FINANCIAL LIBERALISATION IN ASIA

Analysis and Prospects

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DEVELOPMENT CENTRE SEMINARS

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ASIAN DEVELOPMENT BANK
DEVELOPMENT CENTRE
OF THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Foreword

This volume contains contributions from participants in the fourth conference of the International Forum on Asian Perspectives, entitled “Financial Liberalisation in Asia: Analysis and Prospects”. The conference was held in Paris on 2 and 3 June 1998, as part of the Development Centre’s research programme on Global Interdependence and its External Co-operation activities. It was jointly organised by the Forum’s co-sponsors, the Asian Development Bank and the OECD Development Centre.

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Preface

Despite talk of "recovery" or of an "encouraging long-term outlook" for Asia, we are still groping for an understanding of the financial crisis in Asia. As is all too often the case, we find ourselves trying, after the fact, to develop a framework for thinking about events that have already happened. This is nonetheless a useful exercise. The crisis is still with us and policy–makers are still endeavouring to formulate new policies in response.

The fourth annual Asian Development Bank and OECD Development Centre joint Forum on Asian Perspectives responded to this need for further analysis and policy recommendations. As in previous years, the forum brought together policy–makers, advisors and scholars to discuss recent research on the growth prospects and policy challenges facing developing Asia as well as OECD countries. The theme of "Financial Liberalisation in Asia: Analysis and Prospects" was selected with a view to using this platform to analyse key issues surrounding the Asian crisis. An essential element of any analysis of the crisis should be to obtain a firm understanding of its underpinnings, as a basis for taking steps, nationally and internationally, for encouraging recovery and, even more importantly, preventing a repetition.

Rapid globalisation brought substantial benefits to developing Asia, but it also heightened the risks associated with policy mistakes, weaknesses in financial sector institutions, and problems in corporate and public governance. The crisis is not an inevitable result of the ongoing process of globalisation, but, rather, reflects a mismatch between the liberalisation of external economic relations, on the one hand, and the adjustment of domestic institutions, on the other. External liberalisation is not sustainable in the longer run if it is not accompanied by domestic deregulation and the establishment of transparent governance structures in both the public and private domains and building of regulatory capabilities. Sustainability, therefore, becomes a question of finding the right balance between external liberalisation and reform of the internal regulatory environment in which the public, as well as the private, sector operate.

Why has financial liberalisation in Asia been disorderly so often? The answer seems simple enough: liberalisation is inexpensive, quick and easy to implement; while building the appropriate financial infrastructure is expensive, slow and complex. Thus, many countries have opted for the quick and easy reforms first, undermining the stability of the financial system. To be sure, many Asian countries had made

considerable efforts to strengthen their financial systems before the crisis erupted, but we now realise that much remains to be done. The new architecture of the international financial system is still on the drawing board. Greater volumes of better quality information and tighter monitoring and supervision of international operation in capital markets will perhaps be the features of the emerging structure. Provided policy corrections are made and institutional reforms carried through, the foundations which propelled fast growth in Asia in the past should once again provide the basis for Asian resurgence in the new century. The papers in this volume aim to contribute to this process by discussing the roots and origins of the crisis and suggesting some constructive approaches to crisis resolution.

Jean Bonvin
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January, 1999

Welcoming Remarks

Jean Bonvin

Clearly, the timeliness of this year's Forum is in no small part responsible for the interest aroused by the meeting. After every crisis, the international community reflects on what needs to be done to reduce the probability of future crises. It also seeks to ensure that the crises that do occur can be handled more effectively.

Given the urgency of the present policy challenges for Asia, we are fortunate to have at our disposal an established framework for analysis and dialogue. In designing the International Forum on Asian Perspectives four years ago, our objective was to bring together experts and policy–makers from OECD and Asian countries for an annual dialogue on issues of concern and questions of economic importance to the two regions.

The theme of financial liberalisation was selected with a view to using this platform to analyse key issues surrounding the crisis. In my opinion, an essential element of any analysis of the crisis should be to obtain a firm understanding of its underpinnings, as a basis for taking steps, nationally and internationally, to encourage recovery and, even more important, to prevent a recurrence.

In principle, liberalisation of capital movement makes the economic system more efficient, because it allows national and foreign stakeholders to engage in lending and borrowing that would be impossible in a closed economy, even when such transactions are in everyone's interest. Nonetheless, capital flows can result in debt crisis situations; and many observers feel that external debt can create as many problems as it solves. One key paradox is that international financial liberalisation, which should in theory improve risk management in an economy, often produces the opposite result. The recession that began in Asia in summer 1997 is an example of this.

Not long ago, the uniquely successful economic take–off of East Asia was held up as an example to the rest of the world. Since the summer of 1997, however, the upcoming growth outlook has been negative, poverty has worsened, and explosive social tensions have been created. The contrast is so striking that one must ask whether international financial liberalisation, which generated massive capital inflows as of 1995, could be responsible for the ensuing disappointment.

Might the main burden of responsibility lie with those economists who extolled the "East Asian miracle"? Not because the earlier results were not remarkable, but because we helped maintain the illusion that this rapid growth sprang from an economic system that ensured efficient allocation of resources. Considerable amounts of capital flooded into these countries in the mid–1990s, when they opened the door to speculative capital flows and when the monetary context in the United States and Japan caused international investors to look for profitable investment opportunities elsewhere.

The reality is that Asia's exceptional growth was not attributable to its economic and financial system, but to extraordinarily high savings rates. In contrast, the financial system was relatively inefficient, owing to inadequate banking supervision, poor due diligence and inappropriate public intervention. Furthermore, risk management was flawed as a result of the implicit guarantees given to banks by governments. Under these conditions, speculative capital, half of which transited via the banking system of these countries, was not used efficiently. It financed a speculative property bubble and poorly assessed or over–ambitious investment, thus overwhelming the shaky financial system. Accordingly, the blame lies more with the initial inefficiency of national financial systems, or at the very least ignorance of their weaknesses on the part of international investors, than with liberalisation of capital flows.

Furthermore, and forgive the cliché, it takes two to tango. International investors share much of the blame: they underestimated the risks when they flocked to East Asia. Over and above appraisal errors made by rating agencies, with which everyone is now familiar, the architecture of the international financial system prevents accurate risk assessment by international investors.

Some distortions result from erroneous signals emitted by the national policies of host countries. For example, they provided an implicit guarantee of exchange rate stability or implicit protection of banks without having the resources needed to back this up.

Other distortions stem from the fact that public bilateral and multilateral interventions over the past 15 years have partially "socialised" the risks assumed by international banks in the event of debtor default, in order to prevent the international financial system from collapsing. The signal sent to private bankers created a problem of "moral hazard" which led them to underestimate the risks incurred.

Comparisons have been made with the Mexican crisis of 1994 in this regard. We tend to overlook the 1982 crisis, which was the first major international crisis to be socialised, although in this instance the risk transfer process was partial and took longer. We also forget that before the multilateral institutions were set up, private creditors assumed all their own risks. In crises prior to the Second World War, a period marked by strong financial globalisation, creditors bore the risk incurred in full. Russian borrowing in France is a well–known example. The *ex post* return on bonds issued by that era's "emerging" countries were, on average, comparable to the return on

investment in Western Europe, as US economist Barry Eichengreen showed a few years ago: these risks were assessed accurately and, on the whole, remunerated accordingly.

The experience of the past 15 years shows that international banks may well have underestimated risks. Although international finance has diversified significantly in recent years, international banks were at the centre of the Asian crisis, as they were in 1982. Over the 1995–96 period, bank loans accounted for two–thirds of the new financing received by the five Asian countries hit by the crisis.

Clearly, the emerging Asian countries and their creditors share the blame for the crisis. In future, we must:

— be more cautious in implementing financial liberalisation reforms, which are still necessary in order to achieve proper capital allocation; and

— reform the international financial system, as promised by G–8 heads of state and government when they met in Birmingham.

Asia and OECD Member countries must now work together to ensure that this mishap does not become a catastrophe:

— a social catastrophe caused by increased poverty and the emergence of unemployment in these countries; and

— an economic catastrophe, because Asian economies still have many assets that must not be wasted. The biggest asset of all is their considerable human capital, in the form of a working population that is determined, highly trained and skilled.

Welcoming Remarks

Mitsuo Sato

I would like to take this opportunity to express our deep appreciation to the Minister of Finance of France and to his representative, for participating in our Forum and providing an excellent venue for our meeting. I would also like to express our gratitude to the Government and people of France for their invaluable contribution and support to the Asian Development Bank and its developing member countries over the past three decades. To the OECD in general and to the Development Centre in particular, we appreciate and welcome your continuing co–operation.

Earlier Forums have discussed “Regional Co–operation and Integration in Asia”, “Investing in Asia”, and “The Future of Asia in the World Economy”. This time, following tumultuous events in Asia’s financial sectors, our theme is “Financial Liberalisation in Asia: Analysis and Prospects”. The previous Forums helped to increase mutual understanding and contacts between Asia and Europe. This Forum will increase understanding of the benefits and pitfalls of financial liberalisation in Asia and will contribute to getting Asia back on to the track of sustained growth.

In the last year, the most significant economic event in Asia and the world has been the financial crisis that erupted in mid–1997. Many people are asking: *i)* why the Southeast and East Asian economies which were highly commended not too long ago for their rapid economic development now face such a severe crisis; and *ii)* what role financial liberalisation played in Asian economic growth and in precipitating the Asian crisis.

First, let me reassure you that Asia’s potential is far from exhausted. Asian economies are now in a long–term process of catching up the advanced economies, with plenty of experience and strong underlying macroeconomic fundamentals. In the months and years to come, bold measures will be taken which will allow Asia to overcome the formidable obstacles it is facing.

Now let us turn to the origins of Asia’s current financial crisis. Essentially, there was a mismatch between capital account convertibility and capacities for financial and exchange rate management in these economies. With good investment potential built up by past economic success, foreign capital inflows had accelerated, especially where capital accounts were liberalised. To keep local currencies from appreciating

and to keep inflation under control, much of the foreign capital inflow was sterilised, driving a wedge between domestic and international interest rates. With exchange rates effectively pegged to the US dollar, this encouraged even more capital to flow into these countries.

The surge of private foreign capital eager to share in Asia's expansion prior to mid–1997 brought about imbalances in the financial sectors of the countries that were eventually most affected by the crisis. Furthermore, the behaviour of some financial institutions reflected an implicit belief that their financial liabilities were guaranteed by their respective governments. These financial entities were often subject to non–transparent and lax regulatory enforcement. In a context of surging capital inflows, implicit government guarantees to creditors encouraged excessive risk–taking and allowed loan quality to deteriorate. Poor corporate governance due to lack of transparency and inadequate accounting and auditing standards also contributed to overly risky behaviour. Some of the corporate firms, especially the big ones, were seized by the so–called "too big to fail" syndrome. At the same time, an implicit belief that effectively fixed exchange rates would be maintained indefinitely discouraged the prudent hedging of foreign liabilities.

To make the situation worse, a self–reinforcing vicious circle has occurred between currency declines and banking and corporate failures. The falling currency drastically increased the local currency equivalent of the foreign debt owed by local enterprises, which, in turn, exacerbated the currency decline. The vicious circle contributed to the drastic depreciation of currencies.

What then are the major lessons to be drawn from this crisis? *First,* that keeping macroeconomic fundamentals sound is necessary for sustained growth, but it is not sufficient. Financial policies do matter critically, as does the appropriateness of exchange rate policy.

Second, Asia's "capital account crisis" has highlighted the risks of liberalising financial systems without ensuring proper structural safeguards. A new challenge for all developing countries is to develop robust and well–functioning domestic financial systems to ensure the most efficient use of capital, which must be accomplished while maintaining sound macroeconomic fundamentals.

Third, greater attention must be given to the sequencing of reforms. If developing Asia is to continue to enjoy rapid economic growth, it will need to draw on the transfer of capital and know–how from the rest of the world. The challenge ahead is to develop adequate institutional capacities for financial regulation and risk management. The rush to embrace globalisation must not outpace the human and institutional capacity of the domestic financial system.

Fourth, the Asian crisis has highlighted that contagion tends to be most serious among neighbouring countries. There is, therefore, a need to complement global surveillance with regional efforts. Such an effort will involve peer surveillance and a

perspective stemming from an in–depth knowledge of local conditions. Under the Manila Framework and as requested by the ASEAN Finance Ministers, the ADB is considering the establishment of a regional economic monitoring system, in close collaboration with other international financial institutions.

Fifth, the Asian crisis poses a new challenge to the architecture of the international financial system. It has indicated that a massive and quick reversal of capital flows can be devastating for capital–receiving economies, especially when much of the capital is in short–term flows. Information asymmetries between capital suppliers and receivers contribute to amplifying the volatility of capital flows. To smooth the capital flows, there is a need for an architecture to monitor international capital flows actively and to identify potential trouble spots.

Finally, the Asian financial crisis highlighted the need for strong capital markets in developing countries. International borrowing is an imperfect substitute. A well–developed capital market encourages more efficient use of capital resources by placing investment projects under rigorous market scrutiny. It also provides a channel for more stable cross–border investment, enabling borrowers to avoid a mismatch in maturities. True, the market prices of equities and bonds can fall, but issuers are not subject to the same disruption in their financing as when short term bank loans are not rolled over. In fact, a well–functioning capital market helps banks by providing means to securitise their assets; and it improves the standard of corporate governance by putting corporate managers under the stringent monitoring of the marketplace.

We at the Asian Development Bank are doing our utmost to assist our developing member countries affected by the financial crisis. Since it began, we have responded with large–scale, quick–disbursing assistance to Thailand and the Korea in collaboration with the IMF, the World Bank, and bilateral institutions. We are also attempting to assist Indonesia through the extremely difficult times there.

Meanwhile, the Asian Development Bank has been transforming itself from a project financier to a broad–based development institution. While we had our largest single loan and largest total lending ever last year, we have also been actively increasing our technical assistance, policy dialogue, and general resource centre activities. More of our loans are now policy–oriented and aimed at sectoral reforms and development.

One area where we have been particularly active recently is in financial–sector development. We are supporting important financial market reforms, strengthening effective regulatory oversight of banks and financial entities, and promoting greater reliance on the use of market forces. Resources are also being devoted to helping affected economies to cushion the social impacts of the economic downturn. Technical assistance is being given to support capacity building and implementation of reform packages. Capacity building in these economies is also being directed to address cross–cutting issues, such as achieving good governance through greater transparency and accountability.

Through co–financing and provision of partial credit guarantees, we are helping the affected economies to re–enter international financial markets. They can then raise funds that would otherwise not be available to them.

One recent example is particularly worth mentioning. As part of its broader package of assistance, the Bank arranged an export financing facility for Thailand. By providing a $50 million anchor loan and a partial credit guarantee, the Bank helped raise an additional $950 million from commercial banks at lower cost than would have otherwise been possible. This billion–dollar intervention has helped Thailand's re–entry into the international capital markets, and has helped it to maintain the exports necessary to continue earning foreign exchange.

There are now some encouraging signs that most of those economies hurt by the crisis are on the road to recovery. Bold policy reforms have been implemented. Regional currencies and asset markets have risen above their lowest points, but there are still many challenges ahead and much to be done.

Asia is changing rapidly, even if all the changes do not proceed as smoothly as we would always like, and there are still enormous challenges and opportunities ahead in Asia. Financial markets in Asia must play a critical role in channelling resources effectively to where they can be most socially productive. To do so they must be strengthened domestically and then liberalised internationally. In the process, Europe can benefit from, and contribute to, financial liberalisation in Asia.

This Forum will contribute to our understanding of the opportunities as well as the challenges ahead.

Opening Address

Francis Mayer

Let us jump right in and review some of the findings to emerge from the analysis of the monetary and financial crisis that began in a number of Asian countries in summer 1997.

International financial institutions, including the Asian Development Bank, played a key role in the immediate handling of the crisis. Their rapid, co–ordinated response to the emergency rallied significant sums of money; the results of this unprecedented effort have been satisfactory in many ways. Intervention by multilateral financial institutions enabled Asian governments to embark upon necessary reforms and contain financial spillover from the crisis.

This initial result, however positive, is not in itself sufficient. Other challenges now have to be met. The nascent recovery must be consolidated over the long term, and better ways to prevent this type of crisis in future must be found.

— The first challenge is to consolidate the fledgling economic recovery in the Asian countries affected by the crisis and to complete the structural reforms that are a prerequisite to re–establishing confidence.

— Special attention must be paid to restructuring and modernising financial and banking systems. The fragility of such systems was one of the main triggers of the crisis.

— The social consequences of the impending collapse of growth in most countries in the region must not be overlooked. The difficulties facing the Asian countries lie in the need to implement wide–ranging structural reforms while at the same time continuing to offer hope for the future to the most vulnerable segments of society.

— The other challenge will be adapting our policies to the liberalisation of capital movements, notably in order to prevent crises.

— The Asian crisis did not occur because the countries experiencing problems opened their financial markets too widely, but probably because liberalisation was unbalanced. They did not pay sufficient attention to developing the economic and financial structures needed for successful integration into the world financial market.

From this point of view, transparency and due diligence must accompany capital account liberalisation. This applies not just to Asia, but also to the international community as a whole.

This general outline should lead to concrete measures aimed at encouraging foreign direct investment, discouraging flows of short–term volatile capital, and facilitating reciprocal opening to competition, good governance and financial system reform. The OECD can contribute to this process by sharing its expertise in these areas, drawing on the experience of financial liberalisation that its members have gained over 50 years. For example, the OECD recently began drafting corporate governance guidelines, which should prove to be a useful reference for both developing and industrialised nations, for companies and governments alike.

Moreover, the international financial community must develop appropriate warning systems, especially within the international financial institutions, so that it can better anticipate future emergency situations. On this subject, the Asian Development Bank should be congratulated for its contribution to the creation of a regional monitoring system. Greater co–ordination among stakeholders is also necessary to ensure that consistent measures are introduced rapidly.

When properly managed, liberalisation benefits everyone. There is no point in taking paths that would lead to withdrawal from the international community.

Introduction

Monika Queisser

The Asian Development Bank and the OECD Development Centre jointly organised their fourth International Forum on Asian Perspectives in Paris on 2–3 June 1998. This annual event has become a valuable platform for debate and dialogue between policy–makers and experts in Asian and OECD Member countries as it addresses emerging issues of economic importance to the two regions. This year's forum was dedicated to the most important issue that Asia is currently faced with: the financial crisis and, more specifically, the analysis and prospects of financial liberalisation in the region.

The Asian crisis has demonstrated the urgent need to rethink the sequencing and comprehensiveness of financial liberalisation. There is increasing evidence that banking crises and currency crises may go hand in hand: disorderly financial liberalisation has tended to precede private lending and spending booms which resulted, first, in risky overexposure of creditor banks, second, in a banking system crisis and ultimately in a currency crisis. The papers compiled in this book address several important issues which arise in this context: Would further opening of Asia's financial systems be helpful or counterproductive in fostering financial stability? What structural reforms need to be undertaken in financial markets of emerging economies to ensure that capital inflows are transformed into productive investment? Which regulatory and other requirements would have to be attached to further financial liberalisation? And what role should international organisations and the private sector play in crisis resolution?

Designing Strategies for Financial Liberalisation

One of the crucial lessons of the recent experience of Asian countries relates to the politics of liberalisation: a strong commitment to realising the benefits of financial liberalisation is required to overcome the practical implementation difficulties. Where commitment is weak, policy–makers are likely to be too sensitive to short–term adverse effects leading to delay or even reversal of financial liberalisation. Increasingly,

policy–makers and academics alike are beginning to question the benefits of free capital mobility. Globalisation and growing trade and investment liberalisation, however, make it difficult to imagine the development of an increasingly integrated world economy without further financial liberalisation. Nevertheless, the advocates of further financial liberalisation need to find convincing answers in light of the economic and social hardship caused by the financial crisis in Asia to support their claim that further liberalisation is warranted and beneficial.

The performance of those Asian economies which opened their capital accounts suggests that financial liberalisation should proceed according to a gradual strategy. Financial systems should be liberalised in phase with the development of the necessary regulatory and supervisory infrastructure. The risks associated with increased capital market integration can be minimised by: *i)* maintaining a sound and consistent macroeconomic framework; *ii)* building strong domestic financial sectors, particularly banking systems, based on market principles; and *iii)* adopting regulatory regimes that utilise accurate market–oriented disclosure systems. These are the most important prerequisites of successful financial liberalisation but they are obviously not easily attained. Difficulties in meeting the necessary prerequisites should not serve as an excuse for delaying financial liberalisation. Instead, governments should prepare the fundamentals as quickly as possible. This would include the removal of implicit government guarantees for financial institutions as well as government interference into the process of credit allocation.

Where inconsistent monetary and exchange rate policies result in a large differential between expected returns on domestic and foreign assets, opportunities arise for speculators to make profits. This can lead to excessive short–term capital inflows, financial–market bubbles and overshooting of exchange rates. Banking systems are especially vulnerable to sectoral or external shocks as well as to systemic risks and governments are often tempted to over–regulate banks to reduce such risks. A policy framework allowing for both the operation of a competitive banking system, including firm entry and exit policies, and a level playing field for all institutions, is the most likely to bring about a robust banking sector which can better withstand real and financial shocks. This point is underlined by the performance of countries with more developed financial sectors and larger institutional capacity such as Hong Kong and Singapore; although both economies could not escape the fallout from the region's recession, they were much less affected by contagion and proved more crisis–resilient than the neighbouring countries

The case for capital account liberalisation remains strong despite the economic and social repercussions of the Asian crisis. There is no agreement, however, on the optimal speed of liberalisation. The advocates of full liberalisation think that attempts to control international capital flows do not work or would not be effective for very long; moreover, they would distract from the real tasks ahead such as maintaining macroeconomic stability, strengthening the financial system, and involving the private sector in crisis resolution. The proponents of a more gradual approach consider controls of certain capital inflows, particularly of short–term capital movements, an effective

measure to contain financial market volatility in the short term. Chile's experience of managing short term capital inflows is mentioned repeatedly as an example which Asian countries might find useful to study in further detail.

The Impact on Trade and Investment Liberalisation

One of the concerns surrounding the economic and financial crisis in Asia is the question of whether economic hardship will make the region's governments more resistant to the idea of pursuing trade and investment liberalisation. Keeping markets open and resisting calls for protectionist responses becomes increasingly difficult in an environment of significant macroeconomic and financial instability and real social dislocation. There seems to be a general consensus, however, that financial and structural weaknesses of the Asian economies are the root of the crisis rather than the degree of trade and FDI liberalisation. On the contrary, many experts actually feel that a crisis would have been less likely and its effects less severe if market liberalisation had been accompanied by greater doses of transparency, predictability and market contestability that increased trade and investment liberalisation brings with it. The crisis could therefore serve to encourage governments to open their markets further and remove distortions inhibiting trade and foreign investment activity. If it leads to a more open environment in the longer term, the crisis could even be regarded as beneficial from an economy–wide perspective although this message offers little consolation to those in the front line of adjustment.

The presence of foreign providers of financial services can be instrumental in helping host countries to build a stronger financial sector. Openness to foreign competition forces domestic firms to become more efficient and to broaden the range and quality of services offered. Foreign firms bring the skills, experience and methods developed in mature financial markets and thus raise professional standards among local practitioners, as well as introducing more sophisticated financial products and services. The positive impact of international providers is particularly evident in the case of Hong Kong which has the most developed financial sector in the region with a very high degree of foreign participation; due to its well–developed financial infrastructure and high degree of transparency, Hong Kong was able to survive the financial crisis relatively unscathed.

Evaluating the Role of Non–Bank Financial Institutions

Apart from improving the operational environment and the regulatory framework of the banking sector, there is also a need to better understand the potential contribution of domestic non–bank financial institutions to financial sector stabilisation. Potential effects of domestic institutional investors, particularly pension funds, on the financial sector can be observed in five areas: development of financial sector infrastructure;

securitisation and resource allocation; asset price volatility; corporate management and control; and the management of capital flows. It appears, however, that the only clearly stabilising impact of pension funds lies in their contribution to the development and modernisation of the financial sector infrastructure. In all other areas, pension funds could have stabilising as well as destabilising effects, depending on the initial conditions, the regulatory framework and the behaviour of other market participants.

The potential benefits of developing a base of institutional investors for the improvement of financial services are large. Whether they will actually materialise, however, depends on the conditions under which pension funds operate. In order to maximise the positive impact on financial sector infrastructure in emerging capital markets, pension funds should be introduced as part of a systemic pension reform, be mandatory for formal sector workers, have a sufficiently high contribution rate, be invested at least partially by competing investment managers with participation of international providers, and be subject to tight regulation and supervision. It should be kept in mind, however, that pension funds are different from other financial intermediaries since they have not only a financial and economic role but also an important social function. While pension funds can be instrumental in fostering financial sector development, their primary role remains the provision of retirement income to workers. In this respect, there is room for policy–makers to take an active role in designing an appropriate framework within which pension funds could strengthen the financial sector and, at the same time, provide reliable retirement income security.

International Co–operation and the Involvement of the Private Sector in Crisis Resolution

The role of international co–operation, and in particular of international organisations with respect to their economic analyses and policy recommendations, is a key element in the resolution of financial crises. The importance of this role has been highlighted in a strategy for the improvement of emerging market countries' financial systems, developed by a group of industrial and emerging market economies under the leadership of the G–10 and widely endorsed by many countries. This plan sets out a framework containing the key elements of a robust financial system, provides for a division of responsibility among all the key players, and seeks to promote co–ordinated action by international institutions such as the IMF and the World Bank in support of countries' efforts to strengthen their financial systems.

Increasingly, concerns are being voiced about the lack of participation of the private sector in the resolution of financial crises. The debt crisis of the 1980s was characterised by the public sector as debtor and a fairly homogeneous group of bank creditors which used the London Club as a forum for debt rescheduling. Since then, the situation has become more complex. In the case of Mexico during 1994–95, the Mexican government as public debtor was confronted with a heterogeneous group of foreign and domestic creditors which proved almost impossible to bring together. The

crisis management was unsatisfactory in the sense that it entailed a complete bail–out of the private sector. The private sector and banks in particular should take part in financial rescue operations for two important reasons: first, the amounts involved have been too large to be taken over by bilateral and multilateral creditors alone; and second, the private sector should bear the cost of its imprudent lending decisions in order to discourage future imprudence of banks in their foreign lending choices. The management of the Asian crisis has taken some of the lessons of previous crises into account and is already moving towards much larger involvement of the private sector. But this has not followed any agreed framework, instead it has taken place ad hoc as it was dictated by the country–specific conditions of urgency. While it is clear that crisis resolution strategies will always have to be tailored case–by–case, a greater involvement of the private sector should become a general feature of all approaches to crisis resolution.

Part One

Dealing with the Asian Financial Crisis

The Asian Capital Account Crisis

Masaru Yoshitomi

Getting the Macroeconomic Fundamentals Right

For more than a decade, Southeast Asian countries (Thailand, Malaysia, Indonesia, and more recently the Philippines) had been praised for their economic success. This was essentially due to their strong conventional macroeconomic fundamentals which included low, i.e. one–digit inflation, no government budget deficit, high rates of domestic savings (30–35 per cent of the GDP), high rates of investment (about 35 per cent of the GDP), and sustained high economic growth (8–9 per cent per annum). This was the main reason why they became so attractive to international investors. The World Bank study, *The East Asian Miracle* (1993), observed that there was no "miracle" since the good economic performance could be explained by these strong macroeconomic fundamentals. Thus it stressed that there was nothing miraculous or mysterious about the excellent performance of the East Asian economies. In terms of economic policy, that meant that good economic performance depends on "getting the macroeconomic fundamentals right". This message remains valid today and for the future.

The current account crises of Asia's emerging market economies were not caused by poor macroeconomic performance such as high inflation and large budget deficits, as has occurred in many developing countries in the past. The present Asian crisis is not a traditional current account crisis. Then what then went wrong with the East Asian economies in 1997? Inasmuch as the financial crisis began in Thailand, this discussion will focus mainly on the experience of the Thai economy.

Getting the Foreign Exchange Rate Policy Right

Favoured by international investors largely because of sustained good macroeconomic performance, Thailand is no longer just a developing country but is also an emerging market economy.

Emerging market economies generally experience massive international capital inflows which exceed current account deficits. Between 1990 and 1995, the annual average current account deficit in Thailand was about 5 per cent of the GDP while net capital inflows amounted to 8 per cent of the GDP. The result was a large surplus in the overall balance of payments (the current account plus the capital account).

If Thailand had adopted a floating exchange rate regime, the Thai baht would have appreciated because of the balance–of–payments surplus which, in turn, would have reduced Thailand's international competitiveness. Instead, the Thai authorities kept the baht fixed in relation to the US dollar. This was understandable since the US dollar had continued to depreciate against the yen until 1995 and, therefore, the fixed rate of the baht to the dollar maintained Thailand's international competitiveness sufficiently, supporting its export–driven economic growth.

Under the fixed exchange rate regime, however, a balance–of–payments surplus causes a rapid expansion of the domestic money supply by the accumulation of foreign reserves. Some of the increased foreign reserves could be sterilised by selling short–term securities to absorb part of the excess money supply. However, such a sterilisation policy maintained an interest rate differential between the Thai baht (at 12–13 per cent) and US dollar (at 5–6 per cent), continuously inviting international capital inflows. Foreign exchange risks were forgotten and international borrowings were not hedged very much. This behaviour was understandable since the fixed exchange rate had been maintained since 1984 when the baht had been devalued from 20 to 25 baht to the dollar. An excess money supply also promotes an acceleration of domestic inflation. However, inflation increased only gradually in Thailand in the 1990s and did not become serious, remaining at one–digit levels. Instead, the current account deficit increased to 8 per cent of the GDP in 1996–97, as opposed to 5 per cent in the immediately preceding years, because the excess domestic demand caused by the excess money supply was absorbed by increasing imports and decreasing exports. The magnitude of the external deficit became equivalent to that of surplus on the capital account.

In this case the unsustainably large current account deficit was not caused by poor macroeconomic fundamentals but by the capital account surplus, which encouraged domestic absorption by excessive domestic bank credit and money supply associated with large foreign reserve accumulation. The size of the capital account surplus essentially determined that of the current account deficit, not the other way round. More seriously, when an equilibrium was attained in the overall balance of payments with the current account deficit matching the capital account surplus, the domestic economic equilibrium collapsed. This was due to the bursting of the bubble, i.e. the asset price inflation which had followed the expansion of domestic bank credit. When international investors observed the breakdown of the domestic equilibrium, they started to reduce capital inflows sharply, creating an increasingly large deficit in the overall balance of payments, since the large current account deficit could not be reduced as fast as international capital moved out of the country. This represented a capital account crisis as opposed to a traditional current account crisis.

