was intended to support several key economic and financial goals agreed on between the IMF and Thailand, such as reducing current account deficits, maintaining official reserves at an adequate level to cover the costs of imports, limiting inflation, and restructuring the financial sector.<sup>23</sup> To accomplish these goals, the government undertook to

carry out a program of increasing taxes, cutting government expenditures (while still protecting spending on health and education, as well as subsidies on bus and rail fares), and — most important, in my view — suspending or restructuring unviable financial institutions and implementing structural reforms in the financial sector.<sup>24</sup>

### **B. Indonesia**

Thailand's economic crisis proved contagious.<sup>25</sup> The steep depreciation of the baht naturally posed threats to Thailand's trade competitors, as Thai exports became cheaper to buy in terms of other currencies. Those threats led to declines in the value of some of the currencies of other countries in the region, which then made it more expensive for borrowers in those countries to service their debts, many of which were short-term, foreign-currency debts. More generally, problems in the Thai economy prompted markets to scrutinize other Asian economies more closely, to see if they showed similar problems.

This added scrutiny illuminated serious weaknesses in Indonesia's economy,<sup>26</sup> including, in particular, its banking sector. Indonesian banks, like those in Thailand, had borrowed heavily from abroad, and had also made loans to domestic companies that were heavily exposed to similar foreign borrowings.<sup>27</sup> As the value of the Indonesian rupiah continued to fall in the weeks following the Thailand disaster,<sup>28</sup> default on those short-term foreign bor-

rowings became more likely, threatening a collapse of the banking system.<sup>29</sup>

In early November, to address this crisis in Indonesia, the IMF arranged a financial bailout package totaling \$40 billion, with the following sources and amounts of funding:<sup>30</sup>

\$10.0 billion from the IMF  
\$ 4.5 billion from the World Bank  
\$ 3.5 billion from the Asian Development Bank  
\$ 5.0 billion from Japan  
\$ 5.0 billion from Singapore  
\$ 3.0 billion from the United States  
\$ 1.0 billion each from four other Asian countries

\$ 5.0 billion in contingency reserves by Indonesia.

### *Thailand's economic crisis proved contagious*

The \$3 billion direct commitment by the United States took the form of "additional resources" or "supple-

mental financing" in support of Indonesia's program with the IMF.<sup>31</sup>

The IMF stand-by arrangement for Indonesia was similar in format to the one for Thailand. For Indonesia, the funding was aimed at promoting (i) monetary and fiscal policies designed to restore confidence to financial markets, (ii) restructuring of the financial sector, with measures to make sure it remained sound, and (iii) deregulation and trade reforms.<sup>32</sup>

This was bitter medicine for Indonesia, and some commentators questioned whether the government, under President Suharto, would in

Suharto departed from certain aspects of it twice in the first few months after the IMF-led financing package was announced — first by proposing a budget inconsistent with it<sup>34</sup> and then by proposing a change in the exchange rate regime by replacing the central bank with a currency board.<sup>35</sup> The latter of these proposals was seen by some as an attempt to give Mr. Suharto's family and friends "a brief moment to convert their huge holdings into dollars and get them out of the country."<sup>36</sup>

### *C. Korea*

On the heels of disaster in Indonesia came the biggest Asian "tiger" turnaround of all: Korea's economy collapsed.<sup>37</sup> In recent decades, the Korean economy had grown rapidly. Its per capita GDP in recent years had risen on average nearly 7% a year, turning a poor agrarian economy into an advanced industrial economy — indeed, the eleventh biggest economy in the world.<sup>38</sup> However, Korea's system of intensive governmental intervention into the details of Korean business and financial activities created problems — in particular, an inefficient financial sector, where banks lacked a commercial orientation. Because bank loans were easy to get, a large number of companies in Korea became highly leveraged. Indeed, as in Thailand and Indonesia, much of the borrowing was short-term foreign debt.<sup>39</sup> Many of these companies went into bankruptcy starting in early 1997, both because of over-investment in some sectors (e.g., steel and autos) and because of a general cyclical downturn. Those corporate bankruptcies resulted, of course, in a big increase in banks' nonperforming loans (they rose to over 7% of gross domestic product), and a big decline in the value of banks' equity.

In short, the financial system was drastically weakened. This downturn was reflected in the rest of the Korean economy.

In early December, the IMF acted. After resisting an IMF bailout for several weeks,<sup>40</sup> the Korean government accepted a financing package totaling about \$57 billion with the following components:<sup>41</sup>

\$21 billion from the IMF

\$10 billion from the World Bank

\$ 4 billion from the Asian Development Bank

\$ 22 billion (approximately) from 12 industrialized countries.

The IMF credit of \$21 billion was the largest one ever made by the institution.<sup>42</sup> The United States was one of the twelve industrialized countries "prepared to make available supplemental financing in support of Korea's program."<sup>43</sup> The amount so pledged by the United States was \$5 billion.<sup>44</sup> However, no disbursement of funds from the U.S. Treasury is expected to be required.<sup>45</sup>

The IMF stand-by credit for Korea had elements similar to those for Thailand and Indonesia.<sup>46</sup> Its overall aim was to help Korea narrow its external current account deficit, to contain inflation, and to promote a recovery in 1999. To accomplish this, Korea pledged to tighten monetary policy, to reduce the government budget deficit (through tax increases and expenditure cuts), and to undertake a comprehensive restructuring of the country's financial sector. In that last respect, Korea agreed to provide by law for more central bank independence, to consolidate and toughen banking supervision along international standards, to require external audits, to close or restructure

supervision along international standards, to require external audits, to close or restructure troubled financial institutions, and to allow foreign entry into the domestic financial sector. Korea's reform program also included measures to liberalize trade and open up investment opportunities for foreigners.

Announcing this reform program was not enough to stop Korea's financial crisis. In the ten days following the unveiling the program, and the huge package of financial support that accompanied it, Korea watched its currency fall by another 40%. Partly responsible for this further drop was the "revelation that Korea's short-term debt obligations were double the figure cited at the time of the IMF negotiations."<sup>47</sup>

The IMF and Korea responded to the continuing crisis with deeper reforms and more money. On December 24, the Korean government announced "an intensification and acceleration" of the reform program agreed to earlier that month.<sup>48</sup> On December 30, the IMF approved a faster disbursement of funds.<sup>49</sup>

### III. Strengthening National Financial Systems

I am not attempting in this article to evaluate all aspects of the IMF's policy prescriptions for Thailand, Indonesia, and Korea. As noted above, these elements include tightening monetary policy, opening up to foreign competition, and reducing budget deficits by increasing revenues and cutting back on expenditures. Although these prescriptions have a common-

sense appeal — indeed, some of them resemble steps an individual would have to take to avoid personal bankruptcy — common sense might not be good enough for handling a national economic crisis. Therefore, I withhold judgment on those elements of the IMF-supported reform programs.

On one element, however, I have some experience and do wish to offer my views. That element concerns the need to strengthen the national financial systems throughout Asia.<sup>50</sup>

Central to each of the three IMF packages summarized above was a set of measures to strengthen the financial sector.<sup>51</sup> Indeed, financial restructuring was "the heart of the program" in Korea.<sup>52</sup> This could be the silver lining to the dark cloud of economic disaster in Asia. The crisis has provided the impetus for Thailand, Indonesia, Korea, and other countries to adopt some of the fundamental principles of modernization and prudence that every country's financial sector needs.

The following paragraphs summarize what I consider to be the most important of those principles. They fall into three categories — central bank independence, modern international banking standards, and rules and procedures for handling troubled or insolvent banks. My thesis, in a nutshell, is this: (i) a strong national financial system will have a central bank that is independent from short-term political pressures, although ultimately accountable to political authorities, (ii) commercial banks should be required, under laws enforced by the central bank as supervisor, to observe interna-



tional standards on making loans, maintaining capital, reporting operations, and the like, and (iii) banks that fail should be restructured or liquidated under strict and special rules that protect depositors and penalize managers and owners.<sup>53</sup> This last point will be discussed first, because in the context of the Asian financial crisis, the issue of how to deal with bank failures assumed the most immediate importance.

### *A. Bank Failures and Bank Bailouts*

Bank failures, like failures in any other type of business, are natural in an economy based on private-sector activity; where private persons are given an opportunity to succeed, they will sometimes fail. But bank failures are different from other types of business failures in an important way: they can infect public confidence in *all* banks, and in serious cases can cause public panics, bank runs, and (if uncorrected) a total meltdown of a financial system. Indeed, the Asian financial crisis featured public panic and bank runs. The bank runs "reached crisis proportions in Indonesia,"<sup>54</sup> where in November, thousands of people jammed around closed banks, having lost confidence in them.<sup>55</sup>

The risk of such bank runs, and the risk of a systemic failure, is a key reason why a country typically will need special rules for handling insolvent banks. Such rules serve what is often called an "exit policy"<sup>56</sup> because they set forth the grounds and procedures on which a financial institution can be ushered out of the financial system without endangering the system as a whole.

All three of the IMF-led bailout packages were made conditional on the establishment

and implementation of effective exit rules.<sup>57</sup> In fact, the closing of banks took on a very high priority, as well as a high profile. For example, fifty-six finance companies were ordered closed in Thailand,<sup>58</sup> and sixteen in Indonesia.<sup>59</sup> In Korea, fourteen merchant banks and two commercial banks had their operations suspended with orders to recapitalize and restructure.<sup>60</sup> By early February, ten of the merchant banks had been closed and all others were given one month to devise survival plans.<sup>61</sup>

Taking such drastic action is both difficult and necessary. It is especially difficult in Asia because of the close government-business-bank interconnections typical in most Asian countries. These interconnections have been called "too-cozy arrangements" between the economic elites and the governments and banks,<sup>62</sup> with government officials directing banks to finance specific investments,<sup>63</sup> and with banks therefore operating with implicit government guarantees.<sup>64</sup> Such interconnections are especially strong in Indonesia, where the family of President Suharto is heavily involved in banks and big companies.<sup>65</sup>

Despite the difficulty of taking tough action against weak or insolvent banks, especially in Asia, it is absolutely necessary to do so. Typically, a bank's financial troubles stem from one of two causes: bad management or inadequate governmental supervision of the financial sector.<sup>66</sup> In the first of these cases (the second case is addressed in part IIIB, below), it is imperative to take immediate action against the financially troubled bank by taking over its management. Otherwise that old management will, through further incom-

petence or dishonesty, lead the bank even deeper into trouble, to the detriment of depositors of that bank and perhaps to the risk of the financial system as a whole.

What specific rules and procedures should be put in place for handling financially troubled banks? Based on work done I have in collaboration with others in several Asian countries, I suggest a legal regime with four main features.

