

The Importance of Banks, the Quality of Credit and the International Financial Order: Reflections on the Present Crisis in South East Asia *

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This essay starts by looking at the multiple causes of the Asian crisis, and then explores some ways, perhaps unconventional, of guarding against recurrence of such crisis.

1. The causes of the present Asian crisis

Major historical events generally have many causes. The crisis consisted in the sudden outflow of capital in the second half of last year from the five Asian countries most concerned and the consequent plunge in their exchange rates.¹ Official comment initially put most blame on domestic failings by these countries.² I list four other factors which seem to me important. The spread of views among academic economists remains wide.³

□ *Professor Dow died on 1st December 1998. We share the feeling of regret of economists all over the world.*

* I am grateful for comments received from Andrew Crockett, Michael Foot, Christopher Huhne, Lord Richardson and Neils Thygesen. The article was originally submitted in May 1998 as an entry to the Jacques de Larosière Essay Competition organised by the International Institute for Finance; its relative brevity reflects the rules for that competition. It draws heavily on my full-length study, *Major Recessions 1920-75*, published by Oxford University Press in December 1998.

¹ At their trough, the exchange rates of Thailand, Malaysia, the Philippines and Korea had fallen by 50% as compared with July last year and that of Indonesia by over 80%. Those of Singapore and Taiwan fell much less and that of Hong Kong very little.

² Stanley Fischer (in January 1998) gave an IMF view which saw the crisis as “mostly homegrown”, and the BIS (February 1998) saw “local banking systems [as] the root of the crisis”.

³ See for instance the discussion in Miller and Luangaram (1998), Chote (1998) and Radelet and Sachs (1998).

1.1. *Domestic financial weaknesses*

Conditions usually stressed include the financial frailty of Asian borrowers (corporations or banks); inadequate, even malign, supervision of banks; incoherent, nepotistic or corrupt methods of government; and lack of good information about government finances and the reserves.

These conditions must have worsened the crisis. But they were not new, and crises have happened to countries where they were not present.⁴ Thus they cannot rank as sole cause. In order to remedy some of these weaknesses the IMF was led to seek conditions which made negotiations more protracted: that too must have worsened the crisis, particularly in Indonesia.⁵

1.2. *Overvalued exchange rates as a cause of the crisis*

Many exchange crises have been caused by inappropriate exchange rates; in such cases the crisis comes when markets get to think the rate is unsustainable; and what drives operators to sell is fear of exchange-rate loss. In this crisis that was probably not important since most foreign borrowing had been in dollars: what drove operators was fear lest private borrowers might become bankrupt or governments default. Currencies probably were overvalued (not Korea's) partly because most were tied to the appreciating dollar. But the main harm probably resulted not from overvaluation, but from the appearance of stability which encouraged borrowers to borrow abroad.

1.3. *Past rapid growth and subsequent recession as a cause of financial crisis*

All the countries involved in the financial crisis had previously enjoyed extremely rapid growth.⁶ That bred a boom mentality in which

⁴ As Stiglitz (1998) for instance notes.

⁵ That is the case whether or not the IMF was right to insist on such conditions, or whether – as Feldstein (1998a and 1998b) has argued – the IMF's conditions went beyond what was strictly required to deal with the exchange crisis. That question is difficult for an outsider to judge and is beyond the scope of this essay. In my view IMF support is not like central bank lending of last resort (LLR), and thus cannot be made unconditionally (as Feldstein has argued it should be); LLR by central banks is also rare.

⁶ Hong Kong, South Korea, Singapore and Taiwan (here called the 'Old Tigers') had grown rapidly since the mid-60s. Thailand, Malaysia and Indonesia (the 'New Ti-

investors, domestic and foreign, underrated risks. Fast growth promised high returns to investment, and thus helped to cause what proved to be unsustainably large capital inflows into the area.

Since 1996 Thailand, Malaysia and Indonesia, and now Korea, have been in recession (Chart 1).⁷ The recessions were probably triggered by the slackening of their export markets. The collapse of the boom must have been one reason for the reversal of the inflows.

Some accounts treat recession as a by-product of the financial crisis. But recession probably came first and helped to cause the financial crisis, which in turn worsened recession. Because of these interconnections, financial crises and recession are likely to last longer than they did in Mexico.