Free international capital mobility deprives monetary policy of control over money supply. This can fuel too much domestic demand, hence accelerating inflation and/or increasing the external deficit to an unsustainable level, as shown by the case of Thailand in the 1990s. The economic policy message is clear: in order to control domestic inflation and current account balances in the context of free capital mobility, it is important to "get the exchange rate policy right." Such a policy was even more vital when the dollar was appreciating against the yen in 1996–97, since Thai international price competitiveness was falling because of the fixed rate to the dollar. When and how to exit from a fixed exchange rate regime remain difficult policy issues. In Thailand, the adoption of a free float in early July 1997 resulted in a free fall of the currency.

Getting the Composition of Capital Inflows Right

How can the sudden collapse of the baht since 2 July 1997 be explained?, The currency depreciated to 50 baht to the dollar in just a few months, i.e. by 50 per cent, at the end of 1997. The sudden reversal of the overall balance of payments from a surplus to a deficit implied the sudden turnaround of the exchange rate from appreciation to depreciation. The responsibility for the sudden reversal of the international capital investment must be in the composition of capital inflows.

The Thai economy enjoyed export–led growth, greatly helped by foreign direct investment (FDI), particularly from Japan, in industries such as electrical appliances, home electronic goods, and automobiles. Natural market forces rather than deliberate regional trade arrangements have led to increasing integration of Asian economies, not only of Southeast Asia but also of the NIEs (Korea, Taiwan, Hong Kong and Singapore) and China. Such natural integration has been empirically demonstrated by the so–called gravity model in which bilateral trade flows are positively correlated with the level of economic activity of each partner country and negatively correlated with the geographical distance between the trading partners. It is also interesting to note that the stock of Japanese FDI has been found to be another important explanatory variable promoting natural economic integration in Asia. Such integration has advanced hand in hand with dynamic changes in the comparative advantage of each economy in Asia, from natural–resource based products to simple labour intensive ones, to medium–tech industries, and finally to capital–intensive products such as petrochemicals, iron and steel. As a result, the Asian region as a whole has been transformed into a manufacturing centre with a global market, in contrast to the traditional international exchanges of primary commodities from the South and manufactured products from the North.

This integration covers almost every category of products and almost every stage of production in accordance with dynamically evolving comparative advantages. The advance of such natural integration has been striking, particularly since 1985, a

benchmark year for the yen's appreciation against the US dollar. Japan's exports to Asia as a whole now account for more than 40 per cent of its total exports, compared with 24 per cent in 1985, while Japanese exports to the United States declined to 30 per cent of its total exports from 37 per cent in 1985. East Asia's share of Japan's total manufactured imports increased from 21 per cent in 1985 to 38 per cent today. The so–called reverse imports into Japan, that is, imports of products made by Asian affiliates of Japanese multinational companies, account for about 15 per cent of Japan's total imports from Asia.

In the 1990s, however, regional integration extended beyond linkage based on trade and FDI. International financial integration has greatly promoted dramatic increases of capital inflows to emerging Asian markets. As a result, FDI is no longer the dominant source of financing for external deficits of Southeast Asian economies. Other forms of capital inflows such as foreign portfolio investment and bank loans have become dominant. This is a consequence of domestic financial deregulation and capital account liberalisation in Southeast Asian countries.

In Thailand, inward FDI used to be equivalent to a dominant portion of the current account deficit. Between 1994 and 1996, however, FDI declined to less than 10 per cent of the amount of the current account deficit. Instead, foreign bank loans suddenly increased in 1993 (when the offshore capital market was opened) and surpassed FDI by a factor of ten from 1994 to mid–1996, a period when foreign bank loans alone exceeded the current account deficit of 6 to 8 per cent of the GDP. Given that the exchange rate had been fixed and stable since 1984, the international interest rate differential of 12–13 per cent for baht and 5–6 per cent for the dollar was the primary reason for such massive inflows of foreign bank loans to Thailand. Accordingly, domestic bank credit expanded to over 90 per cent of the GDP in 1993–96 from 60 per cent in the preceding three years. This expansion of credit was accompanied by a euphoria about the economic outlook, based on the good macroeconomic fundamentals, but it resulted in asset price inflation, particularly in commercial real estate.

As already mentioned, the real estate bubble burst and the balance sheets of local finance companies and commercial banks started to deteriorate exactly when the capital account surplus had led to a greater current account deficit, even though the overall balance of payments had been in equilibrium in 1996. When an external deficit becomes too large and is increasingly financed by foreign bank loans with short maturity, any shock, even a small one, is likely to promote questions about whether the situation will be sustainable. One shock came when export growth, the engine of Thai growth, plummeted to almost zero in the second half of 1996 from 20–25 per cent annual increases in preceding years, because of the strong domestic absorption and declining international price competitiveness. International banks which felt threatened by these developments started to reduce capital flows into the Thai economy. Therefore, the overall balance of payments suddenly went into deficit, since the increased current account deficit was no longer covered by the smaller capital account surplus after the fall in international bank lending.

At this point, the authorities suddenly had to choose between a nominal depreciation of the exchange rate (instead of appreciation) or maintaining the peg to the US dollar, which would lead to increasingly larger deficits on the overall balance of payments and a rapid loss of the accumulated foreign reserves. Perceiving this situation, the market made a 180–degree turnaround, engaging in speculative attacks against the baht in anticipation of its possible depreciation.

The abrupt fall in capital inflows leading to their reversal and the speculative attack caused a sharp depreciation of the currency, much greater than justified by the macroeconomic fundamentals such as domestic inflation or the real exchange rate appreciation during the preceding years of massive capital inflows under the fixed exchange rate regime. Such overvaluation of the baht was estimated to be 10–15 per cent, but actual depreciation has amounted to 40–50 per cent.

The lesson for economic policy of the Thai experience is that it is indispensable to "get the composition of capital inflows right" in order to prevent a sudden shift from a large surplus to a deficit in the overall balance of payments and to avoid extreme volatility of the exchange rate.

"Getting the Framework of Financial Institutions Right"

A capital account crisis has two aspects. One derives from massive net capital inflows surpassing the current account deficit, imposing a difficult choice on the monetary authorities between the different exchange rate regimes and domestic monetary control. The other involves the extreme volatility of such capital movements, including the possibility of sudden reversal when they are biased towards the short–term capital inflows.

Thus there are both currency and maturity mismatches during a capital account crisis. The currency mismatch refers to the mismatch between borrowing in dollars and lending in local currency. Hence, once the local currency depreciates, the dollar–denominated liabilities on the balance sheets of local financial institutions and enterprises increase in terms of local currency, aggravating the problem of the excess of liabilities over assets, i.e. leading to bankruptcy. The maturity mismatch refers to a mismatch between borrowing short and lending long. The maturity mismatch makes it difficult for financial institutions to liquidate long–term loans when demand deposits are withdrawn, thereby aggravating the liquidity crisis of the domestic financial and banking systems. Furthermore, if short–term loans have been used for unproductive or inefficient investment projects because of poor corporate governance and a weak regulatory framework in the financial sector, the market value of assets held by banks and finance companies declines, aggravating the insolvency crisis.

In sum, the currency crisis in Thailand was exacerbated by a domestic banking crisis. Furthermore, the currency and the banking crises mutually reinforced each other. This is because the currency depreciation increases the dollar–denominated

liabilities of financial institutions in terms of local currency, aggravating the domestic banking crisis which, in turn, induces international banks to withdraw short–term loans, causing further currency depreciation. Here, we have the fourth lesson for economic policy: getting the framework of domestic financial institutions right.

At an early stage of economic development, governments may intervene extensively in the market in an unfriendly manner, including in financial intermediaries, especially in the banking industry. Banks are often owned by the state. Interest rates are regulated at lower–than–market levels and, therefore, are often negative in real terms. Also there are high reserve requirements in terms of banks' deposits. This situation is called financial repression, under which financial intermediaries cannot efficiently perform their important functions of mobilising savings and channelling them to potentially more productive enterprises. Once interest rates are deregulated and state–owned banks are privatised, interest rates become positive in real terms, and the private saving rate starts to rise.

Concerning bank credits, it is very important to identify the specific difficulties confronting the banking industry after deregulation and liberalisation and recognise how different the financial market is from ordinary markets of goods and services. First, although the lender knows that borrowers differ in the probability of defaults, it is not possible to ascertain perfectly which borrowers have high probabilities of default. Second, while the lender knows that borrowers can undertake actions which will affect the likelihood of repayment, those actions cannot be monitored perfectly. In other words, the process of allocating credit and monitoring its use cannot simply be left to the market, in which excessively high risk–taking borrowers will probably compete for funds by offering to pay higher interest rates. Banks face the very difficult task of avoiding such borrowers and selecting the right ones. Moreover, banks have to avoid the so–called adverse selection and need to monitor borrowers carefully in their use of credit to reduce moral hazard once loan contracts are made.

Therefore, after deregulating interest rates and privatising state–owned banks, the behaviour of the banking industry will become even more important to intermediate efficiently between savings and investment by avoiding both adverse selection and moral hazard.

After liberalisation in Southeast Asia and South Korea, there has been a large increase in the number of banks but several oligopolistic banks have accounted for a very high proportion of total loans. Those banks have extended bank credit to large industrial groups or conglomerates (chaebols in the case of South Korea). These conglomerates often dominate the industrial sector as well as the financial sector, since they are large shareholders in financial institutions. The structure of both banking and non–banking industries corresponds very closely to the pattern of distribution of economic power and wealth in these Asian countries. What is even worse, the state and the conglomerates collaborate by directing bank loans towards targeted industries. Generally speaking, large commercial banks should monitor borrowers carefully i.e. conglomerates, before and after bank loans are extended, particularly at the stage

of economic development when the stock market is not developed sufficiently to exercise external control over governance of corporate enterprises. However, commercial banks in these Asian countries have not performed such monitoring functions well. Many loans have been obtained through patronage.

The so–called sequencing issue refers to whether domestic financial deregulation and liberalisation should precede, follow, or be carried out simultaneously with international capital account liberalisation. It is generally agreed that domestic financial deregulation should precede capital account liberalisation. However, it is even more important to establish a new regulatory framework of prudential measures, including prompt corrective actions, and an explicit deposit insurance scheme to contain new financial risks associated in particular with excessive risk–taking by banks and financial institutions after domestic financial liberalisation. However, the regulatory authorities have tended not to exercise appropriate supervision and inspection over the banking system in these Asian countries.

In sum, both poor corporate governance in the large conglomerates and the weak regulatory framework of the banking industry have aggravated the financial crises rooted in maturity and currency mismatches. Therefore, the importance of "getting the framework of financial institutions right" cannot be stressed too strongly in order to avoid serious banking crises.

An "International Lender of Last Resort"

The last but not least difficult area for economic policy is how to contain the mutually reinforcing banking and currency crises. Banking crises in both Thailand and South Korea triggered currency crises. The banking crises were caused by excessive lending by banks and financial companies to the real estate sector in Thailand and to industrial conglomerates in South Korea in the 1990s and the defaults associated with bubble–bursting in Thailand and overcapacity in inefficient manufacturing by conglomerates in South Korea. The defaults of large borrowers have seriously impaired the value of the assets in the balance sheets of banks and financial companies. However, after the currency has sharply depreciated due to the sudden reversal of international bank lending and to speculative attacks, the liabilities of the balance sheets of banks and non–banks have also sharply increased in terms of domestic currency, since a large portion of their liabilities are denominated in US dollars. Thus the currency crisis has increased the excess of liabilities over assets, aggravated the banks' solvency problems and the banking crisis. In turn, the worsening of the banking crisis has further accelerated the withdrawal of international bank lending because of the increased possibility of defaults of the borrowers. Foreign reserves equivalent to 3–6 months of imports, which once appeared ample for current account deficits, proved grossly insufficient during the capital account crisis compared to the much larger amount of outstanding short–term international bank loans and speculative hedge funds. Is it possible to prevent such financial crises from reinforcing each other?

Since the insolvency of domestic financial institutions was compounded by an international liquidity shortage caused by the withdrawal of short–term international bank lending and speculative attacks by hedge funds, both problems have to be attacked simultaneously. To resolve the domestic banking crisis, insolvent institutions should be closed down by compelling their top management to resign and their shareholders to suffer losses, but depositors should be protected by using public funds (potentially taxes) in order to prevent a systemic crisis. However, in sharp contrast to available prescriptions for the domestic banking crisis and insolvency problem, an international lender of last resort is urgently required to cope with international liquidity crises. The international community could have provided sufficient international liquidity to the Asian economies, which could have prevented the unnecessary currency depreciation due to the shortage of foreign reserves in relation to the massive withdrawal of international bank loans as well as the speculative activities of hedge funds.

From this analysis, the fifth economic policy message becomes clear: in order to prevent banking and currency crisis from mutually reinforcing each other, it is indispensable to consider an "international lender of last resort" so as to cope with the international liquidity crises confronting the affected countries.

It goes without saying that this international facility is all the more important to contain the so–called contagion problem. International liquidity crises originally caused by contagion eventually create domestic insolvency crises through the mutually reinforcing mechanism described above.

Globalised Finance and Herd Behaviour of International Investors

There appear to be two schools of thought on the Asian crisis in the context of globalised finance. One school considers global finance to be like a large jet aircraft, which can easily and swiftly reach any corner of the globe and is very convenient. However, when an aircraft accident occurs it tends to be highly sensationalised even though the ratio of accidents is much lower than that of passenger cars and trains. In order to further minimise the frequency and damage of accidents, various safety regulations have to implemented without undermining global competition.

In contrast, the other school of thought sees global finance as a big ocean on which small boats, i.e. emerging market economics, are sailing. However seaworthy small boats are, they can be swallowed by big and stormy ocean waves. Thus the only possibility is to strengthen the domestic regulatory framework of financial institutions in the emerging market economies to minimise the damage of financial crises.

However, it would be naive to believe that strengthened regulatory frameworks can completely eliminate financial crises in the global financial system. What is needed is some control over massive and short–term international capital inflows into small emerging market economies.

To be sure, the second of the two schools of thought seems more realistic. The "herd" behaviour of international investors, including banks, is closely associated with the globalisation of finance. It would be very costly for each international investor to obtain the appropriate information, correctly analyse it and determine which investment projects in emerging market economies are really viable. There is no explicit or implicit delegated monitor, in the case of domestic financial markets. Monitoring is costly before and after international investment is committed so that international investors tend to follow what others are doing, leading to "herd" behaviour. The emerging market economies are remote from the world financial centres but nonetheless are extremely attractive to international investors. This herd behaviour in globalised finance accounts for not only the massive international bank lending to emerging Asian countries but also for the sudden reversal of these capital flows.

How to penalise such international investors remains an important international regulatory policy issue. Once an international liquidity crisis arises in a heavily indebted emerging market economy due to the sudden withdrawal of international lending, international investors tend to be protected. However, this will encourage, or at least it will not discourage international investors from repeating the same mistake of excess lending without hedging risks, and it will also increase moral hazard by an implicit official guarantee of the assets of international investors. Thus it is important that an international policy would penalise them once they fail and they should know the penalties before they commit to international investment.

Conclusions

The Asian financial crisis is a capital account crisis in globalised finance rather than the traditional current account crisis, and is profoundly rooted in the double mismatches of currency and maturity.

From this financial crisis in Asia, five economic policy messages are drawn: *First,* it is important to get the macroeconomic fundamentals right in order to achieve sustained robust growth as emphasised by the World Bank's study on the East Asian Miracle. This message remains as important as before. *Second,* it is important to get the foreign exchange policy right, as shown by the weakened autonomy of domestic monetary policy under free international capital mobility, in order not to accelerate inflation or to increase the current account imbalance to an unsustainable magnitude. *Third,* it is important to get the composition of capital inflows right, in order to avoid extreme volatility of the exchange rate or the sudden swing of the overall balance of payments between surplus and deficit. *Fourth,* it is important to get the framework of financial institutions right, in order to prevent serious banking crises by avoiding adverse selection and moral hazard problems, as well as problems of restructuring industrial conglomerates and their relationships with financial institutions. *Fifth,* getting the international lender of last resort ready for coping with international liquidity

shortages of individual countries exposed to the sudden reversal of international capital flows, speculative attacks and contagion effects, so as to avoid currency depreciation which is larger than justified by macroeconomic fundamentals. At the same time, a new international regulatory framework should be designed to penalise international investors once they fail.

Out of these five economic policy messages, the first two policies (getting "macroeconomic fundamentals" and "the exchange rate policy" right) have traditionally been concerns of the International Monetary Fund. However, the last three policies have not been in the IMF's domain. In the 21st century, these three new policy issues will become much more important because of the capital account convertibility advocated by the IMF in the context of the highly globalised capital market. In order to get the composition of capital inflows right, it is necessary to deal with the question of how to control the composition and the volatility of capital inflows, either by tax and reserve requirements on particular capital inflows or through prudential measures. In order to get the framework of financial institutions right, it is necessary to address the fundamental question of the relationship between the real estate cycle and banking behaviour. A key issue here is whether prudential measures such as prompt corrective actions centreing on regulations on banks' capital ratios are sufficient to prevent a bubble or whether more direct control of the allocation of bank loans to the real estate sector is required. Finally, the concept of an "international lender of last resort" deserves serious consideration. The IMF should be equipped with such short–term but massive international facilities. The Japanese yen should be rapidly internationalised so as to take care of the international liquidity problem in Asia. In this context, the Japanese authorities' October 1997 proposal for the formation of an Asian Monetary Fund (AMF) should be considered carefully. In this context, it is necessary to consider how the conditionalities associated with capital account crises should differ from the conditionalities associated with traditional current account crises.

Strengthening Financial Systems

Mario Draghi

The question of strengthening financial systems and fostering the orderly liberalisation of capital transactions has been on the agenda of the G–10 Deputies for some time. Moreover, work on it has been carried out in partnership with the emerging market economies. This increased co–operation with other countries is part of the new architecture of the international monetary system that is quietly emerging. Indeed, my own view, and one expressed by the Deputies on several occasions, is that we will not see a wholesale overhaul of the international monetary system. Instead we shall witness a gradual evolution in the pattern and nature of international co–operation and interaction.

The functioning of financial markets has been changing dramatically over the past several years, in the wake of competitive, regulatory, and technological changes. We are witnessing a number of key trends in today's financial markets: deregulation and liberalisation of cross–border flows, disintermediation of global savings, reduced scope for proprietary information technology as information needed to assess market and credit risks becomes a commodity, increased product innovation and sophistication, emergence of a global arena in which broader markets circle the entire globe through 24–hour trading, and consolidation to achieve risk reduction and economies of scale.

In a significant way, these forces are causing capital markets to become truly "global" in scope and homogeneous in their goals and actions. In the international environment in which markets operate, nonetheless, macroeconomic and structural policy decisions are taken at a national level and they may be driven by narrowly defined and misinterpreted local interests. The downside risks of this latent asymmetry loom large: the economic and social costs of an abrupt divorce of global capital flows from local policies are the flip–side of the large gains in growth and living standards stemming from a virtuous combination of good policies and free trade and capital flows. The way markets punish policy inconsistencies may be as fast and material as investors can stampede to rush away from non–performing assets. In yesterday's world dominated by long–term official flows, disbursements used to decline in a relatively smooth and lagged fashion in the face of weak policies. In today's world of global capital markets and real–time finance, financial stability has emerged as a crucially important public good for the international community.

The Asian Crisis

The events leading to the Asian crisis have taught us some important lessons. Obviously the crisis did not arise from a single source. A number of factors played an important role, including current account imbalances combined with currency pegs, inefficient microeconomic allocation of capital inflows, and contagion spreading across the region due to a fall in investors' confidence and a domino effect on currencies in the region triggered by the devaluation of the Thai baht. Currency pegs that were inconsistent with the domestic policy settings, a high level of short–term, foreign currency debt, and the depletion of international reserves rapidly led to a currency crisis first, and a domestic liquidity crisis soon after. The hotly debated issues of the optimal exchange rate regime and the capital account liberalisation will not be discussed here, except to note that a pragmatic approach is warranted in both the adaptation of exchange rate arrangements and the gradual lifting of barriers to capital account liberalisation. It is a fact that the increase in capital mobility has made pegged regimes more difficult and risky to manage, thus impairing the traditional appeal of currency pegs as effective means of achieving disinflation and transparent fiscal and income policies. As regards capital movements, the increasing openness and integration of capital markets is mainly driven by the markets themselves and by the welfare gains reaped from liberalisation. The lesson learned from Asia is not that it is possible, or desirable, to force market evolution to go backward. Controls may be temporarily opportune but, in the end, they invariably do not work and are distorting. The lesson learned from the Asian crisis is that there is a need for a carefully designed sequencing of liberalisation within a consistent macroeconomic and exchange rate framework, with the domestic financial, and particularly banking, sector ranking high on the agenda of structural reforms.

Indeed, possibly the most striking feature of the Asian crisis appears to be inadequacies of most financial sectors, much more so than in Latin America. In particular, poorly managed banking systems were a central issue of the Asian crisis. The *cahier des doléances* of the banking systems in emerging Asia is unfortunately long, ranging from the overextension of credit well beyond the pace of growth of the real economy to its concentration in the real estate and equities sectors; excessive reliance on short–term borrowing in foreign currencies with a view towards temporarily lowering debt servicing costs; poor credit valuation, loan classification and provisioning; build–up of large off–balance sheet positions; and insufficient capital. The resulting risk concentration, asset–liability mismatches, and feeble provisioning left the banking industry extremely vulnerable to a shift in credit conditions, exchange rates, and asset valuations. Last, but certainly not least, recovery and reform in Japan is part and parcel of the solution to the problem because Japan is such an important market for Asian exports and its own serious problem of non–performing loans needs to be solved if confidence is to be restored in the whole region.

The evidence of the need for strengthening the financial system is overwhelming, but it should be kept in mind that building well– functioning and adequately capitalised financial systems in the region is a daunting, though inescapable task. Given the size of the banking systems relative to GDP, the sheer magnitude of the endeavour is staggering: returning to the 8 per cent BIS capital adequacy requirements in the region, including Japan, implies recapitalisation needs ranging between 20 and 30 per cent of GDP in the countries concerned. This roughly compares with 4 per cent of GDP for the US savings and loans crisis and 13 per cent for the Mexican episode. This also gives a good idea of the compelling need to accompany the redressing of the balance sheets with big strides in a badly needed overhaul of the financial sector.

The basic point is simple. Both prevention and management of the crisis have no chance of being successful unless they are accomplished with the market and through the market. Be that as it may, we will focus on three areas: information provision, strengthening of financial systems as ways to prevent crises, and management of the crises once they have erupted.

On information much has been said. The nature, quality and timeliness of information are crucial not only for a correct and transparent functioning of the market, but also for its own existence. It is a well known fact in economic theory that markets tend to break down in absence of correct information. When this information is lacking the action of regulatory authorities also becomes weak and ineffective. But there is another dimension to the markets' need for information. It is also of the utmost importance for governments to communicate their objectives and instruments credibly and in a timely manner so that market expectations can develop efficiently.

Obviously there is much more that can be done to make financial systems stronger. Driven by this belief, a group of industrial and emerging market economies developed a concerted strategy for promoting the robustness of emerging market countries' financial systems. This strategy has been endorsed by a wide range of countries and can be seen as the "master plan" for strengthening financial systems in emerging market economies. It has two main components. First, it sets out a framework containing the key elements of a robust financial system. Second, it provides for a division of responsibility among all the key players, and seeks to promote co–ordinated action by international institutions such as the IMF and the World Bank in support of countries' efforts to strengthen their financial systems.

The strategy is based on a vision of what constitutes a sound financial system. According to this concept, a robust financial system is built on three basic elements. The first element is a sound macroeconomic and institutional setting needed to support a strong credit culture and effective market functioning. The second element is strong stakeholder oversight and good internal governance of financial institutions. The third element is sound regulatory and supervisory arrangements that complement and support effective market discipline.

We have seen how sound macroeconomic policies and a robust institutional infrastructure are essential for financial stability. Economic policy excesses sooner or later disrupt the financial market. Such shocks are made worse if the financial infrastructure is weak.

Effective market discipline and good corporate governance are the cornerstones of robust financial systems. The Asian crisis has demonstrated that excessively cosy relationships between owners and managers, borrowers and lenders, and overseers and those they oversee will inevitably lead to distortions in incentives and the misallocation of resources.

Good supervision and regulation in all segments of the financial sector are the final element of a robust financial system. High standards of supervision in banking are particularly important because of its systemic significance, but they are also important in insurance and securities market activities. All types of supervision should seek to strengthen effective market discipline and strong stakeholder oversight.

Without procedures for implementing the three basic elements, the concerted strategy that has been developed and endorsed would be hollow. Hence great attention has been given to the allocation of roles and responsibilities of national authorities, international institutions and international groupings. The guiding principle has been to exploit comparative advantage and to rely to the maximum extent possible on market incentives. The point of departure is the recognition that national authorities must have the ultimate responsibility for policies undertaken to strengthen financial systems. They bear the primary cost of weaknesses in these financial systems and, as the experience of numerous countries demonstrates, these costs can be substantial. However, the international community can be of assistance in several important ways. It can provide a corpus of sound principles and practices developed through a broad international consultative process involving national experts with relevant expertise and experience. Six areas have been identified where such a corpus of internationally agreed principles and practices is in the process of being developed. These six areas are:

i) accounting;

ii) payments and settlements;

iii) banking supervision;

iv) securities market supervision;

v) insurance supervision;

vi) supervision of conglomerates.

Moreover, should there be other areas where sound principles need to be developed in the future, the principles should be worked out by the same international consultative process, involving national experts, that has been used to develop principles of sound practice in the above areas.

Having a set of widely–agreed principles and practices is helpful in three respects. First, it provides assistance to countries seeking to build robust systems. Second, it provides a benchmark against which market participants can evaluate the adequacy of countries' arrangements to support the stability of their financial systems. This in turn creates a powerful incentive to adopt the principles and practices because risk premiums may be levied if the principles are not implemented. Finally, it provides a framework that international organisations can use in their country programmes.

Each international organisation should support countries' efforts to adopt the various sets of sound principles in keeping with its own mandate and comparative advantage. For example, the IMF will take stock of the progress of adopting the core principles of banking supervision and seek to identify instances where the inadequate application of such principles could have macroeconomic implications. It will also continue to bring to the attention of the authorities macroeconomic imbalances that could disrupt the financial sector. In addition, the IMF can help to enhance the capacity of markets to exercise discipline by promoting the improvement of the quality, timeliness and comparability of key data disseminated by national authorities.

The World Bank and the regional development banks are the most appropriate institutions for providing advice and financing for the development of robust, efficient financial structures in emerging markets. In doing this, they should promote sound, market–oriented banking and financial systems with an adequate array of financial markets. This entails strengthening supervisory regimes, encouraging the resolution of banking problems in keeping with market principles, providing advice on privatisation of state–owned banks and developing the financial and legal infrastructure.

Co–operation among the international financial institutions to exploit their comparative advantages and to avoid duplication and contradictory advice is also essential. For this reason effective operating procedures must be developed to ensure their co–ordination. It is therefore welcome that the IMF and the World Bank have begun to put in place such procedures, seeking to identify specific areas where one or the other should take the lead and to co–operate in areas of joint responsibility.

But having done our collective best to prevent crises, we can remain assured that they will continue to erupt, even if, hopefully, with lower frequency.

When a crisis erupts, effective policy action should satisfy three basic requirements: it should be fast, it should be credible, and it should be of adequate size.

Recent crises have seen as the major actors on the financing side, the international financial institutions, especially the IMF, and, for the first time, bilateral governmental sources. It is now clear that this is not enough and does not represent fair public and private burden–sharing in resolving the crisis. Private capital flows are of a much greater magnitude than that of any conceivable public support. They are also part of the problem, and can become part of the solution, since they can constitute a much

more robust safety net than public flows. However, action on this front has not followed any agreed framework thus far, but has been taken on an ad hoc basis as has been dictated by the country–specific conditions of urgency.

Three years ago, in the wake of the Mexican crisis, the G–10 Deputies produced a report where some ideas on how to manage sovereign liquidity crises were first explored. Some of them foresaw the insertion of specific clauses in debt contracts designed to ease crisis management, others analysed the possibility of an agreed temporary generalised standstill in the country’s payments, and still others contemplated the possibility for the IMF to lend into arrears. Little action followed that report.

The same ideas are now being studied by the IMF and by a wider group including some emerging market countries. It is conceivable that the final outcome of these reflections will be that private creditors contribute to the management of crises in which they are involved to a greater extent, and according to a better defined framework than is the case today.

In conclusion, better economic policies, better information, better distribution of risks and of incentives, a better institutional framework both at the national and the international level, better co–ordination between the official and the private sectors may not be sufficient to avoid all crises in the future, but it will certainly be helpful in avoiding some of them and in managing at a lower cost the ones that cannot be avoided.

Lessons from Hong Kong's Experience of the Crisis

Alec Tsui

The Hong Kong financial market is unusual in Asia in that it has already been almost totally liberalised for many years. Capital has moved freely in and out of Hong Kong for longer than it has in the United Kingdom. The banking and securities markets (including membership of the Stock and Futures Exchanges, SEHK) are open to firms and practitioners from any part of the globe.

This openness has made Hong Kong the most international financial centre in Asia, as well as helping its financial markets to grow disproportionately compared to the size of Hong Kong's own economy. The equity market has increased in the last ten years from a capitalisation of $54 billion to $411 billion (tenth largest worldwide), with an average daily turnover of $2 billion, a tenfold increase over the decade. The volume of cross–border bank lending out of Hong Kong has risen from $514 billion in 1993 to $596 billion in 1997. Hong Kong has consistently been the main centre of operations in Asia for international fund managers.

This evolution was fostered by open and free–market government policies in the economic and financial fields, based on minimum interference with market mechanisms and limiting the role of government to the provision of a sound fiscal, monetary and regulatory framework. Thus, Hong Kong presents one of the few available case studies in Asia of a truly liberalised market.

Of course, Hong Kong's position is unusual in being economically within the orbit of the largest emerging market in the world while retaining a separate financial market, due to the separate currency and to controls on capital movements from Mainland China — all reflecting the "One Country, Two Systems" formula which governs Hong Kong's relationship with the Mainland. This has not prevented Hong Kong from becoming an important capital formation centre for Mainland–based or Mainland–controlled enterprises. A total of $26.4 billion has been raised since 1993 by so–called "H share" and "Red Chip" companies. In 1997, 46 per cent of new equity issued through the SEHK was by such companies. Taking debt and equity together, over 60 per cent of the total capital raised by Mainland China internationally in 1997 came through Hong Kong. Thus Hong Kong assists the Mainland to access

international markets, without needing to open its domestic market at this stage of its development. At the same time, growing participation by Mainland issuers and intermediaries in the Hong Kong market is contributing to the spread of financial market experience and skills on the Mainland. This symbiotic relationship between Hong Kong and Mainland China is a unique phenomenon in financial market history.

