Explaining Compliance with International Commitments to Combat Financial Crisis: The IMF and the G7

Ivan Savic
Ph.D. Candidate
Columbia University

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Abstract:

G7 commitments are a crucial element of international efforts to combat financial crises. The members of the G7 are the source of much of the world's capital. Through individual action, regular coordination through Summits and Finance Minister Meetings, and their large voting shares in the IMF they effectively regulate and structure the international financial architecture. Finally, the G7 regularly supports and often supplements the efforts of the IMF to contain and reverse financial crisis. This paper will examine the relationship between the G7 and the IMF and how it affects the ability of both organizations to deal with crises. Specifically it will look at the influence of the G7 in the IMF and how the G7 coordinates and works with the IMF in crisis response. The paper will develop a model of coordination among the G7 and between the G7 and the IMF and then look at the record of their commitments since 1975 and the G7's role in bailouts such as those created in response to the Asian Crisis of 1997/98.

Introduction

Financial crises have been a long-standing issue in the international financial system and have in fact been around since it emerged in the late 1800s. As the international system has developed and become more sophisticated, numerous institutional efforts have been made to prevent the outbreak of financial crises. And yet for a number of reasons, which will be discussed below, financial crises have not been eliminated. For the foreseeable future financial crises will remain an important part of the world economy and will continue to be a threat to both its stability and its continued development. Responding to them effectively remains crucial.

This paper investigates the role played by the Group of Seven in dealing with international financial crises. It is important to remember that the G7 was originally created, in the form of the G5,[1] to deal with the aftermath of the collapse of the Bretton Woods exchange rate system. Although the institution has come to encompass a number of economic, security and other international issues, dealing with financial problems and crises remains, and must continue to remain, an important aspect of the G7's responsibilities. It will be argued that, while responding to smaller crises, which do not represent a serious threat to the international system is still best left to the governments directly facing such crisis, the IMF and other International Financial Institutions (IFIs), the G7 has an important role to play in the most serious crises, those which threaten the stability of entire regions and even the world economy. In fact the G7 remains indispensable in this role.

What the G7's role has been on this issue, as well as what it needs to be, will be examined in four stages. The first section of the paper will look at the logic of responding

[1] The original members included the US, Japan, UK, West Germany and France.

to financial crises and will outline the role of intervention and discuss why intervention remains important. The second section will look at the "privileged position" of the G7. It will argue that the G7 is able to deal with its own financial problems, either through individual or through the coordinated actions of its members. This puts the G7 in the unique position of being able to deal with its own financial crises without external aid. The third section will look at the strength of the G7 in addressing financial crises and will outline the G7's importance to in these situations. The final section will evaluate the G7's role in responding to the Asian Financial Crisis. The paper will conclude with a brief summary of the argument.

Logic of Intervening in Financial Crises

Given the importance of this issue and the broad ramifications that a financial crisis can have on the economic and political stability of a country, it is not surprising that there is a vast literature on the topic. This section will briefly look at four aspects of the issue: 1) why crises happen and how they spread; 2) how to best respond to them; 3) the ramifications of intervention; and 4) the politics of creating a bailout package.

The debate surrounding the origins of financial crises has looked at both the general causes of crises and the origins of specific ones. The heart of the debate is whether financial crises are caused by shifts in fundamentals underlying markets, in particular poor economic policy, or markets imperfection (Kaminsky & Reihart 1996; Corsetti, Pesenti & Roubini 1998; and Horowitz & Heo 2001). Alternatively, some have argued that crises result from irrational or unscrupulous behavior of investors, which leads to the collapse of sound financial markets (Kindelberger 1978; Obstfeld 1986;

Morris & Shi 1995, 1998, 1999 & 2001; and Antiles 2001). The logic here is that sound markets can collapse because investors begin to believe that they will. This change in beliefs, often an overreaction to new information, leads to a panic in the rest of the market as investors begin to fear a collapse and begin to exit the market. In such situations even rational investors who know that the panic is unfounded must leave the market, otherwise they will be left holding a worthless asset.