First, the law should provide (preferably by a statute enacted by the parliament, but alternatively in an administrative regulation issued pursuant to such a statute) that the central bank — or other official entity responsible for bank supervision<sup>67</sup> — is entrusted with determining whether a bank is already insolvent or is in immediate danger of becoming insolvent. Typically, "insolvency" of a bank can take either of two forms. The first relates to liquidity: a bank is insolvent if it is unable to meet the demands of depositors and other creditors in a timely manner. The second form of insolvency is "book insolvency," which can be expressed in two different ways: (i) the bank's liabilities exceed its assets; or (ii) the bank's losses are so big that they will use up the bank's capital and reserves. These forms of insolvency can be expressed in the following statutory provision:

A bank is insolvent if one or more of the following situations exist:

- (a) the bank is not able to meet the demands of its depositors or to pay its obligations in the ordinary course of business;
- (b) the value of the bank's liabilities exceeds the value of the bank's assets;

- (c) the bank has identified losses that are sufficient in amount to extinguish the bank's capital and reserves.

These tests for insolvency — or the specific calculations used in applying them — might differ from those used in a country's general bankruptcy laws. There is nothing wrong with that. As noted above, banks are different from other companies. Even in countries with well-developed general bankruptcy laws and procedures, it makes sense to have separate rules and procedures to deal with financially troubled banks, because banks have such a central role in the country's economy.

Second, the law should provide that if the bank is found to be insolvent or on the verge of insolvency, the central bank will appoint a provisional administrator, sometimes called a "conservator." The conservator can be the central bank itself, or it might be an individual or a legal entity that meets certain prescribed qualifications relating to experience, financial resources, and neutrality. Immediately upon being appointed, the conservator will assume full control over the bank and will undertake a comprehensive inventory of the bank's assets and liabilities. Based on this information, the conservator will, within a prescribed period of time, report to the top authorities in the central bank on the prospects for the troubled bank. Specifically, the conservator will offer an assessment of whether the troubled bank (i) can be restored to health in its current form, by taking specified drastic measures to improve its operations, or (ii) should be placed in receivership, for purpose of either restructuring it (for example, by merging it with a stronger bank) or presiding over its "winding down" (full liquidation), in which the bank's assets would be sold and the proceeds from that sale

would be distributed among depositors and other selected creditors. Indeed, any course of action proposed by the conservator must be aimed at protecting depositors and selected creditors, and not the bank's shareholders or former managers. The rights of the shareholders would be automatically suspended upon the appointment of the conservator, and the old managers would be either fired or demoted.

Third, the law should provide that if (following the conservator's recommendation) the central bank selects the first course of action — restoration to health in the bank's present form — then the conservator will carry out a detailed restoration plan. For these purposes the law should grant broad powers to the conservator, including these: the power to hire and fire bank staff and to reorganize the bank's administration; the power to change policies on lending, borrowing, and other operational matters; the power to sell assets, close branches, accept new capital contributions, and change the bank's charter. In some cases, of course, the bank's existing shareholders might object to some of the more drastic of these measures — especially the bringing in of new capital, since that would result in a dilution of their own shareholder interests in the bank. There are at least three responses to such a complaint: (i) the existing shareholders are the ones responsible for bringing the bank to the brink of failure, so they have no strong equitable claim to have their interests protected; (ii) although the proportionate rights of the old shareholders would be reduced, those rights would now apply to a much stronger bank that has more capital and is more likely to survive; and (iii) if the new capital (and hence new shareholders) were not brought in, the probable outcome is receivership and liquidation, in which case the existing

shareholders would almost surely receive nothing at all.

Fourth, the law should provide that if (following the conservator's recommendation) the central bank selects the second course of action — receivership — then a receiver will be appointed for this purpose. Three key differences distinguish a receivership from a conservatorship: (i) aims of the receivership, (ii) powers of the receiver, and (iii) rights of the shareholders. The aim of a receivership is not to restore the bank but to extinguish it. Placing a bank in receivership acknowledges that restoration is impossible. Instead, the bank must be liquidated. Such a liquidation can take a variety of different forms, depending on what ultimate outcome is most cost-effective in the circumstances. One form of liquidation is a purchase-and-assumption transaction, in which a healthy bank (or perhaps more than one) purchases the insolvent bank's assets and assumes its liabilities — most importantly, the liabilities to depositors. Another, more radical, form of liquidation would require the gradual winding down of the bank's business and distribution of its assets. In this case, the receiver would try to collect on as many of the bank's loans as possible, sell off the bank's physical assets, prepare a list of claims against the bank, and then distribute to the legitimate claimants the proceeds of the loan collections and sales of assets. The law should specify the priorities of such a distribution. Typically, depositors should have very high priority. If there is no deposit insurance system in place — a situation, incidentally, that tends to make bank runs more likely — the distribution of proceeds from a liquidation should first favor small depositors, then larger depositors, then other creditors, perhaps with special priority for cer-



tain creditors who advance bridge loans during the receivership or who have secured interests. In order to carry out these functions, the receiver would have an array of powers even broader than those of a conservator. In contrast, the rights of the shareholders would be less than those under a conservatorship. All such rights would be extinguished by operation of law upon the central bank's decision to place the bank in receivership.

The four-point approach suggested above for handling financially troubled banks has two complementary aims: to protect the financial system as a whole, and to protect the individual depositors of the troubled bank. It is important to emphasize again, however, that two classes of parties are *not* protected: shareholders and management of the bank. Typically, they should lose their interest in the bank — that is, their equity holdings or their jobs — because they undertook the risk or responsibility for the success or failure of the bank. They should not be protected against the consequences of their own bad investment judgment or their poor performance. Instead, they should be fully exposed to the competitive forces of the marketplace. Otherwise, a problem of "moral hazard" arises: that is, a person could reap the rewards from his or her actions when things go well, but would not suffer the full consequences when things go badly.<sup>68</sup>

I raise this "moral hazard" point because it bears on the rationale behind the Asian bailout, and the apparent misperception that some people have about who or what is being bailed out.

The aim of the IMF-led bailouts in Thailand, Indonesia, and Korea was to provide funding to the governments of those countries as a short-term bridging mechanism, so that the economic disasters they suffered in the latter part of 1997 would not become worse. Because those economic disasters were caused in part by weak banking sectors, the IMF-led funding has been made available only on the condition (among others) that Thailand, Indonesia, and Korea undertake drastic reforms of their banking sectors — and this includes putting in place exit rules that will force insolvent banks out of business and in that sense punish the owners and managers responsible for their insolvency.

Even for those banks that receive injections of new equity capital or that are otherwise restructured and thereby saved, the main beneficiaries are, and should be, the depositors. Their deposits will, after such a restructuring,

be safer because the depository bank is stronger.

Accordingly, I see no "moral hazard" associated with the financial sector reforms that have been forced by circumstances upon Thailand, Indonesia, and Korea — assuming, of course, that forceful exit rules such as those outlined above are applied. The bank's old shareholders and management will lose their investments and their jobs.<sup>69</sup>

On the other hand, what about the other banks involved in the Asian financial crisis, those international banks that made loans to companies, banks, or governments in Thailand, Indonesia, or Korea? Doesn't the IMF-led

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## Lessons from the Asian Financial Crisis

bailout funding reward them — or at least protect them against loss — despite their poor judgment in lending to borrowers unworthy of credit? This question has worried many commentators, some of whom strenuously condemn the IMF-led Asian bailout on grounds that it creates a "moral hazard" by merely encouraging similar imprudent lending in the future.<sup>70</sup>

I favor taking a two-step approach to the "moral hazard" problem regarding such international lending. The first step focuses on the short term, and the second step takes a longer-term view.

In the short term, a cost-benefit analysis suggests that there was little choice but to undertake the Asian bailouts. It does seem likely that avoiding the "moral hazard" by letting the economies of Thailand, Indonesia, and (especially) Korea collapse would have taught the international lenders a valuable lesson in risk assessment; That would have been a benefit. On the other hand, though, that benefit might have come at a very sobering cost: the contagion of collapse could have reached beyond those three countries to infect Japan, bringing down its economy and perhaps those of other countries. Indeed, some risk of that remains.

U.S. government officials have relied on this "domino theory" in defending U.S. participation in the IMF-led bailout efforts.<sup>71</sup> As one commentator has put it, "[t]his domino argument may be exaggerated, but testing it by seeing what would happen if the Asian tigers were left to melt down would be the greatest roll of the dice of the post-Cold War era."<sup>72</sup>

IMF officials assess the short term "moral hazard" problem as follows: "[t]he global

interest lies in containing and overcoming the Asian crisis as quickly as possible, even at the cost of some undesirable side effects."<sup>73</sup> Spelled out more fully, the position is this:

In effect, we face a trade-off. Faced with a crisis, we could allow it to deepen and possibly teach international lenders a lesson in the process; alternatively, we can step in to do what we can to mitigate the effects of the crisis on the region and the world economy in a way that places some of the burden on borrowers and lenders, although possibly with some undesired side effects. The latter approach — doing what we can to mitigate the crisis — makes more sense.<sup>74</sup>

Officials from the Clinton Administration have concurred in this view. The U.S. Secretary of the Treasury testified in late January that he "would not spend one nickel for the purpose of protecting investors or banks" but that "any action to force investors and creditors involuntarily to take losses, however appropriate that might seem, would risk serious adverse consequences" that could disrupt the U.S. economy.<sup>75</sup>

In the longer term, however, such bailouts are dangerous and should be avoided. As one commentator has observed, the IMF and its bailout beneficiaries should, in principle, "provide the guarantees needed to keep current creditors engaged while swearing that it is the last time that such guarantees will be provided." In order for such a "swearing" to constitute a credible commitment, of course, the IMF or other international actors will need to take

some definitive action toward preventing future crises of the types that brought Thailand, Indonesia, and Korea to their knees. One proposal now being circulated is to establish lending curbs that would discourage the flow of short-term loans across borders.<sup>76</sup> So far, U.S. officials have distanced themselves from such a proposal,<sup>77</sup> and IMF officials have called it a "controversial issue" that would have to be studied carefully before adoption.<sup>78</sup> Whatever the fate of that particular proposal, however, the challenge is clear: some way must be found to help countries ward off future disasters like the Asian financial crisis of 1997.

**B. Imposing  
International  
Banking  
Standards**

Rationalizing a financial sector — by liquidating the failed banks and restructuring the weak ones — can correct some crucial immediate problems but cannot assure the long-term health of the system. That requires strong and effective bank supervision. Typically, responsibility for bank supervision lies with the central bank,<sup>79</sup> and the following paragraphs refer to bank supervision as a function of the central bank.

In dealing with the Asian financial crisis, the IMF concentrated on stiffening the banking standards. For example, under the IMF-supported reform program, Korea pledged (among other things) (i) to set a timetable for all banks to meet or exceed Basle standards on capital adequacy,<sup>80</sup> (ii) to strengthen accounting standards and rules to meet international practice

and require large financial institutions to have their financial statements audited by internationally recognized firms,<sup>81</sup> (iii) to force market accountability by requiring financial institutions to publish twice yearly key data on loans, capital, and ownership, and (iv) to pass legislation consolidating the supervision of all banks, including specialized banks and others, in an agency with operational and financial autonomy.<sup>82</sup>

These specific examples fit into a comprehensive fabric of banking standards and supervision. A key lesson to be learned from the Asian financial crisis is that this fabric of standards and supervision must be kept strong. In

this respect, I believe six elements are especially important and should be expressly addressed in the legislation (or regulations) governing a country's banking sector: (i) licensing of new banks or transfer of a bank's

shares; (ii) capital adequacy requirements; (iii) insider lending and connected lending; (iv) foreign currency exposure; (v) accounting and reporting requirements; and (vi) legal authority to carry out examinations and impose corrective measures.