1.4. *The overall structure of Asian countries' balance of payments*

A country that runs a current deficit takes a risk, since the capital inflows needed to finance it can vary much more rapidly than the real flows that determine the current account. In 1991-97, total private flows into seven of the Asian countries varied from one year to another by no less than 3.5% of GDP – largely (but not only) because of short-term flows (Table 1).

What deficit is safe depends on how well a country runs its affairs generally. In the circumstances of these countries to tolerate deficits of 3% of GNP was in my view risky, and 5% very risky. For the past six years Indonesia and the Philippines had deficits in this range, and Thailand and Malaysia well above it (Table 2).⁸ I conclude that

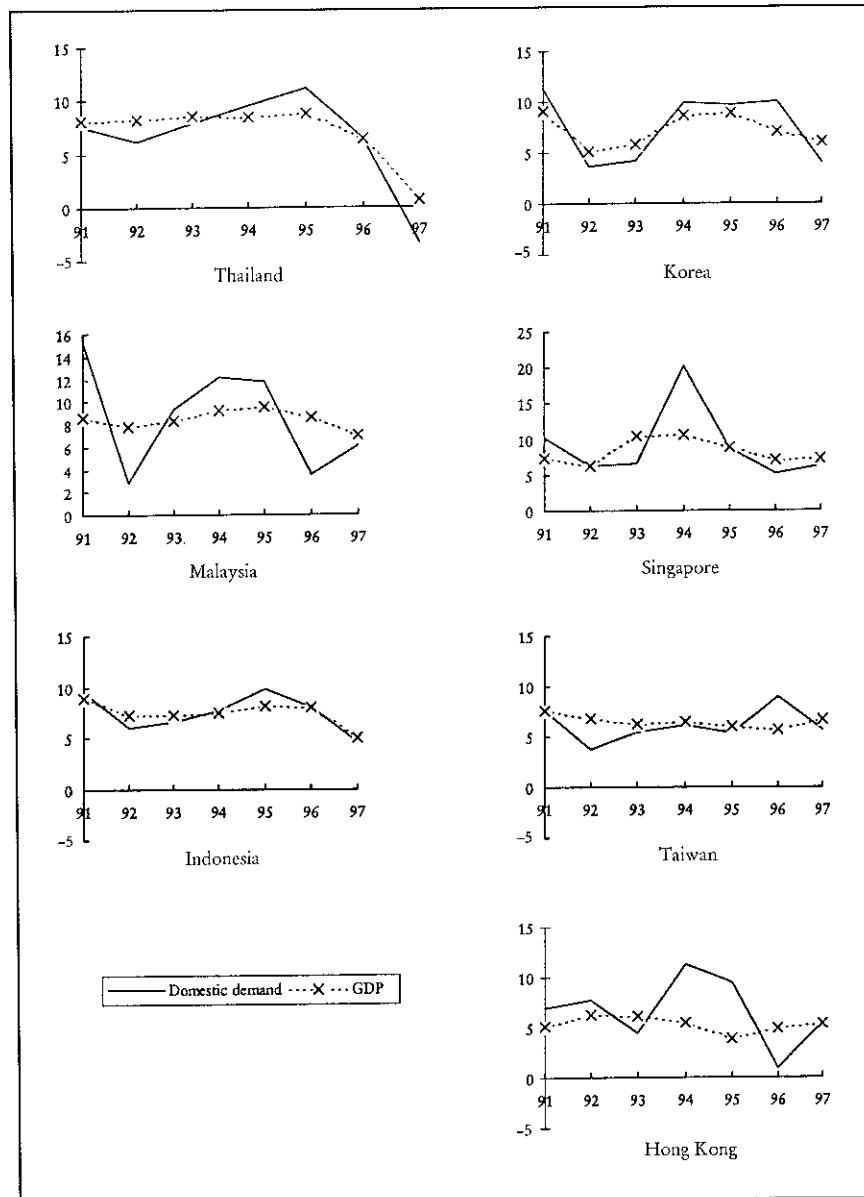
gers') – which were economic colonies of the first group and of Japan – enjoyed growth at least as fast, or since 1990 even faster. Foreign investment by the first group, and also by Japan, implanted in the second group the technologies which had produced their own growth (Kong Yam Tan 1995). This was largely the work of the Chinese diaspora throughout the area; and depended (as is standard when the institutions of civil government are weak) on family relationships. Because of these links, the income, output and trade of the area is closely intertwined. The first group are often called the Newly Industrialising Countries (NICs); the second group, along with the Philippines (which has grown less fast) is often referred to as the ASEAN-4 (Association of South East Asian Nations).