A related debate concerns the spread of financial crises from one market to another and from one state to another. This is a common characteristic of the most severe financial crises such as the financial meltdown of 1929 and the Asian Financial Crisis. There have been a number of studies that have convincingly shown that crises do spread (Botman & Jager 2002; and Edwards & Rigbon 2002). The main area of debate here is what causes crises to spread and it mirrors the debate surrounding the origins of crises. On the one hand, the contagion school argues that crises can spread to healthy markets (i.e. those where prices are in line with fundamentals). As a market in crisis collapses, investors in "similar" markets begin to fear that their investments are now also in danger. In response they will pull out of these "similar" markets, even if they are in fact sound, leading to a new crisis (Ahluwalia 2000; Yusoff & Zulkhibri 2000; Chang & Majnoni 2002). The vulnerability school, on the other hand, argues that contagion does not happen and that financial crisis will only spread to those markets that were vulnerable to a financial crisis prior to the initial outbreak (Warr 2002; Simone 2002). That is, crisis will only spread to markets where prices are not in line with their underlying fundamentals.

However, these two schools are not incompatible and a number of recent works have argued that the outbreak and spread of crises, in particular the Asian Financial

Crisis, are characterized by both the presence of panic and responses to market deviations from fundamentals, which result from bad policies or institutions (Burnside, Eichenbaum & Rebelo 2000; Pesenti & Tille 2000; Claessen & Forbes 2001; and Chang & Majnoni 2002).

Given the dislocating effects of financial crises as well as their economic, political and social repercussions, many scholars have turned to the question of crisis prevention. A significant portion of the literature has focused on reforming institutions in the hope that this will prevent the outbreak and spread of future crises. The focus here has been on both the reform of the International Financial Architecture (IFA) (Garber 1996; Goldstein 1997; Cooper 2002; Hveem 1999; Eichengreen 1999, & 2002; and Neeman & Orosel 2002) and the reform of domestic institutions and policy (Kane 2002; Goodhart 2002; and Lam 2002) which will make markets less susceptible to crises. Such work is important since the costs of crises can be quite high and it would, therefore, be preferable to prevent crises rather than respond to them. However, it is doubtful that any plan to reform domestic or international institutions, even if it were universally and consistently implemented, would completely eliminate all possibility of financial crisis. Additionally, it would not be surprising to find flaws and inconsistencies in such reforms, since current efforts are a working compromise of neo-Keynesian and neo-liberal principles (Cartapanis and Herland 2002). Thus, international crisis management remains a critical area for investigation.

The final and smallest section of the literature addresses the need for an International Lender of Last Resort (ILOLR) for distressed markets. The earliest work dealing with this topic was Kindelberger (1978). He developed a theory of market collapse based on a model of irrational market behavior, which can only be resolved by a single actor filling the role of ILOLR. He extended this work to international crises and argued that such crises will always occur and that their negative effects can only be stopped by a dominant economic state playing the role of the ILOLR. His theory denied the possibility that an international organization or even a group of states could act as an ILOLR. It also argued that if the dominant state were unwilling to play this role the international economic system would be unstable and prone to collapse. Thus, he explained the onset of the Great Depression by America's reluctance to be an ILOLR. The current literature has gone beyond this proposition and has accepted that the IMF or a group of states can play such a role. Additionally, a number of authors (Boorman, et al 2000; Kumar, Masson & Miller 2000; Goodhart and Huang 2001; Jeanne & Wyplosz 2001; Kenen 2002) have recently conducted studies in which they have argued that an ILOLR can play a useful role in providing liquidity in the case of crisis and reduce the threat of contagion.

The rest of the literature has focused on analyzing the effect of IMF programs. One group has analyzed the effect of IMF bailouts on recipient states. Bird & Rowlands (2002) have looked at the effects of IMF programs on the restoration of international capital flows into the recipient country. Alfaro (2002) has looked at the domestic winners and losers of stabilization programs. Bordo & Schwartz (2000) and Przeworski & Vreeland (2000, 2001, 2004) have analyzed the impact of IMF loans on the macro performance of the recipients. Others have also looked at the effects of bailouts on the private sector. Kho Lee & Stulz (2000) studied their effects on US banks and Jonas

(2002) has presented a neo-liberal position, pointing to the moral hazard problem in the private sector caused by IMF bailouts.

One important aspect of the problem that has been ignored is the effect of political crisis on financial bailouts. That is, any time there is a serous financial crisis, there is a possibility that a political crisis will also develop. Often a political crisis has as much impact on the success or failure of a bailout, as does the underlying financial crisis that the bailout is designed to combat. As noted above, with a few exceptions, the literature has focused on the causes of international financial crises, the moral hazard problems associated with bailouts, and the longer-term economic and political effects of both crises and bailouts. While examining all these issues is important, it fails to provide insight into how bailouts actually work and the forces that shape them.