Although selection of these six particular elements emerges from banking law work I have done in various Asian countries, these and other elements find concise expression in the recently-developed *Core Principles for Effective Banking Supervision* prepared under the auspices of the Basle Committee on Banking Supervision.<sup>83</sup> The following paragraphs draw liberally on those "Core

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Principles" in explaining the points I believe should appear in national banking laws — especially in those of Asian countries following the financial crisis of 1997.

First, the central bank should be given broad and unequivocal authorization over the licensing of a new bank and the transfer of a bank's shares. The Basle Committee's "Core Principles" state these points as follows:

Principle 3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base

....

Principle 4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interest in existing banks to other parties.<sup>84</sup>

The justification for setting strict criteria for the entry of a new bank into the system is similar to the justification for applying tough "exit" rules, discussed above in part IIIA: to protect the interests of the depositors and the integrity of the financial system as a whole. Entry restrictions should not be used, of course, to shelter poorly-run existing banks from the rigors of new competition. However, entry restrictions can provide important protec-

tion against a host of dangers, including incompetent or untrustworthy managers, inadequate capitalization, sloppy lending practices, faulty record-keeping, and the like. Strict control over the entry of new banks is preventive in nature, aimed at avoiding the need for later, probably expensive, cures. Bank licensing authority is therefore closely related to bank supervisory authority, and for that reason I believe both these functions should usually be entrusted to a single institution — preferably a central bank having the type of independence discussed in part IIIC below. However, licensing and supervisory functions would not necessarily have to be placed in a single institution, and the language of Principle 3 in the Basle Committee's "Core Principles" reflects the division of these two functions in some systems by referring to the "licensing authority."<sup>85</sup>

Once the bank is established, however, responsibility for overseeing it must shift to the supervisory authority. In that capacity, the central bank must have power to review and, if necessary, disapprove another method of "entry" into the banking system: buying into an existing bank. That is the subject of Principle 4 quoted above. Even if a bank's original owners and managers are honest and competent, all that honesty and competence could disappear if a pack of scoundrels purchase a controlling interest in the bank.

The second of the six elements of banking supervision that I consider crucial concerns capital adequacy, which one source calls "the most important, single element within bank supervisory . . . systems."<sup>86</sup> Capital adequacy refers to the ability of a bank to face risks by relying on amounts that have been paid in by the shareholders, together with certain other

reserves. One of the Basle Committee's "Core Principles" focuses on this element:

Principle 6: Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. . . .

The explanatory text accompanying the "Core Principles" elaborates on the importance of a bank's equity capital:

[I]t provides a permanent source of revenue for the shareholders and funding for the bank; it is available to bear risk and absorb losses; it provides a base for further growth; and it gives the shareholders reason to ensure that the bank is managed in a safe and sound manner. Minimum capital adequacy ratios are necessary to reduce the risk of loss to depositors, creditors and other stakeholders of the bank and to help supervisors pursue the overall stability of the banking industry.

Capital adequacy ratios have received much attention in the past decade, and the widely accepted practice now has three main elements: definition of capital; risk weights; and prescribed ratios.<sup>87</sup>

The definition of capital, though complicated, may be summarized thus:<sup>88</sup> a bank's total capital consists of "Tier 1" capital plus

"Tier 2" capital. Tier 1 capital includes paid-up share capital and disclosed reserves (for example, retained profits and general reserves). Tier 2 capital includes several other kinds of reserves, subject to strict limitations. The objective underlying such a complex definition of capital is to measure the funds that could reasonably be regarded as available for enabling the bank to bear risk and absorb losses.

Appearing on the other side of a bank's balance sheet from capital are the bank's assets. The notion of "risk weights" applies to those assets. A bank's assets consist of cash, claims on other banks, sometimes claims on other countries (such as U.S. Treasury notes), and of course loans that the bank has made to businesses or individuals. Some of those assets, such as cash, present virtually no risk of loss in value. Others, such as loans to the private sector, involve a substantial risk of loss; some of the loans, for example, might not be repaid. A graduated scale of "risk weights" by category of asset (and certain off-balance-sheet items) has been developed by the Basle Committee and widely adopted,<sup>89</sup> in order to measure the overall risk that the bank's capital will need to cover.

Having measured capital and risk, the final step is to establish minimum ratios of capital to risk. In the Basle Committee's words, "a weighted risk ratio in which capital is related to different categories of asset or off-balance-sheet exposure, weighted according to broad categories of relative riskiness, is the preferred method for assessing the capital adequacy of banks."<sup>90</sup> In other words, a bank's strength to roll with the punches of a competitive market can be measured by dividing its capital by its

risk-weighted assets. It is that ratio — capital to risk-weighted assets — that the central bank should prescribe and enforce.

A typical capital adequacy requirement would read like this: "Each bank must maintain a minimum ratio of total capital to risk-weighted assets of at least 10%."<sup>91</sup> The ratio would be prescribed by the central bank, not fixed by statute, and should be changed from time to time as circumstances warrant. Somewhat higher or lower ratios could be applied to banks that are exceptionally weak or strong, respectively, in other aspects of their operations or management.

The third of the six elements of banking supervision that I consider most important, after licensing and capital adequacy requirements, relates to insider lending and large-exposure lending. A bank engages in insider lending (sometimes called "connected lending") when it provides loans to its own shareholders, managers, or other employees, or their relatives. A bank engages in large-exposure lending when it lends a large amount of money to one entity, or several entities related to each other by share ownership.

Insider lending can eat the heart out of a bank. In egregious cases, a bank's management will permit loans to be made to large shareholders on preferential terms — for example, at a lower interest rate than usual, or without requiring collateral for the loan. If the borrower then fails to repay the loan on time, the bank can find it difficult to press for collection. Eventually, such an unrepaid loan will, in effect, amount to a permanent transfer of assets from the bank to the borrower, at the expense of the depositors whose funds were used to make the loan.

The temptation or pressure to make such insider loans should be resisted by statutory provisions placing limits on the overall volume of such loans and prohibiting preferential terms.<sup>92</sup> Such a provision might read like this:

The maximum amount of credit that a bank may provide to a bank insider, including credit to any person related to that bank insider, shall be equal to 5% of the bank's total capital, and the maximum amount of credit that a bank may provide in the aggregate to bank insiders and persons related to bank insiders shall be equal to 20% of the bank's total capital. The terms and conditions on which any such credit is provided shall be no more favorable than those generally applicable.

The term "bank insider" could then be defined broadly to include "any shareholder, director, officer, employee, or other person involved in the ownership, management, or operation of a bank." The term "related person" (or "person related to") could be defined to cover not only natural persons, such as a parent, spouse, sibling, or child of a natural person, but also related legal entities as well. Two legal entities are related if one has a controlling ownership interest in the other or if both are owned or controlled by a third person or entity.

The definition of "related person" is also important for the rules that a country's banking law should have against excessive exposure to a single borrower or group of related borrowers. A typical provision on this point might read like this: "The maximum amount of cred-

it that a bank may provide to any one person or group of related persons shall be equal to 20% of the bank's total capital."<sup>93</sup> Without such a provision as this, a bank might expose itself so much to a single borrower or group of borrowers that a single default could consume all or most of the bank's capital.

The fourth of the six elements of banking supervision that I consider most important relates to foreign currency exposure. If financial institutions in Thailand, Indonesia, and Korea had been subject to more stringent limitations on foreign currency exposure, the economic disaster hitting those countries in 1997 might have been averted. In Thailand, for example, "[l]ocal banks borrowed in dollars, converted to bahts, tacked 7[%] onto the rate they had to pay, and pumped the money into the economy."<sup>94</sup> Once the baht dropped in value more than 7% against the dollar — it actually dropped by over 50% between July 1997 and January 1998<sup>95</sup> — the banks were in trouble.

A statutory (or regulatory) provision that could help prevent such troubles might read like this: "A bank's foreign currency exposure on an aggregate basis shall not exceed 20% of the bank's total capital, and a bank's foreign currency exposure in respect of any single foreign currency shall not exceed 10% of the bank's capital." An even more conservative approach would be to disallow foreign borrowing to fund domestic lending, leaving this risky and speculative business to other entities that play a less pivotal role in the economy than banks do.

The fifth of the six elements of banking supervision that I consider most important relates to accounting and reporting require-

ments. Several of the requirements recommended in the preceding paragraphs — for example, those on capital adequacy — can be enforced only if the banks provide accurate and usable financial information on a regular basis. The Basle Committee expressed this point as follows:

Principle 21: Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.<sup>96</sup>

The Basle Committee also emphasizes two other related points that are essential: (i) that the accounting standards used in preparing reports "should be based on accounting principles and rules that command wide international acceptance" and (ii) that the financial reports should be subjected to the scrutiny of an external audit.<sup>97</sup>

The last of the six elements of banking supervision that I consider most important concerns enforcement powers. The central bank (or other institution responsible for bank supervision) should be empowered by statute to issue implementing regulations, to undertake both off-site surveillance and on-site examination of banks, and to take a range of enforcement actions with respect to banks that fail or refuse to comply with supervision

requirements.<sup>98</sup> These actions should range from the issuance of a warning to the revocation of a bank's license. They should include the power to impose fines, to issue cease-and-desist orders, and to suspend or dismiss bank management in extreme cases. As discussed above in part IIIA, the central bank should also have authority to impose a conservatorship or a receivership on failing or insolvent banks. All these powers should be enumerated in the banking law of a country.

A vigorous application of these six key elements of bank supervision — regarding entry requirements, capital adequacy, insider and large-exposure lending, foreign currency exposure, accounting and reporting, and enforcement powers — can strengthen any banking system. Urging them on Thailand, Indonesia, and Korea will help not only those countries but also the rest of Asia as well. China, Japan, and other economies also need to strengthen their banking systems. Japanese banks, for example, are reported to have "a crushing burden of bad debts"<sup>99</sup> that has prompted the Clinton administration to urge Japan to establish a tough plan to close failing banks and restore confidence in the country's financial system.<sup>100</sup> According to one report, "the nightmare that still haunts bankers and executives around the world is the failure of a large Japanese bank that provokes a run on deposits."<sup>101</sup>

Avoiding such a nightmare will require rigorous bank supervision, including the imposition and enforcement of such international banking standards as those I have mentioned above. These measures will contribute to an overall economic modernization, in which the close "links between government, banks, and

enterprises" are reconsidered so as "to match the requirements of a globalized world economy."<sup>102</sup>

### *C. Central Bank Independence*

Next, I turn to one particular kind of link between government, banks, and enterprises that is especially important — the relationship between the government and the central bank. Although the IMF's response to the Asian financial crisis focused more on the urgent points raised above — dealing with failed or troubled banks and strengthening bank performance for the future through better supervision — the issue of central bank independence also received some attention. An element of the Korean reform program, for example, is the enactment of legislation providing for central bank independence.<sup>103</sup>

What is meant by central bank independence? The Chairman of the U.S. Federal Reserve Board described it recently in offering suggestions for avoiding economic disruptions: "central banks need to be independent, meaning that their monetary policy decisions are not subject to the dictates of political authorities."<sup>104</sup> That is the nucleus of central bank independence. In the following paragraphs, I shall elaborate on that description and recommend several specific methods for promoting central bank independence.<sup>105</sup>

It is first necessary to consider what a modern central bank is and what it is supposed to do.<sup>106</sup> Typically, it is a legal entity, created by statute, having its own capital, wholly owned by the government, but operated by a board of directors responsible for running the central bank in a commercially prudent manner, while carrying out the functions entrusted



to it. Those functions can usually be divided into two categories: one primary function and a handful of secondary functions.

