# The Economic Case for the Asian Monetary Fund

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Paper for
The 2004 Academy of International Business (AIB)
Southeast Asia Regional Conference
*Regional Cooperation, Strategic Alliances, and World Business*

August 5-7, 2004

Macau, China

Organized by
Hong Kong Institute of Business Studies, Lingnan University, Hong Kong

## Introduction

During the past two decades, various policies of the International Monetary Fund (IMF) have often been criticized by many from both developing and developed countries when it tried to cope first with the LDC debt crises in the 1980s and then with a series of international financial crises that have plagued the global economy since the early 1990s, such as the 1994-95 Mexican peso crisis, the 1997-98 Asian financial crisis, the Russian and Brazilian financial crises in 1998-99, and most recently the Argentine and Turkish financial crises in the early 21st century. In addition, the manner in which the new head of the IMF was chosen recently has also been criticized by many observers and especially by those from Asia, injecting further doubt into the proper function of the IMF in today's global financial system in general and the relevance of the IMF to Asia in particular. In March this year, Horst Koehler suddenly resigned as the managing director of the IMF in order to run for the largely ceremonial post of the German president. His departure in early 2004 as the managing director of the IMF was viewed by many as absurd as his arrival at the IMF in 2000. By tradition, the job of the IMF managing director goes to a European while the presidency of the World Bank is occupied by an American, leaving no scope for an Asian ever to head either of the two premier Washington-based international financial institutions.

Furthermore, Europe's method of choosing the managing director of the IMF has often been both irresponsible and opaque. In 2000, for example, Chancellor Gerhard Schroeder of Germany waged a ferocious campaign to place a German national at the head of the IMF to succeed the outgoing French managing director, Michel Camdessus. Germany's first choice at that time was Caio Koch-Weser, state secretary of the German finance ministry, but the U.S. government flatly vetoed him considering him less than fully qualified. Then, Chancellor Schroeder turned to another German, Horst Koehler, at that time the president of the European Bank for Reconstruction and Development based in London. But everybody knew that he was nobody's first choice.

In order to replace Horst Koehler in 2004, both Germany and France originally agreed on the candidacy of a Frenchman, Jean Lemierre, a former top French treasury official and now the president of the European Bank for Reconstruction and Development. However, Spain, Britain and other European countries pushed for Rodrigo Rato, the outgoing finance minister of Spain, who finally was elected as the new managing director of the IMF with the additional support of the United States and Latin American countries as well. Left in the cold as usual in this entire process were Asian countries, which have an important stake in the proper running of the international financial system, as they suffered heavily from both the Asian financial crisis of 1997-98 and its aftereffects connected with IMF conditionality packages accompanying IMF financial assistance to Asian crisis countries. As the international monetary and financial architecture now stands, the two most important international financial organizations, the World Bank and the IMF, are dominated by the Western powers of North America and Europe. The voice of Asia in the twin Washington-based institutions has been marginalized during the past sixty years of their entire existence and there is no likely prospect that this situation will ever change in the foreseeable future.

## The Decreasing Relevance of the IMF to Asia

Since the IMF and the World Bank were established at the Bretton Woods Conference in 1944 convened at the famous American resort of Bretton Woods in the New England region, hence known as the Bretton Woods twins, the voice of Asia has always been marginal in the two international financial organizations. It is troubling indeed for Asia that, in the Bretton Woods twins, China has fewer votes than Italy and even Saudi Arabia, India fewer than Belgium, and Korea fewer than Denmark, even though these Asian countries are far more important in the current global economy in terms of their economic sizes, world trade volumes and populations than their respective European counterparts. Even though China's population is the largest in the world and its economy in purchasing power parity terms is the second largest in the world after the U.S. economy, China's IMF quota is tied with Canada's at only the 8th among its 184 member countries.