⁷ Recessions are best measured not by absolute changes but by shortfalls from the normal growth rate, and for the Tiger economies growth of 5% thus marks a recession. For these countries, recessions are probably best measured in terms not of GDP but of domestic demand which fluctuates more than GDP.

⁸ The 'Old Tigers' were different. Korea's deficit remained small until 1996 when it rapidly grew to 5% of GDP but Taiwan, Singapore and Hong Kong mostly ran large surpluses. Korea (but not the other 'Old Tigers') also relied on short-term inflows to match its relatively small deficit.

CHART 1

DOMESTIC DEMAND AND OUTPUT IN SEVEN ASIAN COUNTRIES 1991-97
(% annual change)



Source: IMF (1997 table A1).

the size of the 'New Tigers' deficits (and to a lesser extent Korea's) and their reliance on short-term finance were important causes of the crisis.

TABLE 1
FLUCTUATIONS IN CAPITAL INFLOWS INTO SEVEN ASIAN COUNTRIES, 1991-97
(Year-to-year changes in net private capital flows and three main components as % of GDP)

	Net direct investment	Net portfolio investment	Other ('short-term' flows)	Net private capital flows ^a
<i>The New Tigers</i>				
Thailand	0.2	1.3	5.6	5.0
Indonesia	0.9	0.5	1.4	1.7
Malaysia	0.9		5.6	5.7
Philippines	0.2	1.1	1.1	3.0
<i>The Old Tigers</i>				
Korea	0.1	1.0	1.3	1.1
Taiwan	0.2	0.2	1.7	1.4
Singapore	2.1	4.7	5.1	6.8
Average of 7 above countries	0.7	1.5 ^b	2.9 ^b	3.5

^a Total is less than sum of components since some changes in components are offsetting.

^b Omitting Malaysia.

Source: IMF (1997, Table 1).

TABLE 2
CURRENT ACCOUNT BALANCES
(% of GDP)

	1975-82	1983-89	1990-95	1996	1997
<i>The New Tigers</i>					
Thailand	-5.6	-3.2	-6.7	-7.9	-3.9
Indonesia	-1.2	-3.3	-2.5	-3.3	-2.9
Malaysia	2.0	-0.7	-6.2	-4.9	-5.8
Philippines	-6.5	-0.3	-4.1	-4.7	-4.5
<i>The Old Tigers</i>					
Korea	-4.6	2.5	-1.4	-4.9	-2.9
Taiwan	1.6	12.9	4.1	5.2	4.2
Singapore	-8.8	1.8	12.0	15.0	14.0
Hong Kong	1.9	8.3	4.5	-1.3	-1.5

Source: IMF (1997, Table A1).

1.5. *The instability of bank lending*

Large bank lending to the Asian countries was part of the boom psychology, which then collapsed. Alternation between phases of overconfidence and caution appears to be a general characteristic of bank lending, found not only in international flows but inside mature economies, and a characteristic of financial markets generally.

In the present crisis this general underlying instability must have interacted with, and magnified, more specific causes. That helps to explain the scale of the crisis and its spread from one country to another (contagion), and this was a key factor.

These five factors must have interacted (Chart 2). Interconnections of this sort make the system difficult to handle.⁹

2. The present approach to the problem

Three lines of thought underlie the proposals set out later in Section 3.