The primary function is, or should be, to promote price stability. High rates of inflation — or, put differently, rapid drops in the purchasing power of the currency — can rob people of their savings, can make their business dealings risky and difficult, and can undercut their economic life generally. Countless times, runaway inflation has drawn countries into economic misery or even political chaos. Hence, in recent years, the trend has been to place price stability at the top of the list of duties placed on central banks.<sup>107</sup> To promote price stability, a central bank typically has at its disposal several instruments of monetary policy. These include the authority to set discount rates, impose reserve requirements on banks, and conduct open market operations.

A central bank typically has other functions as well.<sup>108</sup> First, the central bank usually serves as banker, agent, and adviser of the government. This includes serving as a depository for government funds (although the government should be free to place deposits with other institutions as well), acting as the government's fiscal agent for various purposes, and rendering advice to the government on monetary and financial affairs. Second, the central bank usually is authorized to hold and manage the foreign exchange reserves of the state, and to carry out foreign exchange regulations and controls. In many cases, a central bank also bears responsibility for foreign exchange policy more generally, including the establishment and management of the country's exchange system — the mechanism by which

the external value of the currency is to be determined.

Third, the central bank often serves as the supervisor of financial institutions, or at least those financial institutions that carry on the business of banking.<sup>109</sup> This supervision does not amount to instructing or influencing banks as to what loans to make to whom. Instead, banking supervision entails imposing and enforcing rules of the type discussed above in part IIIB, to guard against dishonesty and to promote prudent management of the bank's resources, including the depositors' funds. Fourth, the central bank also has another function directly affecting the commercial banks: to serve as lender of last resort. This means that the central bank stands ready to provide credit to banks, subject to strict limitations on terms and amounts, in case of a temporary liquidity shortfall. Lastly, the central bank is often authorized to issue the country's currency.

In order to perform these functions effectively, the central bank needs substantial independence from short-term political interests. This is especially true in respect of the primary goal of price stability. Many studies, though not all, have suggested that greater central bank independence yields more monetary stability.<sup>110</sup>

In discussing central bank independence, numerous authors have asserted that in order to determine just how much or how little independence a central bank really has in practice, one cannot rely entirely on the formal legal structure — the provisions in the written laws governing the central bank — but must also take into account various political and informal realities.<sup>111</sup> I do not dispute this assertion.

However, the statutory provisions can always serve as a basis for central bank independence, and as a ground on which a central bank can resist undue pressure from short-term political interests. Therefore, it is important to examine several key statutory provisions designed to grant autonomy to the central bank, and I believe the IMF should press for legislative reforms along these lines in Thailand, Indonesia, Korea, and other countries.

One set of provisions aimed at promoting central bank independence concerns the appointment and service of central bank governors and directors. Typically, the terms of office for these persons should be relatively long — at least five years, and preferably as much as eight years.<sup>112</sup> To avoid the impression that the central bank is merely a department of the executive branch of government, the appointment authority should not rest entirely with the executive branch but should instead provide for input from other sources, such as the legislative branch.<sup>113</sup> Dismissal of such officials from their posts should be possible only in exceptional circumstances, and not at the whim of the government.<sup>114</sup> Nor should the government be able to reduce the salaries of such officials during their term of office.<sup>115</sup>

A second set of provisions aimed at promoting central bank independence concerns its financial status. The central bank should have its own capital and should have the authority to place some portion of its net profit into a gen-

eral reserve fund to offset future losses that might occur.<sup>116</sup>

A third set of provisions aimed at promoting central bank independence places limits on central bank credit to the government. These might be "the most relevant of institutional guarantees of central bank independence."<sup>117</sup> The limitations can take several forms. Central bank lending to the government should (i) be limited in amount, (ii) be limited in duration, (iii) be collateralized with adequate security, and (iv) carry market-based interest rates.<sup>118</sup>

What does all this have to do with the Asian financial crisis? I believe the crisis in Asia could have been averted, or at least minimized in its impact, if Thailand, Indonesia, and Korea had followed before 1997 the policies and practices summarized above — effective exit rules to handle troubled or insolvent banks, internationally-accepted banking supervision standards, and central bank independence. Moreover, I believe that embracing such policies and practices now, not only in those three countries but elsewhere as well, can help avoid or minimize future financial crises.

*Most Americans have only a faint understanding of what the IMF is and does*

#### IV. U.S. Participation in Bailouts — Serving American Interests at a Bargain

Many Americans spoke out against U.S. participation in the IMF's "bailout" of the Asian economies.<sup>119</sup> This final section considers those objections. I conclude that they are largely misguided because they either (i) mis-

understand the financial relationship between the IMF and the United States (and other member countries) or (ii) underestimate how U.S. participation in the IMF-led bailouts serves the interests of the United States.

**A. *The United States and the IMF***

Most Americans have only a faint understanding of what the IMF is and does. One commentator might not have been exaggerating in saying that "[n]inety-nine point nine percent of Americans have a vague notion of what the IMF is and have a wrong impression about the US financial role in the IMF."<sup>120</sup> While so big a subject cannot be tackled in a short article, I do want to explore one specific aspect of the IMF: the relationship it has with the United States. My aim is to explain why U.S. membership in the IMF — and thus the IMF's provision of bailout financing — does not involve any significant cost to U.S. taxpayers, contrary to what some Americans seem to believe.<sup>121</sup>

The IMF has been described recently as a credit union for countries.<sup>122</sup> That is reasonably accurate. One of its purposes is to provide short-term balance-of-payment loans to its members when they need help getting over a temporary economic downturn.<sup>123</sup> With such financing available, a country should not have to resort to the behavior that had proved so harmful in the period between World War I and World War II — namely, exchange controls and currency devaluations.<sup>124</sup>

In order to have the funds necessary to provide short-term financing to its member countries, the IMF requires each member country to place funds on "deposit"<sup>125</sup> with the IMF in a prescribed amount.<sup>126</sup> In return, the member receives certain entitlements referred to as

Special Drawing Rights (SDRs), the international reserve asset created by the IMF in accordance with the First Amendment to its Charter in the 1960s.<sup>127</sup>

In the case of the United States, the value of the funds it has so deposited with the IMF is about SDR 27 billion,<sup>128</sup> equivalent to about \$36 billion as of mid-1997.<sup>129</sup> That transaction does not amount to a contribution or a budgetary expense. Instead, "[t]ransactions between the United States Treasury and the IMF are, by definition, monetary exchanges through which the United States receives an international reserve asset comparable to a convertible foreign currency. These monetary exchanges are not budgetary receipts or expenditures."<sup>130</sup>

The deposit of funds by the United States with the IMF entitles the United States to borrow from the IMF, not only in the amount of the deposit but up to three times that amount, or even more in exceptional cases.<sup>131</sup> The United States has not had to borrow from the IMF in the last few years, but it did take advantage of that opportunity as recently as 1978.<sup>132</sup>

The biggest borrowers from the IMF in the past two decades have been the less-economically-developed countries. In providing short-term financing to those borrowers, the IMF often disburses U.S. dollars.<sup>133</sup> The IMF pays interest to the United States on the dollars so lent.<sup>134</sup> During most of the 1980s, for example, when IMF lending was high because of the debt crisis,<sup>135</sup> the United States enjoyed a net gain of \$628 million per year on the amounts it held in the nature of deposits at the IMF.<sup>136</sup>

In short, U.S. membership in the IMF constitutes not a spending of funds collected from

the U.S. taxpayer<sup>137</sup> but rather a holding of reserve assets in a form that earns a net return for the U.S. taxpayer. As the U.S. Treasury Secretary expressed it recently: "over the past fifty years, our contribution to the IMF has not cost the taxpayer one dime. There are no budget outlays. Our contribution does not increase the deficit, or divert resources from other spending priorities."<sup>138</sup>

It could be argued that IMF membership, though not involving an expenditure of funds, does impose one kind of cost — opportunity cost. The United States might be able to earn higher returns by holding more of its reserves in other assets, such as yen or deutschemarks, or high-quality debt instruments denominated in those currencies, and holding correspondingly less of its reserves in SDRs. In doing so, however, the United States would reduce its entitlement to borrow from the IMF and would face more exchange risk than it does in holding SDRs, which are valued on the basis of a basket of strong currencies.<sup>139</sup>

Parking some of the country's reserves in the IMF strikes me as a smart thing to do, given the interest we earn on them and the entitlements and influence our participation triggers. Besides, if IMF membership were ever seen to be contrary to U.S. national interest, the United States could withdraw from the organization entirely, in which case the dollars placed with the IMF would be returned to the United States.<sup>140</sup>

### *B. Serving the U.S. National Interest*

The preceding paragraphs offer reasons why U.S. participation in the IMF bailouts — and indeed U.S. membership in the IMF more generally — carries no real price tag to the U.S.

taxpayer. While that point is not unimportant, given the misimpression that some Americans seem to have in that regard, it does not tell what benefits the United States can expect to gain from supporting the IMF in its Asian bailouts. That is the matter addressed in these closing pages.

I believe it is in the national interest of the United States to participate in IMF-led bailout packages for Asian countries in crisis for at least four related reasons.

First, as discussed at some length earlier in this article, the conditions attached to the IMF financing require strengthening of financial systems in those countries. The significance of these strengthening measures will not be lost on other countries in Asia. Indeed, perhaps this is the biggest lesson to be learned from the Asian financial crisis: an economy can crumble almost instantly if its government permits commercial banks and other financial institutions to conduct business on a fast-and-loose basis, flaunting internationally-established norms and making loans on non-commercial criteria. This is a lesson that cannot be ignored by Japan and China, the two economic powerhouses in the region.

