Introduction

Can regional financial arrangements help prevent the outbreak of financial crises in emerging and developing economies? Should the governments of these countries follow the example of Western Europe and stabilise the exchange rates in their region by fixing them to each other rather than to the dollar, the yen or the euro? Should international organisations like the IMF and the World Bank become much more open and supportive to regional monetary arrangements? These are the questions discussed in this book. In light of the recurring financial crises of the last eight years – Mexico (1994), East Asia (1997), Russia (1998), Argentina (2001) – these questions are highly relevant for policymakers as well as the public at large.

The book starts with a chapter by Charles Wyplosz on Europe's experience with exchange rate arrangements. Wyplosz analyses why Western Europe has been so successful, and whether its experience holds lessons for other regions of the world. He focuses in particular on the choice of exchange rate and capital mobility regimes and argues that Europe's story contradicts the one suggested by the current conventional wisdom that fixed exchange rate regimes are doomed to fail in a world of unfettered capital flows. Commitment to fixed exchange rates was considered far more important than establishing full capital mobility. Capital mobility was restrained for decades, both internally and externally, and was only fully implemented after achieving a high degree of trade integration and establishing powerful regional institutions.

"Put differently," concludes Wyplosz, "regional trade integration, exchange rate stability and institution building came first, capital mobility and monetary union came last."

Wyplosz suggests that countries that aim to deepen trade integration may opt, like Western Europe did before, for a mutually fixed exchange rate regime. He stresses that policymakers should realise that applying financial restrictions is not as sinful as generally is believed nowadays.

Wyplosz' analysis incited an interesting debate. For example, Leslie Lipschitz, of the IMF, said that he could not imagine a country successfully imposing any kind of capital account restriction when it had already l iberalised capital flows. "You cannot get the genie back into the bottle," Lipschitz observed. Lipschitz' view was shared by those who argue that financial markets have been liberalised and linked to each other through sophisticated computer technology to such a degree that it would be foolish to think that one could return to the former days of financial

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restrictions. Wyplosz viewed this as nonsense. "I don't agree with the view that you can't put the genie back in the bottle because the genie has become so sophisticated. I think the bottle too has become much more sophisticated. If we wanted to restrict capital movements we could use all this wonderful technology for that."

Bill White, of the Bank for International Settlements, did not believe there is any evidence that fixed exchange rates would encourage trade. In fact, he argued, it is the other way around. "What happened after the collapse of Bretton Woods? Trade exploded when currencies started to float. And what has happened in recent years since many smaller countries have chosen to float their currencies? Again, the growth of trade volumes has been dramatic."

However, Zdeněk Drábek, of the WTO, observed that Bill White dismissed the fact that East Asian countries had been growing rapidly for 20 to 30 years because they had stable exchange rates. "The conventional wisdom and prevailing argument of the time was that one reason why the countries have been growing so fast was precisely the fact that they had a clear notion of the advantages of stable exchange rates."

Brian Kahn, of the Central Bank of South Africa, compared the lessons of Wyplosz' analysis for the African experience. One of the critical challenges policymakers in Africa are facing, said Kahn, is the will to engage in regional integration (which requires partially giving up sovereignty) and deal with the problem of "centre country". "Many of the debates in Southern Africa about regional integration, particularly monetary integration, focus on the 'problem' of South Africa being the dominant country," observed Kahn.

In the second part of the book, which deals with economic convergence and financial stability in Central and Eastern Europe, Oldřich Dědek examines one of the key economic policy issues for countries aspiring to become members of the European Union: real versus nominal convergence, or in other words, "Copenhagen" versus "Maastricht" criteria. The so-called Copenhagen criteria aim at establishing a market economy and closing the economic gap between the candidate countries and the member states of the European Union. The Maastricht criteria, on the other hand, set a number of nominal economic parameters for inflation, long-term interest rates, public budgets and the exchange rate.

Dědek observes that many economists believe that the real convergence criteria of Copenhagen and the nominal convergence criteria of Maastricht compete with each other and that "exaggerated" ambitions to meet nominal convergence criteria (such as low inflation and low public debt) will harm real convergence and result in slower growth. According to this critical view, more time is needed to close the economic gap between the accession countries and the EU member states. However, there is also an alternative view, which stresses the complementarity between real and nominal convergence.

Dědek discusses the trade-offs between real and nominal convergence and suggests that each candidate country will have to choose its own path, taking into account its own historical experience and social preferences.

In his chapter in the second part of the book, János Vincze argues that not all financial crises seem to be equally destructive, and he distinguishes between "bad" and "good" crises. He defines those that amplify real disturbances as "bad", and those where fluctuations have risk-sharing features and do not aggravate real shocks as "good". In Central and Eastern Europe, it is widely believed that full membership of the EU will reduce the vulnerability to financial crises, says Vincze. This may be true with respect to "bad" crises, but being "locked in" by a regional arrangement will not prevent financial crises from happening, as Mexico's crisis after its accession to NAFTA illustrates. Vincze observes that the accession countries may become vulnerable to financial crises in particular during the intermediate stage before fully joining the EU and recommends bold liberalisation of the financial sector to shorten the intermediate stage.