a) *Reforms must suit an imperfect world*

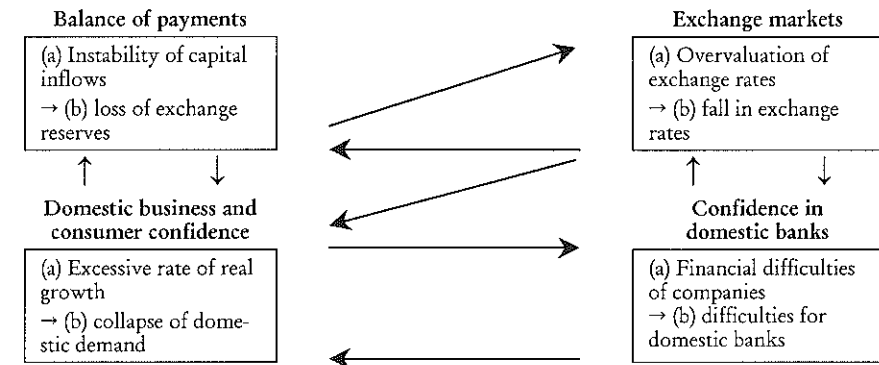
All must agree that reforms in borrowing countries to their internal systems of regulation are highly desirable. But the agenda is very extensive,¹⁰ and cannot be achieved overnight: it has taken the mature economies decades, even centuries, to instal their (still imperfect) systems of governance and control. Given the unsatisfactory conditions that are likely to prevail, it appears dangerous to allow the scale of international capital flows to be determined meanwhile entirely by market forces. For the present, something like the restrictions propo-

⁹ See Jervis (1997): compare also Wolfenson (1998): "My guess is that in five or seven years there will be another crisis based on some other factor that we don't now anticipate".

¹⁰ The sort of widespread reform in borrowing countries now being specified includes, for instance, capital adequacy, lending standards, asset valuation and effective loan recovery mechanisms; transparency, disclosure and accountability standards; provisions ensuring that insolvent institutions are dealt with promptly; the creation of strong autonomous central banks; and publication of adequate financial information (see for instance the discussion reported in IMF 1998).

sed in Section 3 below would be better than the complete freedom of capital movements now being pressed by many observers.

CHART 2
SIMPLIFIED PICTURE OF CRISIS INTERACTIONS: RELATIONS
BETWEEN DEVELOPMENT IN BALANCE OF PAYMENTS, EXCHANGE RATES,
REAL GROWTH AND CONFIDENCE IN BANKS^a



^a Boxes show (a) general condition and (b) reaction in crisis situation.

b) *Reasons for the basic instability of financial markets*

There are grounds to think that however good the institutional infrastructure becomes, international banking flows will continue – like financial markets in general – to be liable to oscillate between phases of overconfidence and loss of confidence. Those who emphasise the rationality of financial markets see them as consistently seeking optimum equilibrium situations, and thus to be stable. But in the short term, they are evidently capable of being highly unstable.

What prevents financial markets working well in this sense is basically insufficient knowledge. Thus for markets to work well, each lender would have to be able to make his own assessment of the risks of different types of lending and adjust his lending rates accordingly. An increase in borrowing by any borrower (agent or country) would raise the risk premium and tend to restrict lending to that borrower – smoothly and without panics and crises. In fact lenders do not have that knowledge and tend to follow an (ill-informed) collective view. The direction of behaviour then tends to be self-reinforcing, but at critical points reverses. Markets would work better if agents took full-

er account of the risks; proposals 2 and 3 below are designed to increase awareness of risks.

Turning points in financial markets seem to be inherently unpredictable.¹¹ The same is probably true of large turning points in the economic cycle, which are usually in part driven by financial markets. Search for early warning indicators may thus be doomed to failure. Useful prediction requires not just undated warnings but fairly precise prediction as to timing. By this standard, no one predicted the Asian crisis – not the IMF nor the credit-rating agencies, nor the banks.¹² Perhaps they should not be blamed – the fault was to think prediction possible and that a prediction of no crisis gave assurance that no crisis would occur.¹³ The proposals below do not aim at better forecasting, but at making do without it.

c) *The need for the authorities to supervise the quality of credit*

If the authorities are to try to moderate phases of overconfidence in bank lending, a hands-on type of action is required (as by monetary policy or as e.g. in proposal 3 below). Putting in place good institutions and static rules is not likely to be enough. Avoidance of instability in international banking flows should furthermore be a concern not only of bank supervisors in borrowing countries, but also of those in lending countries (since international crises are likely to cause bad debts for lending banks, which will then hamper them in their domestic function of financial intermediation). Supervision of international flows should be seen as one aspect of central banks' task. Bank lending *inside* each country is also potentially unstable. To keep it under a degree of control, the authorities need to keep a watch on the 'quality of credit'¹⁴ and try to prevent emergence of overspeculative conditions in financial markets.