Second, the IMF conditions also include relaxation of restrictions on foreign trade and investment in those countries,<sup>141</sup> a goal U.S. businesses and negotiators have worked toward for several years. As one writer has put it, "many experts believe that one of the most far-reaching consequences of the Asian financial crisis will be a greatly expanded American business presence in Asia."<sup>142</sup>

Third, economic collapse in any Asian country — especially Indonesia which has the world's fourth-largest population,<sup>143</sup> or Korea

which has one of the world's largest economies<sup>144</sup> — is bad news for the rest of Asia and potentially for the rest of the world. The U.S. economy relies heavily on U.S. exports, including those to Asian countries.<sup>145</sup> Dramatic drops in the values of Asian currencies, like those seen recently in Thailand, Indonesia, and Korea, can put U.S. export performance at risk. Economic and financial reforms designed to strengthen the Asian economies should help restore the confidence necessary to stop further erosion in currency values, and thereby help guard against further loss in U.S. exports and the jobs they produce. Those same economic and financial reforms, and the stability they can bring, will likewise help U.S. direct investment in those countries. In short, U.S. economic well-being depends importantly on Asian economic well-being, thus effective economic reforms in the Asian countries at risk will help the United States. To stand on the sidelines and watch our trading partners suffer economic meltdown would be senseless. As explained in part IIIA of this article, it *does* make sense to let imprudent private sector entities, including banks and other companies, suffer failure at the hands of a competitive market. However, the health of a national economy as a whole is important enough to justify our support — conditional, of course, on the undertaking of reforms that will make repeated support unnecessary.

Fourth, other values the United States wants to promote — including, for example, the protection of environmental resources, labor standards, and human rights — are served better in the long run by financial stability and growth than by instability and economic depression. Hence these non-economic

interests are also served by helping stem further economic disaster in Asia. Some critics claim that the IMF should have given more attention to these non-economic interests than it has done in arranging the Asian bailouts.<sup>146</sup> I question that. For one thing, I doubt it is possible to incorporate requirements on these complex and controversial non-economic subjects into the reform programs being supported by the IMF.<sup>147</sup> Even if it were possible to do so, I question the competence of the IMF to handle these issues. In sum, I consider it more appropriate for the United States to pursue those interests by other means. Hence, U.S. participation in the IMF bailouts is not, in my view, fatally flawed by the lack of "environmental conditionality"<sup>148</sup> or pressure on other non-economic matters.

All four reasons identified above apply equally to both indirect and direct U.S. participation in the Asian bailouts. By indirect U.S. participation, I refer to U.S. membership in the IMF. However, recall that for two of the three countries involved, the United States promised direct support as well — \$3 billion in the case of Indonesia and a portion of the \$22 billion amount available to Korea on a contingency basis.<sup>149</sup> It is not clear that any of these direct payments will in fact need to be made. Whether or not they are made, I believe committing the funds serves the national interest of the United States for an additional reason: it give credible evidence of direct American concern for the well-being of our Pacific Rim neighbors and allies. Just as the special relationship the United States enjoys with Mexico was solidified in late 1994 and early 1995 when, in the face of extreme pressure on the peso, the United States provided Mexico with a

\$20 billion loan<sup>150</sup> — which was repaid earlier than agreed or expected<sup>151</sup> — likewise American relationships with Indonesia and Korea can only be helped by American willingness to provide direct financial support to those countries. I believe the United States should have offered similar direct financial support to Thailand.<sup>152</sup>

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### Notes

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1. See William Barnes, *Thais End Most Baht Controls*, FIN. TIMES, Jan. 31, 1998, at 2.
2. See *id.*
3. See INTERNATIONAL MONETARY FUND, IMF BAIL OUTS: TRUTH & FICTION (Jan. 1998) <http://www.imf.org/external/np/exr/facts/bailout.htm> [hereinafter IMF BAIL OUTS].
4. See David E. Sanger, *Risking I.M.F. Aid, Suharto Dismisses Central Banker*, N.Y. TIMES, Feb. 18, 1998, at A1, C5. See also Andrew MacIntyre, *I'm Shocked, Shocked To Find That Cronyism Is Going On in East Asia — We May Rue the Day the U.S. and the IMF Saved Suharto*, L.A. TIMES, Jan. 18, 1998, at M1 (noting that "[i]n seven months, the rupiah had fallen from 2,500 to below 11,000 against the dollar.>").
5. See IMF BAIL OUTS, *supra* note 3.
6. See Bill Jamieson, *Lost Seoul Despite a Record IMF Loan*, SUNDAY TELEGRAPH (London), Dec. 14, 1997, at 5.
7. See IMF BAIL OUTS, *supra* note 3.
8. See Steve Glain et al., *Trapped Tiger: Financial Meltdown Drives South Korea Into a Tight Corner*, WALL ST. J. EUR., Dec. 12, 1997, at 1.
9. See Jacqueline Doherty, *Costly Lessons: The Debt Raters Know What's Wrong in Korea*, BARRON'S, Jan. 26, 1998, at 22. In January those bonds bounced back some in value. See *id.*
10. For general information, see IMF BAIL OUTS, *supra* note 3. The IMF bailout packages, and U.S. participation in them, are discussed *infra* part IIB.
11. IMF "conditionality" refers to the practice by which the IMF will disburse funds to a borrowing country only so long as the borrower continues to meet certain conditions specified in advance. For more detailed discussions of IMF conditionality, see *Fostering Sustained Policy Implementation*, 26 IMF SURV.: SUPPLEMENT ON THE IMF 10 (1997); RICHARD W. EDWARDS, JR., INTERNATIONAL MONETARY COLLABORATION 244-46 (1985); John W. Head, *Environmental Conditionality in the Operations of International Development Finance Institutions*, 1 KAN. J.L. & PUB. POL'Y 15, 21-22 (1991) [hereinafter *Head I*]; Jacques J. Polak, *The Changing Nature of IMF Conditionality*, in 184 ESSAYS IN INTERNATIONAL FINANCE 22 (Princeton University Department of Economics ed., 1991).
12. See INTERNATIONAL MONETARY FUND, IMF APPROVES STAND-BY CREDIT FOR THAILAND (Aug. 20, 1997) <http://www.imf.org/external/np/sec/pr/1997/pr9737.html> [hereinafter IMF CREDIT FOR THAILAND]. For other references to Thailand's economic woes, see Rachel Holmes, *Thais Count Cost of Baht Battle*, TIMES (London), Aug. 22, 1997, at 26 (referring to the threat Thailand's foreign debt posed to its foreign exchange reserves); Jathon Sapsford & Paul M. Sherer, *Southeast Asian Neighbors Ease the Burden of Thailand's Bailout*, WALL ST. J. EUR., Aug. 12, 1997, at 9 (referring to the threat to foreign exchange reserves).
13. See IMF CREDIT FOR THAILAND, *supra* note 12, at 1.
14. See Steven Butler, *'It Was Too Easy To Make Money' And Now the Thai Economy Is Barely Afloat*, U.S. NEWS & WORLD REP., July 28, 1997, at 41.
15. See IMF CREDIT FOR THAILAND, *supra* note 12; Butler, *supra* note 14, at 41.
16. See Michel Camdessus, Address at the Institute of Advanced Business Studies of the University of Navarra, Barcelona, Spain (Nov. 28, 1997).

<<http://www.imf.org/external/np/speeches/1997/mds9717.htm>>; Shigemitsu Sugisaki, Address at the Symposium on Capital Flows & Financial System Stability in Asia (Dec. 8, 1997) <<http://www.imf.org/external/np/speeches/1997/120897.htm>>.

17. See IMF CREDIT FOR THAILAND, *supra* note 12; *Implications of the Asian Financial Crisis: Before the House Comm. on Banking & Financial Services*, 105th Cong., 2d Sess. (1998), available in 1998 WL 37819 [hereinafter Greenspan] (statement by Alan Greenspan, Chairman of Board of Governors of the U.S. Federal Reserve System, Jan. 30, 1998).

18. For accounts of Thailand's attempts during July to fight off attacks on the value of the baht, see generally Ted Bardacke, *Thailand Fights Off Attack on Currency*, FIN. TIMES, Aug. 2, 1996, at 3; Joseph Rebello et al., *Baht Is Freed To Market Forces*, WALL ST. J. EUR., July 3, 1997, at 11.

19. See IMF BAIL OUTS, *supra* note 3.

20. For a discussion of the nature of U.S. participation in the IMF, see *infra* part IV.

21. See Art Pine & David Holley, *What's Behind U.S. Bailout Money?*, L.A. TIMES, Nov. 1, 1997, at D1.

22. From a legal perspective, most IMF financing does not take the form of loans. Instead, it consists of exchanges of currencies, typically under what is known as a stand-by arrangement or stand-by credit. For example, in approving a stand-by credit for Thailand, the IMF authorizes Thailand to purchase from the IMF a specified amount of hard currency using Thai bahts. Thailand is then required to reverse the transaction not later than a specified date by repurchasing the baht with hard currency. For more detailed explanations of stand-by arrangements, see EDWARDS, *supra* note 11, at 248-76; John W. Head, *Suspension of Debtor Countries' Voting Rights in the IMF: An Assessment of the Third Amendment to the IMF Charter*, 33 VA. J. INT'L L. 591, 594-95 nn.6-10 (1993) [hereinafter *Head II*].

23. See IMF CREDIT FOR THAILAND, *supra* note 12.

24. See *id.*

25. For an account of how the economic problems in Thailand spread to other countries, see Michel Camdessus, *supra* note 16. The remainder of this paragraph paraphrases points made there.

26. See INTERNATIONAL MONETARY FUND, IMF APPROVES STAND-BY CREDIT FOR INDONESIA (Nov. 5, 1997)

<<http://www.imf.org/external/np/sec/pr/1997/PR9750.htm>> [hereinafter IMF CREDIT FOR INDONESIA] (referring to import monopolies, to lack of transparency in governmental decision-making, and to overexposure to foreign-currency debt).

27. See Cesar Bacani, *Now the Hard Part: Indonesia Reaches an Agreement with the IMF*, ASIAWEEK, Nov. 14, 1997, available in 1997 WL 13178068 (noting that in late 1997 Indonesia's corporate sector was estimated to have "\$65 billion in dollar-denominated debt"); Raphael Pura, *Indonesia Plays Waiting Game on IMF Aid*, WALL ST. J. EUR., Oct. 20, 1997, at 13 (noting that Indonesian companies and banks had accumulated foreign loans of \$56 billion by March 1997 and several billions more since then); Michael Richardson, *The Asian Test Case: Indonesia*, INT'L HERALD TRIB., Oct. 28, 1997, at 13 (reporting estimates that private Indonesian companies and banks may have foreign debt totaling \$90 billion, about \$30 billion more than officially acknowledged).

28. In mid-August, the rupiah dropped in value 7% in one day. See Nick Cumming-Bruce, *Indonesia Battered By Currency Storm As Rupiah Hits All-Time Low*, GUARDIAN (London), Aug. 15, 1997, at 19. By the end of October 1997, the rupiah was worth 35% less against the dollar than it had been at the beginning of 1997. See Michael Richardson, *Indonesia to Get Aid of \$23 Billion*, INT'L HERALD TRIB., Nov. 1, 1997, at 1.