It is also important to point out that the conventional wisdom on international sovereign lending, and on crisis bailouts in particular, is misleading. As Vreeland (2004) points out, the conventional wisdom regarding international loans and conditionality is that they result either from 1) the “dictates” of the ILOLR or from 2) the government’s need to pass necessary but unpopular economic reforms while shifting domestic resentment away from themselves and onto the ILOLR. These two approaches, however, are too simplistic and do not accurately capture the considerations that shape bailout agreements.

Finally the current literature overlooks the influence of popular protests on bailout negotiations. There are two reasons why we should expect that political unrest and specifically popular demonstrations will play an important part in crisis response. The first is theoretical: Polyani (1944), Ruggie (1983), Simmons (1994), Eichengreen (1996) and others have argued that the nature of the international economic and financial system, as well as the ability of governments to make economic policy, radically changed beginning in the interwar period. Since this time popular opinion has become an important factor shaping economic policy, even in authoritarian regimes. The second reason is empirical: popular protests have shaped this process in the past. In two recent examples popular unrest, brought about by financial crises and measures taken to alleviate them, has led to the fall of seemingly stable regimes. Thus, the Argentinean Crisis of 2001/02 led to the fall of a democratically elected regime, not through the ballet box but by citizens taking to the streets, and resulted in a prolonged period of political instability. Similarly, during the Asian Financial Crisis, the Suharto regime, that had seemed well entrenched before the crisis, collapsed after being in power since 1967.

Thus for a bailout to work successfully, the government and ILOLR must effectively navigate the often conflicting demands of investors and citizens. After all, there is little point in creating a bailout agreement if it will lead to the collapse of the government that signed it. And even if the government does not collapse, the likelihood that it will enact measures that are extremely unpopular once the crisis has passed is small (Kahler, 1993). Thus, the negotiation process is a very delicate one and for this reason it is best left as a bilateral negotiation between the government and the IMF. As will be argued below, G7 interference at this stage will usually only complicate things at a time when quick action and a clear signals to international investors are necessary. The G7 should not get involved at this stage except in extreme cases where it can remove deadlock between the government and the IMF. Otherwise, the G7s most important contribution to crisis response is in providing additional financial muscle to the IMF agreement, and in using its influence in financial markets and with domestic private lenders to add credibility to IMF bailouts. This means that the G7 should only intervene in the most threatening crises and primarily to support IMF programs.

The G7's Privileged Position in the International Financial System

Part of the importance of the G7 in dealing with financial crises is that its members on the whole have a privileged position in the financial system. This is not simply due to their wealth, their highly developed and open markets, and the fact that they represent the largest voting block in the IMF. What gives the members of the G7 a privileged position is the fact that they are largely immune to financial crises on the scale that threaten many developing and newly industrialized nations. As a result, G7 members do not need the help of countries and institutions beyond the G7 to deal with financial problems.

This, however, has not always been the case. In the early Bretton Woods period, from 1944 to the early 1970s the member of the G7 were just as likely to need IMF help in dealing with crises as developing nations were. In fact, during the 1950s and 1960s the bulk of IMF lending was in fact to developed nations. One of the first major crises that the system faced was the Pound Sterling Crisis of 1947. And of course the Bretton Woods system collapsed in the early 1970s in part because the US was no longer able, nor willing, to maintain the post war system. If we look at the Interwar Period and the Pre-WWI Period we find that many developed counties in fact experienced severe financial crises that they could not solve themselves. For example, one of the events that ushered in the formation of the Pre-WWI Financial System was the Barings Bank Crisis of 1890. In this instance, it was ironically the supposed Hegemon, i.e. Great Britain that faced a financial crisis, which was bailed out by France, Germany, Russia and others.

Thus, the first important aspect of this privileged position is that the G7 countries are less likely to experience a severe financial crisis that will require outside help. The members of the G7 have very large, very diversified financial markets. This means that difficulties in any one company are less likely to cause a cascading effect that will lead to the collapse of other companies and the market as a whole. In addition, the overall financial market is also diversified and large, which means that serious problems in one financial sector, or even its collapse, well not bring down the entire financial system. What is more likely is that investors will simply go from one type of investment to another, safer, investment. This means that unlike even the more sophisticated emerging financial markets, those of the G7 are much less prone to the escalation of financial difficulties.