Bearing in mind Hong Kong's unusual circumstances, some lessons can perhaps be gleaned from its experience during the financial market upheaval in Asia over the past ten months.

The *first* and obvious point is that, despite the mature market infrastructure, Hong Kong was not unscathed by the turmoil. No financial centre (at least of Hong Kong's size) can be immune nowadays to waves of market sentiment (and therefore capital flows) generated by events in neighbouring countries. Such waves are bigger and faster today than they used to be, because the sea of global money is bigger and has fewer breakwaters. Moreover, cross–border information flow has become much more efficient. In the case of Hong Kong, the main focus of the waves was the currency peg to the US dollar. Thanks to the strong fundamentals of the Hong Kong economy, including a high level of foreign currency reserves, the peg has held firm. This was not achieved, however, without Hong Kong's undergoing a sharp and painful downward adjustment of asset prices, including stock and property prices. This is one of the unpleasant benefits of being an open economy — adjustment to a changed environment occurs quickly. Hong Kong has always been famously flexible and quick to develop new products, markets and sources of revenue when old ones die out. The cost structure had become inflated in recent years, but it has now been rapidly brought down to a level where, hopefully, it is sufficient to ensure Hong Kong's international competitiveness. If it is not sufficient, market forces will quickly ensure that it becomes so. One macroeconomic conclusion from Hong Kong's experience therefore is that being a highly liberalised market ensures rapid adjustment to competitive pressures. This is painful in the short term but permits quick recovery and healthier long–term growth. Economic and commercial flexibility needs, however, to accompany liberalisation.

A *second* macroeconomic lesson is that large and efficient securities markets (both equity and debt) help to protect emerging economies from the kind of shock Asia has just experienced. One major cause of the dislocation in most of the affected countries was excessive reliance on bank lending to meet the capital needs of corporates, particularly short–term bank lending, and particularly in foreign currency. Equity, by contrast, has stabilising qualities; though investors may sell their shares in a troubled company, and thus drive down the market price, this does not precipitate defaults on loans, with their attendant impact on the banking system. Furthermore, companies with a strong equity base are obviously less prone to failure. One of the reasons Hong Kong has weathered the storm with relatively few corporate failures is that the equity market plays a more important part in providing the capital used by commercial enterprises than it does in most emerging markets. Hong Kong's major listed

corporations, for the most part, are relatively lowly leveraged. Thus, development of equity markets is part of the long term cure for Asia's recent troubles and, indeed, is being prescribed as such by the World Bank and other international agencies.

The same principles apply to fixed–income securities markets. Bonds, even in foreign currency, tend to have longer maturities than commercial bank loans. Best of all, a domestic bond issue avoids currency risk. However, corporate bond markets in most Asian countries are even less developed than equity markets. Of course, developing the investor base for a fixed–income market is not something which can happen overnight. An essential foundation is usually a reasonably liquid government bond market, providing a benchmark for corporate issues. In Hong Kong, the Monetary Authority started a programme over a decade ago of developing the market in Exchange Fund Bills and Notes (even though the Hong Kong government has no need to borrow) partly in order to foster the development of a corporate bond market.

An open equity market is, of course, subject to a higher risk of volatility, being exposed to the waves of global capital. Having a large and active domestic investor base can help to absorb such waves. But these waves are now such that even the giant markets of the world such as New York and London have become more volatile in recent years. A market the size of Hong Kong's cannot hope to escape such volatility. It is particularly important, therefore, when opening the doors to global capital, to have strong risk management systems in both the banking and securities markets.

Hong Kong is now widely recognised as having one of the more robust regulatory systems in Asia. But it was not built overnight. Nor would it be what it is today without having undergone some significant shocks in both banking and securities sectors a decade or more ago. Due to systems established in the light of such past experience, Hong Kong was able to absorb a very sharp downward adjustment in asset prices in the latter part of 1997 without any significant problems in the banking system and with the loss of a few of the some 500 broker firms; and the latter did not give rise to any systemic dislocation. This was partly due to modern and well–managed clearing and settlement systems, which of course lie at the heart of any market's risk management process.

Another lesson to be drawn from Hong Kong's experience is that establishing international confidence in the fairness of markets needs to go hand in hand with the process of liberalisation. That means confidence in the effectiveness of the investor protection regime. A sudden shock due to some improper corporate actions against investors can severely undermine market confidence. So can the perception that a market is being manipulated by insiders. The process of liberalisation can itself create new challenges in this respect. In today's global markets, some international investors have the ability, by virtue of their size in relation to many emerging markets (magnified by their leverage capability), to move those markets (intentionally or otherwise) in a manner damaging to other investors. This is compounded by the rapidly increasing volume of proprietary trading activities undertaken by large international banks and securities houses and the exponential growth of derivative markets. There has been

much debate in international forums about whether and how to regulate more closely the cross–border activities of hedge funds and the multi–jurisdictional operations of international financial institutions. This remains one of the thorniest issues created by the liberalisation process.

A related lesson from the crisis, widely reflected in press comments, is that market liberalisation needs to be accompanied by market transparency. Disclosure of information both at the national level (about volumes and maturities of bank borrowing, for example) and at the level of individual financial institutions and listed companies (for example, about non–performing loans, off–balance sheet liabilities, events affecting corporate financial performance) needs to become part of the governmental, commercial and market culture. Hong Kong has a relatively high level of transparency by Asian standards. But there is still a need to raise disclosure standards further, along with other Asian markets. Disclosure, however, needs to be a two–way street. There has been justified criticism of the way some big international investors have been able to build up positions without the rest of the market being able to see what they are doing. This goes back to the importance of fair markets. Enforcement at the multinational level is notoriously difficult, but, if liberalisation is to continue at its present pace, the world's regulators must find a way of dealing more effectively with multi–jurisdictional situations.

For markets seeking to liberalise, there is another dilemma somewhat like the chicken–and–egg question. Having a deep and liquid market is one of the best protections against volatility. One way of building liquidity is to encourage foreign participation in a country's stock market. However, large–scale participation by foreign investors exposes a country to sudden and destabilising inflows and outflows. Hong Kong was fortunate in having had a relatively liquid domestic market for many years, due to a strong popular equity culture. This grew in parallel with gradually increasing foreign participation. Foreign participation in some other Asian markets grew much more precipitously. One lesson of the crisis appears therefore to be that the pace of liberalisation should not be forced.

Market depth comes from, among other things, having a well–diversified investor base, including both retail investors (which tend naturally to be domestic) and institutional investors (which most foreign investors are). In many emerging markets there is a relative scarcity of domestic institutional investors. The establishment of mandatory retirement saving schemes (such as that currently being introduced in Hong Kong) is both fiscally necessary and helps to broaden domestic equity and debt markets.

Paradoxically, one of the quickest and most effective ways of developing domestic financial markets is to open them up to participation by foreign intermediaries — banks, securities houses, fund managers, accountants, lawyers, etc. Foreign firms bring the skills, experience and methods developed in mature financial markets and thus raise professional standards among local practitioners, as well as introducing more

sophisticated financial products and services. Such opening can be done on a joint venture basis to encourage local participation. It does not *per se* need to be accompanied by the removal of controls over capital movement.

This leads to the last point, which is the importance of ensuring that human resource development proceeds in parallel with the liberalisation of financial markets. The starting point must be a plentiful supply of individuals from schools and universities with educational backgrounds relevant to financial services, including accountancy, law, business administration and (above all) information technology. Such a supply of human resources is the lifeblood of any capital market. It needs to be supplemented by a full range of professional training facilities operating according to international standards. This is a field in which Hong Kong has recently been making a determined push, through (among other things) the establishment of a new Securities Institute with a mandate to administer and set standards for examinations leading to professional qualifications.

Despite the problems associated with financial market liberalisation, the overall desirability of liberalisation *per se* should not be questioned. Liberalisation brings increased private sector capital to support development, more efficient allocation of capital generally, the discipline of markets in place of decisions by bureaucrats or politicians, incentives for improved corporate profitability, increased transfer of skills and technology, and many other benefits. These benefits considerably outweigh the drawbacks. Hong Kong today is often held up as one of the best advertisements for what liberalised markets can do. However, Hong Kong's position as a metropolitan economy is different from that of many Asian countries, and Hong Kong's financial markets have had a longer time to mature. As we saw last year, over–hasty integration of emerging economies into today's global capital markets can lead to severe dislocations. The resultant economic pain is being borne mainly by ordinary people throughout Asia. There are many people saying that the doctrine of open markets was part of a western conspiracy to undermine Asian economies, and now to permit western companies to acquire assets in Asia on the cheap. However distorted such reasoning may be, its political appeal should not be underrated. In pursuing the future cause of liberalisation, western and multilateral policy makers should be sensitive to the particular circumstances of each country, as well as to the need to balance advice to Asian governments with action to prevent any misuse of liberalised markets by big movers of global capital.

Causes and Implications of East Asian Financial Crisis

Kumiharu Shigehara

Introduction

Financial problems have been a prominent cause in the economic downturns in the English–speaking OECD countries and some Nordic countries in the early 1990s, as well as Japan's protracted phase of poor macro–performance in recent years. These problems include: the balance–sheet problems of financial institutions and/or the fragilities of the enterprise or household sector with excessive debt positions associated with declines in equity or real asset prices. They typically arose in the wake of or in conjunction with substantial liberalisations in the countries' financial sectors.

The financial structures of emerging market economies in East Asia have remained less developed than in the industrial world. Attempts at financial market modernisation in the 1980s were generally considered to be inadequate. The challenge in the 1990s has been to achieve more liberalised financial systems in the process of further economic development, without incurring the difficulties that the industrial countries have experienced. Unfortunately, the recent events have demonstrated that a number of emerging market economies of East Asia have failed to meet this challenge. The unfolding adverse consequences of the financial crisis in these economies are far greater than those experienced by OECD countries in the 1990s.

It is now a consensus view that financial sector weaknesses contributed to the economic crisis in emerging East Asia. But many other countries in that region and the rest of the world also have weak financial sectors and have not experienced a crisis. Financial sector weakness can therefore not be considered as the unique root cause of the crisis. It is clear that a number of factors have interacted with each other to bring about the crisis and magnify its severity in emerging East Asia. The precise relationships between them appear to be different in different countries in that region and further analysis is required to determine their causal relationships precisely.

Causes of the Financial Asian Crisis

Given the time limit, the discussion of highly selective causes and implications of the financial crisis in emerging East Asia will be highly selective.

The first point is that the recent financial crisis in emerging East Asia differs from previous crises in developing countries — such as the Mexican peso crisis of 1995 and the Latin American debt crisis of the early 1980s.

— Both the Latin American debt crisis and the Mexican peso crisis, with the major exception of Chile's episode, were associated with heavy external borrowing of the public sector. In the case of emerging East Asia's financial crisis, the main source of difficulties lay with the private sector. The budgets were generally balanced in emerging market economies in East Asia, in contrast to many Latin American economies previously hit by the financial crisis.

— Moreover, these East Asian economies were characterised by high private saving rates. Excessive consumption was not a source of external deficits. These economies were also more successful in keeping inflation lower than were Latin American economies.

There were also differences in the international environment. World trade remained buoyant in 1997, while interest rates in international capital markets were kept low. In contrast, the Latin American debt crisis of the early 1980s occurred against the background of high interest rates following the Volcker measure of monetary tightening and widening US budget deficits. The Mexican peso crisis occurred after the worldwide rise in long–term interest rates from the beginning of 1994.

Partly because of these favourable domestic and international factors supporting the emerging market economies of East Asia, the depth and breadth of emerging East Asia's financial crisis have surprised us. Indonesia's current account deficit was not exceptionally large in the several years before the crisis (it averaged 3.8 per cent of GDP over 1995–96), although it was rising. And Korea's deficit had begun to come down in the first half of 1997 from its 1996 level of just under 5 per cent of GDP. True, Thailand was running a large current account deficit — averaging nearly 7 per cent of GDP over 1990–96 and 8 per cent of GDP in 1995–96. But, we must remember that Singapore ran a current account deficit averaging about 9 per cent of GDP from 1975–82, and this period is generally considered as an era of remarkable economic success.

The early diagnosis was that the exchange rates of emerging market economies in East Asia were overvalued. Many observers considered that they had lost international price competitiveness by something of the order of 10 per cent. Then, why did the 20 per cent devaluation of the Thai baht on 2 July last year trigger a full–blown crisis, quickly spreading to other countries in South East Asia and eventually to Korea? It appears that a self–fulfilling loss of confidence played a key role in deepening and spreading financial crises. Even countries with relatively limited international capital

transactions can suffer from sharp outflows of capital in a major crisis of confidence. Emerging market economies in East Asia integrated into international financial markets were more vulnerable. The inflow into these economies was around $40 billion in 1994, and doubled to nearly $100 billion in 1996. It reversed to an outflow of around $12 billion in 1997. The volatility of exchange rates was largely associated with changes in capital flows. The problem was exacerbated by the short–term nature of capital flows and the foreign currency denomination of debt without hedging. The build–up of short–term, unhedged debt increased the vulnerability of emerging East Asian economies to a sudden loss of confidence. Once confidence was lost, rushed hedging of short–term foreign–currency debt aggravated the situation.

The vulnerability of emerging market economies in East Asia is also associated with the fragility of financial sectors, which in turn, at least in part, reflects the effects of earlier large capital inflows. Large inflows led to easy funding for projects and asset prices were bid up. The practice of local banks of relying on the availability of collateral rather than on a rigorous analysis of profitability encouraged huge credit expansion hand–in–hand with the rise in asset prices and the value of collateral. Such practice also skewed bank lending towards real estate and construction. The lack of transparency about corporate balance sheets and other information also encouraged reliance on collateral. These problems were exacerbated by implicit or explicit government guarantees which encouraged banks to assume excessive risk, and by lax supervision and regulation, which failed to ensure that banks made adequate provisions against problem loans or to maintain adequate levels of capital. Investors' realisation that these weaknesses in the financial sector were shared by most other countries in the region, as well as emerging market economies elsewhere, was a powerful force in generating contagion once the crisis started.

The problems were magnified by inadequate attention paid by external creditors to the risks involved in lending to these countries. They lent despite inadequate information about borrowers or knowledge about their unhedged foreign–currency exposure. Was this because of their expectation that they could be bailed out in the event of failure? Or, can it be explained simply in terms of collective "exuberance"? Is it true that foreign investors thought that they were working in a riskless world, and made their investment decisions accordingly, and then suddenly realised the risk and reversed their positions? Further, rigorous analysis is needed to answer these questions. Whatever the final answers are to them, it is clear that private sector lenders from industrialised countries should assume their proper share of the responsibilities for the sound functioning of de–regulated and globalised financial markets.

Lessons from the Recent Crisis

What are the lessons to be drawn from the recent crisis on the basis of what I have just said about the main features of the East Asian financial crisis? An important lesson is that even economies with fairly sound macroeconomic policies can fall victim

to a sudden loss of confidence in the new environment of more integrated international capital markets. Emerging market economies with relatively strong fundamentals such as high saving ratios, sound fiscal positions, low inflation and high growth, have often experienced large capital inflows that create problems that increase their vulnerability to an adverse shift in investor sentiment. The inflows add to inflationary pressure under the fixed exchange rate regime. When public finances are in a healthy state and the size of the government is small, it will be difficult to fully offset inflationary pressure by fiscal retrenchment. How about the effect of offsetting monetary action? Sterilised intervention will encourage foreign creditors to continue lending, as it prevents interest rates from falling in response to capital inflows.

Countries such as Hong Kong and Argentina have successfully maintained a currency board system for the past several years. But, for a number of countries, the burden of domestic adjustment required for the operation of a currency board would be too great to bear. If so, some flexibility would be needed in the area of exchange rate management as a safety valve. That said, the exit from fixed to floating rate regimes could produce turbulence in markets, unless the timing is well chosen. It would probably be better to shift from a fixed exchange rate to a more flexible regime when macroeconomic conditions are stable, in particular when the current account positions are favourable.

The recent crisis in emerging East Asia has clearly demonstrated the importance of the interaction between financial market weakness and economic disturbances. Much has been said about the importance of strengthening prudential regulation and supervision. The strategy of a number of banks in OECD countries of relying on local banks in emerging market economies for the screening of borrowers and channelling of credits according to their recommendations, did not work well, as local banks generally lacked the necessary credit assessment skills and operated in a lax supervisory environment. While this episode underscores the importance of emerging countries' adherence to a set of 25 "core principles" set out in 1997 by the Basle Committee on Banking Supervision, it is equally important to consider ways to strengthen the capacity of banks in industrial countries to conduct their international operations with greater prudence.

Over the years, an important device for strengthening the soundness of banks in industrialised countries has been risk–weighted capital adequacy standards. The Basle Accord on capital standards in 1988 was a significant achievement in this respect. But, recently, calls for reform have begun to grow. Risk–weighting that assigns zero risk to all OECD Member countries' sovereign debt and a reduced weighting (20 per cent) for claims on banks may need to be reconsidered. Means need to be found to prevent capital ratios from becoming unduly distorted by fluctuations in equity prices and associated unpredictable changes in the valuation of unrealised capital gains counted as part of capital. More generally, the Basle Accord should not prevent private banks' efforts to develop and use their own models for measuring and managing risks prudently in their banking operations. It is also worth emphasizing that countries need to apply the Basle standards in a manner that is meaningful based on their particular

circumstances. The Asian crises have underscored that banks in countries undergoing rapid change in their financial systems are likely to need to maintain capital ratios significantly above the Basle minimum if they are to be financially sound.

With respect to the role of rating agencies, they apparently led a competitive race to the bottom in reducing ratings after the crisis, but were not of much help in flagging potential trouble earlier on. This is not to disparage the important role that credit rating agencies can play in disseminating information and bolstering market discipline or the importance of improving credit rating agencies' ability to effectively monitor risks in emerging markets. However a lesson from the Asian crisis is that banks need to improve their own in–house credit assessment skills so that they do not become overly dependent on the views of the rating agencies.

Rating agencies do not usually have access to any more data than private participants generally do. This leads to the important issue of greater transparency, as highlighted in the *communiqués* of the recent meetings of various international financial groups and committees. No one would disagree with the assertion that "more information is better than less information". The IMF's Special Data Dissemination Standard and the BIS data on bank lending are some of the important international efforts to provide relevant information to market participants. The issue is not whether more information is needed, but "where the crucial information deficiencies lie". There is an urgent need for monetary authorities of both developed and emerging market economies jointly with private sector participants to address this issue.

The recent crisis has demonstrated the risk inherent in partial and incoherent financial liberalisation. When short–term capital movements were substantially more liberalised than long–term flows and enterprises' capacity to borrow abroad were severely restrained, inflows concentrated on banking channels and the vulnerability of the banking system was magnified. Had liberalisation of financial markets focused more on equity and bond markets, the banking system would have suffered less damage. A more balanced approach to financial market opening also requires putting appropriate infrastructure and framework conditions in place, including improved corporate governance structures and improved relationships between the government, financial institutions and business firms.

The crisis in emerging East Asia raises broader issues concerning the management of the international financial system. As was the case in Mexico in 1995, the amount of financial resources that have been disbursed by the IMF and other lending institutions is large. However, it is considerably less than the potential capital movements which the crisis could entail. This has placed responsibility on private creditors to set up refinancing facilities to overcome short–term funding problems, which is reminiscent of the process of Latin American debt rescheduling during the 1980s. Where negotiations prove successful, as with the recent agreement between Korea and major international banks, favourable effects can become visible in financial markets quickly. There are, however, legitimate questions about whether the emerging East Asian crisis could have been more limited if lenders from OECD countries had paid greater attention

to the risks inherent in lending to borrowers in emerging market economies on which they had limited information. In order to prevent the recurrence of large–scale international financial crisis, it will be necessary to ensure that participants in international capital markets are not sheltered from the consequences of their own actions.

Concluding Remarks

Let us conclude with some quotes from the *Communiqué* of OECD Council meeting at Ministerial level held on 27–28 April. OECD Ministers noted that the events in Asia have underlined the importance of international monetary and financial co–operation and of the advantages of all parties working together in a co–ordinated manner to prevent, manage and contribute to overcoming crises of a global nature. Ministers also noted that the impact on trade and investment of the current financial situation in Asia poses challenges for the multilateral system. All countries have a substantial stake in economic stability and development in the Asian region. OECD Ministers agreed on the importance of all countries maintaining open markets and resisting protectionist pressures. They confirmed the importance of stable trade financing facilities and of providing development assistance targeted to help address the economic and social implications of the financial crisis for affected Asian countries. In this context, Ministers endorsed the establishment of an OECD special programme to address structural issues arising from financial instability in non–member economies, to complement on–going co–operation with emerging and transition economies in Asia and elsewhere. We hope that this programme will help these economies follow a path of continued liberalisation, structural reform, good governance and the maintenance of a favourable investment climate which should contribute both to the good performance of these economies and to a strengthened multilateral system.

Korea's Financial Crisis: Causes and Prospects

Soogil Young

"The only way we can revitalise the economy is to implement the IMF agreement fully. We should do so, without even allowing an error of one per cent."
Kim Dae–Jung, President–elect, 22 December, 1997

Overview

The year 1997 was, to say the least, an extraordinary one for the Republic of Korea (hereafter, "Korea"). With his term in office due to expire in February 1998, President Kim Young Sam had meant it to be the year in which he would see the completion of the "New Economy" that he promised to deliver at the time of his inauguration in 1993. Throughout 1997, however, there was actually a steady weakening of the old economy that had been known as the "Miracle of the Han" because of its dynamism and prosperity since the early 1960s. In November, there was a dramatic loss of international confidence in the Korean economy, causing currency and stock prices to lose half of their value, and on 21 November, the Korean government had to ask the IMF for a bail–out to save the economy from collapsing.

On 3 December 1997, the IMF agreed to arrange a stand–by credit of at least $55 billion for Korea, $21 billion from the IMF, $10 billion and $4 billion from the World Bank and the ADB respectively, and at least $22 billion from the United States, Japan and other industrial countries as the "second line of defence", conditional upon the country's acceptance of a structural adjustment programme. The breadth and stringency of this programme, which appeared to be a prescription for overhauling the economy, came as a shock to many Koreans. In any case, the currency crisis continued to worsen and the situation was further aggravated by the campaigning for the presidential election of 18 December.

A turning point was reached with the election of Kim Dae–Jung. He immediately began to explain to the nation that the IMF prescription was the only means of overcoming the problems facing the Korean economy. He accepted the IMF–prescribed structural adjustment programme as his own and began to oversee and direct its implementation by appointing an Emergency Economic Measures Committee with the consent of President Kim.

Although it was still two months before President–elect Kim Dae–Jung's inauguration, he began to gain the trust of the international community with respect to Korea's readiness to undertake all of the economic reform measures prescribed by the IMF agreement. The first tangible fruit of these efforts was the understanding worked out by the Korean government and the IMF, announced on Christmas eve, for an early disbursement of $11 billion early in 1998 from the credits already agreed on, consisting of $2 billion from the IMF, $1 billion from the World Bank and $8 billion from the second line of defence. In return, the Korean government promised to accelerate implementation of the structural adjustment programme. As a result the currency crisis ceased worsening.

Since then, various steps have been underway in Korea to stabilise the currency market and promote structural reform of the economy. These efforts, especially in the area of structural reform, began to be pushed in earnest after President Kim's inauguration in late February. His reform drive has been guided by the IMF prescription and he has been intent on implementing this programme in full and on schedule, even trying to go beyond this. His goal, as he declared in his inaugural speech, was to promote the "parallel development of democracy and a market economy". He believes that this goal is broadly consistent with the IMF prescription, but it requires a more comprehensive approach to structural adjustment. In any case, an extensive range of economic reforms has been undertaken by the new Korean government

These reforms have been wrenching and unnerving for the Korean people. However, they have apparently earned the Korean economy a degree of international confidence, for since early in 1998 the currency market has experienced relative stability and there has been a considerable gain of external liquidity. Nonetheless, the reforms have just begun and the future of the Korean economy is fraught with social pain, uncertainty and risk. Naturally, many important questions arise concerning the economy's future. The most critical one is whether all these reforms for transformation into a "democratic market economy" will help the Korean economy regain its dynamism, and if they will, when the new dynamism will begin to emerge.

Causes of the Crisis

Chaebols, the Key Vulnerability

At the root of Korea's current financial crisis are the chaebols with their well–known problematic features. This is indicated by the fact that the Korean economy began to plunge into the current crisis with the onset of bankruptcies of chaebols, which are still continuing. These bankruptcies began in January 1997 with that of the now–notorious Hanbo Steel group, followed by 12 other bankruptcies of chaebols in that year. Four of these were among the 30 largest chaebols, including the seventh–ranking Kia.

The serious vulnerability of the chaebols to sharp business downturns is a combined outcome of two problematic features of chaebols: one, their persistent tendency towards excessive and reckless diversification into various unrelated businesses, including many risky ones; and two, excessive dependency on financing by incurring debt. These characteristics of chaebols have been nurtured over many years by a number of factors such as:

— the domestic capital market's lack of depth and its lack of openness to foreign investors;

— poor corporate governance under which the chaebol is controlled by its founder or his family without being legally accountable for most of the key management decisions;

— the entrenched system of cross–credit guarantees between subsidiaries;

— lack of transparency of intra–group financial relations, protection from competition for corporate control through mergers and acquisitions, as well as from international competition in product markets, and;

— the backwardness of domestic commercial banks and other financial institutions, which are incapable of competent risk management and, at the same time, susceptible to political influence in their credit allocation decisions.

Backward Financial Sector

The deficiencies of the financial sector have been critical for the chaebols, for without such deficiencies the evolution of chaebols with their present–day problems could have been prevented. The problems of the financial sector, in turn, have been caused by the government itself. The government overregulated commercial banks for the purpose of intervening in credit allocation while neglecting to develop an appropriate system of prudential regulation for these banks. In contrast, there has been very little regulation of any kind of non–bank financial institutions. In general, prudential regulation has been lacking throughout the financial sector and this, in particular, has been responsible for reckless channelling of foreign short–term debt into the domestic corporate sector by domestic financial institutions, exposing Korea's corporate and financial sectors to serious risks of short–term illiquidity.

Government Intervention and Moral Hazard

It is easy to see that one major factor has been responsible for most of the problems of Korea's corporate and financial sectors, notably a long tradition of government intervention in the allocation of financial resources among sectors and firms for the purpose of promoting high economic growth and rapid industrialisation. Government intervention has suppressed the development of appropriate governance for corporations and commercial banks, in particular, and it has been accompanied by implicit guarantees of bailouts, carried out in practice when there were threats of bankruptcies.

It is now well established that these guarantees gave rise to a pervasive problem of moral hazard throughout the private sector, encouraging excessive risk–taking in investment decisions as well as excessive leveraging of chaebols. The same moral hazard seems to have operated in the labour market, too, and especially since the democratisation of the labour market in the late 1980s, it seems to have contributed to this market's inflexibility.

Financial Globalisation

In all fairness, it should be noted that the financial crisis was not caused by the problems of the chaebols alone. A critical factor has been the globalisation of financial capital that has accelerated since the early 1980s. This trend toward financial globalisation has been reinforced by the easy monetary policies of Japan and other industrialised countries, especially during the early 1980s. In the early 1990s up to 1996, there was also a period of heightened euphoria over the prospects of the developing East Asian economies, making them a principal destination of much of the global flow of funds. These international financial market trends of the 1990s contributed to the large inflow of financial capital to East Asian developing economies, in general, and encouraged Korean financial institutions and chaebols to borrow from abroad far beyond prudent levels.

Confidence–Shaking Developments

A problem with global funds is that their movement can be destabilising. They react to self–fulfilling volatile expectations and move quickly in herds. In this situation, anything that reduced international confidence in the Korean economy could create havoc by causing the flight of international capital. This is what actually happened to the Korean economy in 1996–97, when a series of developments gradually but steadily eroded international confidence in the Korean economy, especially during 1997. What were those developments?

First, there was a sharp drop in the growth rate of the Korean economy from 9 per cent in 1995 to 7 per cent in 1996, led by a sharp drop in export performance as well as the subsequent widening of the current account deficit from less that 2 per cent of GDP to 5 per cent of GDP. Together with the widely shared observation of "too high costs" of doing business in Korea and "too low efficiency" in various sectors of the economy, this situation caused a feeling of economic crisis among Koreans, leading to the replacement of key economic ministers, including the deputy prime minister in July 1996.

Second, the drop in the economic growth rate was soon followed by an increasing number of corporate bankruptcies, including those of the 14 chaebols mentioned earlier. Needless to say, these bankruptcies meant rapid increases in the nonperforming loans held by financial institutions.

Consequently, the Kim Young Sam government felt compelled to respond to the deepening economic crisis. Accordingly, beginning in December 1996 and over the course of the subsequent year, apart from once again replacing the economic deputy prime minister as well as other economies ministers in March 1997, the government attempted to implement a few major measures, but these attempts conspicuously failed. These obvious failures may be considered the third development that led to a further serious weakening of international confidence in the Korean economy.

The first failure involved an attempt to reform labour laws to facilitate worker lay–offs for speedier structural adjustment of the economy. The reform bills passed the National Assembly in December 1996 but they had to be revised in March 1997, thus delaying implementation of key reforms. The second failure was the inability, in the face of major corporate bankruptcies, to dismiss the responsible management promptly. This failure was most dramatically illustrated by the case of the Kia group where it took more than three months after the bankruptcy before the incumbent chairman could be dismissed. Furthermore, Kia was eventually placed under the protection of the Korea Development Bank, creating the semblance of a nationalisation of a major bankrupt firm. The third failure was that the National Assembly did not pass the financial reform bills to strengthen the prudential regulation of financial institutions, which had been the fruit of 11 months of work by the Presidential Commission for Financial Reforms. The government failed to persuade the National Assembly to enact these bills largely because of an acrimonious confrontation between the Ministry of Finance and Economy and the Bank of Korea over who should supervise financial institutions.

These abortive measures were intended to enhance the working of the market mechanism. The failures clearly demonstrated two points. One was that in Korea interest group politics would continue to thwart the market mechanism and the forces of competition. The other message was that the existing Korean government could not be expected to resolve the country's economic problems. As a result, international confidence in the Korean economy began to weaken noticeably, especially during the second half of the year.

One more government failure relating to the emerging economic crisis should be mentioned. During the previous two years, the Korean currency had failed to respond to the devaluation or depreciation of the Chinese yuan and Japanese yen. This was especially serious viewed against the concern with "high costs and low efficiencies" at the time. Instead, the government unsuccessfully tried to launch a campaign to increase efficiencies or cut costs by 10 per cent.