29. See John Aglionby, *Jakarta Calls for Rupiah Aid*, GUARDIAN, Oct. 9, 1997, at 21 (noting the risk that if rescheduling of foreign loans does not take place, a full-scale banking crisis could result).

30. See IMF BAIL OUTS, *supra* note 3.

31. See IMF CREDIT FOR INDONESIA, *supra* note 26. See also Pine & Holley, *supra* note 21, at D1 (noting that "[t]he U.S. bilateral support would be drawn down only if the other funds are drained" and that the U.S. money could not be used unless Indonesia complied fully with the IMF-sponsored program).

32. See Bruce Clark et al., *Indonesia Reckons Cost of IMF Aid Package*, FIN. TIMES, Nov. 1, 1997, at 3.

33. See, e.g., *id.* (noting that Suharto was reluctant to accept IMF financing and advice, and then remained vague on how the program targets would be met, especially those regarding the financial sector, where his family has large economic interests); Bacani, *supra* note 27, (noting continued vagueness about financial reforms and refusal of a half brother of Suharto to sign liquidation

papers for a large bank he controls); *Can the IMF Save Asia?: The Fund and the Region's Lenders Do Not See Eye To Eye, But Together They Can Find the Solution*, ASIAWEEK, Jan. 16, 1998, available in 1998 WL 7904736 [hereinafter *Can the IMF Save Asia?*] (reporting that a financial institution owned by one of Suharto's sons, though closed, had been reopened under another name, creating the "perception . . . that the aging president is protecting the interests of his family and friends at the expense of economic reform.").

34. See generally Sanger, *supra* note 4, at C5 (noting that the budget Suharto proposed in early January "greatly exceeded the [IMF's] limits."); INTERNATIONAL MONETARY FUND, STATEMENT BY THE MANAGING DIRECTOR ON THE IMF PROGRAM WITH INDONESIA (Jan. 15, 1998) <<http://www.imf.org/external/np/sec/nb/1998/NB9802.htm>> [hereinafter PROGRAM WITH INDONESIA] (noting that the 1998/99 budget will be revised and that implementation of other elements of the original reform program would be accelerated and deepened).

35. See generally Sanger, *supra* note 4, at A1 (noting that Suharto's dismissal of the central bank governor and move toward a currency board, was an act of defiance "that increased the risk that the country would lose [the] rescue package."). For a description and evaluation of currency boards, see Peter Passell, *In Indonesia, Showdown On Risky Bet*, N.Y. TIMES, Feb. 19, 1998, at C1.

36. Sanger, *supra* note 4, at C5.

37. Except as otherwise indicated, information in this paragraph is drawn from INTERNATIONAL MONETARY FUND, IMF APPROVES SDR 15.5 BILLION STAND-BY CREDIT FOR KOREA (Dec. 4, 1997) <<http://www.imf.org/external/np/sec/pr/1997/pr9755.html>> [hereinafter IMF CREDIT FOR KOREA].

38. See Martin Feldstein, *Refocusing the IMF*, FOREIGN AFF., Mar.-Apr. 1998, at 20, 24.

39. See Glain et al., *supra* note 8, at 1 (reporting that as of early December the ratio of South Korea's net foreign debt to its gross domestic product was at least 25%).

40. See Rahul Jacob et al., *Reality Cheque: Korea's Long-Neglected Banking Crisis Finally Leads To An IMF Bailout*, TIME INT'L, Dec. 1, 1997, at 25 (noting the Korean government's deep reluctance).

41. See IMF BAIL OUTS, *supra* note 3.

42. See IMF Board Approves Record \$21 Billion Stand-By To Support Korea's Adjustment Program, 26 IMF SURV. 385 (1997).

43. IMF BAIL OUTS, *supra* note 3 (referring to the commitments of the industrialized countries as "a second line of defense").

44. See *Aim of Korea Program Is To Stanch Immediate Crisis, Permit Return To Stability and Growth*, 26 IMF SURV. 386, 387 (1997) [hereinafter *Aim of Korea Program*].

45. As of the end of January, no disbursement had been made. See *Implications of Asian Financial Crisis: Before the House Comm. on Banking & Financial Services*, 105th Cong., 2d Sess. (1998), available in 1998 WL 37815 [hereinafter Rubin I] (statement of Robert E. Rubin, U.S. Secretary of the Treasury, Jan. 30, 1998).

46. Except as otherwise indicated, information in this paragraph is drawn from INTERNATIONAL MONETARY FUND, REPUBLIC OF KOREA: IMF STAND-BY ARRANGEMENT (Dec. 5, 1997) <<http://www.imf.org/external/np/oth/korea.htm>> [hereinafter KOREA STAND-BY ARRANGEMENT]. For other accounts of the terms of the credit, see John Burton, *South Korea Announces IMF Bailout Conditions*, FIN. TIMES, Dec. 6, 1998, at 3; IMF CREDIT FOR KOREA, *supra* note 37.

47. See Jamieson, *supra* note 6, at 5.

48. INTERNATIONAL MONETARY FUND, KOREA STRENGTHENS ECONOMIC PROGRAM (Dec. 24, 1997) <<http://www.imf.org/external/np/sec/nb/1997/NB9732.htm>>.

49. See *IMF Accelerates Disbursement to Korea; Schedules High-Level Visit to Indonesia*, 27 IMF SURV. 1 (1998).

50. In writing this part of the article, I have drawn on my experience in helping prepare banking laws and regulations in several Asian countries at the invitations of the central banks in those countries and under the auspices of the Asian Development Bank and the International Monetary Fund. My observations here, however, do not necessarily reflect the views of those institutions.

51. See *supra* text accompanying notes 24, 32, 46. The U.S. Secretary of the Treasury described the reforms required under all three financing packages in this way: "At their core, these reform programs aim to strengthen financial systems, improve transparency and supervision, eliminate the interrelationships between banks, the government, and commercial entities, open capital markets,



and institute appropriate monetary and fiscal policies." Rubin I, *supra* note 45.

52. *Aim of Korea Program*, *supra* note 44, at 386.

53. Although the IMF-supported reform programs in Thailand, Indonesia, and Korea addressed weaknesses in a wide range of financial institutions, my discussion will focus mainly on banks. A bank is usually defined as a financial institution that is engaged in the business of both (i) accepting deposits from the public and (ii) making loans on its own account. It is the first of these elements — accepting deposits from the public — that makes banks especially important to a national economy.

54. Greenspan, *supra* note 17. He pointed out that "[t]he state of confidence so necessary to the functioning of any economy has been torn asunder." *Id.*

55. See Bacani, *supra* note 27. For another account of bank runs in Indonesia in November 1997, see Susan Sim, *Weeding out Indonesia's Ailing Banks*, SINGAPORE STRAITS TIMES, Nov. 1, 1997, at 34.

56. See, e.g., IMF CREDIT FOR INDONESIA, *supra* note 26; IMF CREDIT FOR KOREA, *supra* note 37.

57. See IMF CREDIT FOR THAILAND, *supra* note 12; IMF CREDIT FOR INDONESIA, *supra* note 26; IMF CREDIT FOR KOREA, *supra* note 46.

58. See *Asia Picks Up the Pieces*, ECONOMIST, Jan. 3, 1998, at 69.

59. See *id.*; *Can the IMF Save Asia?*, *supra* note 33.

60. See IMF BAIL OUTS, *supra* note 3. In early January 1998, the government started taking steps to sell the country's two weakest banks. See *Government To Sell Two Banks By Next Month*, KOREA HERALD, Jan. 5, 1998, available in 1998 WL 7563448.

61. See Namju Cho, *Korea Shuts 10 Merchant Banks*, WALL ST. J. EUR., Feb. 2, 1998, at 24.

62. *All Things Considered* (National Public Radio, Feb. 6, 1998) (quoting Richard Neu, a senior economist with the Rand Corporation).

63. See Greenspan, *supra* note 17.

64. See *Why Did Asia Crash?*, ECONOMIST, Jan. 10, 1998, at 66 (reporting views of Paul Krugman of the Massachusetts Institute of Technology).

65. See, e.g., Bacani, *supra* note 27, (indicating that Suharto's half-brother, second son, and daughter have large shareholdings in banks); *From Jakarta and Manila: Battle for the Economy*, ASIAWEEK, Jan. 16, 1998, available in 1998 WL 7904737 (noting the "First Family's

economic dominance" in big Indonesian business entities).

66. For references to these in the context of a twenty-four country study, see *Lessons from Systematic Bank Restructuring*, 27 IMF SURV. 8 (1998); see also *Strengthening the Framework for Financial Stability*, 26 IMF SURV. 338, 339 (1997).

67. As noted below, responsibility for bank supervision does not need to rest with the central bank, although it often does. See *infra* text accompanying note 79.

68. This description of "moral hazard" is drawn from testimony by Alan Greenspan. See *The Asian Financial Crisis: Before the House Comm. on Banking & Financial Services*, 105th Cong., 2d Sess. (1998), available in 1998 WL 37799 (testimony of Alan Greenspan, Chairman of Board of Governors of the U.S. Federal Reserve System).

69. See *IMF Standby Credit, Performance Targets*, EAST ASIAN EXECUTIVE REPORTS, Dec. 15, 1997, at 18 (noting that, according to an IMF spokesperson, the exit rules for Korea will avoid moral hazard because it will entail losses to shareholders); IMF BAIL OUTS, *supra* note 3 (noting that in IMF-supported programs, "shareholders and, as far as possible, also creditors of insolvent institutions should bear the losses" resulting from the failure of the institutions); *id.* (noting that shareholders of closed banks in Indonesia "have had their capital written down and shareholder losses will not be compensated."); *id.* (stating that all unviable financial institutions in Thailand will have "their management changed, and shareholders' equity written off.").

70. See, e.g., *\$18 Billion for the IMF?*, Editorial, WALL ST. J. EUR., Feb. 5, 1998, at 12 (claiming that "IMF bailouts invite investors to take fliers on excessively risky ventures" and that "[t]he main effect of IMF meddling is to warp the banks' incentives."); Feldstein, *supra* note 38, at 30 (claiming that "promising creditors that they will not lose in the current crisis also encourages those lenders and others to take excessive future risks."); Thomas L. Friedman, Editorial, *Bail Out Asia? Yes, But Make Banks Suffer*, NEWS & OBSERVER (Raleigh, North Carolina), Jan. 20, 1998, at A11 (noting the view held by some "that the world is better off letting the foreign banks . . . get burned so they will be less reckless in the future"); George P. Shultz et al., *Who Needs the IMF?*, WALL ST. J. EUR., Feb. 4, 1998, at 10 (comments by a former U.S. Secretary of State, a former U.S. Secretary of the Treasury, and a former chairman of Citicorp positing that "[t]he promise

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## Lessons from the Asian Financial Crisis

of an IMF bailout insulates financiers and politicians from the consequences of bad economic and financial practices, and encourages investments that would not otherwise have been made.").

71. See Friedman, *supra* note 70, at A11 (noting that U.S. officials use the "domino theory" argument to warn "that if huge economies like Korea, Thailand, and Indonesia are allowed to just go bankrupt they will take down other emerging markets, . . . and likely drag down Japan.").