This is not to argue that their financial markets are immune to problems. For example, in the late 1990s the Japanese financial system experienced severe problems and many scandals came to light that implicated the powerful Ministry of Finance of corruption and mismanagement.[2] This was a contributing factor to the slowdown of the Japanese economy, but Japan did not experience the kind of financial meltdown that a crisis of this magnitude would have caused in a less developed country. At the same time, the US was experiencing the dot-com boom, which as the 1990s progressed, increasingly turned into a stock market bubble that would burst in 2000/01. In addition, the bursting of the dot-com bubble later lead to the development of a similar bubble in the US real-estate

[2] As a result the Ministry of Finance lost a lot of its power and influence. Most importantly it lost banking supervision to the newly formed Financial Services Agency, and it also lost its control over the monetary policy of the Bank of Japan.

market, but the economy continued to grow. Therefore, although these events caused problems to the Japanese and US economies, respectively, they did not lead to the kind of economic devastation that such incidents would have caused in a smaller, less diversified financial market.

More importantly, these markets are, on the whole, well regulated by government and industry agencies. This means that their markets have better transparency and are less vulnerable to the escalation of financial problems into full-blown crises. The result of this is that, when difficulties arise, the problem can be more easily identified, isolated from the rest of the market, and dealt with. A good example of this is the case of Long-Term Capital Management (LTCM) in the US. This important hedge fund was experiencing severe difficulties in 1998 as a result of its exposure to East Asian financial markets. Member of this hedge fund included the economists, Myron Scholes and Robert Carhart Merton, who shared the 1997 Nobel Memorial Prize in Economics for their work on risk and the development of the Back-Scholes Model.[3] Thus, the success of the Hedge Fund rested in large part on it ability to manager risk in unprecedented ways and before the crisis it was making up to a 40% annual return on its investments. Yet ironically, it was excessive exposure to unanticipated risk resulting form the Asian Financial Meltdown that would lead to a total lose of $4.6 billion. The Federal Reserve Bank of New York organized a $3.625 billion bailout by private banks, because of fears that a default by LTCM would lead to a vicious cycle of defaults and a serious financial meltdown on Wall Street.

[3] Fischer Black who gave his name to the model did not share the noble prize because his death in 1995 made him ineligible.

It is also important that during a financial crisis, both domestic and international investors will desperately seek a safe investment to weather the financial storm in. This capital 'flight to safety' mechanism puts the members of the G7 in a much stronger position compared to other economies. If capital moves from one distressed financial sector in a G7 economy, it will most likely find safety either in another sector in the same country or it will look to other G7 financial markets for safety. In the financial system today, the securest and safest investments are usually found in the G7. This has two important implications. First, the G7 counties will not experience the kind of devastating capital flight that a developing country facing an international crisis would. This means that the effect will never be as devastating as it is for emerging markets. Second, when capital leaves a G7 financial market, it will likely end up seeking safety in another G7 financial market. This means that most financial difficulties that a G7 country experiences can be treated as domestic problems or as G7 problems. The best example of this is the problems associated with the rising US dollar of the 1980s. As a result of US policy, interest rates kept rising in the US leading to massive capital inflows and a strengthening of the US dollar. At first the US was not interested in this problem, but as the dollar continued to rise, the Reagan administration realized that something had to be done. As a result on September 22, 1985 the G5 (the G7 minus Canada and Italy) signed the Plaza Accord, in which they agreed to cooperate to push the dollar down. This eventually led to the signing of the Louvre Accord in February 22, 1987 by the G6 (Italy was invited to join but declined to finalize the agreement). The goal this time was to stabilize the dollar after it declined following the Plaza Accord.

Of course Plaza and Louvre were not responses to full blown financial crisis, but they do show the inter-vulnerability of the G7's financial markets. Quite simply, they cannot function in isolation from one anther. This is exactly why the G7 has had regular meetings of its finance ministers to discuss the international financial system and coordinate to solve any problems that might arise. This means that for a member of the G7, the most logical place to turn to in a crisis is the G7.

A final interesting case to consider is that of the European Monetary Systems (EMS), which experienced two crises, one involving the British Pound in 1992 and another involving the Pound and Italian Lira in 1992/93. These events would have very important consequences because they would simultaneously push most Europeans to decide on adopting a single currency and the British, and some other EU members, to opt out if this decision. But while these crises would have the aforementioned important longer-term effects, in the short run, the crisis did not lead to serious problems for any of its members. Also, the members of the EMS did not ask for any outside help in dealing with the crises. There are two reasons for this. The first is that the EMS was outside the normal responsibility of either the G7 or the IMF. More importantly, the crises did not threaten the well being of the EMS members and it would have been a bit humiliating for them to ask for IMF help.