¹¹ Given the prevailing orthodoxy of rational expectations, the question has not been much discussed. But see Goldberg and Frydman (1996) and the references there given.

¹² For the record of the rating agencies, see Fitch-IBCA (1998).

¹³ In any case, if the IMF had been able to predict, would that have been useful? Especially if the IMF had been known to be able to predict, disclosure of forecasts might well have precipitated the crisis it feared.

¹⁴ Sayers (1976, p. 273), writing of the Bank of England in the 1920s, remarks that the Bank regarded "control over the quality of credit" as "one of its essential duties". The Bank at that time did this by scrutinising the names on the bills it accepted for rediscount and the kind of business that they involved. This concept is not quite

For individual firms, banks are a convenient first source of credit in an expansion. For the economy as a whole, the banking system is probably *essential* to financing an expansion.¹⁵ Large fluctuations in economic activity go with, and are exaggerated by, waves of overconfidence, which are destined later to collapse. Thus prudential supervision of the quality of credit is integral to maintaining stable growth. That is the true justification of monetary targets: such targets have not proved an exact way to put a lid on inflation, but they are a good pragmatic way to maintain the quality of credit. As the world economy becomes ever more integrated, and the banking system more global, this will become ever more important. The proposals below are essentially to be seen as ways to carry out that task in its international aspect.

3. Four illustrative proposals

These proposals are put forward as offering possible ways to guard against future crises, but not as being exhaustive.¹⁶

Proposal 1. Steps by borrowing countries to limit the scale of inflows

Several countries have tried to limit inflows. Here it is suggested that borrowing countries generally should be encouraged to do so; and

the same as 'banking soundness' which the IMF volume edited by Enoch and Green (1997) emphasises.

¹⁵ This is because in an expansion, the banking system is able to provide would-be investors with finance *in advance of final savers being in a position to commit themselves to purchase additional securities* (see e.g. Smithin 1994, pp. 174-77, and Godley 1996, pp. 3-4). This proposition depends on two familiar identities: *i*) the equality for the banking system as a whole of marginal loans and deposits; and *ii*) the national income identity of total output, income and expenditure, and hence the equality of *ex post* savings and investment at all stages of a Keynesian multiplier process.

¹⁶ The steps proposed would be less intrusive than two other proposals which have the same general aim. Tobin's (1978) suggestion for a small tax on cross-border flows could probably not be large enough to be effective (see Eichengreen 1996 and Davidson 1997). Soros's (1997) credit insurance scheme to limit banking flows would I think have powers which would be too extensive and would prove disruptive.

that there should be agreed rules. For instance, the aim might be that borrowing countries:

a) should seek to limit the size of current deficits (this might involve direct controls to limit inflows so as to prevent the exchange rate being driven above some desired competitive level, selected as likely to produce only small current-account deficits);¹⁷

b) should seek to put limits to short-term inflows, i.e. banking inflows and trade credit (that might involve direct governmental controls by governments of borrowing countries on the borrowing of corporate borrowers).¹⁸

I suggest that there should be discussion, e.g. within the IMF and OECD, with a view to reaching an international consensus about what strategy borrowing countries should try to follow. With regard to *a)* the rule should probably be flexible, i.e. countries with good prudential arrangements might be judged safe with larger current deficits; but otherwise the rule might be that total capital inflows should be kept to (say) 3 or 4% of borrowing country's GDP. For short-term inflows the rule might be to limit them to (say) 1% of GDP. Such rules should be indicative not mandatory: for much of the time borrowing countries, even if they tried, would anyhow not meet the norms. But consistent failure to meet them might count as a minus in assessing countries' creditworthiness (proposal 2 below).

Proposal 2. Scheme for more focussed international supervision of banking flows

The proposal is that there should be a procedure of 'peer group' scrutiny in which the credit situation in each borrowing country would be examined in the presence of the banking supervisors of neighbouring countries and also of the main lending countries. (Table 4 is an illustration of the kind of questions that might be asked.) The 'examination' procedure might apply first to South East Asia, but later to Latin America and other areas, probably as separate groups.

¹⁷ For Chile's experience with such a policy see Agosin and Ffrench-Davis (1996) and Ffrench-Davis (1998).