72. *Id.* Friedman also notes that if Japan's economy "goes down, that will seriously impact U.S. interest rates and markets. And it won't just be Billionaire Bob who takes a hit, but also Joe Sixpack's pension fund, mutual fund and, maybe, job. Millions of workers in developing countries would also be ruined." *Id.* A former U.S. Treasury Department official also subscribes to the domino theory, saying that the globalization of financial markets carries "the risk of a global market meltdown that could shatter confidence and plunge the world into recession or worse." Roger C. Altman, *The Nuke of the 90's*, N.Y. TIMES MAG., Mar. 1, 1998, at 34.

73. IMF Support for Asian Programs, 27 IMF SURV. 50 (1998).

74. Fischer Presents IMF Perspective on Origins, Implications of Asian Crisis, 27 IMF SURV. 21, 22 (1998).

75. Rubin I, *supra* note 45.

76. See Louis Uchitelle, *I.M.F. May Be Closer To Lending-Curb Idea*, N.Y. TIMES, Feb. 3, 1998, at C4.

77. See IMF BAIL OUTS, *supra* note 3.

78. Hubert Neiss, *Asian Experience Underscores Need for Swift, Corrective Policy Action*, 26 IMF SURV. 287, 288 (1997).

79. In some countries, responsibility for bank supervision rests with other organs of government. The reform program for Korea's financial structure seems to anticipate that another organ — that is, not the central bank — would have that responsibility. See KOREA STAND-BY ARRANGEMENT, *supra* note 46; Michael Schuman, *Korean Legislature Passes Key Reforms*, ASIAN WALL ST. J., Dec. 30, 1997, at 1; Sin Yong-Bac, *Assembly Opens Session to Act on Financial Reforms*, KOREA HERALD, Dec. 21, 1997; *Bank Fears Bills Will Erode Control*, SOUTH CHINA MORNING POST, Dec. 20, 1997, at 2.

80. See KOREA STAND-BY ARRANGEMENT, *supra* note 46. For an explanation of the Basle standards, see *infra* text accompanying notes 86-91. The Thailand reform

program also included measures to improve bank capital. See IMF CREDIT FOR THAILAND, *supra* note 12.

81. See KOREA STAND-BY ARRANGEMENT, *supra* note 46.

82. See *id.*

83. Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (September 1997) <<http://www.bis.org>> [hereinafter cited as *Core Principles*]. The Basle Committee on Banking Supervision (hereinafter referred to as the Basle Committee) is a committee of banking supervisory authorities established in 1975 and consisting of representatives from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. See *id.* at 1 n.1. Many of the Core Principles resemble (though in more general form) provisions found in the U.S. banking law. For a synopsis of some of those provisions, see WILLIAM A. LOVETT, *BANKING AND FINANCIAL INSTITUTIONS LAW IN A NUTSHELL* 121 (1992) (describing bank licensing rules and procedures, 125-29 (comparing U.S. and international capital adequacy requirements), 159 (describing insider lending restrictions), 139 (noting some key reporting requirements).

84. *Core Principles*, *supra* note 83, at 4.

85. *Id.*; see also *id.* at 9 (noting that in some countries "responsibility for licensing banks is separate from the process of ongoing supervision.").

86. E.P.M. Gardener, *Capital Adequacy and Large Exposure Standards*, in J.J. NORTON, *INTERNATIONAL BANKING REGULATION AND SUPERVISION: CHANGE AND TRANSFORMATION IN THE 1990s* 191, 193 (J.J. Norton et al. eds., 1994).

87. For a general discussion of the development of capital adequacy requirements, see Cynthia C. Lichtenstein, *Introductory Note in International Convergence of Capital Measurement and Capital Standards*, and other documents of the Basle Committee on Banking Regulations and Supervisory Practices, 30 I.L.M. 967 (1991) [hereinafter *Capital Standards*]. As she notes there, the work of the Basle Committee has received very broad acceptance around the world. See *id.* at 967-68.

88. This summary draws from the Basle Committee's "definition of capital included in the capital base" appearing as Annex 1 to *Capital Standards*, *supra* note 87, Annex 1, at 997-1000. For a textual explanation of the definition, see *id.* at 983-88.

89. See *Capital Standards*, *supra* note 87, Annex 2, at 1001-02. For a textual explanation of those risk weights and their significance, see *id.*, *supra* note 87, at 988-94.

90. *Id.* at 988.

91. In July 1988 the Basle Committee recommended a target capital assets ratio of 8% "as a common minimum standard which international banks in member countries will be expected to observe by the end of 1992." *Id.* at 994.

92. For the Basle Committee's suggestions on insider lending, see *Core Principles*, *supra* note 83, at 26. Principle 10 urges the establishment of "requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks." *Id.* The Basle Committee uses the term "connected lending," defining it as "the extension of credit to individuals or firms connected to the bank through ownership or . . . control." *Id.* at 20.

93. According to the Basle Committee, "25% of capital is typically the most that a bank or banking group may extend to a private sector non-bank borrower or a group of closely related borrowers without specific supervisory approval." *Core Principles*, *supra* note 83, at 26. Principle 9 says that "supervisors must set prudential limits to restrict bank exposure to single borrowers or groups of related borrowers." *Id.* at 25.

94. Butler, *supra* note 14.

95. See Barnes, *supra* note 1.

96. *Core Principles*, *supra* note 83, at 35.

97. *Id.* at 36.

98. For references in the Basle Committee's "Core Principles" to these matters, see *Core Principles*, *supra* note 83, at 6 (Principle 16 regarding on-site and off-site supervision), 7 (Principle 22 regarding authority to take corrective action).

99. Sheryl WuDunn, *Japan's Bank Mantra: We're O.K., We're O.K. Right?*, N.Y. TIMES, Feb. 3, 1998, at C5. The banks report that they have \$560 billion in bad or questionable loans. See *id.*

100. See David E. Sanger, *U.S. Sees New Villain in Asia Crisis: Tokyo's Leadership*, N.Y. TIMES, Feb. 22, 1998, at 3.

101. WuDunn, *supra* note 99, at C5. The risk of such a run would turn in part on the adequacy of deposit insurance. Japan has a deposit insurance system that protects

deposits up to 10 million yen. See Ryuzu SATO ET AL., JAPAN, EUROPE, AND INTERNATIONAL FINANCIAL MARKETS 229 (1994). Indeed, the Japanese government recently "adopted a 'fail safe' policy of 100% de facto deposit insurance for all Japanese financial institutions in order to forestall a depositor run against weakened institutions" in the face of a financial crisis arising out of big Japanese banks' "massive and imprudent exposure to downturns in the Japanese real estate and stock markets." Arthur E. Wilmarth, Jr., *Too Good to be True? The Unfulfilled Promises Behind Big Bank Mergers*, 2 STAND. J.L. BUS. & FIN. 1, 64 (1995).

102. Sugisaki, *supra* note 16.

103. See Korea STAND-BY ARRANGEMENT, *supra* note 46. Proposals to increase central bank independence in Korea had appeared several months before the financial crisis surfaced in that country in late 1997. See ECONOMICS DEPT., BARCLAYS BANK, INTERNATIONAL CHRONOLOGY: JUNE 1997, available in 1997 WL 10206036 (reporting proposals to grant independence to the central bank to set monetary and inflation targets).

104. Greenspan, *supra* note 17.

105. In making the following observations, I am not arguing for complete independence of a central bank from the rest of the governing political structures of the state. No one would reasonably argue for that. See THOMAS F. CARGILL, CENTRAL BANK INDEPENDENCE AND REGULATORY RESPONSIBILITIES: THE BANK OF JAPAN AND THE FEDERAL RESERVE 5 (1989) (noting that "central bank independence from government is not to be taken in the literal sense" and that "no one argues that the central bank should be, or could be, completely isolated from its institutional environment."). The important question is where to strike the balance between two competing values: autonomy and accountability of the central bank. Because central bank statutes are typically replete with provisions making the central bank accountable to the government or the parliament, my comments focus on central bank autonomy.

106. The following account of a typical modern central bank is based on my study of central bank statutes from over twenty countries, all enacted or taking effect in the 1990s. That study arose out of work I have done throughout this decade in assisting with the drafting of central bank statutes in several newly-independent countries, all under the auspices of the International Monetary Fund or the Asian Development Bank. I do not draw substantially on U.S. law and practice for these purpose,

since the functions typically assigned to central banks in modern legislation are, in this country, scattered across a number of institutions, including the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and others. For an overview of the roles of these institutions, see LOVETT, *supra* note 83, at 116-17.

107. For an economic analysis of the importance of price stability, see MAXWELL J. FRY ET AL., *CENTRAL BANKING IN DEVELOPING COUNTRIES* 13-16 (1996). Those authors explain that a growing dislike of inflation has led to the conclusion "that the objective of a central bank must be to achieve price stability." *Id.* at 16. They also note that some modern central bank statutes reflect the primacy of price stability as an aim of the central bank, and they surmise that even more statutes would do so if they were to be revised today. See *id.* at 17, 19. In their conclusion, they say they "detect a general acceptance of the benefits of price stability as the primary central bank objective . . ."

*Id.* at 113. For another reference to the "growing consensus in support favor of price stability as the prime objective of a central bank," see ANAND CHANDAVARKAR, *CENTRAL BANKING IN DEVELOPING COUNTRIES* 5 (1996).

108. For an example of a central bank statute enumerating the functions summarized here, see *The Charter of the Central Bank of Chile*, specifically articles 3 (monetary stability), 28-33 (currency issue), 36 (supervisor of financial institutions), 37 (banker, agent, and advisor to government), 39-52 (foreign exchange responsibilities), 54-55 (lender of last resort). *Aprueba Ley Orgánica Constitucional del Banco Central de Chile*, 95 *Recopilación de Leyes y Reglamentos* 18.840, at 421 (1990). These functions also appear in the statute in articles 2-6, 14-16, 25-29 of the Mexican central bank. "Ley del Banco de México," D.O., 23 de diciembre de 1993.

109. For a simple definition of the business of banking, see *supra* note 53.

110. See, e.g., CARGILL, *supra* note 105, at 1 (citing studies suggesting "that the susceptibility of the monetary authority to political institutions has serious and adverse long-run effects on the economy."), 13 (citing a 1985 study in which two central banks judged most independent, those of Germany and Switzerland, had achieved lower inflation rates than several central banks having less independence), 19 (citing the general conclusion "that the more independent the central bank the lower the rate of inflation and the government deficit."); Marta

Castello-Branco & Mark Swinburne, *Central Bank Independence*, 29 *FINANCE AND DEVELOPMENT* 19 (Mar. 1992) (noting that "the last few years have seen a growing volume of literature suggesting . . . that independent central banks may promote price stability."); Stanley Fischer, *Modern Central Banking*, in *THE FUTURE OF CENTRAL BANKING* 300 (Forrest Capie et al. eds., 1994) (concluding after a review of various studies that "[t]he evidence leaves little doubt that, on average, economic performance is better in countries with more independent central banks."); C.A.E. GOODHART, *THE CENTRAL BANK AND THE FINANCIAL SYSTEM* 63 (1995) (noting that "econometric/statistical tests have shown that countries with more independent central banks have had generally lower inflation rates."). For expressions of some contrary opinion, see CARGILL, *supra*, at 169 (concluding that "the claimed statistical association between low inflation and formal central bank independence should not be given the importance it has been afforded in discussions of how to structure a price stabilizing central bank."); Castello-Branco & Swinburne, *supra*, at 19, 21.