The point of all this is that the countries that make up the G7 are in a privileged position compared to the rest of the world. This does not mean that they are immune to crises but that those crises that arise are usually easily dealt with in the national or G7 context. And even those crises that lead to the collapse of a particular financial sector are not nearly as devastating as they would be for an emerging market. This means that, due to the resilience of its members' financial markets, the G7 is able to act as an aid to any effort to deal with serious financial crises when they emerge. If the G7 was not in such a position and was as vulnerable as any other group of states, then its importance to financial crisis response would not be nearly as great.

The G7's Role in Combating Financial Crises

In addition to the G7's privileged position in the current international financial system, the G7 also has a very important role to play in crisis response because if its connections to the global financial system. There are three aspects of the institution that make it not only useful in this capacity but also very much essential. They are its members' position in the IMF, the resources at the command of these governments and the level of institutionalization of the G7 itself.

The G7 has a controlling share of the IMF member votes. As a result, no changes to the IMF can be passed without the approval of the G7 member countries. This is an essential element of the equation because the nature and behavior of financial crises is constantly changing. This means that the IMF has itself had to change over the years to more effectively regulate the global financial system and respond to periodic crises. Thus, from its original mandate of overseer of the Bretton Woods Gold-Exchange Standard it has greatly expanded its role to cover an increasing number of financial issues. As the international financial system continues to expand and develop, the IMF will have to keep pace. This of course is impossible without the support of the G7. It is also often the case that during the most severe crises the IMF must change rapidly in order to cope. During the Asian Financial Crisis, for instance, a number of major changes to the IMF had to be enacted. As a result of G7 support it was agreed that the IMF's cores resources would be increased by 45%. This also meant that the Articles of Agreement had to be amended. The details of this will be discussed at greater length in the final section of the paper.

The second important factor is that G7 members have at their command a unique set of resources that make them an indispensable partner to the IMF in any serious financial crisis. The most obvious of these is of course the vast reserves at the disposal of the G7. If the IMFs resources, and those of other IFIs, prove inadequate to deal with a crisis, the G7 can step in and provide additional funds, which is exactly what happened during the Asian Financial Crisis. Of course, a better solution to this problem is to be able to provide the IMF and other IFIs with the resources they need to fulfill their obligations. But since changes to the IMF and its quota take time to enact, especially since it requires the approval of member legislatures, the G7 or a subset of its members, is able, more then any other organization, to cover such short falls when they develop. This is something that not only happened during the Asian Financial Crisis, but was also a factor in a number of other cases, such as the Mexican Peso Crisis of 1994/95. During this crisis, United States and Canada arranged currency swaps and loan guarantees totaling $20 billion and $1 billion respectively. At the same time the IMF provided an 18-month Stand-by Credit Agreement for around US $17.7 billion and the Bank for International Settlements offered a $10 billion line of credit.

But the importance of the G7 countries is not limited to providing additional liquidity during a crisis, arguably more important that this is the G7 influence in the financial markets. The G7 counties are home to the world's top financial centers and private financial institutions. They are also the largest source of international capital in the world. This makes the G7 incredibly influential in world markets. This is important because responding to a financial crisis is not simply a matter of throwing money at a distressed market. International markets today are simply too large and too fast for this to work. Instead, the key to stabilizing distressed markets is in convincing investors that measures will be taken to correct the problem that led to the crisis in the first place. Thus the loan attached to any agreement is not so much important for the liquidity it gives to distressed markets but for the confidence it provides to investors that the government receiving the loan will act to correct the problem and, therefore, convince investors that staying in the market is in their long-term interests.

The G7 is invaluable here because, by supporting any IMF (or other IFI) agreement, it enhances the recipient's credibility in the eyes of investors. In addition to this, the government can influence private financial institutions and convince them to provide support to governments experiencing a crisis. As will be shown below on, this is exactly what happened with the South Korean government during the Asian Financial Meltdown.

The final important factor is the level of institutionalization of the G7. The regular Summits, in addition to the biannual Finance Ministers' meetings provide a forum for monitoring the international system, discussing current trends and identifying potential or actual problems. This means that the G7 can develop and coordinate policies on issues relating to the international financial system. This is important because the resources at the disposal of the G7 would be of little help if there was no consensus on how and when they should be used.

All this is not to imply that the system is perfect. There are numerous cases in the past where the G7 experienced serious internal disagreement on a number of important issues. Thus, it took a long time for the G5 to arrive at the Plaza Accord and similar problems existed before the creation of the Louvre Accord. Also, the G7 Denver Summit and the Finance Ministers meeting on the eve of the Asian Crisis did not identify the storm that was brewing at the time. However, such problems would be only more numerous and severe in the absence of regular G7 meetings.