At the same time, the current financial resources of the IMF are woefully inadequate to cope with another Asian financial crisis similar in size to that of 1997-98. The total IMF quotas as a percentage of world imports have declined from 58 percent in 1944 to just 3 percent in 2003, largely because the Western industrialized countries, which have not borrowed from the IMF in the last 25 years, have become reluctant to agree to increased IMF quotas commensurate with the increased volume of world trade and international financial flows. As a result, the ability of the IMF to handle major international financial crises has declined drastically. At the end of 2003, the total usable IMF resources amounted to only $150 billion, compared to over $1.5 trillion of foreign exchange reserves held by just five Asian countries (or "economies", to be politically correct) of Japan, China, Taiwan, Korea and Hong Kong at that time. Since IMF has already lent out much of $150 billion to its member countries, a more appropriate measure of the IMF's true capacity to assist any *future* borrowers is known as the "one-year forward commitment capacity" (FCC). It takes into account that some of the IMF's available resources have already been committed and that a prudential balance is also needed to safeguard the liquidity of creditors' claims on the IMF and guard against any potential erosion of the IMF's base of available resources as well as any amounts that are projected to be repaid to the IMF over the coming 12 months. The IMF's one-year FCC stood at only $84 billion as of early 2003, which is far less than the foreign exchange reserves of Hong Kong which stood at $121 billion as of mid 2004.

Out of the total outstanding IMF loans of $97 billion as of end 2003, just three countries of Brazil, Turkey and Argentina accounted for 72 percent, exhibiting severe concentration of the IMF's credit risk exposure to only a few non-Asian countries. Consequently, the IMF is now at the mercy of its biggest non-Asian borrowers. The IMF has been over-exposed to Latin America, to Brazil with $28 billion loans and Argentina with $16 billion, and its mistake in granting huge loans to Argentina in 2001 has been skillfully manipulated by the Argentine government in March, 2004, when the IMF was forced to roll over its maturing Argentine loans despite the largest default in history by the Argentine government of $107 billion on its private creditors.[1]

Role of the U.S. Government and the IMF in Too-Hasty Asian Financial Liberalization

Many economists have argued, and even some key former officials of the Clinton Administration of the United States now admit, that both the U.S. government and by extension the IMF pushed the developing countries, especially the Asian emerging markets, too hard for financial liberalization and freer capital flows in 1990s, allowing foreign capital to stream into Asia. The booming Asian economies of the early and mid 1990s were a tempting target for foreign investors from industrialized countries. The U.S. government wielded its enormous influence in Asia both directly and through the IMF to open up Asian financial markets, hailing the virtue of free capital flows but neglecting to make them safer. Encouraged by Western scholars and journalists who acclaimed the bright future of Asian emerging markets and the coming "Asian Century",

[1] "The IMF Blinks", editorial of *The Wall Street Journal*, March 11, 2004.

Western portfolio investors and bankers in the 1990s were too happy in pouring investment capital into Asia. Much of these foreign capital inflows was used by Asian businessmen for speculative real estate developments and other ambitious projects without due consideration of sound investment criteria.

Although the U.S. government traditionally encouraged financial liberalization of developing countries as highly desirable for their own sake, it has also been reported that the Clinton Administration especially pushed hard for free capital flows in part because this was what its supporters in Wall Street and the U.S. banking industry wanted.[2] Quoting a number of former key Clinton aides, a *New York Times* article reports that the push for financial liberalization was directed at Asia in particular, largely because it was seen as a potential gold mine for American banks and brokerage houses. The idea was to press Asia to ease its barriers to American financial services and products, "helping Fidelity sell mutual funds, Citibank sell checking accounts and American International Group sell insurance."[3]

A case in point was the U.S. negotiation strategy on Korea's entry into OECD during the 1990s. *The New York Times* quotes a senior OECD official, who stated that "To enter OECD, the Koreans agreed to liberalize faster than they had originally planned. They were concerned that if they went too fast, a number of their financial institutions would be unable to adapt."[4] The same *New York Times* article also cites a U.S. Treasury Department memorandum dated June 20, 1996, which lays out U.S. Treasury's negotiating position, listing priority areas for further financial liberalization in Korea. These included letting foreigners buy domestic Korean bonds, letting Korean companies borrow abroad both short term and long term, and letting foreigners buy Korean stocks more easily, all of which were "of interest to U.S. financial services community," according to the memo. In the end, Korea opened up its financial markets the wrong way by keeping restrictions on foreign long-term investments in Korea but freely allowing short-term overseas borrowings by Koreans, even though short-term capital flows are far more volatile than long-term credits as the subsequent event in Korea during the Asian financial crisis has proved.

In Asia, there is a strong suspicion that the IMF was also used by the U.S. government

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[2] "How U.S. Wooed Asia To Let Cash Flow In", *The New York Times*, February 16, 1999.