111. See, e.g., Castello-Branco & Swinburne, *supra* note 110, at 20 (noting that "formal legislative arrangements . . . are not always a good indicator of actual independence" because political leaders can often exert influence "irrespective of formal mechanisms."); CARGILL, *supra* note 105, at 5 (stating that "the formal relationship between the central bank and the government as defined by the laws and rules establishing the central bank . . . can misrepresent the degree of central bank independence.").

112. A recent study found five-year terms for the chief executive officer ("CEO") to be typical in central banking statutes in developing countries. See FRY ET AL., *supra* note 107, at 101. Article 11.2 of the charter of the European Central Bank provides for eight-year CEO terms. See *A TREATY ESTABLISHING THE EUROPEAN COMMUNITY*, Feb. 7, 1992, Protocol on the Statute of the European System of Central Banks and of the European Central Bank, 31 I.L.M. 331 (1992).

113. See, e.g., National Bank Law of Kazakhstan Republic (art. 15) (on file with author), art. 15 (appointment of the central bank's board by the Presidium of the Supreme Soviet upon recommendations by the various entities).

114. See, e.g., "Ley del Banco de México," *supra* note 108, arts. 43, 44.

115. See, e.g., *Aprueba Ley Orgánica Constitucional del Banco Central de Chile*, *supra* note 108, art. 10 (salaries are set for two years by a commission); Amendments and Addenda to the RSFSR Central Bank (Bank of Russia) Act, RF Federal Act No. 65-FZ, art. 16(5) (Apr. 12, 1995) (on file with author) (compensation of the Chairman and board members is to be set by the board).
116. For examples of provisions on these points, see National Bank Law of Kazakhstan Republic, *supra* note 113, arts. 7-9; Law of the Republic of Kyrgyzstan "On the National Bank of the Republic of Kyrgyzstan," arts. 5, 6 (1992) [hereinafter *Kyrgyzstan National Bank Law*] (on file with author), Bank of Namibia Act 1990, 42 Government Gazette of the Republic of Namibia Act 8 of 1990, arts. 5-7 (on file with author).
117. CHANDAVARKAR, *supra* note 107, at 227.
118. For examples of provisions incorporating most of these limitations, see *Kyrgyzstan National Bank Law*, *supra* note 116, arts. 10.1, 10.2; Bank of Namibia Act 1990, *supra* note 116, arts. 34(2)(b), 42, 45-47.
119. See, e.g., James K. Glassman, Editorial, *Who Needs the IMF?*, WASH. POST, Dec. 9, 1997, at A25; Joe O. Rogers, Editorial, *The IMF or Bust?*, WASH. TIMES, Feb. 17, 1998, at A17. Many critics have also condemned the IMF action generally. In addition to those cited *supra* note 70 in connection with the "moral hazard" issue, see Fred Hiatt, Editorial, *Aid to the Good*, WASH. POST, Dec. 22, 1997, at A27 (IMF actions improperly overlooked labor issues); Robert Kuttner, *Bailout Blunder*, WASH. POST, Jan. 5, 1998, at A19 (IMF action will induce a deep recession in Korea); Jerome I. Levinson, Editorial, *One-Dimensional Bailout*, WASH. POST, Dec. 31, 1997, at A21 (IMF improperly forced deflationary programs). Criticisms were also voiced from Europe and Asia. See, e.g., *\$18 Billion for the IMF?*, *supra* note 70 (criticizing both the policies and the secretive character of the IMF); *Show Me the Currencies: Cash in the Bank Is the Way To Play 1998*, ASIAWEEK, Jan. 16, 1998 (criticizing the IMF's policies in addressing the Asian financial crisis).
120. Xan Vongsathorn, *U.S. Contribution To IMF Is Much Less Than 40 Per Cent*, NATION, Feb. 2, 1998, available in Lexis, Nexis Library, Emerging Markets File.
121. See, e.g., Glassman, *supra* note 119 (asserting that the IMF is "using the hard-earned money of U.S. taxpayers").
122. See *The Fight to Fund the Fund*, ECONOMIST, Feb. 21, 1998, at 25 (describing the IMF as "[r]ather like a credit union."); Friedman, *supra* note 70, at A11 (noting that most Americans "don't even realize that the IMF is a credit union for countries.").
123. See INTERNATIONAL MONETARY FUND, THE ROLE AND FUNCTION OF THE INTERNATIONAL MONETARY FUND ix (1985) [hereinafter *ROLE AND FUNCTION*]. For other accounts of the history and purposes of the IMF, see EDWARDS, *supra* note 11, at 4-8; A.W. HOOKE, THE INTERNATIONAL MONETARY FUND: ITS EVOLUTION, ORGANIZATION, AND ACTIVITIES 1-9 (1982).
124. "In the 1930s, many countries attempted to maintain domestic income in the face of shrinking markets through competitive devaluation of their currencies and resort to exchange and trade restrictions. Such measures could achieve their objectives only by aggravating the difficulties of trading partners who, in self-defense, were led to adopt the same policies." HOOKE, *supra* note 123, at 1.
125. See *The Asian Financial Crisis: Before the House Comm. on Banking & Financial Services*, 105th Cong., 2d Sess. (1998) available in 1998 WL 37799 [hereinafter *Rubin II*] (statement of Robert Rubin, U.S. Secretary of the Treasury, Jan. 30, 1998) (describing U.S. transfers to the IMF as "deposits").
126. See *Quotas Determine Members' Voting Power, Financial Access*, 26 IMF SURV.: SUPPLEMENT ON THE IMF 4 (1997) [hereinafter cited as *Quotas*].
127. See Hooke, *supra* note 123, at 9; *An International Reserve Asset*, 26 IMF SURV.: SUPPLEMENT ON THE IMF 20-21 (1997). A member country's quota determines that country's voting power in the IMF, the country's maximum access to the balance-of-payments assistance it can get from the IMF, and (in most cases) the country's share in an allocation of SDRs. See TREASURER'S DEPARTMENT, INTERNATIONAL MONETARY FUND, FINANCIAL ORGANIZATION AND OPERATIONS OF THE IMF 16 (1991).
128. See *Quotas*, *supra* note 126, at 5.
129. See *An International Reserve Asset*, *supra* note 127, at 21 (showing an end-July 1997 conversion rate of SDR 1 = US\$1.35862).
130. H.R. REP. NO. 102-569, (II) at 7 (1992), reprinted in 1992 U.S.C.C.A.N. 2740, 2745-46. *The President's Fiscal Year 1999 Budget Proposal: Before the Senate Comm. on the Budget*, 105th Cong., 2d Sess. (1998), available in 1998 WL 41549 (statement of Robert Rubin, Secretary of the Treasury, Feb. 3, 1998) (explaining that when the IMF draws amounts deposited with it by the

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United States, the United States receives "a liquid interest-bearing offsetting claim on the IMF of equal value.").

131. See *IMF Financing Helps Members Pursue Sound Policies*, 26 IMF SURV.: SUPPLEMENT ON THE IMF 12, 14 (1997) (noting that a country's cumulative access limit is 300% of quota in usual circumstances but can be higher in exceptional circumstances). In the recent IMF financing for Thailand, Indonesia, and Korea, those countries were able to draw amounts equaling 505%, 490%, and 1,939 %, respectively, of their quotas. See IMF CREDIT FOR THAILAND, *supra* note 12; IMF CREDIT FOR INDONESIA, *supra* note 26; IMF CREDIT FOR KOREA, *supra* note 37.

132. See H.R. Rep. No. 102-657, at 49 (1992).

133. For details on the use of "freely usable currencies" in IMF transactions, see *Head II*, *supra* note 22, at 595 n.8.

134. See *ROLE AND FUNCTION*, *supra* note 123, at 45; *The Fight to Fund the Fund*, *supra* note 122.

135. See *Head II*, *supra* note 22, at 597-98.

136. See S. REP. NO. 102-292, at 5 (1992).

137. See Rubin II, *supra* note 125; *The Fight to Fund the Fund*, *supra* note 122.

138. Rubin I, *supra* note 45.

139. The value of the SDR is determined on the basis of the weighted average of current values of the U.S. dollar, the deutschmark, the French franc, the Japanese yen, and the pound sterling. The value of the SDR tends to be more stable than that of any single currency in the basket. See *An International Reserve Asset*, *supra* note 127, at 20.

140. See INTERNATIONAL MONETARY FUND, ARTICLES OF AGREEMENT, July 22, 1944, art. XXVI §§ 1, 3, Schedule J (as amended 1990) (1993).

141. See *IMF and Indonesia Agree on Accelerated Economic Reforms*, 27 IMF SURV. 17, 20 (1998); PROGRAM WITH INDONESIA, *supra* note 34; IMF CREDIT FOR KOREA, *supra* note 37; KOREA STAND-BY ARRANGEMENT, *supra* note 46.

142. Nicholas D. Kristof, *Asia's Market Ills Cut Its Resistance To U.S. Businesses*, N.Y. TIMES, Feb. 1, 1998, at A1. See also *All Things Considered*, *supra* note 62 (an economist's comment that the United States "will be a principal beneficiary of more open markets" in Asia because of the currency crises there).

143. See THE WORLD ALMANAC AND BOOK OF FACTS 1997 838 (Robert Famighetti ed., 1997).

144. See *supra* note 38 and accompanying text.

145. See Rubin I, *supra* note 45 (noting that "[t]hirty percent of U.S. exports go to Asia, supporting millions of U.S. jobs, and we export more to Asia than Europe.").

146. See, e.g., Hiatt, *supra* note 119, at A27.

147. Testifying in late January 1998, the U.S. Secretary of the Treasury noted that although environmental protection, labor standards, and human rights "are critically important to the United States" they could not be effectively addressed in the Asian bailout context because "designing and obtaining sustained adherence to programs to restore financial stability in countries in crisis is extremely difficult" at best, without trying to pursue additional goals. Rubin I, *supra* note 45.

148. For a discussion of "environmental conditionality" in the context of international development finance institutions such as the World Bank, see *Head I*, *supra* note 11, at 15.

149. See *supra* text accompanying notes 31 and 44.

150. See John Greenwald, *Don't Panic: Here Comes Bailout Bill*, TIME, Feb. 13, 1995, at 34.

151. See Paul Blustein, *Mexico To Pay Back U.S. Loan Early*, WASH. POST, Jan. 16, 1997, at E3.

152. As indicated above, the United States was criticized for not participating directly in the Thailand bailout package. See *supra* text accompanying note 21.