Absence of an Early Warning System

Efforts to avert or to contain the currency crisis could have been more effective if there had been an "early warning system". An accurate and timely monitoring of foreign debt levels and foreign exchange reserves would have served to provide an early warning system, but this monitoring did not exist.

The lack of an early warning system seems to have been related to two institutional problems. As a result of a merger of the Economic Planning Board and the Ministry of Finance, the Ministry of Finance and Economy became too large and too complex to be supervised effectively by its minister. Another factor was the open confrontation between the Ministry of Finance and Economy and the Bank of Korea over who had responsibility for overseeing the management of foreign debt and reserves. Co–operation between them had broken down.

Furthermore, problems had been aggravated by the performance of the macroeconomy. The growth of the economy kept decelerating until the first quarter of 1997 but began to recover thereafter, reaching a growth rate of 6 per cent in the third quarter. The recovery was led by an increase in the growth of exports. The balances in the current accounts began to improve at the same time, as a result. This recovery of the macroeconomy led the authorities to believe and claim that the fundamentals were strong and encouraged them to ignore early warning signs.

Contagion from Southeast Asia

One last critical factor which contributed to the onset of Korea's financial crisis was the contagion from Southeast Asia. The contagion operated through two channels. One was the interdependence of exchange rates, so that devaluations in Southeast Asia contributed to expectations of a major devaluation of the Korean currency. These expectations were reinforced by a major depreciation of the Taiwanese dollar in October. The other channel of contagion was a perception of similarities between the developing Asian economies. Recognition of structural problems in Southeast Asian economies sensitised international investors to similar problems in other East Asian economies. Thus the East Asian euphoria turned into an East Asian panic.

Political Leadership

Having listed the key factors which led to the Korean financial crisis, it should be noted that its onset required a confluence of all the factors mentioned. None of them could be singled out as the factor mainly responsible for the crisis. All of the listed factors were implicated in the crisis which implies that the Korean financial crisis was not easily precipitated

One way of explaining this remarkable development is to focus on the globalisation of financial markets. Globalisation requires an adaptation of national systems of governance to steer clear of its dangers while taking advantage of its new opportunities. But the national system in Korea had failed to adapt.

In the final analysis, the crux of the matter was the political leadership's failure to promote and launch the necessary reforms. However, the financial crisis seems to have helped make clear that reform cannot be avoided. The crisis has imposed fundamental economic reforms and at the same time has given rise to a leadership that seems to be equal to the challenges posed by the urgency of the situation.

Towards a New Approach to Freedom of Capital Movements and Capital Account Liberalisation?

Benoît Cœuré

The origins of the Asian crisis have now been pinpointed: weak financial systems, inadequate due diligence and poor allocation of resources, marked by a tendency to over–invest in projects with ever lower returns. These shortcomings were exacerbated by a combination of massive foreign currency debt and overly rigid foreign exchange policies.

The lessons to be learned from the Asian crisis can be used to re–assess the development strategies of emerging countries and, more generally, the architecture of international economic co–operation. This process has already begun; one offshoot is the statement by the IMF Interim Committee, which needs to be extended further in three areas: strengthening transparency in both public and private sectors, financial system stability, and private sector involvement in crisis resolution.

Additionally, the Asian financial crisis highlighted the volatility, unpredictability and sometimes harmful impact of capital movement towards emerging countries. Does this challenge existing strategies for opening the capital account? Should the "doctrine" advocated by the OECD, the IMF and the international community, which aims for the greatest possible opening of trade in goods, services and capital, be reconsidered? Should controls on capital movements be introduced?

These issues are important for developing and developed nations alike. There is renewed interest in capital controls throughout the world; examples include the so–called Tobin tax and Chilean–style regulation of short–term borrowing. The recently created ATAC movement in France aims to combat financial instability and advocates a generalised Tobin tax on all capital movements. The concerns raised go beyond the immediate situation and are well worth discussing at length.

Capital Account Liberalisation: The Groundwork for Discussion

Capital Accounts Must Be Liberalised

Everyone is familiar with what economics textbooks have to say on the benefits of liberalising capital accounts, so there is no need to review them here. Understandably, countries which are catching up rapidly want to invest more than their national savings allow, even if the savings rate is high. This implies a current account deficit, which must be financed somehow. To do so properly, i.e. for the best possible allocation of international capital, the capital must be free to move. This positive–sum mechanism leads to better allocation of capital at world level and, in the end, to higher growth for all. There is no question but that financial liberalisation has contributed to the rapid growth of the world economy over the past several years.

Nor is there any need to re–open the long–standing debate started by McKinnon on sequencing, i.e. the priority to be given to liberalising current transactions and opening capital accounts. It is increasingly clear that the two are mutually reinforcing and must therefore go hand in hand, if only because liberalisation of trade — whether in goods, services or capital — is first and foremost a political transformation that involves society as a whole.

The European Union's approach illustrates this point: free movement of capital under the Single European Act of 1987 was a tremendous spur to integration of the goods and services markets. The introduction of the euro, which is after all but a monetary reform, will strengthen this process.

• *Financial liberalisation spontaneously encourages short–term financing, exposing borrowers to reversals of confidence on the part of lenders.*

Some observers believe that the Asian financial crisis illustrates the adverse impact of opening capital accounts: the growth in short–term financing, particularly in foreign currencies, undeniably helped to trigger the crisis, since this capital is at the mercy of reversals in lender confidence.

Before any remedies are proposed, it would be useful to understand why short–term financing was encouraged. A number of factors can be identified:

— exogenous institutional and historical constraints that included a lack of organised bond markets and a predominance of bank financing, which is more propitious to informal relations; and regulatory constraints that included restrictions on equity investments;

— an endogenous "headlong rush" on the part of local financial institutions, which were facing liberalisation at a time when their balance sheets had suffered from years of controlled management of the economy. Banks carrying doubtful accounts that did not yield a return resorted to outside borrowing to cover their costs. At the same time, the value of their assets declined, because the best customers also preferred to borrow abroad at lower cost. That left the banks seeking ever more

remunerative loans. In an increasingly risky environment where investment projects became ever harder, if not impossible, to manage, lenders were understandably reluctant to be saddled with long–term commitments.

The end result was a system that was as rigid as bank financing in terms of risk premiums, but did not share the potential advantages of bank financing, such as stability and information sharing.

- *Even sophisticated controls on capital movements cannot withstand underlying trends.*

These drawbacks have prompted calls for controls on capital movements. Examples include J. Tobin's recommended tax on foreign currency "round trips" and a Chilean–style deposit obligation for capital inflows.

A Tobin–style tax is not very realistic, because it would have to be implemented in a co–ordinated manner on all financial markets and for all financial instruments. Otherwise, ways around it would be found immediately.

More generally, such controls extend the time horizon of investors. Therefore, in the very short term, they can be useful in preventing the formation of speculative bubbles, a role that that should not be overlooked. Financial theory has shown that the workings of financial markets can be adversely affected by flaws — such as information asymmetry, transaction costs, and the cost of acquiring information — that cause pertinent information to be "trapped" on a particular market segment and not reflected in prices.

Nevertheless, as Rudi Dornbusch — whose opinion of the Tobin tax is rather favourable — so eloquently argued in a recent article, in the end such controls merely create additional "friction" and are powerless to combat underlying trends. Finally, as Dornbusch points out, this tax already exists *de facto* on the market as the bid–ask spread. This spread can be quite wide on emerging markets that are not very liquid or on which transaction costs are high.

- *Greater recourse to long–term capital would provide stability.*

A system that relied more on long–term financing would have four advantages:

i) financing of any type (loans, bonds, equity) would be more stable and would protect borrowers from across–the–board revisions to forecasts; it would thus give market analysts and ratings agencies more time to evaluate, without pressure, the fundamental parameters of companies and countries;

ii) market financing has the edge over bank financing in that it enables continuous adjustment of risk premiums, thereby providing a gradual warning to countries monitored by the markets. When investors have sufficient information and use it correctly, continuous revision of risk premiums can become a balancing mechanism on world markets. This approach should therefore be combined

with a concern for the transparency of the private sector and of local governments and with the information diffusion strategy recommended by the IMF in the wake of the Mexican crisis; this strategy could be implemented more efficiently and extended to private sector stakeholders;

iii) direct investment is the preferred vector of technology transfer and of the diffusion of technological advances and human capital (spread of production technology, management, financial and accounting methods, etc.), which is central to economic convergence;

iv) last but not least, equity financing, when accompanied by proper "corporate governance" (disclosure of information, respect of minority shareholders, specialised committees, etc.) permits close monitoring of corporate investment projects by lenders; this significantly improves resource allocation. What is needed is the gradual introduction of incentives to improve the operation of market mechanisms, which have proved their effectiveness in developed economies.

Towards a New Approach to Liberalisation

What conclusions can be drawn from the above arguments?

i) Our goal should continue to be the greatest possible liberalisation of capital, goods and services markets.

We now have a clearer idea, however, of the transition process that leads to such liberalisation.

ii) Long–term capital must take priority over short–term capital in the financing of emerging countries. This requires the development of local bond markets and incentives for equity financing, i.e. foreign ownership in domestic companies. Two comments are called for here:

— there may be some concern that foreign investment could jeopardise national independence. This is a legitimate concern, shared by developed countries. However, the process can be gradual. There is no need for foreign investors to acquire majority shareholdings; even a minority shareholding by a major international investor, industrial partner or pension fund is a powerful "spur" that can significantly advance corporate governance;

— there is no question of imposing a "world standard" in terms of corporate financing. Developed countries also find it difficult to choose among the various models of corporate financing and governance, such as bank financing, creation of shareholder value, etc. Moreover, the developed countries are far from perfect, which means they are poorly placed to tell others what to do. There have been suggestions, not entirely unfounded, that the situation of developed countries in the late 1990s

has encouraged financial instability in emerging countries. In a context of high global liquidity and low growth in continental Europe and Japan, the low returns encountered by some European and Japanese financial institutions on their home markets has caused them to seek higher returns elsewhere.

iii) Prerequisites for capital account liberalisation should include a shake–out of financial institutions' balance sheets (so as not to trigger the above–mentioned "headlong rush"), compulsory transparency for public and private sector players, and effective implementation of international due diligence. The latter should involve compliance with the Basel Committee's core principles and widespread application of VAR risk assessment methods for both market and credit exposure.

This brings us back to McKinnon–style sequencing, but this time within the capital account. Sequencing must be guided by the market, i.e. meet investor expectations as well as possible in the light of progress made on structural reforms, and must be accompanied by gradual state withdrawal. The latter's role should shift from intervention and direct steering of investment to regulation. Sequencing must also be credible, i.e. based on a timetable that is respected, which has not always been the case in Asian countries.

Above all, sequencing must not be used as an excuse for delaying financial liberalisation; on the contrary, it should accelerate prior financial sector reform.

iv) This should not preclude consideration of measures to curb financial market volatility in the very short term. This is not a taboo issue. Nonetheless, all involved should bear in mind that short–term friction is no substitute for structural reform. In–depth examination of the measures introduced by Chile would be useful. Special attention should be paid to the respective contributions of these measures, on the one hand, and of structural reforms and overall economic performance on the other, to the results obtained in terms of direct investment inflows.

Multilateral institutions have a key role to play in this process. The IMF is one, of course, because it centralises information and because it is the only institution that can provide operational guidance for this transition. That is why France backs an extension of the Fund's remit to include the movement of capital. The aim is not immediate, uncontrolled liberalisation, but rather a sequential approach to liberalisation. The OECD should also play a major role, because it can draw on nearly 40 years' experience on the part of developed countries, which have already gone through this process, have made mistakes and can share what they have learned with other countries. The OECD also has invaluable experience with regard to structural issues, such as corporate governance, which is indispensable for local implementation of the reforms proposed here.

Current Issues and Concerns in the Philippines and ASEAN

Cayetano Paderanga, Jr.

The Asian currency crisis, if the popular accounts are to be believed, came upon us like a tropical thunderstorm, sudden and without warning, overpowering even the healthiest economies. Countries left in the wake of this hurricane have been devastated. Anybody visiting any of the capitals of these nations cannot help but feel the pervasive sense of pessimism. Immediate prospects for growth are dismal, unemployment and inflation are on the rise, and expansion plans have been shelved indefinitely.

The commitment to open economies remains. In the background lies the hope and expectation that the countries are fundamentally sound and could take a short time to recover. Still, in the midst of this enveloping gloom initial doubts about the road that these countries have taken have resurfaced, some qualifications are made about the rush, as is sometimes claimed, into globalisation and financial openness. The initial anger had been directed at speculators and contagion but serious qualifications of the benefits of globalisation have followed. Initial derisive dismissal of bitter outbursts of some Asian leaders at external speculators and their proposals to reverse financial flows have been followed by second thoughts that they may have a point after all.

Laments about the behaviour of market players — sometimes pejoratively branded as speculators — have been given credence by the surge of contagion that surprised most of those involved in currency management. In a perverse form of competitive devaluation, markets — looking at the structure of manufacturing and exports in the region — formed self-fulfilling expectations about the reaction of currencies to exchange rate adjustments in other countries.

What was astonishing was the rapidity and apparent inevitability of market reactions to events in neighbouring countries. A herd instinct that could only have been rooted in inadequate information about individual countries and firms made currency management ineffective and futile.

Economic and Financial Indicators

On the other hand, there are indications that some of the economic fundamentals were misaligned. The divergence of rough calculations of the real effective exchange rate from those indicated by the maintenance of purchasing power parity had been pointed out by some of the region's economists for several months. The unfulfilled expectation of a regional response to the effective devaluation carried out by the People's Republic of China in 1994 coupled with the effective anchor of the region's currencies to the US dollar (which strengthened relative to the Japanese yen and German deutschmark in the first half of 1997) heightened the feeling of impending currency corrections. Hunches about the exchange rate were fortified by developments in the real magnitudes of the region. Trade and current account imbalances increased and export growth drastically slowed down. Doubts about the sustainability of the region's growth rates had actually shown up in economic newsletters and magazines in the year before July 1997.

The initial doubts, once recognised, were strengthened by the discovery that the region's financial sectors were dangerously stretched. Most countries had experienced a resurgence in the very rapid growth in domestic credit. Real bank credit growth resumed at 20 per cent or more, and the ratio bank credit to deposits rose beyond 100 per cent. This resulted in an increase of the money multiplier around the region. At the same time, foreign indebtedness as measured by the ratio of net foreign liabilities to deposits also increased.

During this period, industrial and manufacturing production in the affected countries were decelerating, indicating that the funds were being channelled to other areas. The result turned out to be asset price bubbles in these countries. Real estate prices, luxury consumer good prices and stock market values boomed. Serious currency and term mismatches between sources and uses of funds developed.

Impact of the Crisis

The impact of the crisis has been severe. In the Philippines for example, the currency correction has resulted in a depreciation of nearly 40 per cent and the loss of billions of dollars in gross international reserves just to counteract sudden spikes in the exchange rate. These disturbances and the exchange rate adjustment have resulted in a slowing of growth. While the GDP growth for the Philippines was originally projected to be more than 7 per cent for 1998, it is now hoped that the economy will grow by 3 per cent this year. The unemployment rate was expected to be 7.7 per cent this year; instead it reached 8.4 per cent in January. And the inflation target has had to be adjusted back to 7.5-8.5 per cent instead of the original 5.0-5.5 per cent.

The effects of the financial crisis have been compounded by the effects of the El Niño phenomenon, but there is no denying the profound impact of the crisis. In fact, given how the events have unfolded, there is reason to believe that the uncertainty and lack of information may have contributed to a vicious cycle that fed on itself. Moreover, the extent of adjustments, e.g. in the exchange rate, may have gone far beyond what was really necessary (see e.g. McKinnon, 1997).

Lessons from the Crisis

Macroeconomic Management

The first lesson is that good macroeconomic management is still important. With respect the financial sectors and the Asian crisis, one should not lose sight of the fact that there were fundamental imbalances which had been allowed to develop. Macroeconomic discipline may have slipped in the euphoria of discovering the benefits of emerging economies. This in itself may be worth noting.

As newly found confidence in the economy grew, a substantial divergence between the equilibrium rate dictated by interest rate differentials and that needed for maintaining production competitiveness occurred. While this can be tolerated for some time, economic managers need to recognise that credit tension has its limits and that at some point investors and lenders will require evidence of sustainability (e.g. trade and current account balances must soon appear bearable). Faster growth, in the end, must be anchored on fundamental reforms and adjustments to changing conditions[1].

While there may still be no universally accepted sequence of liberalisation, prior steps may need to be done before certain stages are entered. Adequate financial sector infrastructure needs to be installed before full liberalisation is attempted[2], and there must be an appropriate legal structure for bankruptcy and foreclosure. Finally, the episode also indicates the limits of the exchange rate as an anchor for inflation; it may be convenient for strengthening other anti-inflationary measures, but it must be recognised that a single exchange rate cannot remain at the same level forever. The longer it is retained, the greater the likelihood that imbalances are being created.

Financial Sector Reforms

For the moment, let me just enumerate some of the lessons on necessary financial sector reforms indicated by the currency crisis:

— clearer rules and better enforcement;

— improvement of central bank examination and supervision;

— improvements in accounting and auditing;

— development of capital markets;

— solution of maturity and currency mismatches; and

— improvement of disclosure and transparency.

As an extension of the financial sector reforms, some lessons concerning moral hazard emerge from the Asian currency crisis. The temptation to "over-borrow" has already been pointed out (e.g. McKinnon and Pill, 1996). When the government or the economy cannot afford the extent of the exchange rate adjustment (i.e. when the rate adjustment imply unbearably high economic and social adjustments), over-borrowing may also count on a guaranteed exchange rate. Because of this, supervisors need to be especially vigilant about the extent of foreign currency exposure.

Further difficulties may be related to the political economy in macroeconomic management. Powerful interests can be sorely tempted to take advantage of the interest rate differentials and implicitly make a bet on the stability of the exchange rate. This will be magnified if these interest groups perceive themselves to have special access to inside information on how hard the prevailing exchange rate will be "defended" or how much they can influence the management of that rate once the market unexpectedly reverses. If there is substantial exposure to foreign liabilities, the implicit guarantee on the exchange rate can, in fact, validate the belief of these interests no matter how accurate their initial assumption may have been.

In this connection, there may be a need to exercise even more caution in the application of universal banking in the more volatile environment of a globalised financial sector. Financial integration and the presence of contagion introduces more risks, which may not be properly recognised or discounted by banking management in the presence of moral hazard induced by deposit insurance. Allowable activities must be closely monitored[3].

On Capital Flows

It is probably difficult to arrive at a definitive conclusion on capital flows at this point. Some of the issues still need to be sorted out. First, the phenomenon of contagion indicates that markets can move without fundamental economic reasons in a particular economy. The herd instinct and speculative second-guessing can be just as powerful as any other cause. While improving information on economies, banks, and other firms may ultimately be helpful, reasonable economic policy makers may not be willing to give up control right away.

Second, market myopia along the lines of the "congestion problem" in spatial economics may be difficult to remove even with an inundation of macro and microeconomic information. As investors pour into a country or particular industries within that country, depending on the size of the inputs and ratio of individual

transactions to the whole market, there is an impact on that country's solvency and its credit rating. Yet investors or fund managers may not be able to weigh fully their individual impact on the whole market. As a result, the danger may not be recognised until it is too late. The danger is magnified if this same market atomism and myopia exists on the borrowing side[4]. This consideration may make it difficult to manage asset bubbles on the basis of providing information alone. Economic managers may require more direct instruments (which may need to be used cautiously and sensibly).

The last consideration on capital flows is related to a mismatch between the equilibrium rates dictated by the interest rate parity and by purchasing power parity. In the presence of a divergence, policy makers may need instruments to arrive at market exchange rates that provide a sustainable compromise between the two rates over the medium and long term[5].

Attitude Towards Globalisation and Markets

Policy makers and participants in the various markets will need to accept some volatility in prices and rates as the necessary cost of reaping the benefits of market efficiency. Markets allocate resources and distribute goods by using prices as a very efficient method of signalling changing conditions. Increased fluctuations are therefore part of the framework for relying more on the market for global exchange. This will enhance world output growth and distribution through increased access to capital for lower-income economies. In most circumstances, therefore, price variations should be allowed to play out. Undue dampening of these fluctuations may actually aggravate the needed adjustments when, finally, these have to be carried out. This change of the world view should be communicated to business people and the public at large. In our schools, in our training institutions and in the media, we should now start to change the message about the milieu the agents can expect to operate in, how to develop and use innovations such as hedging instruments in order to adapt to rather than resist market fluctuations. This educational task has to be undertaken rapidly and comprehensively.

Notes

1. Among others, it requires that in the process of take-off in countries like Korea, the economy will need to adjust to new factor conditions as endowment limits are reached, like when full employment of the labour force requires adjustment to higher wages.
2. See Brooks and Oh (in this volume).
3. Here we abstract from the currently discussed problems of supervision authorities over multinational banks and their branches and related issues.
4. As the economy becomes more developed and the economy/market gets bigger, this effect may diminish.
5. An example is the skilful use by the Chilean central bank of reserve requirements to try to approximate interest rate and purchasing power parity exchange rates.

Financial Liberalisation in Asia: Analysis and Prospects

Klaus Regling

How Strong and Convincing is the Case for Free International Capital Movements?

Two issues have become particularly important in the context of the Asian crisis: one is fairly general, the second more specific.

The *first* issue relates to the question of whether the case for free international capital movements is really as strong as we thought up to a year ago; or whether we have to reconsider the arguments as a result of the Asian crisis. The *second* issue concerns the involvement of private creditors in crisis management.

We are in the middle of a possibly dramatic shift in public opinion. Up to a year ago, before the Asian crisis began, the majority of financial experts, academics, government officials and the media believed that free international capital transactions were positive in general. Like free trade, free international capital flows would enhance competition and increase the efficient use of resources thus leading to more growth. As with free trade, this was considered to be positive for everyone involved: not a zero–sum–game, but a growing cake from which everyone could get a bigger slice.

Today, after the economic and social cost of the Asian crisis are becoming more and more apparent, public opinion is shifting. When the OECD Ministerial meeting in May discussed the Multilateral Agreement on Investment, for example, growing public concern about the impact of free capital flows on cultural and social values was revealed. This prompted some OECD Member countries to take a more cautious stance towards the MAI and was certainly one reason for the Ministers decided to have a "pause".

Now the first academic papers are appearing that question the benefits of free capital mobility on theoretical grounds. One example is “The Capital Myth” by Jagdish Bhagwati in the May 1998 *Foreign Affairs*. He argues that “...the claims of enormous benefits from free capital mobility are not persuasive. Substantial gains have been asserted, not demonstrated...”. A forthcoming Princeton Essay by Dani Rodrik presents an econometric study of almost 100 countries with the conclusion that “free capital mobility, all things considered, has no significant impact on countries economic fortunes”. (*The Economist*, 23 May 1998).

For the non–academic layman, there are some simple arguments that seem to be convincing.

— Without the explosive growth in capital flows to emerging markets in recent years, clearly, the subsequent crisis would not have been possible.

— Does not the performance of China and India demonstrate that high growth rates can be achieved without capital account liberalisation? Who wants to argue that China’s long–term growth rate could have been higher than 9 to 10 per cent, had capital account liberalisation been faster?

— What do we tell the Indonesian shopkeeper who has no international involvement but may face bankruptcy as interest rates on his rupiah debt move up to 60 or 80 per cent simply because Indonesian conglomerates and banks borrowed excessively in international markets?

We need to find convincing answers to these questions if we want to maintain the momentum for worldwide capital account liberalisation. As the *The Economist* said recently: “The burden of proof lies with those who favour capital mobility”. This is true. But, considering the evidence available so far, the case for capital account liberalisation remains strong.

— Can international trade be really free without free capital movements? It is difficult to see how a single market, as in the European Union, could work and reveal its full potential if EU member states still had capital controls in place.

— With the development of new financial instruments, it is becoming more and more difficult to control certain capital flows and to liberalise others, such as trade–related flows or direct foreign investment.

— Also, as Manuel Guitian of the IMF has argued, the “innovations in capital markets have provided additional channels for the circumvention of controls”[1]. In other words, it is becoming more and more questionable whether capital controls are effective and can really do the job they are supposed to do, namely to isolate a country from external shocks and give policy–makers greater monetary autonomy.

— Finally, economic progress in the world economy is inevitably linked to an efficient distribution of world savings which implies that some countries have capital account surpluses while others have capital account deficits. And if we accept the argument that competitive and free markets ensure an efficient allocation of resources, then we have to refrain from capital controls.

The IMF has the most at stake in this debate, as it prepares to include in its articles of agreement the mandate for capital account liberalisation. In the next international capital markets report, to be published later this summer, it will present theoretical arguments and empirical evidence in favour of free capital movements. Hopefully, this report will also shed some light on the Chinese phenomena of high economic growth despite a high degree of capital controls. The answer may well be, as Alan Greenspan said in a recent speech[2], that economic systems, "in which governments that exercise substantial influence on resource allocation ... can produce vigorous growth for a time when the gap between indigenous applied technologies and world standards is large, such as in the Soviet Union in the 1960s and 1970s and Southeast Asia in the 1980s and 1990s. But as the gap narrows, the ability of these systems to handle their increasingly sophisticated economies declines markedly".

No doubt, the debate for and against free capital movements will become lively. More and more academic papers will appear; we know, economists are very good at explaining *ex post* why something went wrong, the benefits of free capital are not as easy to measure as the possible cost in times of crisis.

— Financial sector crises during the last two decades in Latin America, Scandinavian countries and now Asia have cost between 10 and 20 per cent of GDP.

— The penalties for bad economic policies are higher with free capital movements. If international markets loose confidence in a government and withdraw capital, the impact on the exchange and interest rates, on stock and bond markets can be huge.

— Such financial market reactions can occur very quickly. Financial markets are more volatile than goods markets and tend to overshoot.

It is not surprising that those who have always been sceptical about liberalisation and market mechanisms now focus on these costs of free capital movements and will misuse events in Asia to present their case.

Nevertheless, attempts to control international capital flows will not work or will not be effective for very long, and would distract from the real tasks ahead of us, i.e.

i) maintaining or re–establishing macroeconomic stability which includes an appropriate exchange rate policy;

ii) strengthening the financial system, in particular its supervision;

iii) improving data transparency and disclosure;

iv) establishing appropriate accounting standards and building capacity in accounting, auditing etc.; and

v) involving the private sector in resolving the crisis.

These issues have been identified by the G–7 and others as the real problems we need to concentrate on in order to strengthen the international financial and monetary system. Weaknesses in these areas are at the root of financial sector crises. Disruptive capital flows are just the symptoms. New restrictions on capital flows will not strengthen the international monetary system.

Of course, countries that have not yet liberalised their capital account transactions should, ideally, do this as part of an overall strategy in which macroeconomic stability, proper regulatory regimes and strong institutional frameworks are in place.

Moreover, if it is true that controls become ineffective over time as globalisation continues and market pressures to open up the capital account grow, the time available for cautious, controlled deregulation may not be as long as some may wish. Hence, early and comprehensive actions are needed in all countries seeking access to international capital markets while remaining sensitive to the risk of a financial crisis.

This plea for comprehensive capital account liberalisation does not imply that certain capital inflows should not be controlled for supervisory purposes. If banks borrow offshore in US dollars to finance domestic real estate development, bank supervisors must be concerned, and alarm bells should ring if banks borrow short–term offshore and lend domestically long–term. Controls to limit such activities are necessary and should not be classified as restrictions on capital flows.

Private Sector Involvement and Crisis Solutions

However, financial crises cannot be avoided altogether even under the best of circumstances. This leads to the second issue which is how to obtain greater private sector participation resolving the crises, i.e. how to ensure that private investors carry an appropriate share of the burden when there is a crisis. This is one of the issues identified by the G–7 and others on which more work needs to be done to strengthen the international monetary system.

Recent financial market developments in Asia have highlighted the role of the private sector in crisis management. Indeed, since the end of last year there has been a remarkable change in attitude on involvement of private creditors. It is now widely accepted that the private sector, and banks in particular, should take part in financial rescue operations.

There are mainly two reasons for this change in attitude. First, it is clear from the amount of private financing involved in many cases that the public sector, i.e. the multilateral institutions and bilateral creditors, cannot meet crises alone. Second, it is recognised now that public sector support gives rise to moral hazard problems, and, therefore, that the public sector should not do it alone.

Of course, moral hazard cannot be avoided entirely. The IMF is there to help in times of crisis, to provide money and to smooth out the adjustment efforts. But policy makers and publicly–funded international financial institutions must try to limit the moral hazard problem by involving the private sector at the outset of a rescue operation; *all* categories of creditors must accept a fair share of the burden.

In this respect, the international community has broken new ground in dealing with the Korean and Indonesian crisis. Of course, every crisis is different and every country is different. Consequently, crisis management and private sector involvement needs to be tailored to the specific circumstances of each individual country. In this regard, we still do not have clear ideas how to proceed in time of crisis, in particular how to involve private creditors for all conceivable debtor–creditor relationships.

Table 1 shows the possible relations between the different debtor categories (public sector, private bank, private non–banks) and the different creditors (banks, bondholders); the situation of some countries before the onset of the crisis is indicated.

Table 1. **Possible Debtor-Creditor Relationships**

Creditor Debtor	Private Banks	Private non-banks (Bond markets)
Public Sector	*Case No. 1:* London club	*Case No. 2:* Mexico
Private Banks	*Case No. 3:* Korea, Thailand	*Case No. 4:* —
Private non-banks	*Case No. 5:* Essentially Indonesia	*Case No. 6:* Partially Indonesia

Note: Creditor-debtor-relationships shown for individual countries represent the situation before the beginning of the crisis.

Case No. 1 (upper left–hand corner) reflects the debt crisis of the 1980s with one debtor, the public sector, and a fairly homogeneous group of bank creditors. The international banking community used the London Club as a forum for rescheduling public sector debt. Solutions included reschedulings, deferments, debt and debt service reductions, debt–equity swaps, and debt reductions. According to the approach adopted at that time creditors were told no IMF money would be provided unless the banks also provided new financing and restructured their claims. This approach worked quite well in restoring orderly financial relations and providing fresh money. Since then, however, the situation has become more complicated.

Case No. 2 (upper right–hand corner) reflects, to a large extent, Mexico in 1994–95. Instead of a limited number of banks the country was confronted with a heterogeneous group of bondholders. It proved almost impossible to bring together the Mexican government with its (foreign and domestic) creditors. Unilateral action

(a moratorium) would have impeded access to international capital markets for some time and might have imposed undue economic cost. In the end, the crisis receded thanks to an up–to–then unprecedented IMF loan, US support and strong actions taken by the Mexican government. The crisis management was successful in the sense that the Mexican economy recovered rapidly. However, in a more general sense it was unsatisfactory, because it implied a complete bail out. Many private creditors got out of Mexico without losing a single cent and this experience may have contributed to unsound creditor behaviour in subsequent years, and thus to the severity of the turmoil in recent months.