[3] *Ibid.*

[4] *Ibid.*

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

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

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

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

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

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

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

In 1997 and early 1998 during the height of the Asian financial crisis when many Asian countries needed massive emergency funds to cope with panicky capital outflows from the Asian region, there were serious discussions among some Asian countries on establishing an Asian Monetary Fund (AMF) in order to supplement the Washington-based IMF. The Japanese government, for example, was willing to make a major contribution of up to $50 billion to the new AMF that might have an initial capital resource of about $100 billion, with the rest of its capital to be contributed by China, Hong Kong, Taipei and Singapore. The proposal for an AMF was strongly supported by other Asian countries such as Malaysia and Thailand as a way to supplement the dwindling IMF resources. Australia also showed its support for an AMF and even its willingness to join it.[5] Unfortunately, the idea of a new AMF was bitterly opposed predictably by both the U.S. government and the IMF, which were afraid of the presumed erosion of their traditional monopolistic influence on Asian economic policy making. Opponents of the AMF argued that a regional fund such as an AMF would unnecessarily duplicate IMF's activities and lead to moral hazard problems. However, the moral hazard problem associated with mutual liquidity provisions by both the IMF and an AMF to an Asian country in financial crisis cab be addressed by policy harmonization between the two institutions similar to the harmonization of loan covenants between the World Bank and regional development banks such as the Asian and Inter-American Development Banks.

In hindsight, a growing number of observers believed after the Asian financial crisis that such a regional fund as AMF makes a lot of economic sense.[6] When the IMF remained the only guardian of the Bretton Woods system of globalized fixed exchange rates during the 1945-73 period, perhaps there was no need for such regional monetary funds. Since the breakdown of the Bretton Woods system in 1973, however, the IMF has evolved from "the" global monetary system guardian into just another *development finance agency* similar to the World Bank. Under the Bretton Woods system that existed from 1945 through 1973, countries seeking IMF assistance were <u>both</u> developing and industrialized countries. (In fact, such industrialized countries as Britain, Italy and France were among the heaviest borrowers from the IMF in those days while

[5] "Asian Monetary Fund – More Harm Than Good?" *Asia Times Online,* September 22, 2000.

[6] C. Fred Bergsten, "Reviving the Asian Monetary Fund," *The International Economy*, November-December 1998.

the total volume of IMF loans to developing countries was negligible in comparison.) During the past three decades since the breakdown of the Bretton Woods system in 1973, however, the IMF's loan clients have been almost exclusively developing and emerging market countries, which are the same client base of the World Bank and other regional development banks. In fact, the IMF has now become another *de facto* World Bank, catering exclusively to the developing country clientele only, which is quite different from the 1945-73 period. It is no wonder then that some influential voices such as *The Economist* in London have argued for a merger between the IMF and the World Bank.

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

## Economic Rationale for an Asian Monetary Fund

The inadequacy of the IMF to cope with today's international financial problems has become increasingly evident. Its governance system is also antiquated since it primarily reflects the economic reality of the world some sixty years ago towards the end of World War II. Consequently, the voting power of Asian countries is disproportionately underrepresented in the IMF compared to the economic size, trade volume and foreign exchange reserves of Asia. Furthermore, the IMF's resources alone are no longer sufficient in coping with new types of international financial crises that have afflicted the global economy in recent decades and that are likely to erupt in the coming years as well.  Compared to today's world trading volume and the magnitude of international financial market activities wherein the *daily* foreign exchange trade volume alone is about $1.5 trillion, the current size of IMF quotas with total usable resources of barely $150 billion is awfully inadequate to cope with another sizable international financial crisis like that of the 1997-98 Asian financial crisis.

Since the IMF has in reality no practical leverage over the Western industrialized countries that have never borrowed from the IMF during the past 25 years, it has exercised its vaunted surveillance function in a rather skewed manner only upon developing countries while exempting major destabilizing economic policies of powerful industrialized countries such as the United States and Germany.  Consequently, the IMF represents mostly the Washington consensus in international economic and financial management of developing countries, while being practically helpless in dealing with some genuine concerns of developing countries over the wayward policy stance of powerful Western industrialized countries.