¹⁸ A policy of matching banking inflows by reserve increases is probably not a workable alternative.

TABLE 3

SHORT-TERM CAPITAL INFLOWS^a
(% of GDP)

	1975-82	1983-88	1989-95	1996	1997
<i>The New Tigers</i>					
Thailand	1.5	7.4	7.4	7.7	-12.6
Indonesia	1.0	2.6	2.1	2.7	0.1
Malaysia	0.8	2.3	3.8	4.5	-0.6
Philippines	-2.7	0.9	1.4	8.5	4.5
<i>The Old Tigers</i>					
Korea	-1.6	0.8	0.9	3.0	3.4
Taiwan	0.7	-2.8	-1.9	-2.1	-2.6
Singapore	-3.2	-2.4	-3.6	1.8	3.6

^a Measured as estimated total private capital inflows less estimated net direct investment and less estimated net portfolio investment. (Hong Kong not available.)

Source: IMF (1997, Table 1).

The objects would be to make banking supervision in both lending and borrowing countries focus more sharply on the changing situation in borrowing countries; make borrowing countries more aware of what aspects of their performance worried lenders and would affect the terms on which they borrowed; and provide supervisors in lending countries, when overseeing the external lending of their own banks, with a fuller knowledge of conditions in lending countries.

Increasing the efficacy of banking supervision is a central banking function; and a procedure of case examinations among banking supervisors might best be done by the Bank of International Settlements as a central banking body. It would probably not be well done by a body in which governments are involved (and thus perhaps not by the IMF). Full and timely data would be essential; the BIS already collects the statistics of international banking flows, and could come to play an important role as the central banking body of the world. Alternatively, a new body could be created under the aegis of the BIS or the IMF, or jointly by the central banks of the Group of Three.

Proposal 3. Scheme for collective discussion by international banks of credit situations in borrowing countries

A further proposal is that a similar procedure should be initiated by representatives of the main banks engaged in international lending, perhaps under the aegis of the *International Institute of Finance*, which would consider the same sorts of question (Table 4). Representatives of the supervisory authorities of crucial selected borrowing countries would also be invited.

The aim would be to make lending banks more sensitive to changes in conditions relevant to assessment of creditworthiness. The test of its success might be that it resulted in a greater spread of borrowing rates as between different borrowing countries and larger and more frequent changes from month to month as conditions changed.

Proposal 4. International assistance to strengthen the position of banks in stricken Asian countries and in Japan

This proposal is aimed not at future crises, but at the present situation. It is motivated by the fear that the debilitated state of banks in South East Asia and Japan could extend and deepen the present crisis. Politically, it could be helpful in gaining acceptance for proposals 1-3 above.

Banks in these countries are in a poor state for several reasons: a) banks held their reserves in property and equities which depreciated in value; b) often under political pressure, banks lent to companies which were poor risks; and c) recession has put even sound companies into difficulties or even bankruptcy. Many banks may themselves face bankruptcy, or if they survive will have to curtail their lending. The biggest example of what weak banks can do to an economy is (in my view) the US Great Depression of 1929-33, which reduced GDP by a third and the size of the banking system almost as much.¹⁹ The weakness of the banks in Japan is probably also the reason why since 1992 Japanese growth has been so hesitant. Their weakness is now a world problem, which will hold back Asian recovery, and in turn be itself worsened by continued crisis in Asia.

¹⁹ Friedman and Schwartz (1963) – who however do not see bank failures as the reason for the depression being so large (as I think was probably the case).

TABLE 4

ASSESSMENT OF COUNTRY-RISK: ILLUSTRATIVE QUESTIONNAIRE
EXAMPLE OF QUESTIONS WHICH MIGHT FORM THE BASIS
OF AN EXAMINATION PROCEDURE^a