In the follow–up of the Mexican crisis the Group of Ten undertook a study which was published in May 1996[3]. The study made several recommendations so that bondholders could participate more easily in the solution of a debt crisis. It suggested certain provisions in debt contracts that would *i)* provide for the collective representation of debt holders in the event of crises; *ii)* allow for qualified majority voting to alter the terms and conditions of debt contracts; and *iii)* require the sharing among creditors of assets received from the debtor.

In addition, it "recognised that in certain exceptional cases the suspension of debt payments may be a necessary part of the crisis resolution process" and concluded that it might be advisable for the IMF to disburse its loans even if the recipient countries continued to accumulate arrears on some of its international debt–service obligations.

This "lending into arrears" could both signal confidence in the debtor countries' policies and longer–term prospects and indicate to unpaid creditors that their interests would best be served by quickly reaching an agreement with the debtor. Since 1996 no concrete action has followed these recommendations, but they will be reconsidered now.

Case No. 3 reflects to an important extent the situation in Korea and Thailand before the beginning of the crisis. Domestic private banks were indebted to foreign banks. This was again a somewhat new and particularly difficult situation because a large share of the debt was short–term. When foreign bank creditors lost confidence, maturing claims were not renewed as would have been the case normally.

Initial attempts to provide Korea with enough IFI and bilateral money to substitute for the outflow of private money had to fail because the amounts were just too big. Therefore, a few days before Christmas last year, an attempt was started to convince major international banks that it would be in their own interest to stay in Korea, to rollover short–term debt and to extend maturities. This was quite successful. Since 29 December, the first working day after private creditor banks had been approached, more than 90 per cent of maturing short–term debt has been rolled over. At the end of January, an agreement was reached to extend maturities by one to three years and in the meantime a debt exchange has become effective under which $21 billion in short–term debt has been exchanged for medium– and long–term instruments.

Of course, this solution was made much easier after the Korean government assumed most of the liabilities of the Korean banking sector. To some extent this was unavoidable because a certain share of the banks' foreign liabilities had been covered by an informal public sector guarantee. Thus, Korea was no longer in a Case No.3 situation but became a Case No. 1. This is easier to solve; but it also means that the solution found for Korea is not a generally applicable model. Government guarantees, which imply a nationalisation of private debt, present particularly serious moral hazard problems.

Nevertheless, it is interesting that most observers, including representatives of large international banks, agree today that in the case of Korea, the call to bankers to stay in should have come earlier.

Case No. 4 characterises a situation which has not been an important case from the standpoint of crisis management — at least not thus far.

Case No. 5 essentially reflects the Indonesian problem. Public sector external debt does not pose a problem for Indonesia, even at a very low rupiah exchange rate, because it is mainly long–term and largely concessional. The problem lies in the private sector. Hundreds of corporations have borrowed large amounts with short maturities and in foreign currency.

This is a new phenomenon. Again, a new framework had to be developed. One key issue was whether public money should be used. However, this would have intensified the moral hazard problem and would have strained the Indonesian public sector that already had to extend massive guarantees for its domestic banking sector.

The framework announced by the Indonesian government in late February was a compromise. As part of an overall public sector guarantee for deposits and other liabilities of Indonesian banks, some of the private sector external debt was also covered. But foreign creditors and Indonesian non–banks were asked to negotiate case by case and to restructure unsustainable corporate debt.

To allow "breathing space" for these individual negotiations, a three–month debt service pause was announced as part of the framework. Since then, a bank steering committee was established which has had several rounds of discussions with the Indonesian side — not the Indonesian government — to agree on a number of principles that will govern the individual rescheduling negotiations. In early June, the steering committee was to meet in Frankfurt. Besides discussions about the corporate debt, the steering committee is also trying to come to an understanding with the Indonesian side on restoring pre–crisis levels of trade financing and of interbank lines.

If this approach works, which will be time–consuming under the best of circumstances, we may have a model of how to address problems represented by Case No. 5. Part of the solution must be that some of the foreign creditors and some of the Indonesian corporations, i.e. the owners, will have to bear some of the restructuring cost through write–downs and by closing certain enterprises. This will be particularly complex in countries that do no have in place appropriate bankruptcy procedures, like in Indonesia today.

Case No. 6 reflects another part of the Indonesian situation. Bonds issued by private non–banks were included in the debt service pause and may be restructured on a case–by–case basis. The G–10 recommendations mentioned under Case No. 2 would apply here as well.

To summarise the six debtor–creditor relations, we can say, that the solution developed for Case No. 1 worked successfully in the 1980s, while the Mexican solution in 1994-95 caused serious moral hazard problems.

The involvement of private creditors (Case Nos. 3-6) requires new solutions, on which the work is now proceeding. In some cases, the possibility of an officially sanctioned standstill should not be ruled out. However, difficult legal questions have to be examined before definitive recommendations can be made. Appropriate bankruptcy procedures will be important to find adequate solutions for overindebted private borrowers, and the recommendations put forward by the G–10 after the Mexican crisis should be reconsidered.

Role of the IMF and of Governments

What is the appropriate role for the IMF and governments of major banking centres in all this?

The IMF's job is to give economic policy advice and to support the government's reform program. Also, the IMF may act as a broker to bring together debtors and creditors. Clearly the IMF cannot impose a specific solution on market participants — and it certainly should not do so. But it is important to look into the IMF's policy, for example, in the case of arrears to private creditors. It can be expected that the consideration of standstill clauses in bond contracts and the possibility of IMF lending into areas will be reconsidered. Clearly, such measures are a restraint on capital flows. But in a crisis all creditors have to assume part of the burden. In any case, such restraints on the free flow of capital would only remain in place until an agreement between creditors and debtors had reached. More importantly, the imposition of any restraints would be subject to IMF approval to avoid abuse.

Finally, concerning the role of governments in creditor countries. I mentioned that governments talked to their banking communities about the Korean situation and also about the Indonesian situation. This was very important for getting the process going. But even G–7 government cannot, and should not, push their banks into something that they would not do by themselves. Commercial banks have to base their decisions on their own assessment of their long–term business interests. The government's role must be limited to explaining the situation, to suggesting possible approaches and to giving some assurance that certain solutions will be supported by creditors in all major financial sectors.

Notes

1. Speech to the 1998 NBER Conference by Manuel Guitian, "Capital Controls: A View from the Fund".
2. At the Economic Club of New York, on December 2, 1997.
3. Group of Ten (1996), *The Resolution of Sovereign Liquidity Crises: A Report to the Ministers and Governors*, Basle.

Part Two

Capital Flows and Stability

Asia's Financial Crisis: Is Financial Liberalisation the Villain?

Douglas H. Brooks and Soo–Nam Oh[1]

Introduction

By the end of June 1997, there were signs that Asia's rapid economic growth of the last few decades was beginning to wane, but few foresaw the breadth and depth of the financial crisis that would ensue. What became apparent was that Asia's extraordinary economic growth had outpaced its institutional development. This did not seem of great concern to many policy makers as long as the rapid growth continued, but things began to come unhinged during the 1996 export slowdown, and by the second half of 1997 the market's severe discipline had been experienced.

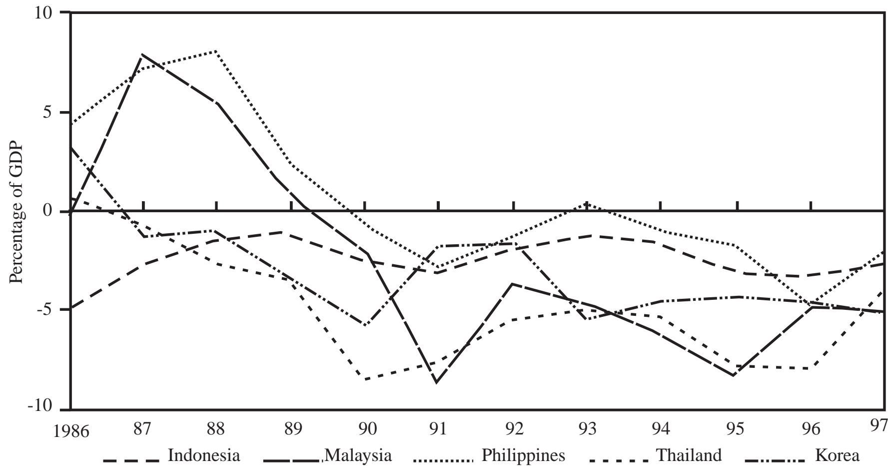
As the Asian financial crisis unfolded, some said that liberalisation was involved. Such arguments generally noted that countries such as the People's Republic of China or India, where liberalisation had proceeded much more slowly, had not been subject to the same swings in market sentiment as the more affected countries. In view of the questions about liberalisation, this paper first reviews recent trends in Asian economies and the resulting currency and financial crisis. It then examines alternative approaches to financial liberalisation, and argues that a sequential approach to liberalisation is necessary where institutional capacity needs to be developed, but that government commitment to the process and maintenance of the pace of sequencing are as important as the liberalisation measures themselves.

Asian Economic Growth and the Currency and Financial Crisis

Most East and Southeast Asian developing economies have followed what is termed an "export–led" growth strategy in recent years. In fact, most of these economies have been importing more than they were exporting and current account deficits began to increase, especially in the 1990s (Figure 1). By 1996, the current account deficit as

a share of gross domestic product (GDP) had reached almost 8 per cent in Thailand, over 6 per cent in Malaysia, and about 5 per cent in the Republic of Korea (henceforth, Korea). While substantial, these current account deficits did not cause much alarm as it was generally believed that most of the imported goods were going to be used to increase productive capacity. At the time, there appears to have been little concern for ensuring such that imports increased productive capacity *efficiently.*

Figure 1. **Current Account Balances, Selected Asian Economies, 1986-97**

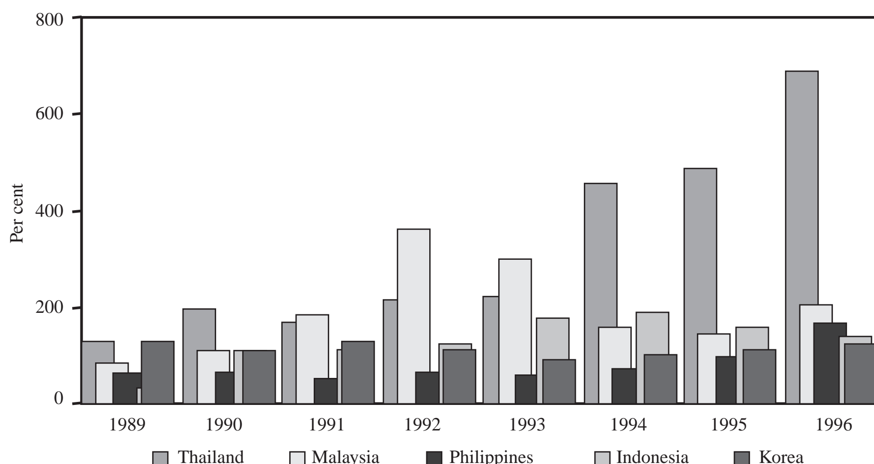


Source: Asian Development Bank, Economics and Development Resource Center data.

The current account deficits were financed by substantial net inflows of foreign capital. In the 1990s, this was increasingly private foreign capital. Foreign investors contributed sufficient capital to sustain the current account deficits, increase official reserves and even help drive up asset prices, particularly in property and equity markets. Capital inflows were largest in the People's Republic of China, but on "a cumulative basis, from 1987 through the end of 1986, Korea received $80 billion, Thailand received $75 billion, Indonesia and Malaysia received $68 billion each, and the Philippines received $23 billion. These inflows averaged nearly 12 per cent of GDP per year in Malaysia, 7.4 per cent in Thailand, 5.7 per cent in Indonesia, 5.1 per cent in Korea, and 4.3 per cent in the Philippines" (ADB, 1998).

The large capital inflows, together with high domestic saving rates, financed an extraordinary investment boom. However, they also led to imbalances and fragilities in the financial sectors of the recipient countries. The foreign liabilities of domestic commercial banks increased faster than foreign assets (Figure 2). Much of the collateral accepted for loans consisted of real estate or equities, whose recorded value contained a substantial "bubble" element. Banks were also primarily engaged in long–term lending, but borrowing short term, leading to an unbalanced maturity structure of their assets and liabilities.

Figure 2. **Banking Sector External Exposure**
(foreign liabilities as per cent of foreign assets)

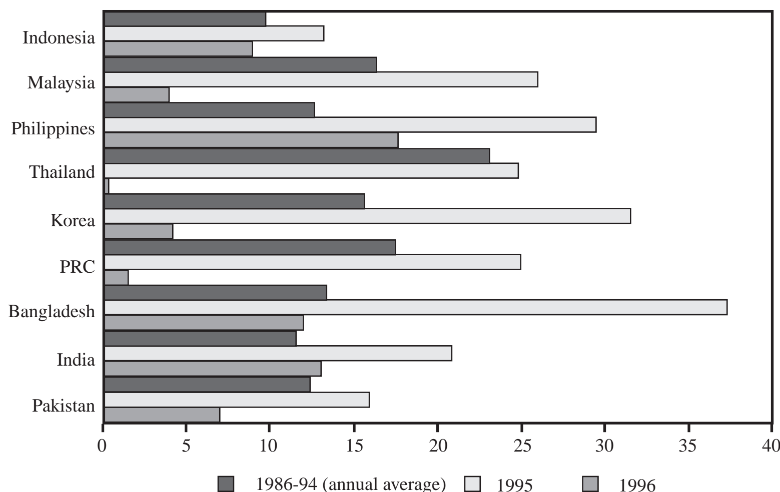


Source: World Bank data.

This large capital inflow brought substantial benefits to these countries, especially when it came in the form of foreign direct investment. However, much of it came in the form of short–term loans or portfolio investment. This portion of the capital inflow was particularly susceptible to changes in investor sentiment. Moreover, structures of corporate governance emphasized personal connections over more formalised procedures, and capital was often directed towards investment projects without careful risk assessment. In part, there was also inadequate risk assessment because economic agents in the region assumed there were implicit guarantees by governments to rescue financial institutions or companies, and that nominal exchange rates would remain effectively pegged, generally to the dollar. Belief in the implicit guarantee of financial institutions was based on the assumption that the strong political connections of the ownership of these institutions would lead to government assistance in times of financial distress. In addition, these financial entities were subject to nontransparent and lax regulatory enforcement. In a context of surging capital inflows, implicit government guarantees to creditors encouraged excessive risk–taking and led to deterioration of loan quality. Belief in the implicit guarantee that the government would absorb the exchange rate risk of foreign borrowing led to large, unhedged positions on the books of many companies.

As export growth in the region slowed sharply in 1996 and even turned negative in Thailand (Figure 3), investors' exuberance faded. The stock exchange of Thailand declined steadily from early 1996 to early 1998, while a decline in Korea's stock exchange followed a few months after Thailand's. Stock markets in Malaysia and the Philippines began declining after February 1997, and in July in Indonesia.

Figure 3. **Declining Export Growth in Selected DMCs**
(per cent)



Source: Asian Development Bank, Economics and Development Resource Center data.

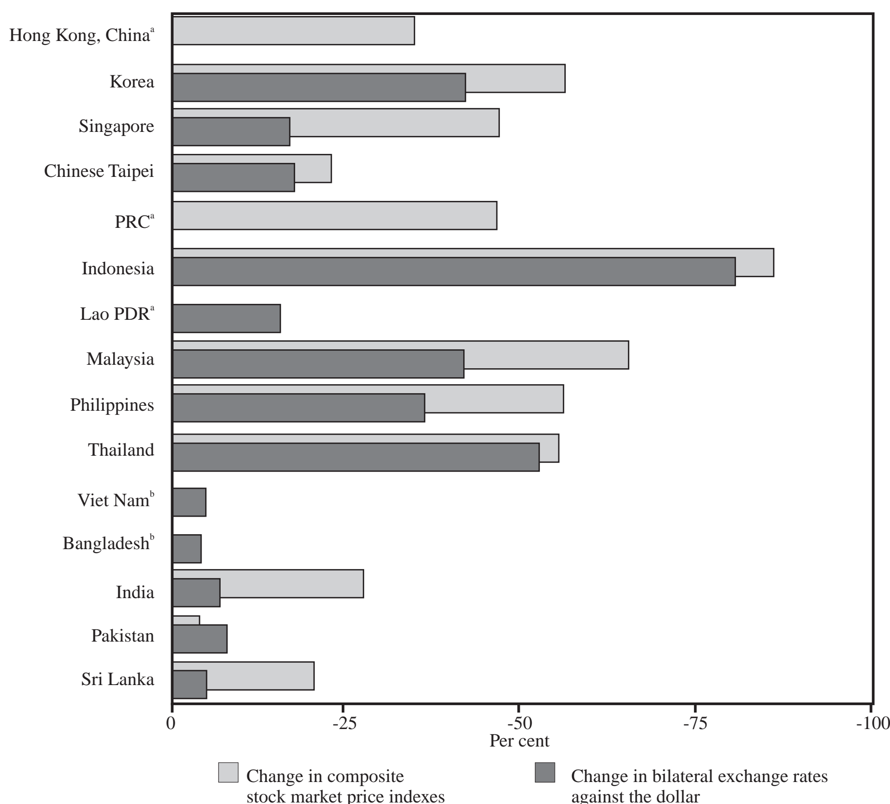
Exchange rates, in most cases linked to the dollar, which had been appreciating, came under increasing pressure. After losing a substantial amount of reserves defending the Thai baht, the Bank of Thailand let the baht float on 2 July 1997. It quickly sank by about 15 per cent in the first week alone. Having seen that market forces overpowered the Thai government, investors and speculators began to question the ability or commitment of other governments to resist such forces, and adjusted their capital flows accordingly.

From the end of June 1997 through the end of January 1998, nominal exchange rates relative to the dollar depreciated steeply in a number of Asian countries. The Indonesian rupiah depreciated by about 80 per cent and Thai baht fell over 50 per cent. The Malaysian ringgit and the Korean won each depreciated over 40 per cent, and the Philippine peso by more than a third.

Stock markets in Korea, Malaysia, Philippines, and Thailand continued to decline. Indonesia's stock market, had remained buoyant until July, but then fell precipitously. The declines in exchange rates and stock market indexes were not limited to these countries, although these were the ones most affected. Markets throughout the region (Figure 4) and as far away as Australia, Latin America, and Russia were affected.

Despite speculative attacks on a number of occasions and a sharp fall in the Hang Seng index by about 35 per cent from its level at the beginning of July 1997, the Hong Kong dollar maintained its currency board link to the dollar. The People's Republic of China also provided an important stabilizing influence for the region by refusing to devalue the renminbi despite the currency depreciations in many of its trade competitors.

Figure 4. **Changes in Nominal Bilateral Exchange Rates and Composite Stock Market Price indexes in Selected DMCs**
(June 1997 to January 1998)



a. No changes in exchange rates.
b. Stock markets data not available.
Source: Based on data from the BLOOMBERG.

The reliance on large private capital inflows for a significant share of GDP, which had been viewed as a source of great benefit, quickly revealed its liabilities when these flows reversed. Foreign direct investment remained fairly constant, but according to estimates by the Institute of International Finance (1998), the five most affected Asian countries suffered net private capital outflows of $12 billion in 1997, compared to net inflows of $93 billion in 1996. Private capital flows from commercial banks exhibited the sharpest decline. At the end of the 1997, as investors' confidence was shattered, maturing short–term debts in several economies were not rolled over. This resulted in an estimated outflow through commercial banks of $21 billion, as compared with inflows of about $56 billion in 1996. Foreign direct investment in these economies remained more or less constant at about $7 billion, approximately the same as in 1996. But portfolio investment suffered a large outflow of as much as $12 billion in 1997, in contrast with an inflow of about $12 billion in 1996. The

countries' reserves fell despite official assistance and smaller current account deficits as imports declined sharply (Table 1). Interest rates began to skyrocket in these countries, increasing debt servicing difficulties and adding to the liquidity constraint. High, unhedged debt–to–equity ratios, which had been a boon in better times now began to imperil the financial status of companies and the financial institutions which had lent to them. The debt–to–equity ratios of many firms, already high by international standards, rose further as the foreign debt component increased in local currency terms and equity values fell on local stock markets. Liquidity evaporated through the net capital outflows and tightened domestic credit as domestic financial institutions sought to shore up their capitalisation and loss provisions. The share of nonperforming loans rose dramatically.

Table 1. **Five Asian Economies[1]: External Financing**
($ billion)

	1994	1995	1996	1997*e*
Current account balance	**–24.6**	**–41.3**	**–54.9**	**–26.0**
External financing, net	**47.4**	**80.9**	**92.8**	**15.2**
Private flows, net	40.5	77.4	93.0	–12.1
Equity investment	12.2	15.5	19.1	–4.5
Direct equity	4.7	4.9	7.0	7.2
Portfolio equity	7.6	10.6	12.1	–11.6
Private creditors	28.2	61.8	74.0	–7.6
Commercial banks	24.0	49.5	55.5	–21.3
Nonbank private creditors	4.2	12.4	18.4	13.7
Official flows, net	7.0	3.6	–0.2	27.2
International financial institutions	–0.4	–0.6	–1.0	23.0
Bilateral creditors	7.4	4.2	0.7	4.3
Resident lending/other, net[2]	**–17.5**	**–25.9**	**–19.6**	**–11.9**
Reserves excluding. gold (– = increase)	**–5.4**	**–13.7**	**–18.3**	**22.7**

e = estimate
1. Indonesia, Korea, Malaysia, Philippines, and Thailand.
2. Including resident net lending, monetary gold, and errors and omissions.
Source : Institute for International Finance, 1998.

Developing Asia's financial institutions were ill–equipped to deal with the sudden surges in capital flows and the frenetic pace of economic activity associated with globalisation during the period of rapid growth. Poorly regulated banks channeled funds from savers to investors inefficiently, encouraged by rising asset prices. Standards of loan appraisal and portfolio management were generally inadequate. Weak or poorly enforced disclosure requirements led to a lack of accurate information.

As economic performance worsened, inadequacies in the underlying institutional framework became more apparent. Weaknesses in systems of regulation, supervision, and corporate governance were compounded by underdeveloped auditing and accounting standards, and legal systems that were inexperienced in, and unprepared for, major bankruptcy and foreclosure proceedings. Perverse incentives resulting from partial liberalisation measures also became apparent, as in the Bangkok International Banking Facility's encouragement of short–term external borrowing.

Korea and most of Southeast Asia are now undergoing wrenching macroeconomic and sectoral adjustments whose implications for real economic activity are only gradually being revealed. The social consequences of the crisis are likely to be serious as prices and unemployment rise. Many of those least able to protect themselves, such as migrant workers, will be severely affected. The expectations of many in Asia's emerging middle classes have been affected, and relatively weak social safety nets are coming under increasing stress.

On the other hand, the longer–term outlook for the region is more encouraging. Human capacities have not been destroyed, social and physical infrastructure remain largely intact, and policies and institutional structures that promote openness and macroeconomic stability have been strengthened. It can be expected that growth will again be stimulated by the high capacity for mobilising resources, reasonably good infrastructure, favorable demographics, an open trading system and the general commitment to macroeconomic prudence. In time, structural weaknesses in financial systems can and will be rectified. More efficient capital markets will evolve and foreign capital will return. However, developing Asia can ill afford a "lost decade", much less a "lost generation". In this context, it might be asked: Is there an alternative approach which could have led to more resilient financial systems providing the benefits of globalisation while limiting the potential drawbacks?

Alternative Approaches to Financial Liberalisation

Financial liberalisation refers to the progressive allocation of resources according to market forces rather than personal relationships or by government direction. Therefore it aims at strengthening the competitiveness of the financial sector. However, the establishment of a sound financial sector must be a prerequisite for full financial liberalisation if it is recognised that financial systems in developing capitalist economies facing uncertainty appear to be inherently unstable (Kindleberger, 1989; Minsky, 1977 and 1982).

As the Asian financial crisis revealed, proper sequencing in financial liberalisation must ensure that adequate institutional capacity exists before subjecting the economy to massive international capital volatility. There can be large potential benefits of an open capital account from increased liquidity and investment, and access to technology and new methods of corporate governance (ADB, 1995). These rewards, however,

must be balanced against the risks and the steps taken to mitigate those risks. Asian economies with closed capital accounts were spared the worst of the crisis's contagion effects. In other economies, such as in Chile and Colombia, where measures were taken to reduce maturity mismatch by lengthening the maturity structure of capital inflows, domestic economies appear to be less prone to external shocks.

At the least, adequate institutional capacities for financial regulation and risk management are needed before subjecting the domestic economy to the potentially volatile forces of an open capital account. Capital markets can contain a host of market failures, such as moral hazard, adverse selection, and a variety of externalities including those related to monitoring and networks. In this regard, the timing and sequencing of reforms can be as important as the reforms themselves in creating a resilient financial system in developing countries.

As already noted, it was primarily a cut–off of short–term bank lending that accounted for the sharp reversal in net capital inflows in the recent Asian crisis. In the rush to benefit from capital inflows, a number of steps to improve governance and capacity that should have been undertaken early on in the critical banking sectors were neglected in developing Asian economies. Once these institutional inadequacies became apparent, foreign investors were no longer eager to roll over maturing short–term loans.

Institutional capacity also plays a key role in developing well–functioning capital markets which can withstand the potential instability arising with globalisation. In particular, the market infrastructure for the trade and custody of securities, sound systems of corporate governance that protect minority shareholders' rights, and information disclosure practices are essential (ADB, 1998). Regional economies with greater capacity for risk management such as Singapore and Hong Kong weathered the crisis much better than those where investors lost confidence in sectors with poor auditing and accounting standards, inadequate prudential regulation and supervision in banking, inadequate disclosure rules, lack of transparency, and ineffective bankruptcy and foreclosure procedures.

Asia's continuing financial crisis requires broad and deep structural reforms in the region's financial sectors. Two different options are commonly advocated for achieving this goal. One option is to proceed with the liberalisation according to an optimally designed schedule, and the other is to adopt a broader, more rapid approach. We can call them the gradual approach and the big bang approach, respectively. The gradual approach, as already mentioned, would first reform and strengthen institutions as necessary to reduce the risks for economic management before undertaking liberalisation of the financial sector.

Both approaches allow governments to take the initiative in designing and implementing liberalisation. Beyond that, if one interprets financial liberalisation as a process to reduce government influence over the financial sector, these two approaches

can be clearly distinguished. The gradual approach focuses on market failures and the need to correct those failures sequentially before proceeding with further liberalisation. In contrast, the big bang approach emphasizes government failure and argues that government regulations should be replaced by market discipline at the earliest possible date.

Both approaches aim for the greatest total net benefits of liberalisation. The big bang approach emphasizes the accumulation of potential distortions which may be created by separate and inconsistent policy steps under a gradual approach. It argues that when all liberalisation policies are considered as a whole and implemented together the market mechanism will assure adjustment to the new environment, and economic efficiency can potentially be achieved quickest and at the least cost. However, there is little empirical evidence to substantiate this claim in the context of developing countries and, considering the potential consequences if it does not go so smoothly, few policy makers are likely to be willing to assume those risks.

Sachs (1990) has advocated use of the decisive and rapid approach in the transition of Eastern Europe's economies. His arguments for a swift and dramatic leap consider reform as a seamless web, and that the mammoth bureaucracies which remain in place and the sheer scale of the adjustments needed militate against a gradual approach. Even though his frame of reference was the transition from a socialist economy to a market economy, a much broader concept than financial liberalisation, Sachs's arguments can be applied to the need for urgent financial liberalisation in Asia. For example, Winiecki (1998) argues for rapid liberalisation so that international financial markets can signal warnings earlier and policy makers can react faster than in a system where government intervention is only gradually reduced.

Alternatively, the sequential approach, if properly implemented, gives priority to financial reforms according to the extent of their expected benefits and dislocations. It assumes that if the financial system is reformed step by step, it can adjust to the changing environment with minimum social and economic costs. Hence, the importance of adequate institutional capacities. The sequential approach has generally been the dominant type of economic reform in market economies.

A number of discussions of the appropriate approach to liberalisation *once institutional structures are adequate* have focused on the order of liberalisation between the financial sector and the real sector, and between the domestic sector and the external sector (Edwards, 1984; McKinnon, 1982 and 1991). The general consensus, as Table 2 shows, is that the preferred order is domestic real sector reform, then domestic financial sector reform, followed by the external real sector (trade account), and finally the external financial sector (capital account). Domestic financial sector liberalisation must precede capital account liberalisation to ensure efficient intermediation of capital inflows. Stiglitz (1998) and Feldstein (1998) support such a sequence as a way of reducing shocks to existing businesses and politics.

Table 2. **Sequencing of Economic Reforms**

	Domestic	External
	1	3
Real	• setting up a market price system • removal of implicit or explicit taxes or subsidies on firms • privatisation	• removal of trade barriers (current account) • trade account convertibility
	2	4
Financial	• domestic banking system • domestic capital markets	• removal of capital controls

Source: Gibson and Tsakalotos (1994).

Financial Liberalisation Experiences

Within the domestic financial sector, most recent financial liberalisations in developing countries and developed countries have followed the standard sequence. In each stage of liberalisation a detailed schedule was made for the measures necessary. For example, in most cases of interest rate liberalisation in domestic financial sectors, loan interest rates were liberalised in advance of deposit rates, and long–term interest rates were liberalised before short–term interest rates.

Asian countries have generally carried out financial liberalisation using a gradual approach with sequenced liberalisation, but not always in the recommended sequence or with full commitment to the reform process. Indonesia's domestic financial liberalisation was implemented step by step. The first financial reform in 1983 liberalised interest rates of state banks, abolished credit ceilings of banks, and reduced policy loans. In the next financial reform in 1988, financial institutions were allowed to offer more products and entry barriers for banks were relaxed. Similarly, capital market reforms were implemented through 1987 and 1988. In the case of Indonesia, contrary to the consensus recommendation, domestic financial liberalisation was preceded by external financial liberalisation in 1974. Achievement of the BIS-recommended capital adequacy ratio was only required by the end of 1993.

Malaysia's financial liberalisation started in 1971 with liberalisation of long–term deposit interest rates, relaxation of limitations on products offered by financial institutions, and a reduction of policy loans. However, in the middle of the 1980s, balance sheets of financial institutions deteriorated during a recession. The government reintroduced controls on interest rates to deal with this economic situation. At the same time stronger prudential regulations were introduced. Interest rate liberalisation resumed in 1987 and continued for four years.

In the Philippines, partial interest rate liberalisation started in 1980 but it did not proceed to the next step because of a crisis in the financial markets in 1981. Financial reforms were resumed in 1986, beginning with a reduction in interest rate subsidies by the central bank. Relaxation of bank entry and branching restrictions followed in 1989 and removal of most constraints on foreign capital occurred only in 1993.