In her comments on Dědek and Vincze, Stephany Griffith-Jones stressed that countries like the Czech Republic and Hungary should not engage too ambitiously in disinflation policy, because this might hinder growth of the economy and of productivity. Griffith-Jones disagreed with Vincze's distinction between good and bad crises. She suggested that a more interesting distinction would be between crises in developed and emerging market countries. Since most emerging market crises are extremely costly, she thought it would be better to try and prevent such crises. She also thought that too hasty liberalisation of the financial sector in Central and Eastern Europe could make these countries more vulnerable.

In the third part of the book, which deals with regional economic integration in East Asia and South America, Yung Chul Park examines the rationale and need for a regional monetary arrangement in East Asia. After the financial crisis broke in Asia in 1997, Japan proposed the creation of an Asian monetary fund as a framework for promoting financial cooperation and policy coordination in the region. The idea was that this would help Asian economies prevent and/or better manage future financial crises. The proposal received a positive response from a number of East Asian countries, but it was shelved on the objection of the US, the EU and the IMF. The idea was revived again in 2000 when the ASEAN countries plus China, Japan and South Korea agreed to establish a system of swap arrangements which became known as the Chiang Mai Initiative. The aim of the initiative is to provide liquidity support to countries experiencing

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balance of payment difficulties in order to prevent the financial turmoil and regional contagion that struck East Asia at the end of the 1990s.

Park deals extensively with the question of whether regional financial arrangements are needed in East Asia, and whether they would be effective in safeguarding the region from future financial crises. He discusses arguments opposing the creation of regional financial arrangements and contrasts them with views that suggest that regional financial mechanisms could complement multilateral trade and financial liberalisation while helping to promote global financial stability.

Commenting on Park, Leslie Lipschitz of the IMF reported that the Fund was now "wholly positive" about the Chiang Mai Initiative and other regional financing initiatives in Asia, but warned that they should not provide "unconditional" finance. In other words, the IMF should maintain its role of setting the conditions under which international financial support is given to a country. While Park favours the establishment of a common peg system, Lipschitz argued that the recent experience of fixed exchange rate regimes in Asia, Russia, Brazil and Turkey has been "less than comforting". He therefore opposed the idea of a common currency or peg.

In the chapter on Mercosur, Daniel Heymann observes that macroeconomic turbulence is not a novelty for Argentina, Brazil and their partners. However, there has been little movement in establishing concrete forms of macroeconomic cooperation to deal with such turbulence. On the contrary, recent macroeconomic disturbances, particularly the Brazilian currency crisis of 1999 and the deep recession and financing difficulties of Argentina of 2001-02, have raised scepticism in the Mercosur countries about the benefits of regional integration. Still, economic and political developments will continue to affect individual Mercosur countries, Heymann observes. He reflects on the possibilities for concerted regional action.

Commenting on both Park and Heymann, Amar Bhattacharya, of the World Bank, said that financial experts still talk about fixed versus floating exchange rates for a *country*, whereas the crucial issue is the stability of exchange rates within a *region*. Bhattacharya raised the question of what would be an appropriate regional group in order to establish a regional financial arrangement. He came to the conclusion that it does not need to be a single group or currency bloc, but rather a variety of regional groups (e.g. in Latin America, the Latin American Reserve Fund, ECLAC, Mercosur, the Andean Pact). Such groups are important, he said, because they give voice to smaller countries, create the feeling of "ownership", and provide regional surveillance and policy dialogue. In addition, groups like the Latin American Reserve Fund and the Chiang Mai Initiative give liquidity support to a member in financial trouble.

In a lively debate about the regional integration efforts in East Asia and South America, various issues were discussed including the IMF's monopoly of conditionality, exchange rate stability, market failure in assessing financial risk (in countries and regions), the division of roles between global and regional players, and G-7 intervention in debt negotiations. On the last issue, concerning G-7 intervention, Leslie Lipschitz and Yung Chul Park had opposing views. Lipschitz said that every single IMF finance package is always the result of serious discussions between the Fund and the country concerned, and that the idea of G-7 interference in negotiations between the Fund and Korea was wrong. Park retorted that it was not the G-7 interfering in a coordinated way, but the United States alone who were telling the Koreans what to do. "And it was only when the G-7 agreed and came up with a new financing package that the markets finally took it seriously and stopped attacking the Korean currency. That is on the record. I am not making up the story."

The fourth and last part of the book presents the views of five officials expressed in a joint panel discussion. José Antonio Ocampo (ECLAC) tells why he is in favour of a greater role for regional institutions in the world order. Heiner Flassbeck (UNCTAD) stresses the importance of addressing a crucial topic that remains unresolved, namely a regional approach to the exchange rate issue. Paul Jenkins (Canadian Department of Finance) focuses on the need for establishing a predictable framework for crisis resolution. Leslie Lipschitz (IMF) reports on the new approach of the Fund to crisis prevention and crisis resolution, and gives his view on the complementary role that regional groups can play. Bill White (BIS) discusses the role of the Bank for International Settlements in both crisis prevention and crisis management.

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