Of course, the G7 as an institution is not perfect, and there are two main reasons why the G7 should not try to intervene in all crises. First, the G7 is made up of individual members who have their own interests. The G7's intervention in minor financial crises, not to mention the day-to-day operations of the IMF and other IFIs could be disastrous. In such situations the members of the G7 may be tempted to provide preferential treatment to key allies or to use their position as leverage over states that they are engaged in disputes with (see Kahler, 1993; Eichengreen, 1990). Second, if there is a disagreement on how to respond to a particular problem, then G7 intervention is more likely to produce deadlock than to be a positive factor in resolving the problem. However, as the threat from a financial crisis increases, especially when contagion is a risk, then these two dangers diminish. In more serious crises, the importance of pre-existing ties between some members of the G7 and the country whose market is under attack, as well as any ideological or other disputes between the members of the G7 tends to diminish. As the crisis becomes more urgent and the cost of an unsuccessful intervention increases, the members of the G7 are more likely to overcome particular national interests and ideological positions to find a consensus position from where they can be most effective in dealing with the crisis.

Thus, the G7 has a very import and unique role to play in responding to financial crises. No other intuition, not even the IMF or other IFIs, despite their importance, can draw on the resources that the G7 can during the most severe crisis. But because of its influence and the fact that the G7 cannot act effectively without a strong consensus on what needs to be done, the G7 should not intervene causally in any crisis. It contributes the most when it acts as the final support of the IMF and other organizations in the most serious financial crises.

The G7 Role in the Asian Financial Crisis

There has been a lot of academic and non-academic interest in the Asian Meltdown, and there is still a lot of controversy about the causes, response to and consequences of the crisis. In particular, there is widespread criticism of the IMF's role in responding to the crisis, which many see as making matters worse and economic recovery harder then it would have otherwise been. This section will not try to produce a definitive argument on these issues, which are far beyond the scope of this paper. Instead, it will examine the G7's contribution to crisis response efforts and attempts to contain it. The first part of this section will give an overview of the events that made up the crisis. The rest of this section will analyze the G7's role and draw conclusions about what worked and how the G7 should respond to future crises.

There is still a lot of controversy about whether the crisis was the result of bad policies or bad markets. For the latter category of explanations the two most common cited culprits are technological changes, which lead to faster movement of capital, and the "heard mentality" of markets, which caused investor panic and lead to the collapse of otherwise fundamentally sound markets.[4] There is even a good deal of controversy about how sound the markets were before the crisis. Krugman (1994) argued even before the outbreak of the crisis that there were fundamental problem with the "Asian Miracle" and that the growth of these economies was not backed by any substantial productivity growth, which greatly undermined the economic achievements of the "Asian Tigers." This is in dramatic contrast to the now infamous repost issued by the IMF and World Bank before the crisis, in which these financial institutions finally agreed to praise the "Asian Miracle" despite their previous reluctance.[5]

There is, however, something of a consensus on the role that was played by the following factors. First, the presence of a large volume of "hot money," i.e. short-term capital that was extremely mobile. This made the East Asian economies vulnerable to sudden capital flight. Second, that international investor confidence in developing country currency pegs greatly diminished after the experience of the Mexican Peso Crisis of 1994/95. This was a very import factor both in the outbreak and the spread of the crisis. Many investors went into this region with high confidence in the currency pegs established by the Asian Tigers. This meant that many underestimated the currency risks attached to their investments. When countries expectance problems in maintaining their currency pegs during the crisis, investors realized their investments were much riskier then they anticipated. This produces a vicious cycle in which investors pulling out of the markets put further pressure on the pegs, which would in turn increase the risky-ness of

[4] See the literature review above.
[5] See for example the World Bank Policy Research Paper "The East Asian Economic Miracle: Economic Growth and Public Policy Paper" of 1993 and the World Bank Annual Report of 1997.

foreign investment in these economies, leading to more pullouts, etc. Third, most countries in the region, and Thailand, Indonesia and South Korea in particular, were running large current account deficits while setting their currency pegs too high, particularly with respect to the US dollar. Finally, governments in all these economies were heavily involved in managing their economic growth and had strong ties with national private banks. As a result, most of the large private banks were carrying bad loans on their books, which were backed by government guarantees. Once the crisis broke out and governments began using their reserves to maintain their currency pegs, private banks experienced serious liquidity problems.