In Thailand, the process of interest rate deregulation was initiated in 1980 but was soon interrupted in the first half of the 1980s. Meanwhile, prudential regulations such as a ceiling on bank share holdings and overdraft limits were introduced in 1985. Then financial institutions were allowed to offer more products and entry barriers for banks were relaxed. Interest rate liberalisation was resumed only in 1989, after the end of serious macroeconomic difficulties and a financial crisis. More comprehensive financial liberalisation and prudential regulation were implemented according to schedules laid out in two three–year plans, during 1990–92 and 1993–95. A third plan for 1996–98 has been put on hold as a result of the baht crisis.

Korea also provides an example of deregulation and recontrol of interest rates, indicating at best half–hearted support for liberalisation. Korea introduced comprehensive interest rate deregulation in 1988 only to retreat from it within two months. Interest rate liberalisation resumed in 1991, proceeded in four steps and concluded in 1997. Entry barriers in the banking industry were lowered twice, in 1982–83 and 1989–1992. Entry for securities companies and insurance companies has also been open since around 1990. In the early 1990s explicit government controls on banking management were relaxed. The importance of prudential regulations was emphasized but strict enforcement was delayed, even after the central bank became a member of BIS in January 1997. To pursue further liberalisation, Korea eventually established the Financial Reform Committee. The Committee's report recommended a financial reform programme wide in scope, but when the Asian crisis broke out, the government was still battling for hegemony in the economy before the policy recommendations had been implemented.

The United States also adopted a gradual approach and took a long time to liberalise its financial sector. The long trend toward stricter regulation ended in the late 1970s and the era of deregulation began in the early 1980s. For example, interest ceilings and entry barriers with respect to thrift institutions wishing to provide financial services previously reserved to commercial banks were removed by The Depository Institutions and Deregulation and Monetary Control Act of 1980 and The Depository Institution Act of 1982. Also in 1982, New York became the first state to endorse legislation providing for cross–border affiliation of banks. Therefore the US managed to establish its current competitive system well in advance of most other countries. One of the main features of the US financial liberalisation is that efforts by depository institutions to circumvent obsolete regulations led the government to accommodate to rapid financial innovations. Once markets had initiated liberalisation successfully, their role became more crucial in further financial development.

The sweeping, simultaneous reforms centering on the stock exchange that were put into effect in the UK in 1986, contributed the name “big bang” to this approach. The reforms included liberalisation of commissions, and abolition of the independent certification system and of the restriction on external capital investment in stock exchange members. Following the big bang, securities markets expanded quite smoothly, the level of commissions adjusted to costs and service, and London became the center of European investment banking. This offers perhaps the only example of a big bang approach in practice, and was limited to the securities market. It is important to note the strong institutional capacity present before the big bang was introduced.

The economic reform in New Zealand is another example, close to but not exactly a big bang. This reform, which began in 1984, covered not only the financial sector, but the economy as a whole. Financial reform at the initial stage included overall interest rate liberalisation, abolition of policy loans, and liberalisation of banking asset management such as by introduction of zero reserve requirements. Then entry barriers in the banking industry were removed, ceilings on equity in domestic banks for foreigners were abolished, and banks were privatised. As a result of these measures, a high level of competition in the banking industry led to an increase in non–performing loans, decline in firms’ profitability and a fall in exports. Despite such adverse effects, the government maintained consistent policies and enforced preventive prudential regulations. Largely as a result, the New Zealand economy enjoyed a remarkably good the performance in the 1990s.

In Asia, Japan recently launched a wide–ranging financial liberalisation programme. The government first took an initiative in financial liberalisation right after the first oil shock. However, due to an overly cautious approach and to the rigid dynamics of domestic financial institutions, it led only to uniformity of management and a deterioration of balance sheets. On 1 April 1998, Japan officially began what it termed a “big bang” liberalisation, which aims to embrace the principles of freedom, fairness and internationalisation: a free market based on market principles; a transparent, trustworthy market; and an international market ahead of its time. Although their scope has been called unprecedented, these measures will in practice be introduced gradually through 2001. Measures from the users’ perspective include: expanding the choices of means for investors and borrowers; improving the quality of intermediaries’ services and promoting competition among them; developing a market with further utility; and establishing a reliable framework and rules for fair and transparent transactions. For the soundness of the financial sector, speedy disposal of non–performing assets of financial institutions will be promoted, a prompt corrective action system will be introduced, and disclosure requirements will be enhanced.

Table 3 summarises these observations and illustrates the pace of financial liberalisation in Asian countries.

Table 3. **Comparison of Financial Liberalisation**

	United States	United Kingdom	Japan	ASEAN–4, Korea
1980	Gradual liberalisation The S&L crisis	The Big Bang	Gradual financial liberalisation	
1990	The appearance of new financial products		The rise and collapse of the bubble economy	
1997–98		The birth of the euro	The “big bang”	Financial crisis

Taking Stock of the Gradual Approach

One crucial lesson from financial reforms in Asian countries is that a strong commitment to realising the benefits of financial liberalisation is required to overcome the practical difficulties in implementation. Strong competition in financial markets accompanying liberalisation may encourage financial institutions to pursue aggressive asset management. This increases interest rate risk, liquidity risk, credit risk, and eventually potential systemic risk, as was apparent in Asia’s recent financial crisis. At the same time, changes in the relationships among economic variables may make it difficult to forecast accurately and can reduce the effectiveness of monetary policy. Where commitment is weak, these factors can make policy makers excessively sensitive to short–term adverse effects, and can cause liberalisation to be delayed or even reversed.

Each approach has its advantages. Most countries have considered the potential risks associated with a big bang approach as too great to experiment with. However, examination of the arguments for a big bang approach provides suggestions for mitigating potential risks beyond those generally ascribed to the gradual approach.

First, the fundamental difference between the two approaches can be highlighted by evaluating government capability. The gradual approach is based on a belief in the rational behaviour of government over an extended period and its ability to correct market failures. However, government failure can also be serious. Governments can be captured by those being regulated, there may be a lack of adequate incentives for efficiency within government, and the government does not generally have any informational advantage over the private sector and may be at a disadvantage in response time to market developments. This emphasizes the need for commitment and institutional strengthening, especially before proceeding with capital account liberalisation.

Second, when the early policy steps are informative and their mistakes less costly, a sequential approach can be preferable to a big bang approach, provided that ascent up the learning curve is rapid relative to the interim efficiency loss. The complexity of an economy may make it difficult to prioritise policies in terms of policy reversal costs and informative contribution. But again, this only argues for a cautious approach based on commitment and following institutional strengthening.

Nonetheless, these points argue for involvement of market forces, but not necessarily for a big bang approach. In the Asian context, reliance on market–based financial structures and policy instruments can help to build more resilient financial systems with less reliance on government, while still within the framework of a gradual approach (Dickie and Bond, 1997).

Recent experience provides important lessons for future financial liberalisation. The gradual approach needs to incorporate the positive aspects of the big bang approach. Recognising that the market mechanism is often superior to government, both in terms of efficiency and equity in the Asian context, the government should withdraw from the market, except for its regulatory and supervisory functions, as soon as the necessary institutional capacity is in place. The role of government should therefore be restricted to securing an environment in which the market mechanism can work well. The relevant first tasks include abolition of direct control over quantities and prices in resource allocation, and removal of implicit government guarantees for financial institutions.

To establish a sound financial sector, besides ensuring macroeconomic stability, the government has to strengthen prudential regulation and supervision, and build up capacity in accounting, auditing, etc. To protect the financial system from unexpected internal and external disturbances, the government has to develop and monitor indicators to identify unusual movements in the markets, and it has to prepare appropriate safety net mechanisms. In particular, the government has to establish strong regulatory agencies with clear mandates, which have to be responsible for preventing fraud and constraining risk–taking to levels commensurate with the capital positions of financial institutions. At the same time they must be designed to keep arms–length relationships with entities being regulated.

Furthermore, the scope of financial liberalisation should be extended according to each country's conditions overall. The crucial recommendation in this paper is to liberalise financial markets as much as the market mechanism can replace the government's role, and as fast as the institutional capacity can accommodate new economic developments, in particular in the financial sphere. At the same time, the risks must be balanced with the rewards of capital account liberalisation.

For the ASEAN–4 and Korea, financial liberalisation that is underway needs to be comprehensive to address all major problems of domestic financial institutions and financial markets. Moreover, it could be implemented simultaneously with domestic and external real sector liberalisation. In the case of Japan, where institutional structures are more developed, it could be further expanded to include the foreign financial sector as well.

Difficulties in meeting the necessary prerequisites should not be exploited as a reason for delaying financial liberalisation. Instead, governments should prepare the fundamentals as quickly as possible. Financial liberalisation, as such, was not the villain in Asia's financial crisis but as it had been implemented without the necessary institutional prerequisites, especially before opening the capital account, it can no longer be viewed as the unquestioned hero, as it was formerly perceived to be in much of Asia.

Note

1. The authors are economists at the Asian Development Bank. The views expressed are those of the authors and do not necessarily reflect the views or policies of the Asian Development Bank or its member countries.

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Creation of Market–Based Financial Structures and Policy Instruments to Facilitate Increased Capital Mobility in the APEC Region

Paul M. Dickie and Marian Bond

Introduction

The economic dynamism of the APEC (Asia-Pacific Economic Cooperation Council) economies has been accompanied by their growing integration into the global economy. This increased integration has been fostered by broader financial liberalisation which has allowed greater access to international capital markets. The liberalisation of both domestic and external financial transactions has offered significant benefits through improved financial efficiency and increasing competition in domestic financial systems. These efficiencies take the form of reduced costs of capital, higher returns with diversification for savers, greater capacity for economies to manage real shocks, and increased market discipline for improving domestic performance. At the same time, greater capital market integration and open capital accounts can lead to increased financial risks if they are not accompanied by appropriate macroeconomic and financial policies. Increased capital market integration can also make economies more susceptible to external financial shocks and contagion[1]. In their adjustment to more open and liberal environments APEC economies need to ensure that their financial sectors become increasingly resilient to disruption by using market–based policy instruments to maximise the benefits from capital mobility while at the same time reducing the attendant risks.

To achieve financial stability and truly resilient financial systems capable of further integration with international capital markets, financial markets in emerging APEC economies need to mature and deepen so that their operational outcomes are fully compatible with market forces. This can only occur within a framework which provides effective market discipline to keep banks prudent and transparent. Without free interest rates, for example, financial markets can never mature. Without full and accurate disclosure and information, sound economic decisions cannot be made. Without

allowance for market entry and exit, the financial institutions operating in those markets will never feel the competitive challenges necessary to achieve the required resilience. To build resilient financial systems in APEC economies, market–based policy instruments are required that can effectively guide the economy in the face of increased capital market integration.

The type of monetary and exchange rate policies has become a major determinant of the performance of financial systems in APEC economies. For example, incompatible monetary and exchange rate policies in some emerging APEC economies have created incentives for the private sector to build up external debt. This incompatibility has led to the use of reserve requirements to control domestic liquidity. Such measures will eventually promote nonbank financial institutions to the disadvantage of banks and will weaken the financial system. By adopting more consistent policies, stronger financial systems will emerge. For that reason many APEC emerging economies are adopting floating exchange rate systems which will allow them to reduce the use of reserve requirements. While managing short–term exchange rate volatility has its costs, such volatility permits more independence in monetary policy as well as promoting currency matching in funding and investment.

In building resilient markets it is necessary to understand, first, why financial markets are prone to instability, and then, how market–based instruments and competitive institutions can make markets work better, thereby reducing the potential for instability. APEC member economies reveal a variety of experiences relating to the functioning of the markets and institutions that make up the financial system, to market failure and other forms of financial instability, as well as to policy reforms that have improved the working of markets. Although it is difficult to generalise or develop standardised prescriptions, some features stand out from these experiences which can serve as guidelines for the development of financial markets, institutions and policy instruments that will build resilient financial sectors, capable of integration with international capital markets.

Periods of financial instability often follow periods of rapid economic growth during which substantial variations in the relative performance of the economic sectors have taken place. These variations in turn reflect major fluctuations in relative prices and general business conditions and have sometimes led to large movements in key asset prices. Instability is also marked by external shocks, balance–of–payments difficulties and sharp adjustments in exchange and interest rates. Where there are large foreign exchange exposures and the banking sectors' assets are of low quality, instability has sometimes led to a full–blown financial crisis. Large devaluations associated with these problems have also impaired the ability to service debt with dollar–denominated loans and magnified the losses of banks with large foreign exchange exposures.

This paper examines some of the causes of financial instability in markets of the APEC economies and considers the extent to which the financial institutions (especially banks) are market–based. It then discusses what steps policy–makers can take to improve the functioning of financial markets to facilitate increased capital mobility.

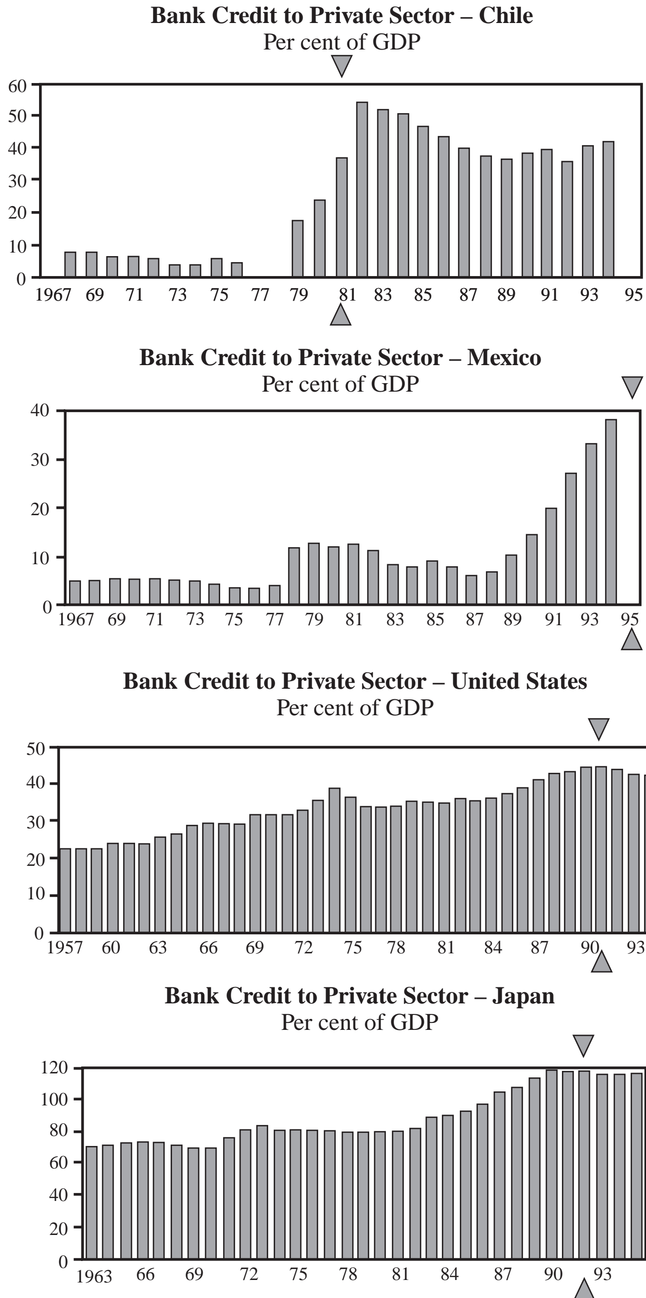
Financial Markets

The sources of financial instability related to markets are not all that clear. However, the problems that some APEC economies have experienced in the past, or are currently experiencing, have some major common elements. Instability appears to arise from excesses emanating from asset prices in relation to the business cycle, often driven by an excessive expansion of bank and other credit. Although financial cycles are not necessarily directly linked to the recurrent nature of business cycles, they are related to the sequence of boom and bust in a particular class of asset prices, where the prices tend to rise exponentially over the financial cycle, and then collapse with varying degrees of volatility. These financial cycles are brought about in large measure by asset market prices overshooting longer–term underlying values[2]. While this overshooting happens frequently, it is quite rare that overshooting results in speculative bubbles in asset prices which, when they collapse, lead to major consequences for the entire economy. The bursting of the equities bubble in the early 1990s in Japan is perhaps the most notable example in recent years; real estate values in various parts of the United States have also experienced major fluctuations that caused serious dislocations. Kim and Moreno (1994) noted that in the early 1990s, the decline in the Nikkei stock price appeared to have greatly contributed to the sluggish growth in bank lending in Japan.

The expansionary phase of the business cycle, when real growth is rapid, is often accompanied by a high rate of credit expansion because borrowers can more easily pass balance sheet and liquidity tests for new loans. These new loans finance investments in real assets whose values generally decline in the business downturn, thereby impairing the security for the loans[3]. Gavin and Hausmann (1995) found that an increase in bank credit to the private sector as a percentage of GDP preceded the financial problems in Chile (1981), Mexico (1982), United States (1983) and Japan (1991) (see Figure 1). The onset of recessionary conditions together with sharp downward pressures in asset prices figure prominently in banking crises because of the lower collateral underlying the loans and the often high concentration of loans in more vulnerable assets such as equities and real estate. In emerging market economies, banks that had developed under tight regulation often lacked the experience to evaluate credit risks properly in a newly liberalised environment. Some took too many risks, with a tacit expectation of official support should they run into trouble, and in many instances, the system of prudential oversight was not tightened sufficiently to cope with greater risk.

The risks of financial instability arising from volatility in asset prices going beyond price changes brought about by supply and demand are considerably higher where there is an open capital account. This is because inconsistent macro and financial policies can lead to considerable divergence between domestic and external market conditions, which provides opportunities for speculators. Volatility can also be greater where domestic markets are quite thin, for example, in equity markets in emerging economies.

Figure 1. **Bank Lending Booms and Banking Crises**



Source: Gavin, M. and R. Hausmann (1995), "The Macroeconomic Roots of Banking Crises", paper presented at IADB Conference on “Banking Crises in Latin America", Washington, D.C., October.

Money and Foreign Exchange Markets

The task of monetary policy has been complicated by capital account liberalisation and greater freedom for domestic financial institutions to engage in international transactions. The enormous growth of financial markets, combined with more open capital markets, has permitted larger inflows of foreign capital and larger and more persistent current account deficits, which accentuate the familiar policy dilemma between targeting the exchange rate or interest rates. Problems have arisen particularly in the emerging APEC economies of Asia where exchange rates were fixed or floated within a narrow band, but unlike Hong Kong many Asian economies did not mirror US monetary policy. For example, in Thailand and the Philippines, domestic and foreign interest rates diverged and businesses had an incentive to borrow short–term US dollars to finance local currency businesses or assets. When fixed foreign exchange rates get out of line with fundamentals opportunities are provided for speculators. Such mismatches can leave the banking system highly exposed if large current account deficits eventually cause a sizable devaluation.

The creation of the Bangkok International Banking Facilities (BIBFs)[4] in Thailand in 1993, which were required to borrow in foreign currency, together with a fixed exchange rate and high domestic interest rates set the scene for Thailand's property boom and the banking system's current difficulties. At the time, Thailand was reluctant to allow the exchange rate to rise to restrain capital inflows, and as foreign exchange reserves rose sharply the perceived risk of exchange rate losses was quite small, and the finance companies' high exposure to the property sector was not seen as risky. Asian economies, such as the Philippines (see Appendix 1) have learned that some foreign exchange volatility must be accepted with the increasing integration of capital markets.

In many APEC emerging economies, capital inflows were accompanied by fixed exchange rates to preserve competitiveness in international financial trading markets. This posed inflationary risks, which varied across countries, depending on the monetary policy framework and differing institutional arrangements and instruments. The extent to which countries could sterilise the inflow of funds and the difficulties they faced also depended on their monetary arrangements, institutions and instruments. Among emerging economies a currency board system was in place only in Hong Kong, where the currency is pegged to the US dollar, and where to minimise the gap between external and domestic interest rates, nominal domestic interest rates were kept below the level compatible with domestic demand pressures. In other emerging APEC economies with fixed exchange rates or fluctuating bands (Chile, Indonesia, Mexico) or periodic adjustment (Korea), the impact of sterilisation policies on interest rates depended on the openness of financial markets and their exchange rate policies. In some economies interest rates fell in nominal terms but in others, including Indonesia, Korea and Thailand, they remained well above US dollar rates which increased the incentive for short–term capital inflows. This led to a build up in demand pressures which, in some economies, were controlled through constraints on domestic credit from banks, or by increasing reserve requirements (Chile, Korea, Malaysia and the Philippines[5]), which distorted banking systems and had adverse effects on bank profits.

With the downturn of export markets in the context of fragile financial sectors and high current account deficits, currencies, particularly in Asian APEC emerging economies, came under pressure and were supported by intervention. In some economies the loss of reserves brought about by speculators forced the adoption of more flexible exchange rate regimes, especially in Indonesia, Malaysia, the Philippines and Thailand, under which exchange rates can adjust to changing economic conditions (see Appendix 2). However a freer floating regime will put great pressure on the region's financial systems unless they move to a more market–oriented monetary system; and emerging Asian economies will need to develop further indirect monetary instruments consistent with floating exchange rate regimes. Money markets and, in particular, the interbank market, are essential for open market operations that will enable central banks to reduce the burden of reserve requirements on banks and allow them to meet the growing competition from nonbanks and financial markets. During the recent turmoil, Asian economies have learned that some foreign exchange volatility needs to be accepted in the growing integration of capital markets. Restoring confidence in these economies will depend to a large extent on the official commitment to market–oriented financial policies.

Capital inflows to many emerging APEC economies have grown considerably during the 1990s[6]; more recently a higher proportion of these capital inflows have been short–term in nature and outstanding bank lending to Indonesia, Korea, Malaysia and Thailand increased considerably between 1995 and 1996, as shown in Table 1. Higher short–term funding accompanied by higher current account deficits may have been one of the reasons why foreign investors considered that the riskiness of investing in some of these emerging economies had increased.

Table 1. **International Bank Lending to Selected APEC Emerging Market Economies**

	Outstanding ($ billion)		Distribution by maturity (end–1996)		Distribution by sector (end–1996)		
Economy	mid-1995	end-1996	1 year or less	Over 1 year	Banks	Public Sector	Nonbank Private Sector
Chile	11.7	15.2	51.2	46.3	24.4	11.1	64.4
People's Republic of China	43.0	55.0	48.9	43.2	41.4	15.4	43.1
Indonesia	40.4	55.5	61.7	34.1	21.2	12.5	66.2
Korea	71.4	100.0	67.5	20.0	65.9	5.7	28.3
Malaysia	14.7	22.2	50.3	36.1	29.3	9.0	61.7
Mexico	59.2	61.3	45.8	42.9	21.1	36.4	42.5
Chinese Taipei	25.6	22.4	84.4	13.8	57.8	2.1	40.0
Thailand	53.6	70.2	65.1	30.2	36.9	3.2	59.6

Source: Bank for International Settlements, *The Maturity, Sectoral and Nationality Distribution of International Bank Lending*, July 1997.

Equity Markets

Most APEC economies have made great strides over the last decade in establishing and invigorating equity markets, mainly as a result of strong economic growth coupled with concerted government efforts to foster equity market development. As a ratio of GDP, equity market capitalisation (which reflects the equity market's ability to mobilise capital) in Hong Kong, Malaysia, and Singapore has exceeded the ratio for the United States, and in economies such as Chile, the Philippines and Chinese Taipei, the ratios of market capitalisation to GDP are close to averages in advanced economies. Market capitalisation is lower in other APEC economies, including Korea and Mexico.

Table 2. **Stock Market Development in APEC Economies**[a]
(market capitalisation as per cent of GDP)

Economy	1986	1996
Australia	57.4	78.0
Canada	45.5	83.5
Chile	25.6	94.5
People's Republic of China		13.9
Hong Kong	134.1	290.8
Indonesia	0.1	41.0
Japan	88.8	71.6
Korea	13.9	30.1
Malaysia	54.7	314.7
Mexico	6.9	33.0
New Zealand	79.3	58.6
Philippines	6.6	96.8
Singapore	95.7	158.5
Chinese Taipei	19.1	100.3
Thailand	6.9	54.8
United States	63.2	112.0

a. Papua New Guinea and Brunei Darussalam do not, as yet, have stock markets.
Sources: *Emerging Stock Markets Factbook*, 1994 and 1997. *International Financial Statistics*, 1987, 1990 and July 1997. Statistical Database System (SDBS), ADB.

In most APEC emerging economies a general consensus exists that governments should play a key role in creating an environment that will foster expanding, competitive and efficient equity markets and encourage private sector participation through investor confidence. Government policy has played a particularly important role in promoting equity market development in Korea, Malaysia, Singapore, Chinese Taipei, and Thailand, and many of the restrictive controls to equity market development were removed in the 1980s. A particular example is the Malaysian Securities Commission, which has set a major goal of moving towards full disclosure–based regulation. Phase I, which ran from 1993 to 1997 set up new policies for the issue/offer of securities,

flexibility in pricing initial public offers, and listing companies without a track record. Under phase II, scheduled to run from 1998 to 2000, market forces will dictate pricing, valuation, and proceeds for all corporate proposals. Phase III will stress stronger enforcement against breaches of securities laws, regulations and rules. Many APEC economies have made notable progress in improving enforcement in recent years, especially Korea, Hong Kong, Malaysia and Thailand, where statutory regulations are enforced by the Securities and Futures Commission. Many economies have also developed, or are working towards, a disclosure–based system similar to the US system. For example, Thailand has increased the emphasis on disclosure standards in the public offering of securities, and in Korea, Malaysia and Thailand, regulators have played a key role in fostering the growth of the capital market. In Korea and Thailand, the government and regulators are involved in supporting the market through the creation of special purpose funds. In Thailand, the SEC has been a pioneer in developing the bond market. Regulators could also take a cue from a study by Chakravarty and Sarkar (1997) which shows that trading abuses can be mitigated by encouraging competition between brokers rather than banning dual trading, which was found to be beneficial to the market overall.

However, the volatility of equity prices in APEC emerging markets is higher than the volatility in advanced markets, as can be seen in Table 3 which shows equity prices in APEC economies in local currencies. In particular, Thailand, Malaysia, and the Philippines have experienced high volatility in equity prices over the past year[7]. The higher volatility can be attributed in part to their less developed legal infrastructure and enforcement mechanisms, which have failed to keep up with the development in securities markets. Markets of emerging APEC economies are also relatively thin, which brings more volatility in prices. Recently in the emerging Asian economies, speculators have also tended to short the equity markets at the same time they shorted concerned currencies[8], adding to volatility in these markets.

In some economies, various forms of restrictions on foreign ownership of stocks of companies have been imposed (Chile, the People's Republic of China, Indonesia, Korea, Malaysia, Mexico, the Philippines, Singapore, Chinese Taipei, and Thailand). Some of these restrictions are statutory, such as provisions limiting foreign ownership to 20 per cent of the total share–holding of a company or requiring that foreign mutual funds leave capital in a company for a minimum of five years. Others are imposed through a company's article of incorporation. Recent research on Singapore stocks has shown that imposing limits on foreign ownership reduces the market value of firms[9]. A transparent framework in which equities can be bought and sold in efficient competitive financial markets by both domestic and foreign investors helps to deepen these markets as well as to reduce price volatility or contagion. Deepening these markets will also help to contain the vulnerability of these countries to contagion brought about by market perceptions.

Table 3. **Equity Prices in APEC Economies**
(in local currencies)

Economy	(Exchange/Index)	end–1996	end–June 1997	end–1996 to end–June 97 (% change)	31 Oct 97	end–June 97 to 31 Oct 97 (% change)
Australia	(Sydney/All Ordinaries)	2 424.60	2 725.90	12.4	2 464.80	–9.6
Canada	(Toronto/TSE Index)	5 927.03	6 424.00	8.4	6 833.70	6.4
Chile	(Santiago/IPSA General)	4 902.59	5 727.15	16.8	5 071.22	–11.5
Hong Kong	(Hong Kong/Hang Seng)	13 451.50	15 196.79	13.0	10 623.78	–30.1
Indonesia	(Jakarta/Composite Index)	637.43	724.56	13.7	500.42	–30.9
Japan	(Tokyo/Nikkei 225)	19 631.35	20 604.96	5.0	16 458.94	–20.1
Korea	(Seoul/Composite Index)	651.22	745.40	14.5	470.79	–36.8
Malaysia	(Kuala Lumpur/Composite)	1 237.96	1 077.30	–13.0	664.69	–38.3
Mexico	(Mexico City/Bolsa)	3 361.03	4 436.52	32.0	4 636.02	4.5
New Zealand	(Wellington/NZSE–40)	2 359.64	2 501.96	6.0	2 355.83	–5.8
Philippines	(Manila/PSE Index)	3 170.56	2 809.21	–11.4	1 818.09	–35.3
Singapore	(Singapore/Straits Times)	2 216.79	1 987.95	–10.3	1 586.07	–20.2
Chinese Taipei	(Taipei/Stock Market Index)	6 933.94	9 030.28	30.2	7 313.40	–19.0
Thailand	(Bangkok/SET Index)	831.57	527.28	–36.6	447.21	–15.2
United States	(NYSE/The Dow)	6 448.27	7 698.58	19.4	7 448.22	–3.3

Source: International Herald Tribune.

Real Estate Markets

Apart from equity prices, real estate prices are the most important for financial market perceptions. Real estate prices are driven by many of the same forces that drive equity prices such as bank credit, real growth, and inflation expectations. Property price booms in the emerging markets, particularly in Asia, have been comparable to those in the advanced APEC economies. In some emerging economies, price cycles have been shorter than in others depending on the responsiveness of property prices to excess supply conditions. In Hong Kong and Singapore, price cycles have been shorter than in Korea, Malaysia, the Philippines or Thailand. Real estate prices figured prominently in the finance companies that were closed in Thailand and press reports suggested that the real estate markets were collapsing all across Asia. The actual situation has been quite different.

Instead of real estate prices plunging in the third quarter of 1997 with the decline in most Asian currencies and stock markets, many of Asia's property markets, particularly in Southeast Asia have opted to stay firm, hoping that the turbulence will soon pass. Many developers have preferred not to sell rather than to lower prices to levels that would clear inventories. Nevertheless, such actions could be futile and, in

any case, they add to the potential problems for the banks and other financiers. The potential problems are more pronounced in countries like Thailand which finance construction costs mainly through bank borrowing. The Philippines stands in contrast as most property developers pre–sell to speculators and other investors, and build only when they have sold enough space to cover construction costs.