A. Background questions (perhaps to be examined annually)	Mark out of 100
1. <i>Financial infrastructure inside country</i>	up to 20
a. Position of central bank: is it free and independent and adequately staffed?	
b. Banking supervision: is it free of political influence and adequately staffed?	
2. <i>Management of the economy</i>	up to 20
a. Is policy directed at maintaining sustainable growth and avoiding speculative and inflationary conditions?	
b. How effective has policy been in the last 2 or 3 years?	
c. Is it likely to be effective in the period ahead?	
B. Current questions (perhaps to be examined quarterly)	
3. <i>Structure of balance of payments</i>	up to 30
a. Current external deficit: is a low deficit (e.g. 2% of GDP) aimed at? Has it been and is it likely to be achieved?	
b. Scale of banking inflows: does policy aim to keep these small? Is policy being and likely to be successful?	
4. <i>Present state of economy as regards speculative behaviour and inflationary pressures</i>	up to 30
Are there signs of speculative behaviour in	
a. domestic financial markets and real estate markets?	
b. corporations' investment behaviour?	
c. banks' domestic lending behaviour?	
d. foreign investors' behaviour in regard to direct foreign investment, portfolio investment and banking inflows?	
Have they been changing much? Or are abrupt changes or reversal possible?	

^a See proposals 2 and 3 in text, on pages 380-82.

What needs to be done is conceptually straightforward: I will revert later to the political difficulties.

a) Bankrupt banks should be closed; and (to preserve continuity of banking services) then reconstituted with new management, new shareholders and new capital. If half bankrupt, half the same treatment should be applied.

b) Since private capital is unlikely to be available, governments in the countries concerned should (in the first instance) take up

the new equity, for resale later as conditions improve. Banks will eventually be profitable again, and there is no reason why they should be given grants.²⁰

c) Since the governments concerned may not under present conditions be in a position to act on the scale required, there should be international assistance.

The following considerations are relevant to the form that international assistance might take. Banks in these countries should hold their capital not in equities or property, but ideally in foreign assets. That would put a strain on those countries' balance of payments, unless banks in a group of countries all subscribed to bonds issued by members of the group. A new umbrella organisation might, then, be created, perhaps under the IMF, which would accept loans from the governments of the crisis countries, and invest the proceeds in the equity of reconstituted banks. The US and European governments might also provide loans. Over 5 or 10 years, the reconstituted banks, as they again became profitable, would buy debt instruments from the umbrella organisation to hold as their capital. International assistance and support by Asian governments would then both be progressively repaid.

The advantages to be claimed for such a scheme are that it a) might quickly restore confidence in the banking systems of the afflicted countries and b) probably thus also in their currencies. That would remove a brake on renewed Asian growth and accelerate repayment of existing international support.

No one will rush to recognise that international assistance to Asia, huge though it is, has not proved enough. By the autumn, however, it is likely to be very clear²¹ that the crisis is worse than the worst that had been feared, and that South East Asia including Japan is still going downhill. If more assistance (still temporary) then seemed needed, it might be better to focus this time (as here suggested) on restoring banking systems – without conditionality, but with commercial safeguards. If on the other hand it seemed likely that recovery was under way and that international assistance could start to be re-

²⁰ Governments would be giving temporary not permanent support to banks. There seems, then, no reason why a tightening of fiscal policy should be imposed, as the IMF is now requiring of South East Asian countries.

²¹ As has indeed proved to be the case.

paid, it would be worth diverting some of it to strengthening the damaged banking systems of Asia.

Possible additional future benefits to the international system

The world is now going to be dominated by three large currency areas – those of the US, Japan and Europe, whose economies are semi-closed and whose monetary policies are therefore bound to be dominated by domestic concerns.²² To judge by US and Japanese experience, their exchange rates are likely to fluctuate widely (e.g. within a margin of $\pm 20\%$ either side of what must be considered an equilibrium rate) and to remain out of kilter for years at a time.²³

It is to be hoped that the three large currency blocs will seek ways to consult and mitigate exchange-rate fluctuations between their currencies. But they are unlikely to be in a position to do much unless they can synchronise fluctuations in their real economies. In the long run that would not be impossible; and international help in recapitalising Asian banking systems could be a step in that direction.

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²² The Bretton Woods system broke down not only because of the increased scale of international mobile funds, but because the US, being a semi-closed economy, was not prepared to adjust domestic policy for balance of payments reasons (see Volcker and Gyohten 1992, pp. 62 and 104). Floating rates for the dollar – and the world – were thus the only solution.

²³ Bergston (1998, p. 36) notes this probability, but does not accept (what I would assert) its quasi-inevitability, and hopes that it could be negotiated away.

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