As many Asian countries have realized that the IMF does not really possess adequate financial resources to assist them in the event of another Asian financial crisis (in other words, as Asian countries have finally realized that the "emperor" wears no clothes), they have had to resort to massive accumulation of foreign exchange reserves themselves.  Since the 1997 Asian financial crisis, the world foreign exchange reserves have increased by $1.3 trillion, and $1.1 trillion of the increase took place in Asia and over $700 billion of the increase occurred in the past two years of 2003-04.  Such a steep increase in Asian foreign exchange reserves has been due to both Asia's huge current account surplus, which amounted to $540 billion during the two years of 2003-04, and the net capital inflows into Asia, which amounted to $178 billion during the past two years alone.   As of early 2004, Asian countries held about $2 trillion in foreign exchange reserves, more than two thirds of the total world foreign exchange reserves.

Foreign exchange reserves are a form of self-insurance of a country against a potential future international financial crisis and, as such, they are very expensive due to their substantial negative carry cost.  Such a negative carry cost is caused by the fact that the cost of capital inflows into Asia significantly exceeds the returns on short-term investments such as U.S. Treasury bills in which the bulk of Asian foreign exchange reserves are held.  Another economic cost of huge foreign exchange reserves held by Asian countries could result from a potential depreciation of the U.S. dollar.  If the dollar, which is viewed significantly overvalued in light of the huge current account and budget deficits of the United States, were to depreciate by 25%, the aggregate losses on \$2 trillion Asian foreign exchange reserves would amount to \$500 billion. If such costly self-insurance in Asia through the accumulation of excessive foreign exchange reserves can be replaced by a collective insurance system in the form of an Asian Monetary Fund financed by some of these very foreign exchange reserves accumulated by Asian countries but now invested mostly outside Asia in such instruments as U.S. Treasury bills and Eurodollar CDs, the overall economic benefit to Asia would also be enormous.

Already, an important step toward a closer monetary and financial cooperation among Asian countries has been taken under the Chiang Mai Initiative (CMI), a framework agreement reached in 2000 on bilateral currency swaps among the 13 Asian countries of the ASEAN+3 group (the 10 ASEAN member countries plus Japan, China and South Korea). The CMI was designed to expand the previous ASEAN Swap Arrangement (ASA), by extending its coverage from the original five members to all ten members of ASEAN plus three additional non-ASEAN countries of Japan, China and South Korea, and by increasing the total size of the swap arrangements. ASA was first established by five of the ten ASEAN member countries[7] in August 1997 right after Thailand triggered the Asian financial crisis in early July 1997, and ASA was originally designed to alleviate temporary liquidity shortages among central banks of the five member countries, and the facility was extensively used.

During the past four years under the CMI, 16 bilateral currency swap arrangements amounting to \$44 billion have been concluded. Such currency swap arrangements allow the 13 Asian countries to access one another for short-term liquidity support similar to IMF financial assistance. Finance ministers of ASEAN plus 3 recently agreed to enhance the functioning of the CMI such as enlarging the size of bilateral currency swaps. An Asian Monetary Fund can be a natural successor to an enlarged CMI with institutionalized economic surveillance that is now delegated to the IMF in Washington under the current CMI. At present, however, the CMI does not require a new institution such as the proposed AMF, and it is instead tightly linked to IMF conditionalities.

Without being constrained by the often-counterproductive IMF conditionality in a next Asian financial crisis, Asian countries can pursue under an AMF framework appropriate

[7] The original agreement was signed by Indonesia, Malaysia, the Philippines, Singapore and Thailand.

economic policies that can assist them more directly rather than serving the parochial interests of the Washington consensus forced upon Asia by the IMF and the U.S. Treasury Department. The IMF has not always acted in the best interests of Asia, and it is about time that Asia should exert its economic independence from the Washington consensus by establishing an AMF. Asian countries already possess the financial means to fund an Asian Monetary Fund in the form of vast amount of foreign exchange reserves.

In recent years, Asian economies have become more tightly integrated. In 2003, Asian developing countries sent 50 % of their exports to other Asian countries. Japan also sent 45% of its exports to Asia, compared to 25% to the United States and 16% to the European Union. In fact, Japan exported more to China, Hong Kong and Taiwan in 2003 than to the United States, the first such development in 130 years. In 2003, China also replaced the United States as South Korea's top export market for the first time in the modern Korean history. Reflecting the trend toward a closer integration of Asian economies, an increasing attention is being paid to the development of Asian bond markets through Asian currency-denominated bonds and the new Asian Bond Fund. An Asian Monetary Fund can be a natural outcome of this trend toward closer Asian economic and monetary integration. All it takes now is for the Asian countries to muster the necessary political will to stand up against the expected opposition from the IMF and its controlling interests in North America and Europe.

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