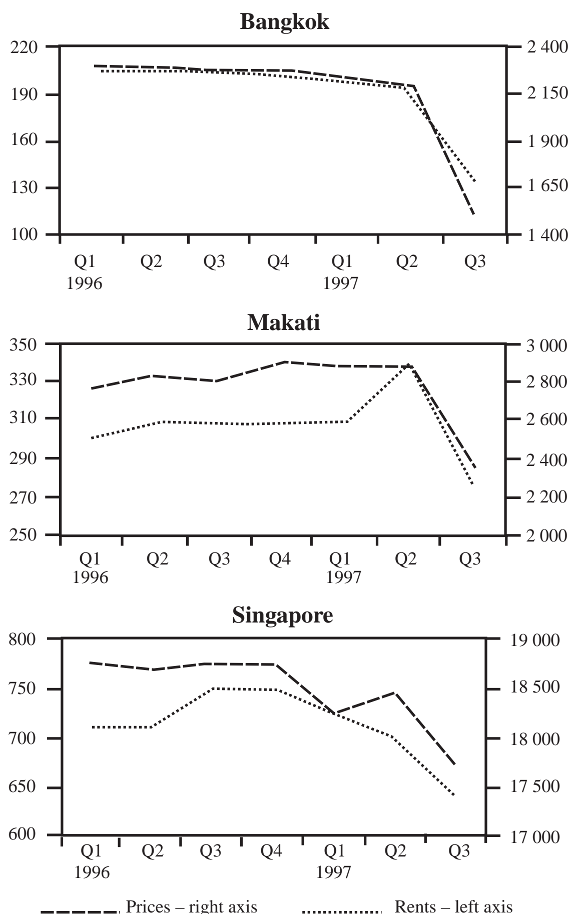
Although the real estate market in Thailand exhibited a 30 per cent across–the–board decline in US dollar terms during the third quarter (Figure 2), prime office prices dropped only 4.4 per cent in baht terms, while rents were down only 2 per cent. Despite the cancellation or postponement of half a million square meters, or 25 new office projects, in 1997, Thailand still suffers from a fundamental property oversupply, with too much new space scheduled to be available in the next couple of years. In Malaysia, prices and rents remained unchanged despite a 30 per cent drop in the value of the ringgit against the US dollar. Meanwhile, in Indonesia and the Philippines, while rents and prices remained largely unchanged during the third quarter, developers who needed cash were offering 20 to 30 per cent discounts off listed prices.

Forward Markets

Along with the growing interdependence of national financial markets, in large measure the result of capital market integration, there has been an enormous growth in markets for financial futures and derivatives. These markets have responded to the greater flexibility in prices, interest rates and exchange rates that accompany more open capital accounts. There are currently around 70 derivative exchanges operating in the world, and trading in financial futures and options accounts for around 75 per cent of their trading volume. Although the most successful futures and options exchanges are in the advanced APEC economies, with the opening up of financial markets to foreign competition, governments in emerging economies are recognising the need for futures and options markets and are beginning to establish their own financial futures exchanges.

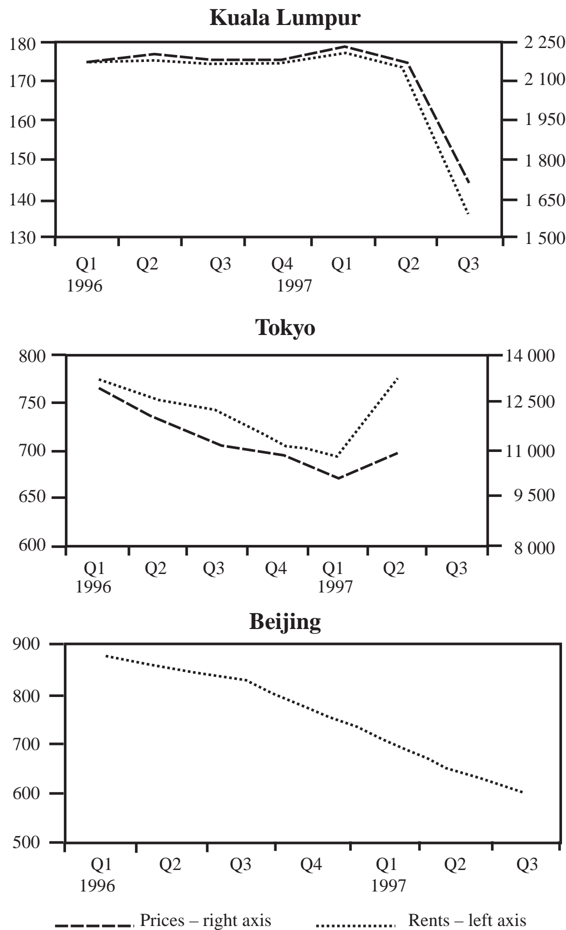
Financial futures exchanges are being developed in a number of APEC economies. For example, the Korean Stock Exchange (KSE) started trading futures on the Korea Composite Stock Price Index in May 1996. The Ministry of Finance also granted the KFE temporary permission to offer future contracts on interest rates and currencies, and trading was to commence as from 1998. The Malaysia Monetary Exchange (MME), a subsidiary of the Kuala Lumpur Commodity Exchange (KLCE), opened in 1996 and started operating in May of that year with a futures contract on the Kuala Lumpur interbank offered rate (KLIBOR). The MME recently announced plans to trade currency futures. Futures on two Chinese Taipei stock exchange indices, the Dow Jones Taiwan stock index and the Morgan Stanley Taiwan stocks index, are traded on the Chicago Mercantile Exchange and the Singapore International Monetary Exchange, but these futures contracts can only be traded outside Chinese Taipei, though futures commission merchants can take orders for approved contracts.

Figure 2. **Average Prices and Rents for Prime Office Properties in Major Cities in Asia***
(in dollars per square metre)



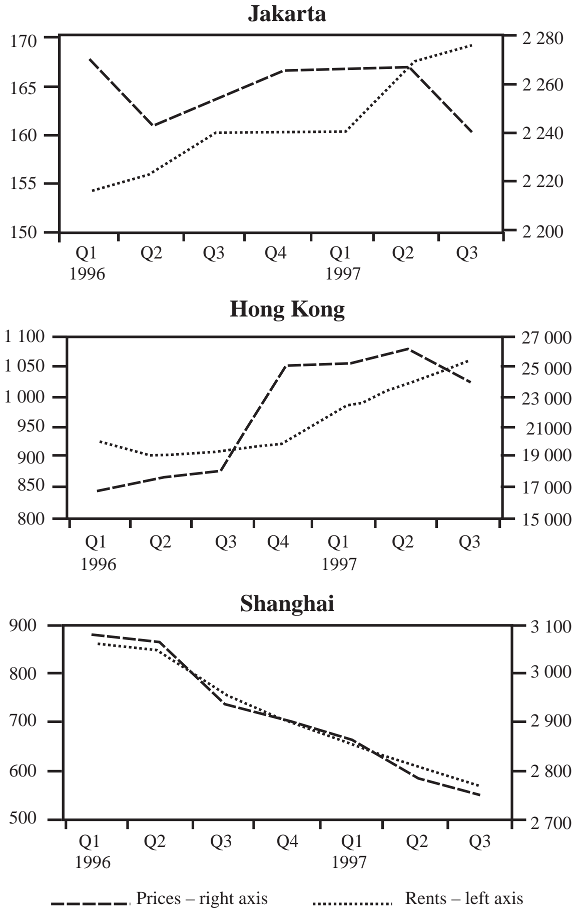
However, despite the need for futures markets in APEC economies, progress in developing these markets has been slow. Part of the reason for this is the underdeveloped nature of financial sectors. Until recently, exchange rates in many of these economies were pegged to baskets and there appeared to be little need to hedge against currency risks. In many emerging market economies, potential institutional customers do not see the need to hedge and do not understand derivatives, and consequently do not want to use them. They also do not have the necessary risk–management systems in place. In many emerging economies, stock market trading is predominantly retail and quite speculative, and retail investors are used to investing in individual stocks, rather than indices or future indices; they are also unused to the idea of being subjected to frequent margin calls.

Figure 2 continued. **Average Prices and Rents for Prime Office Properties in Major Cities in Asia***
(in dollars per square metre)



In emerging economies, governments are developing instruments such as interest rate and currency derivatives only slowly over time as they believe they will make control of interest rates and exchange rates more difficult. Restrictions on short selling, on branching and licensing, or regulations protecting financial institutions from competition, all prevent the development of these markets, as do poor accounting procedures. For example, accounting practices in Korea allow domestic firms to report the value of securities at their purchase price without reporting any losses in portfolio value. This has led to an unwillingness by domestic firms to take advantage of arbitrage opportunities because in doing so they would realise losses on the securities they hold — the value of securities in Korea has fallen by 35 per cent over the past two years.

Figure 2 end. **Average Prices and Rents for Prime Office Properties in Major Cities in Asia***
(in dollars per square metre)



* As of third quarter 1997. Prices and rents in most Southeast Asian property markets reflect currency devaluations rather than actual falls in local currency terms.
Source: Jones Lang Wootton, Ltd.

Developing comprehensive and uniform reporting methods will make the risk of derivative activities more transparent and highlight potential problems requiring supervisors' attention[10].

Restrictions on short selling have also hindered arbitrage activity in Malaysia and banks have been so protected from competition that most of them have not needed to use derivatives. However, the greatest constraint on retail participation in stock index futures in Malaysia is the low settlement of equity transactions, which allows

speculation in equities without putting up any margin. In Chinese Taipei, decisions such as on the type of trading system (electronic or open outcry) for the futures exchange, delayed the operations of the Taiwan Investment Mercantile Exchange (TIMEX). In the Philippines, banks have had to obtain a license under central bank guidelines to trade in the derivatives market.

Many emerging economies have also adopted rules that limit foreign ownership of domestic firms, usually by restricting the percentage of a firm's stocks that foreigners can own. This has curtailed foreign interest in equity and derivatives markets. Recently, for example, foreign investors in Korea were limited to 30 per cent of the average open interest, and are therefore restrained from arbitrage and other participation in futures. On the other hand, on 5 September 1997, Indonesia eliminated the 49 per cent foreign ownership restriction on listed companies as well as on initial public offerings.

With the recent depreciation of the currencies of Asian emerging economies and the move to floating exchange rate regimes, there is a high demand for instruments to hedge local currency exposure, particularly by equity fund managers interested in hedging currency risk. However, now that the risks in some Asian countries are perceived to have risen considerably, instruments for hedging have become scarce. Prior to the Asian currency crises, foreigners could hedge exposure to assets in economies such as the People's Republic of China, Korea, the Philippines and Chinese Taipei by purchasing nondeliverable currency forwards (NDFs); these were the only hedging instruments available to foreigners because onshore currency forward markets are off–limits to foreigners. These NDF markets were flourishing prior to the crisis with trading volumes growing dramatically as foreign investors and companies with increasing activities and investments in Asia hedged their currency risks by selling Asian currencies forward.

Following the crisis, many banks in Singapore have cut back their activities in NDFs. In particular, liquidity in the Philippine peso NDFs was hit as the central bank (in July 1997) limited the amount of dollars local banks could hold and required prior approval before banks could sell foreign exchange through the NDF market. This new regulation, however, may have hindered demand for genuine hedging. The central bank also cut the banks' overbought dollar limit to 10 per cent from 20 per cent of their capital. Recently the costs of short positions have risen enormously as investors and market makers have traded Asian currency risk at considerably higher prices. Philippine one–month NDF rates have risen to 30 per cent from 13–15 per cent since Asian currencies started depreciating, one–month won rates have risen to 14 per cent from 8–9 per cent, and one–month New Taiwan dollar NDFs have risen to 9 per cent from around 6 per cent prior to the crisis. In the long term, with new floating exchange rate regimes, Asian NDF markets will continue to grow and will eventually be replaced by other futures markets. In the short term, currency hedgers will be forced to seek other channels to fund their requirements. With the growth of interest in international institutional investors in emerging APEC economies and securities and the rapid growth of hedge funds[11], institutional investors are finding more inventive ways of shorting weak currencies, particularly through rapidly growing equity markets. As the cost of local currency increased in the emerging Asian economies, speculators also shorted equity markets at the same time they shorted concerned currencies by selling foreign holdings of stocks as a way to obtain local currency.

Financial Institutions and the Market

Competitive financial institutions are in the best interest of most economies because they bring cost efficiency. However, with financial institutions (banks and nonbanks) a balance has to be struck between efficiency and promoting financial safety. Financial safety must be combined with the need to minimise adverse effects on efficiency, competition and innovation, so that institutions can enter the market when there is a demand for them and exit when they are no longer profitable.

It is perhaps useful to view banking within the context of financial markets. Banks as institutions can only survive as long as they provide intermediation more efficiently than borrowers and savers can by concluding contracts independently or through a broker. The bank is a true intermediary in becoming a party to the financing activity. Banks hold non–marketable securities in the form of loans, which they monitor and perform an enforcement function with respect to the loan agreements. The acceptance of the fixed value of the deposit liabilities to finance these loans puts banks in a high–risk situation and provides strong incentives to ensure effective monitoring and enforcement of the loan portfolio[12]. Banking theories suggest that borrowers about whom little is known are best served by banks that are able to screen and monitor them most effectively[13].

Banking Industry, Competitiveness and Disintermediation

Competition in the banking sectors of almost all APEC economies is limited, to a greater or lesser extent, by regulations which steer bankers away from competitive solutions. Impediments to competition include barriers to entry and exit, regulations which discriminate against certain activities (especially of foreign banks), and regulations against mergers. A banking system can become more competitive only if measures are taken to enable the more competitive banks to absorb and reform the weaker banks or to permit new entrants to drive out weaker banks and allow a level playing field for all participants. Regulatory barriers to entry place a prospective entrant at a disadvantage compared to incumbent banks, while other barriers consist of sunk costs (such as costs of buildings, especially for branches), economies of scale and scope, and brand loyalty. Some of these barriers to entry in advanced APEC economies can only be overcome by market forces. This is beginning to happen as the need for widespread branch presence, traditionally considered to be a major barrier to entry into retail banking, is being reduced through internet banking and other technological innovations, such as automatic tellier machines (ATMs). New competitors are also choosing the more profitable forms of banking, by offering a single product or a limited range of products and by targeting specific niche markets, and traditional banks are forced to compete through unbundling their pricing, or by competing for customers through bundling sets of products. Studies have shown that an increase in the level of interbank competition has a positive effect on bank performance as better banks increase their market share at the expense of less efficient banks[14].

Table 4. **Status of Bank Entry in APEC Economies: Commercial Banks**

Economy	Restrictions on New Entrants[a]	Restrictions on Branching	Number of Banks		Number of Branches	
			1990	1996	1990	1996
Australia	Relatively open[b]	Relatively open	37[b]	48[b]	6 575	6 507
Canada	Relatively open	Need approval	62	50[c]	7 406	8 123
Chile	Restricted entry	Restricted entry	35	29	n.a.	n.a.
People's Republic of China	Restricted entry	Restricted entry	10	(1994) 19	125 097	(1994) 151 930
Hong Kong	Open entry	Open entry	(1992) 220	243	–	–
Indonesia	Open entry	Open entry	(1991) 189	239	(1988) 1 690	5 919
Japan	Approval required[d]	Approval required[d]	156	150	11 570	11 460
Korea	Restricted entry	Restricted	23	25	n.a.	722
Malaysia	Limited entry[e]	Limited entry[e]	38	37	998	1 569
Mexico	Open entry	Open entry	20	41	4 462	6 264
New Zealand	Open entry	Open entry	20[f]	17[f]	n.a.	n.a.
Papua New Guinea	Restricted entry	Restricted entry	5	6	357	164
Philippines	Open entry	Open entry	30	48	1 624	3 596
Singapore	Limited entry[g]	Limited entry[g]	141	143	422	473
Chinese Taipei	Restrictions eased recently	Restrictions eased	59	83	1 039	2 001
Thailand	Limited entry	Limited entry	30[h]	29[h]	2 004	(1994) 2 823
United States	Open	Restrictions across states	12 345[i]	n.a.	50 815	n.a.

a. Other than prudential requirements such as a minimum capital and experienced management; domestic and foreign banks.
b. Six Pillars Policy, restrictions on mergers of six largest banks in order to keep degree of competition. Data are for June of relevant year.
c. The largest six comprise 70 per cent of total bank assets. There are 41 foreign banks. These foreign banks are allowed to branch but have to enter the market as subsidiaries of parent companies.
d. Licenses need approval from MOF. Very few licenses have been issued in the last five years. System will open up after April 1998.
e. Branching is very limited; foreign institutions are not allowed to open branch for 10–15 years. ATM is counted as a branch.
f. These are registered banks.
g. Banks can get a license to operate in offshore market. No banks allowed to open in domestic market. Restriction on foreign banks – not allowed to open ATMs.
h. Three licenses granted last year, but there have been no new banks for five years or more.
i. Banks insured with Federal Deposit Insurance Corporation.

Source: Central Bank Reports and Bulletins.

An oligopolistic banking structure has survived reform efforts and stifled competition in many APEC emerging economies, and frequently foreign banks face significant discriminatory limitations, such as prohibition against opening new branches or joining automated teller networks. In a significant number of these economies competitive forces in banking have been constrained by restrictions on the entry of new banks[15] and by regulations that limit flexibility. Table 4 gives an indication of the status of bank entry for commercial banks (both domestic and foreign) in the APEC economies and of the change in the number of banks and branches operating between 1990 and 1996. Of the APEC economies, Australia, Canada, Hong Kong, Indonesia, Mexico, New Zealand, the Philippines, and the US have relatively open entry for new banks, and some others, including Chinese Taipei, and Thailand, have recently granted new banking licenses for the first time in years. When an economy opens up, its banking system it becomes more competitive, but some of the weaker banks should be merged with larger banks. In some economies such as Chile, rules on entry and branching are about to change. In others, competition is constrained by regulations and government involvement in, for example, appointing bank presidents; further, some economies have banks that still have no ability to assess risks because of government support.

Substantial deregulation and policy adaptations have allowed banks to become more competitive in advanced and many emerging economies. These banks have also faced growing competition from other financial institutions and financial markets over the past two decades and disintermediation has progressed relatively rapidly. Banks' share of financial assets in the United States, for example, has fallen from over 60 per cent in the early 1970s to under 30 per cent in the early 1990s[16]. The banking sectors in emerging APEC economies, where in some instances banking sector assets account for up to 80 per cent of total financial sector assets, will increasingly have to deal with these trends in and disintermediation. In Malaysia, for example, disintermediation is already taking place in the banking system with the deregulation and liberalisation of the capital market. However, competition by banks is restricted, especially for moving into more fee–based markets.

In the more advanced APEC economies, mergers have for the most part also increased competition and have sometimes reduced the number of banks[17]. In New Zealand, for example, which has a very open system for entry as well as exit, competition has reduced the number of banks, as some banks did not commence operations or were taken over when they found they could not compete. Branching in more advanced APEC economies is also decreasing with technological innovations in banking.

Presumably banks will have better chances of success in keeping their business if they are efficient. In seeking to improve efficiency, banks may be able to achieve lower costs and higher returns by adjusting their scale or product mix[18]. In addition, banks with similar scale or scope may be able to improve their performance further through superior management (managerial efficiency or x–efficiency). With respect to the returns to scale, studies in the US suggest that returns are maximised in relatively small banks having total assets of $2–$10 billion. In a recent study, Peristiani (1996) found that, during the 1980s, the acquiring banks in the US experienced moderate

gains in profitability due to scale economies but they failed to improve post–merger x–efficiency. At the same time, studies of US banks also show substantial inefficiencies in banking, averaging between 10 and 20 per cent of total costs[19]. Clearly, if such inefficiency levels remain in the US banking industry, there is tremendous scope for efficiency gains in banking systems which have not had to face such a high degree of competition. The changes that have occurred in Indonesia since financial sector reforms were introduced in 1988 tend to confirm the findings on competitiveness and efficiency (see Box 1).

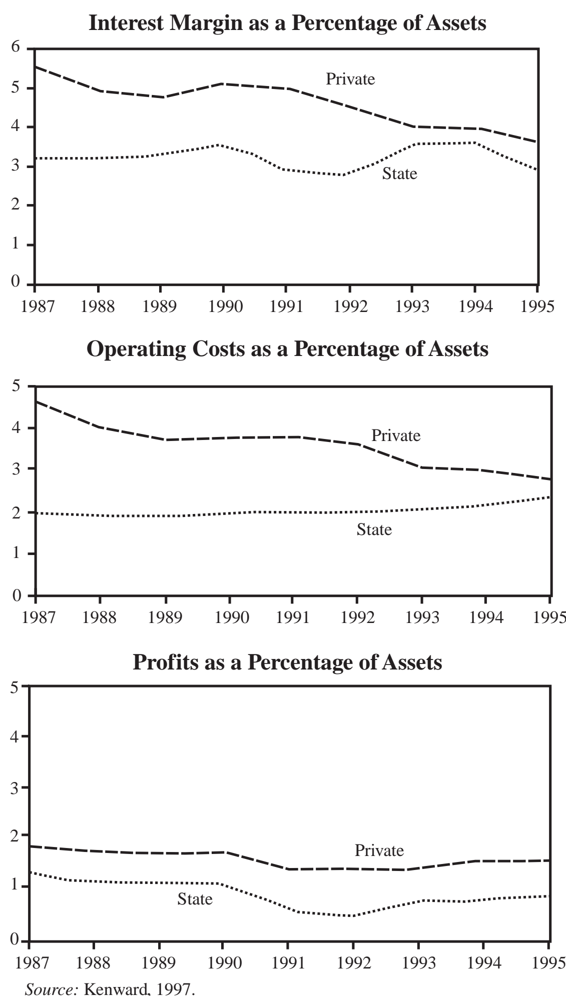
Box 1. **Indonesia and Financial Sector Reform – A Case Study**

The Indonesian banking sector was deregulated in 1988, allowing freedom of entry of new banks. The number of deposit money banks rose from 79 in 1988 to 239 in 1996, based primarily upon new domestic and foreign joint ventures. Even more remarkable has been the expansion of branches from 1 690 in 1988 to 5 919 in 1996. Such a major expansion created difficulties for Bank Indonesia in fulfilling its supervisory role. At the same time, the quality and availability of banking services has increased markedly with, for example, wide availability of ATMs, and a competitive range of financial instruments. Moreover, the efficiency of the banking sector has increased sharply. A benchmark sample of private banks in one study of the deregulation showed that as the result of increased competition, large cost reductions had been passed on to customers in the form of appreciably narrower interest spreads (see Figure 3). Despite the narrow spreads, their return margins were not out of line with international comparators (Kenward, 1997). While the state banks have not responded as well to the more competitive environment, the government has recently announced that a programme would be initiated to revitalise these banks by merging the weaker banks into the more progressive state banks. Overall, the banking sector in Indonesia is now largely market–based and faces intense competitive pressures.

In its Annual Report for 1996, the Bank for International Settlements (BIS) considered measurements of bank efficiency in providing services by using the net interest margin as an approximation for the cost of intermediation by banks. Although this is an imperfect indicator, particularly for international comparisons of bank efficiency, nevertheless, such comparisons show a similarity between net interest margins and operating costs for many APEC economies, suggesting that cross–country differences in interest margins reflect differences in banking efficiency, rather than payment for different risks (Table 5).

Using these measurements, banks in the APEC economies fall into several groups. The first group comprises banks in the then higher inflation economies of Chile and Mexico which have higher interest margins and operating costs. Japan and the higher–income emerging economies of Asia, such as Hong Kong, Korea, Singapore and Chinese Taipei, compose the second group, which for the years 1990 to 1994 had an average net interest margin of between 1.1 and 2.1 per cent of total assets. These economies also have the lowest operating costs, measuring between 0.8 and 1.7 per cent of total assets.

Figure 3. **Cost and Profitability of State and Selected Private Banks in Indonesia, 1987-95**



Source: Kenward, 1997.

Another group consists of banks in other APEC economies, including Indonesia, Malaysia, the Philippines and Thailand, where average net interest margins of between 3 and 4 per cent of total assets have been calculated, with corresponding operating costs of between 1.6 and 4.2 per cent of total assets. It is difficult to make conclusive judgments on banking efficiency across countries, based on measurements of net interest margin, because differences in net interest margins could be a reflection of differences in inflation across the emerging APEC economies. However, the cross–country patterns observed here suggest that inflation was not a key determinant in differences in net interest margins (except for Chile and Mexico), as a percentage of total assets. In other words, the evidence suggests that much of the cross–country difference in interest margins reflects differing levels of banking system efficiency rather than payment for different risks.

Table 5. **Indicators of the Efficiency of the Banking Industry in APEC Economies**

Economy	Share of State-owned Banks (% share of assets) 1994	Operating Costs (% of total assets) 1990-94	Net Interest Margins (% of total assets) 1990-94	Commercial Bank Reserves (% of loans to non-government sector) 1994	1995	Average Inflation Rates 1990-94
Australia	0	3.5	3.7	1.7	1.6	2.0
Chile	14	3.0	6.1	6.7	5.3	15.2
Hong Kong	0	0.8	1.6	0.1	0.1	9.6
Indonesia	48	2.4	3.3	0.5	1.1	8.8
Japan	0	0.8	1.1	1.3	1.2	1.7
Korea	13	1.7	2.1	6.4	6.6	6.6
Malaysia	8	1.6	3.0	11.1	11.0	4.1
Mexico	28	3.9	5.1	1.6	20.4	13.7
New Zealand	0	3.0	3.3	2.4	2.3	1.7
Philippines	23	4.2	3.9	25.2	17.3	11.7
Singapore	0	1.4	1.6	6.7	6.5	2.8
Chinese Taipei	57	1.3	2.0	9.9	8.7	3.8
Thailand	7	1.9	3.7	2.4	2.9	4.6
United States	0	3.8	4.2	1.5	1.4	1.1

Sources: Bank for International Settlements (1996) *Annual Report. Reserve Bank of Australia Bulletin. Philippine Financial System Factbook* (1994). *International Financial Statistics* (1997).

Based on this methodology it would appear that costs to consumers of the more advanced countries is higher than for emerging APEC economies. However, caution must be used in drawing conclusions from this type of comparative international data, particularly because quality and the wide variety of services provided in advanced economies, including transactions, are very different than in many emerging economies and this would necessarily involve different cost structures. Profitability in banking was also higher in advanced economies with high interest margins.

Almost all the APEC economies are now allowing market forces to have more influence over interest rates, and in many emerging economies, the ending of interest rate controls has allowed banks to grow and become more efficient. Proper alignment of interest rates is particularly important for economies that have open capital markets, and operations in money markets need to be aligned with foreign exchange markets.

The share of state–owned banks in the total banking sector assets remains high in some economies in the region, notably Indonesia and Mexico, although both economies now have plans to rationalise their state–owned banks. Efficiency is often impaired by the legacy of bad loans from state–directed lending and also by a failure to rationalise some of the banks as deregulation has occurred[20]. Some emerging economies, such as Hong Kong and Singapore and also Chile, Korea, Malaysia, the Philippines and Thailand have followed vigorous privatisation programmes, and only a small proportion of their financial sectors remains under public control. (The share of state–owned banks in total assets in Hong Kong and Singapore is zero.) In this

context, a notable exception among the region's high–income East Asian economies is Chinese Taipei, where most banking remains under public control, but here, too, the government is permitting some entry and expansion of new domestic and foreign banks.

Fragility in Banking Systems

Banking safety is fundamental to the smooth operation of financial systems and many services provided by banks are built on confidence that transactions will clear and promises will be honoured. Banks are vulnerable to a sudden loss of confidence, which can result in a run on a particular bank or even a run on the whole banking system[21]. Loss of confidence in banks usually occurs after a bank has got into trouble because of deteriorating asset quality; this often occurs when underlying economic conditions change. If depositors lose confidence it becomes rational for them to seek to withdraw their deposits. Even in a situation where a bank is fully solvent and all depositors realise that collectively their best interests will be served by leaving their deposits in the bank, they may still withdraw them. This type of behaviour is comparable to the prisoners' dilemma (see Box 2). Likewise, Cooper and Corbae (1997) showed that complementary to belief–induced withdrawal decisions, belief–induced deposit decisions also play a role in bank runs as only a few will deposit funds if depositors are pessimistic. Solvency, Calvo (1996) argued, lies in the eye of the beholder.

Box 2. **The Prisoners' Dilemma and Bank Runs**

Two prisoners, accused of a crime and held separately, believe they can be acquitted if they both deny complicity. They also know, however, that if convicted, the one that first confesses and implicates his accomplice will receive a more lenient sentence. In such circumstances, it may be rational for each to confess even though they could have achieved a better outcome through collusion (Luce and Raiffa, 1957). This is a similar situation to that faced by bank depositors. If depositors were able to collude they would gain collectively by refraining from precipitating withdrawals. Because they cannot collude, each depositor has an interest in withdrawing his or her deposit first while the bank is still liquid. Even where a depositor judges a bank to be fundamentally sound it may still be rational to withdraw a deposit if others are withdrawing and the bank is likely to become insolvent.

Systemic risk in banking is generally greater than elsewhere in the economy because of the potential for financial disaster in one institution to be communicated elsewhere. This contagion could result from a loss of consumer confidence or because the failure of one institution to settle its obligations directly, may cause the failure of other fundamentally sound institutions. The banking system is vulnerable to contagion effects because of the mismatch between the liquidity and maturity profiles of bank assets and liabilities, and the interconnections of the financial system through the payment and settlement system. In advanced and some emerging APEC economies,

the risk of systemic failure is being reduced through arrangements such as real–time gross settlement systems for payments risk, and the shortening of other settlement cycles for clearing house systems.

The two main policies for ensuring the safety of the financial system are: *i)* prudential regulation, and, of equal importance, *ii)* the maintenance of sustainable macroeconomic policies, and in particular, their contribution to price stability in both product and asset markets. Few financial systems can withstand persistently unsound macroeconomic policies, as chronic price instability distorts business and lending decisions and invariably leads to failures and other shocks.

Regulatory Systems

An economy's regulatory regime will, to a large extent, depend on its stage of development. Other important determining features of a regulatory system are the level of development of the supporting institutional infrastructure, including the legal system and the ability to enforce laws; the accounting and auditing systems and standards; the sophistication of savers, investors, borrowers and issuers; and disclosure standards.

However, whatever stage of development an economy has reached, the regulatory regime must move towards market–based approaches, where the importance of financial markets in allocating resources to their most productive uses is recognised. Where an economy is at an early stage of development, regulatory regimes should facilitate market growth, but in more advanced economies, good policies and disclosure standards are the most important determinants of the financial system's health. In general, liberalisation and more sophisticated instruments as well as globalisation have brought more accurate disclosure by banks in many APEC economies.