The situation was exacerbated by events in the US and Japan. At this time the Federal Reserve under the leadership of Allan Greenspan was increasing US interest rates. This, coupled with the seemingly increased risk associated with investing in the region, lead may investors to move their investments out of East Asia and into the US. The second problem was the short-lived recovery of the Japanese Economy and the strengthening of the US dollar against the Japanese yen. This lead to a decline in competitiveness of the Asian Tiger's export industries with respect to Japanese products, which further aggravated the their current account problems.

The crisis itself broke out in Thailand in the summer of 1997. The Thai economy was experiencing difficulties before this and even the most optimistic analysts had concerns about Thailand. What no one had predicted was how fast Thailand's crisis would spread across the region. Soon the crisis spread to the Philippines, which was quickly forced to float the peso. From there the pressure spread to Hong Kong and Taiwan, although they were able to take measures that minimized the impact of the crisis.

Indonesia was hit next. South Korea, whose commercial banks had close ties to Indonesia, was also seriously hit by the crisis. Despite the relative success of Hong Kong and Taiwan, the pressure on Indonesia and South Korea intensified and it was not until December of 1997 that the crisis was under control in South Korea. Indonesia had a much harder time keeping the crisis under control and domestic pressure eventually lead to the collapse of the Suharto regime. In 1998, the crisis began to spread to countries outside the region, the most serious incidents occurring in Russia, Brazil and Argentina. But while Russia and Brazil would eventually manage to stabilize their situation with the help of the IMF, G7 and other IFIs. The crisis would have a more serious effect on Argentina, which experience continued pressure and despite signs that things were under control, would eventual experience a full blown debt and currency crisis in 2000/01. This eventually led to the fall of the government and a period of acute political instability.

Even the members of the G7 were not fully immune from the crisis, in particular Japan and the US were seriously affected, although in neither case did the crisis have nearly the same impact on these economies that it would have in other counties affected by the crisis. Thus, Japan was particularly hard hit, however, at the time it was already experiencing economic problems and difficulties in its financial sector that were unrelated to the Asian Crisis. Similarly, the US experienced a minor crisis of its own because a large number of its private financial institutions had a lot of exposure to the East Asian financial markets, the most serious case of which was the collapse of LTCM, discussed above. However, in both cases, Japan and the US were not only able to deal with, and to a large extent neutralize the effects of this exposure to the Asian Crisis on their own economies, but they were able to provide a significant portion of the G7's contribution to ending the crisis.

This in fact was truly a global crisis, the like of which had not been seen since the Latin American Debt Crisis of the late 1970s and early 1980s, and really since the financial crisis that lead to the Great Depression of the 1930s. The most affected economies were those of Indonesia, South Korea and Thailand, and eventually Argentina. Less severely affected were Hong Kong, Malaysia, Laos, the Philippines, Russia, Brazil, Japan, the US, and to varying degrees other Latin American countries. Remarkably unaffected were the People Republic of China, India, Taiwan and Singapore.

At first the G7, like most of the world ignored the crisis. At the Denver Summit of 1997 it was completely absent from discussions, despite the fact that the 1995 Halifax Summit was primarily focused on the creation of a new International Financial Architecture in the wake of the Mexican Peso Crisis. Similarly, the bulk of the discussion at the G7 Finance Ministers meeting was focused on issues relating to international financial regulation. There was some talk about the events unfolding in Asia but there was no urgency to the discussion and the G7 was more then happy to leave the issue to Asian countries, regional institutions and the IMF.

This changed dramatically during the next meeting, which was held during the time when Hong Kong was experiencing it currency and stock market difficulties. At the semi-annual IMF meeting the G7 finance ministers agreed to increase IMF reserves by 45% as well as agreeing to amend the IMF's Article of Agreement within the year. The three proposed amendments were to formally expand the IMF's responsibilities to include capital account liberalization, strengthening its role in financial sector reform (with an emphasis on improving national governance and a reduction in corruption), and expanding the allocation of Special Drawing Rights.

During the fall of 1997 Japan and the US provided significant contributions to the "second line of defense" fund for Indonesia, in case the funding provided by the IMF and other IFIs proved inadequate. By November, the G7 formalized the "second line of defense" fund agreement and started working on obtaining legislative authority to contribute to it as the crisis progressed. In December, the G7 gave support to the $35 billion package for South Korea, from the IMF and other organizations, and pledged to reinforce it if necessary. The specific pledges were as follows: the Japan $10 billion, US $5 billion, Germany, France, UK and Italy $1.25 billion each and Canada $1 billion. But more important than the monetary contribution was their influence on private bankers who promised to roll over and reschedule their loans to South Korea. This, in addition to the pledges made by South Korea's newly elected government, proved enough of a boost to investor confidence that the crisis was stabilized without drawing on the "second line of defense" funds.

The pressure on other governments was similarly lessening in this period, with the notable exception of Indonesia, which refused to adopt IMF prescriptions. As a result, at the beginning of 1998 Germany and the US intervened, with the support of other G7 members, and by mid-January, Indonesia negotiated a Letter of Intent with the IMF. Indonesia revised its economic targets and pledged far-reaching structural reforms. However, by April 1998 it became clear that both Indonesia and South Korea could not meet the pledges they had made to Thailand the previous summer. As a result, Canada assumed Indonesia's share in the first line fund to deal with the crisis, which amounted to

$US 500 million. By this time, the crisis in Asia had stabilized. The crisis would eventually spread to Russia and Brazil but further contagion was prevented through joint IMF-G7 actions. Finally, although the US and Japan would also experience direct financial problems as a result of the Asian Financial Crisis, they were still strong enough to deal with these on their own, while still being able to contribute a great deal to the G7 efforts in containing the crisis. Throughout this period the US was experiencing continuous congressional opposition to any attempts to increase IMF quotas. However, the other G7 members successfully covered this shortfall in US support. Thus, the G7 greatly assisted in containing the crisis by providing necessary second line funds to backup the loans arranged by the IMF and other IFIs, helping to restore some confidence in international investors, and pushing reluctant countries into adopting necessary steps to end the crisis.

Before ending this section it is important to highlight one important aspect of the crisis that has largely been overlooked, and that is the role of domestic politics in resolving the crisis and in particular in calming popular unrest. As was noted above, the connection between financial and domestic political crises has largely been ignored, but it is a very important part of the process. This is particularly well highlighted by the different experiences that South Korea and Indonesia had during the Asian Crisis. Both countries experienced the crisis in a very severe and prolonged way. The different outcomes they experienced in dealing with this crisis highlight the important role that domestic politics pays in crisis response.

The importance of domestic politics seemed like it would be more significant in South Korea than in Indonesia. After all, South Korea was a democracy and one that was facing national elections at the time of the crisis, while Indonesia had an authoritarian regime that had been in power since the 1960s and showed few signs of weakening its hold on power. However, once the new government was elected in South Korea it quickly removed investor fears that it would not be able to comply with its IMF agreement. In fact, with its new mandate from its citizens, it was able to commit to these provisions without domestic backlash. On the other hand, Indonesia took far longer to come to an agreement with the IMF, and the final form of this agreement was not reached until after Suharto was removed from power due the popular unrest. One might be tempted to criticize Suharto for this lack of resolve but this would underestimate the pressure his government was under. Despite the seeming stability of his regime, there was widespread but hidden popular resentment towards it. In addition to force, which the Suharto regime had no problem in using against opposition, the other key pillar of his regime was the relative economic prosperity that it offered Indonesia. Once this prosperity was threatened by the crisis, the regime's position deteriorated almost over night. As a result, Suharto had much less leeway in accepting IMF conditions than the South Korean government, which had a much more secure mandate from it citizens. Thus, Suharto could not commit to the policies necessary to restore investor confidence.

This situation highlights the fact that ignoring domestic fallout when negotiating a bailout package can be detrimental not only to the success of the bailout but also to the survival of the regime as well. Unfortunately, this aspect of crisis is often ignored and governments themselves often have a hard time convincing ILOLR of just how serious their domestic constraints are. Thus, while South Korea's great domestic vulnerability as a democracy ended up helping it during the crisis, Suharto's seeming strength as an authoritarian regime proved its downfall.

Conclusions

The G7 thus has an invaluable role to pay in helping respond to financial crises. This is a result of the stability of the G7 member country's financial systems even during the most severe financial meltdowns. Thus, the G7 is able to remain a point of relative stability even in the most troubled financial times. In addition to this, the G7's influence in the IMF, the resources at its command and influence on international and domestic financial actors, and its high level of institutionalization, make it uniquely qualified to intervene in financial crises.

However, because the process of negotiating bailout agreements is delicate and usually involve walking a type rope between market and domestic political pressures, the G7 should not get involved at this level of the bailout process. The G7s presence will only complicate the process and prove counter productive. The G7s most important contribution is in providing additional muscle to IMF bailout, both through the provision of additional funds and though its influence on private financial actors (particularly those that are its own nationals). For this reason, the G7 should only intervene in the most serious financial crises. Namely, financial crises that are less threatening to regional or global financial stability are best left to the IMF.

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