However, too much regulation as well as impediments to innovation and efficiency in financial systems, can seriously reduce the incentives for bank managers and directors to take responsibility for the management of their banks and can increase the risk of moral hazard. Such moral hazards are particularly relevant in banking systems where deposit protection is provided. To minimise moral hazard, New Zealand has introduced a rigorous disclosure regime which has allowed for a significant reduction in the extent of regulation and eliminated the need for deposit protection or pre–announced protection through the use of lender–of–last resort. In New Zealand, public disclosure requirements oblige all banks to issue quarterly disclosure statements on performance statistics and their credit rating to the public. Bank directors are also required to sign disclosure statements and attest to the adequacy of their bank's internal control systems. This type of disclosure system considerably strengthens the incentives for bank managers and directors to identify, monitor and manage their own risks and places market pressures on banks to behave prudently all the time. It also reinforces the perception that the managers and directors of a bank have the sole responsibility for the management of the bank's affairs. One result of this system is that the stronger banks are able to operate at lower costs and the weaker banks are under pressure to strengthen their position.

Disclosure regimes which ensure that banks supervise themselves can be contrasted with regulatory regimes which tend to act only after the emergence of problems. Some APEC economies such as the US have tried to correct these problems by requiring that regulators act in specified ways as bank capital falls below certain given levels[22]. The problem with this, as shown by recent research, is that bank capital is a lagging indicator of banking difficulties, that is, capital write–downs usually occur long after difficulties have been encountered[23]. As a result, there are increasing doubts about the role of regulators in either creating or maintaining a healthy banking sector.

The need to improve the strength of financial systems to prevent financial instability both within a country and internationally has been examined by the Basle Committee on Banking Supervision. In this regard the Committee has prepared a set of Core Principles for effective banking supervision (see Appendix 3). These core principles are intended to serve as a basic reference for supervisory and other public authorities in all countries and internationally, for strengthening supervisory arrangements in connection with promoting overall macroeconomic and financial stability. One particular principle states that banks must have in place systems that measure, monitor, and adequately control market risks. The Committee endorsed the use of "value–at–risk" models (models that measure market risk) which generally capture the risk that they set out to assess, based on a study by Hendricks (1996).

Implementation of the Core Principles will involve carrying out a review of existing supervisory arrangements and, where these are inconsistent in any material respect with the Principles, establishing a time frame for addressing the deficiencies.

If every country were to achieve consistency with the Core Principles, the Basle Committee feels that significant progress will have been made in the process of improving financial stability domestically and internationally. However, in many APEC emerging economies, substantive changes in the legislative framework and in the powers of supervisors will be necessary because many supervisory authorities do not at present have the statutory authority to implement all of the Principles. In such cases, the Basle Committee believes it is essential that national legislators give urgent consideration to the changes necessary to ensure that the Principles can be applied in all material respects. The need for new legislation will be taken into account by the Basle Committee in monitoring progress towards implementation.

Nonbank Financial Institutions

Nonbank financial institutions (NBFIs), such as savings institutions, insurance companies, pension funds, mutual funds, industrial and consumer finance companies, development finance institutions (DFIs) venture capital funds, trust institutions, and leasing companies all compete with commercial banks, in varying degrees, to mobilise savings and provide intermediation services. In the emerging APEC economies, banks currently face competition mainly from DFIs leasing companies and other sources of long–term equity finance, such as life insurance and pension fund companies. However,

as other instruments and institutions offering longer–term borrowing and lending are being developed, in many of these economies DFIs are either being phased out or restructured on a more commercial basis.

In the more advanced APEC economies where traditional forms of intermediation are giving way to newer methods of meeting financial demand, nonbank financial institutions (NBFIs) are becoming increasingly competitive with banks. Stronger competition on a product–by–product basis has led banks to unbundle some of their traditional product mix and, at the same time, to expand their range of products through networking and outsourcing. For example, in Australia, cash management trust companies are competing with banks on the deposit side and mortgage originators on the lending side. In addition, a number of life insurance offices have also increased their home mortgage lending. These institutions have been able to offer deposits or loan products on a stand–alone basis at highly competitive rates, putting pressure on banks to price their products competitively; competition has also contributed to a trend increase in banks' deposit costs, thus reducing their margins. These forces are creating pressures on banks to cut costs and to reduce their cross–subsidies of transaction services. Banks are also seeking ways to offset these competitive pressures by expanding in other areas of business, such as involvement in fund management.

The full impact of competitive pressures from NBFIs is yet to be seen. However, the combination of less regulation and the ability to unbundle basic product lines suggests that the competition between banks and nonbanks will increase. In addition, electronic banking and banking on the internet will also offer competition to traditional banking. In the future, it is likely that the Internet could compete directly with banks as it offers the possibility of direct contact between depositor and creditor. In the future, it is also possible that nonbank competition could create alternative payment systems.

In the growing competition between banks and nonbanks, it is important that neither are hobbled by laws and regulations that limit flexibility in the market place. This requires a leveling of the playing field for both banks and NBFIs so that both are steered towards competitive solutions.

Competition from NBFIs is likely to lead to disintermediation in banking sectors of APEC economies, which could itself help to strengthen banking, particularly in APEC emerging economies where risks may start to be spread more evenly. However, as has been seen recently in Thailand, the failure of NBFIs can have a serious destabilising effect on the financial sector, both through its impact on the customers of the intermediary bank as well as indirectly through its effect on the confidence of the financial sector. In the case of Thailand, domestic nonbank finance companies were highly exposed to the real estate sector and, because they were outside the banking supervision system of the central bank, they were permitted larger exposure limits for real estate investment. Prudential regulation of all NBFIs should be consistent with those for banks, and both banks and nonbanks should move towards market–type disclosure prudential systems where incentives are created for both banks and nonbanks to manage their own risks. Prudential regulation should also aim at ensuring that risks in NBFIs are treated the same way as in banks while, at the same time, providing sufficient flexibility to accommodate differences in the operation of NBFIs.

Improving Financial Stability

What can policy–makers of APEC economies do to improve the functioning of financial markets in order to facilitate greater access to international capital markets? How can this be achieved while, at the same time, allowing financial institutions to function efficiently within a competitive market–oriented system where institutions can enter and exit and where prices can change along with underlying conditions of supply and demand? Improving financial stability in the context of facilitating greater access to international capital markets here means reducing the "excess volatility" in prices that generates uncertainties beyond changes that a competitive market system would imply. "Excess volatility" in market prices has at least two causes: *i)* unsound macroeconomic policies; and *ii)* price instability resulting from market imperfections. Weak financial institutions can also lead to excess volatility in market prices. In some cases, volatile asset prices are also driven by an excessive expansion of bank credit; this often occurs where banks are weak because of a tightly regulated environment and where banks lack the experience to evaluate credit risk. Furthermore, if economic liberalisation measures have not been carried out in an appropriate order prior to opening up the capital account, a country's macroeconomic policy framework could become unstable and lead to excess volatility in its markets.

Macroeconomic Policies

There is no doubt that maintaining a sound macroeconomic environment through prudent monetary, fiscal and exchange rate policies can reduce undesirable price volatility. Macroeconomic policies have become more important for APEC economies, especially where financial liberalisation has been carried out and where capital markets have become more integrated. More highly developed financial markets and instruments increase the opportunities for using funds to hedge against government policies that are seen to be unsustainable, or where inconsistencies in policies are observed. This is particularly true in the foreign exchange market.

There are numerous examples of economies where inconsistencies between monetary and exchange rate policies have resulted in heavy financial and economic costs. The most recent instances involved Thailand in 1997 and Mexico in 1994. In these cases, speculators calculated that large current account deficits, significant borrowing from abroad, and a weakly capitalised domestic banking system created an unsustainable situation.

With increased integration of the global economy through free trade and the international capital market, policy makers cannot pursue stable exchange rates and independent monetary policies at the same time. Since most APEC economies that are moving towards growing integration with the global economy accept the premise of free trade and capital mobility, policy makers will have to make a choice with respect to the exchange rate regime: there can be an independent domestic monetary policy with a floating exchange rate regime, or there can be a fixed exchange rate with a monetary policy consistent with a fixed exchange rate.

Until recently many emerging APEC economies fixed the exchange rate and sterilised capital inflows, curtailing the growth of monetary aggregates by raising domestic interest rates and reserve requirements. These measures had two undesirable effects: *i)* raising domestic interest rates encouraged further short–term inflows; and *ii)* raising reserve requirements reduced banking competitiveness and encouraged disintermediation of the banking sector. It also curtailed borrowing for productive investment if the real interest rate was higher than the marginal return on investment.

Many APEC economies have already chosen to retain independence in their domestic monetary policies by adopting a floating exchange rate system. Under this system more volatility in exchange rates is to be expected. However, orderly movements of exchange rates are more likely when there are sound economic policies and a reliance on market forces. More volatility in foreign exchange markets can be expected where an economy runs large fiscal deficits and large current account deficits (especially if a substantial proportion of the latter is for funding consumables), has a low level of domestic saving, and banking systems are undercapitalised.

By allowing the nominal exchange rate to float, economies can adopt an independent monetary policy. There are two types of policies that a central bank can use to achieve its monetary objectives. *First,* it can impose reserve requirements on banks and/or issue directives to banks and other financial intermediaries about the kind and amount of business they carry out. *Second,* it can take the initiative in buying and selling financial assets, especially government securities (open market operations), and impose conditions as lender of last resort to the banking system. Many emerging APEC economies now have a mix of these two policies, but still rely heavily on the first set. The problem with those policies is that they make arbitrary distinctions among financial institutions, and particularly since reserve requirements are imposed on banks, they foster the growth of other institutions and encourage disintermediation in banking systems. If an economy has an open capital account, these policies will encourage further disintermediation as people shift their business to offshore financial institutions. When used, direct controls on interest rates also weaken financial institutions by distorting the allocation of resources and adversely affecting profitability and efficiency. To encourage a more efficient, effective and competitive financial sector, distortions and restrictions in financial sectors have to be removed.

A more level playing field for all domestic financial institutions and foreign institutions can be promoted through open market operations involving the buying and selling of financial assets, particularly government securities by the central bank. Thus it is preferable to move towards more indirect instruments to control monetary policy and to eliminate direct instruments and regulations. The pace for doing this will depend on particular circumstances, but economies with open capital markets and where distortions have led to rapid growth of institutions other than banks will have to move fairly quickly or see fairly rapid disintermediation of the banking sector. The speed with which open market operations can be implemented will also depend on the

development of monetary instruments, the depth of markets in these instruments and the development of a secondary market. Economies that do not have government debt could consider issuing central bank bills for this purpose. Economies should select operating systems consistent with an efficient and sound interbank settlement system[24].

A major result of open market operations is that they influence decisions in the private sector on whether to save and how to save, directly, rather than via a change in the operating policies of financial institutions. At the same time, open market operations influence lending decisions of financial institutions but in a non–discriminatory manner, and are thus more in keeping with the objective of fostering efficient financial sectors in the face of increasing capital mobility.

While open market operations will influence both the size of monetary aggregates and interest rates, it needs to be remembered that the central bank can choose to control interest rates, or the size of the reserve base and the money supply, but cannot arbitrarily fix both. If the authorities aim to achieve a particular growth in the money supply, they must accept whatever interest rate structure is necessary to achieve this. Similarly, should the authorities decide to try and hold a particular interest rate structure, they must be prepared to supply or absorb whatever volume of financial assets is necessary to achieve this.

Price Instability Resulting from Market Imperfections

The most general source of market imperfections in APEC economies leading to price instability are related to *i)* lack of market structures, and *ii)* lack of quality or timely information made available to market participants (including disclosure standards).

Lack of Market Structures

A lack of market structures is more prevalent in emerging APEC economies, especially in the bond market where only a small portion of long–term investment is financed by corporate bonds. An obstacle to the emergence of bond markets in these economies is the absence of a market for government securities; because governments do not run fiscal deficits they do not need to borrow. Where no market for government securities exists, no benchmark risk–free rate is available to markets and so they must determine both the risk–free rate and the risk premium associated with specific corporate rates. Hong Kong's government has responded to this limitation by auctioning government bonds – even though it does not need the financing – to provide a benchmark risk–free rate and eventually help create a market for corporate bonds. Malaysia and Singapore are considering doing the same. Other East Asian economies have also taken steps to foster the growth of bond markets. Malaysia, for example, established a rating agency for bond issues in 1991. In addition, Hong Kong, Chinese Taipei, and Thailand have strengthened their legal infrastructure for securities (bonds and equity) issues.

By allowing markets to provide market–based benchmarks for medium to longer–term bonds, governments can encourage a deepening of bond markets. Domestic capital markets will also deepen as intervention in and regulation of investment policies of institutional investors are ended. Removing restrictions on foreign participation in domestic bond and stock markets will also encourage them to develop, deepen and strengthen, as well as encouraging the purchase of longer–term debt instruments to replace short–term capital flows. A quality infrastructure environment for securities markets, including an appropriate legal framework and efficient clearing and settlement systems, is also indispensable to the development of domestic securities markets.

Improved Access to Information

Market imperfections can also be reduced by improving access to financial information, and greater emphasis is now being placed on the adequacy of accounting and disclosure standards in both advanced and emerging APEC economies as disclosure–based systems replace government control over the issuance of securities. Full disclosure systems require adequate accounting, auditing and financial reporting as well as legal backing, and many emerging APEC economies are progressing towards making accounting standards consistent with those in the advanced economies. This will greatly improve the role of capital markets in imposing firm discipline[25].

In advanced APEC economies, regulatory systems generally allow relatively free markets, competition in the financial sector, and practitioner–based self–regulation accompanied by strong government oversight. This approach to regulating securities markets is based on the principle that only minimal formal government oversight of the stock exchange and market practitioners is necessary. In many emerging APEC economies, securities regulatory bodies are responsible for promoting both the development and regulation of the market. The state's dual role as a promoter and regulator of capital markets varies throughout Asia. This dual role presents a challenge to regulators seeking to avoid potential conflicts of interest. In addition, in order to protect the interests of the investing public, regulators in some countries have become quite stringent, tending towards overregulation which can stifle the development of the market.

Enforcement of securities regulations is essential to protect investors and preserve the integrity, fairness, and efficiency of the securities markets If, for example, a country does not have the legal and accounting infrastructure for a disclosure–based system at the early stage of market development, this should be recognised at the outset. While the economic benefits of allocative efficiency can best be achieved through a disclosure–based system that relies on market discipline to determine the merits of securities offerings, such a system cannot be relied upon without the trained accountants, lawyers, and analysts essential to the proper functioning of the market. The development of infrastructure necessary to make a disclosure–based system effective should be given high priority. The short–term objectives such as listing standards can be relied upon to control the quality of publicly traded issues.

Weak Financial Institutions

In a generally robust and market–oriented banking system operating in an appropriate environment, competition will ensure that the more competitive banks absorb and reform the weaker banks or that new entrants drive them out. By allowing market discipline and rigorous disclosure requirements to weed out weak institutions, moral hazard is also minimised. In New Zealand, for example, the open door policy, combined with stringent entry conditions for new entrants and a strong emphasis on disclosure, ensures that weaker institutions are weeded out while at the same time minimising the risk of moral hazard.

In many emerging APEC economies, weaknesses in banking systems may remain because of regulation which prevents the weaker banks from being reformed; these weaknesses, together with very rapid economic growth and large capital inflows in the first half of the 1990s, have greatly increased the ratio of credit to GDP (see Figure 1). The opening up of the capital account, unless accompanied by policies to build strong banks, can therefore exacerbate weaknesses in the banking systems; this weakness encourages price volatility through, for example, speculation against exchange rates or large capital outflows. Weaknesses in banking systems, in turn, can destabilise an economy's macroeconomic policies, as seen recently in some East Asian economies.

Where some banks, or a whole banking system are weak or vulnerable to widespread bank failures, or in constant need of government funding to prevent bank failures, a comprehensive programme of bank restructuring should take place so that banks can improve their operations, efficiency and safety. To do so, it is first necessary to ensure that sound policies are in place, including a legal and institutional framework that promotes sound banking and an effective market–based regulatory regime that emphasizes disclosure to minimise risks from moral hazard or contagion. Second, the structure of the sector should not inhibit competition or profitability, and firm entry and exit policies should be in place. Third, measures should be taken to rehabilitate individual banks credibly and transparently or, where necessary, the whole banking system[26].

Financial restructuring should restore solvency by improving banks' balance sheets and income statements, by providing adequate levels of capital and also by giving banks the responsibility to manage their own liquidity and control their own risks. When carried out effectively, this should restore confidence in the banking system and reduce vulnerability to excess volatility in markets brought about by weak banks.

Financial Reform, the Order of Economic Liberalisation and Capital Account Convertibility

It is generally believed that if the opening up of the capital account of the balance of payments does not take place in a gradual and properly sequenced order during economic liberalisation, this could generate macroeconomic instability and destabilising capital flows. Although there is no single recipe for economic liberalisation

as countries face different initial conditions, it is generally agreed that the optimal order of economic liberalisation[27] is one in which tight fiscal control precedes financial liberalisation (lifting controls on interest rates and liberalisation of private capital markets and deregulation of banks, including freeing them from high reserve requirements). So long as domestic banks are restricted and heavily taxed, it would be destabilising to the domestic banking sector to allow foreign financial institutions to operate freely in domestic financial markets.

After domestic trade and finance are liberalised, transactions on current account should be liberalised faster than international capital flows. Quantitative restrictions should be removed or replaced with tariffs prior to tariff reduction. Once current account convertibility and domestic capital markets are fully liberalised and macroeconomic stability achieved, conditions are suitable for allowing free international capital mobility. Otherwise, the premature elimination of exchange controls could lead to capital flight or an unwarranted buildup of foreign indebtedness or both. Free foreign exchange convertibility on the capital account is usually the last stage in the optimal order of economic liberalisation.

Liberalisation of restrictions on external and domestic financial transactions is motivated in part by the desire to improve financial efficiency by increasing competition in domestic financial systems and to reduce financial risk by allowing domestic residents to hold internationally diversified portfolios. In many emerging economies, liberalisation is also being carried out to attract more foreign capital to complement domestic savings. International capital market integration has also highlighted the growing movement towards capital account convertibility. Although all the APEC economies have achieved convertibility on the current account (i.e. all have accepted Article VIII of the IMF, with the exception of Chinese Taipei which is not an IMF member), no economy is totally free of capital account restrictions and most APEC economies still have a substantial number of such restrictions. The advanced APEC economies moved towards capital account convertibility in the 1970s and 1980s; more recently, an increasing number of emerging APEC economies have also moved towards liberalising their capital accounts and this has occurred in conjunction with extensive stabilisation and structural reform programmes.

As emerging economies have removed capital controls, net private capital flows into these economies surged to $235 billion in 1996. These private capital flows provided substantial benefit to emerging market economies and became a very important source of financing current account deficits, but they also brought vulnerabilities and highlighted the need for further policy reform, particularly in exchange rate and monetary management. Increased capital market integration has also highlighted the need for further institutional (regulatory and supervisory) reforms in banking systems and capital markets in emerging economies. The rapid liberalisation of capital accounts brought other dangers, as demonstrated by the financial crisis in Thailand.

In response to crises, such as those in Mexico at the end of 1994, in Thailand and in other East Asian economies in 1997, the IMF is carrying out surveillance of its member countries' capital account policies in order to standardise and facilitate the liberalisation of member countries' capital accounts. The objective is to establish transparent procedures throughout the world that would benefit investment and growth, and IMF surveillance is expected to play a central role in promoting the orderly liberalisation of global capital movements. With the growing globalisation of capital markets, emerging APEC economies face considerable risk if the liberalisation of their capital accounts is not carried out in a comprehensive and orderly manner (with the freeing of capital transactions being sequenced with major reforms in trade and financial policies), and if their macroeconomic and financial policies are unsound or inconsistent. Therefore, emerging APEC economies need to adopt appropriate fiscal and monetary policies along with exchange rate flexibility, as well as further liberalisation and strengthening of domestic financial systems and capital markets, to protect against instability resulting from large movements in private capital flows.

Capital account convertibility involves the removal of all barriers on international financial transactions; this includes controls on financial flows and the purchase and sale of financial or real assets across borders. With complete capital convertibility, companies and individuals (residents and nonresidents) become free to move their financial resources from country to country in response to their views on changing market conditions and to invest them in assets of their choice. This type of freedom contributes significantly to the efficient allocation of global savings and investment, but at the same time, this freedom also has its price. Investors will shun countries that follow inadequate policies or do not properly compensate them for their risks, or large and unexpected flows of capital may cross international borders and have significant destabilising effects on local markets.

With a free capital account, market participants are expected to comply with the legal, security, health and tax requirements of the countries in which they operate, and some financial transactions may be prohibited because the real transactions that give rise to them are forbidden or controlled. For example, if the export of military or other security–related goods is restricted, the payment or financing of such goods would be equally controlled. Even the most liberal countries have regulations on and procedures to limit money laundering or the transfer of funds related to illegal activities such as drug trafficking. Controls that limit capital convertibility usually take the form of exchange controls or quantitative restrictions on capital movements, dual or multiple exchange arrangements, and taxes on cross border movements of financial resources. The effectiveness of these controls depends in part on the efficiency (and honesty) of the bureaucracy in charge of implementing the controls and on their ability to differentiate between current and capital transactions through rules and regulations.

Enforcement of capital account restrictions is becoming increasingly difficult, because current account transactions are becoming increasingly liberal, and because it is sometimes difficult to differentiate current and capital account transactions in many of the liberalised economies as a result of the loss of the control mechanism that liberalisation entails. Capital controls on residents are usually established with the aim of forcing residents to keep resources in the country and thereby increase the amount of domestic capital for investment or to isolate the domestic economy from the implementation of inconsistent macroeconomic policies and to reduce the balance of payments constraint of such policies. However, where the fundamentals, such as exchange rates and interest rates do not reflect market principles, controls will not keep residents from taking their resources out of the country when incentives from the inadequate policies promote it. Illegal flows can also result in further distortionary elements in the economy[28]. Controls on nonresidents usually arise from the desire to keep the exchange rate from appreciating when the balance of payments is strong, and from the fear of the impact on the domestic economy from reversible, speculative inflows of short–term money. Controls have also been established to protect the ownership of domestic assets (real and financial) from falling under the control of nonresidents.

A basic issue with regard to capital controls is whether they can achieve their objectives. Empirical studies show that, by and large, most controls have not been effective, particularly for long periods of time, as individuals are often able to restructure transactions in ways to avoid controls, requiring ever–increasing restrictions and regulations[29]. A significant bureaucracy is required to administer the controls and a serious problem of corruption and incentives for the development of parallel markets can arise. Macroeconomic distortions will also be amplified by the parallel markets as more and more activities avoid official channels.

Conclusion

From the experience of APEC economies with open capital accounts, the evidence suggests that financial risks associated with increased capital market integration can be minimised by maintaining a sound and consistent macroeconomic framework, by building strong domestic financial sectors based on market principles and by adopting regulatory regimes that have accurate market–oriented disclosure systems.

Asset prices, exchange rates and other market prices are more likely to move in an orderly manner if economies implement consistent monetary and exchange rate policies which allow market forces to determine prices or rates. The evidence examined here shows that where policies are inconsistent and allow a large differential to arise between expected returns on domestic and foreign assets, opportunities arise for speculators to make profits, which can often lead to overshooting of exchange rates[30]. Inconsistent policies can also lead to mismatches in currency denomination of funding and investments, which can lead to pressures that weaken domestic banking systems, heightened risks of large capital outflows and excess volatility in prices.

Banking safety is fundamental to the smooth operation of the economic system. However, banking is an inherently risky sector of the economy because intermediation often involves transforming short–term liabilities (deposits) into longer–term more illiquid assets such as real estate and industrial loans. Banks are therefore vulnerable to sectoral or external shocks or policy weaknesses, as well as systemic risks, and there is a temptation for governments to overregulate them to reduce risks. However, the evidence here shows that a policy framework that permits a market–oriented competitive banking system, including firm entry and exit policies and a level–playing field for all institutions, is most likely to lead to a robust banking system better able to withstand real and financial shocks. Regulation can, where necessary, and from time to time, help prevent systemic risks by managing the exit of weaker banks. Moreover, prudential regimes which emphasize disclosure and put market pressures on banks to manage their own risks and behave prudently at all times, lead to stronger and more healthy banking systems, as well as reducing the risk of moral hazard.

Notes

1. Calvo (1996).
2. Randall (1993).
3. Bernanke and Gertler (1989).
4. BIBFs in Thailand were initially created to borrow and lend in foreign currency (out–out) but much of their activity involved borrowing foreign currency abroad and lending it in Thailand.
5. For example, Chile has a reserve requirement of 9 per cent for demand deposits, 4.5 per cent for time deposits and 30 per cent for foreign transactions. The Philippines had a reserve requirement of 13 per cent, augmented by a liquidity requirement of 4 per cent or a total of 17 per cent as of end–November 1997.
6. Spiegel (1995).
7. In a study on US recessions, Estrella and Mishkin (1996) found that stock price declines are a leading indicator (1–3 quarters) of economic downturns and recessions.
8. This occurs when speculators need to purchase foreign currency for dollars as contracts become due. As the cost of obtaining foreign currency increases with higher local interest rates, one way for speculators to obtain the local currency is to sell foreign holdings of stocks.
9. Swee–Sum (1997).
10. Simons (1995).
11. The IMF, in its latest *Capital Markets Report*, estimates that total assets of hedge funds, proprietary traders, and speculative type funds have grown to well above $100 billion.
12. Chant (1992).
13. Bhattacharya and Thakor (1993)
14. Jayaratne and Strahan (1996); Laderman (1993).
15. These restrictions are in addition to prudential regulations for licensing standards which require that potential owners of banks meet capital requirements and are fit and proper to conduct banking activities.

16. Wheelock (1993).
17. Most advanced APEC economies have merger laws to prevent banking monopolies.
18. Wheelock and Wilson (1995).
19. Kwan and Eisenbeis (1995).
20. Huh and Kim (1994).
21. Park (1991).
22. Furlong (1992), Benston (1993), Jacklin (1993).
23. Randall (1993).
24. Axilrod (1996).
25. Williamson (1975) earlier attached considerable transaction costs to traditional capital market processes of policing management because the capital market is an external control instrument, has limited constitutional powers for conducting audits, and has limited access to internal information.
26. Dickie (1997).
27. McKinnon (1983), (1993).
28. Dooley and Kletzer (1994).
29. Obstfeld and Rogoff (1995).
30. Osler and Carlson (1996) developed a model showing that speculators can contribute to and benefit from exchange rate volatility to the extent that they respond to interest rate differentials across countries.

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Appendix 1

East Asian Contagion
The Case of the Philippines

The regional effects of the Thai crisis — asset deflation, banking crisis and exchange rate volatility — spilled over to the Philippines in May and June amidst concerns among international investors and portfolio managers that the Philippines could follow in Thailand's footsteps. There had been relatively little variation in the Philippine peso since the beginning of 1995 around an average value of 26.4 pesos to the dollar. The Bangko Sentral ng Pilipinas, the central bank, spent $2 billion out of its foreign exchange reserves of $12 billion to defend this rate up to 11 July 1997. The remaining reserves of $10 billion still covered more than three months of imports. On 11 July 1997, the peso was allowed to float (see Figure A1).

Economic Fundamentals

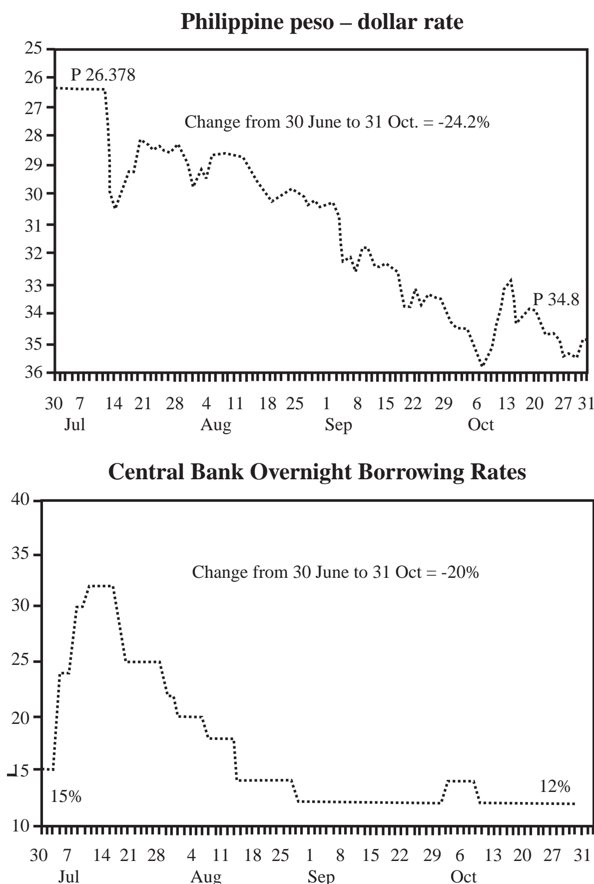
There was an increase in the current account deficit from 4.3 per cent of GNP in the last quarter of 1996 to 4.9 per cent of GNP in the first quarter of 1997. Within the current account the trade deficit had widened in 1996, reflecting the inventory buildup in the electronics industry in North America while imports continued their strong growth. With the strength of the US dollar and with domestic inflation higher than international levels in recent years, the real effective exchange rate of the peso had appreciated by 22 per cent in the 1994-96 period. Nevertheless, this nominal loss of competitiveness was not appearing to have any major impact as exports were recording a very strong rebound, and were up 20 per cent in June 1997 relative to a year earlier.

Managing Contagion Successfully

Let the Market Handle the Speculators

Float — done 11 July 1997.

Figure A1. **Philippine Peso – Dollar Rate and Central Bank Overnight Borrowing Rates**



Source: Asian Wall Street Journal; Bangko Sentral ng Pilipinas.

Drive up the Cost of Borrowing Pesos

Overnight central bank borrowing rates rose to 32 per cent on 10 July 1997 from 30 per cent (from a pre-crisis level of 15 per cent). The borrowing rate was gradually reduced to 14 per cent by 14 August 1997 and was further brought down to 12 per cent on 28 August 1997. Another round of adjustments were made on the overnight borrowing rate, an increase to 14 per cent on 2 October then back to 12 per cent on 9 October. Prime lending rates rose correspondingly to as high as 33-35 per cent, declining to around 26-29 per cent (the pre-crisis prime rate was 15 per cent).

To ensure the effectiveness of the borrowing rate hike, the Bangko Sentral raised the banks' liquidity reserves from 2 to 4 per cent on top of a reserve requirement of 13 per cent, for a total increase from 15 per cent to 17 per cent, effective 31 July

1997. Liquidity reserves are required reserves which can be invested in interest–earning government securities. At the same time, as the overnight central bank borrowing rate was reduced to 14 per cent on 14 August 1997, the liquidity reserves were increased a second time from 4 per cent to 5 per cent. This was further raised to 8 per cent effective 29 August 1997. Later on, this was reduced by 2 percentage points on a staggered basis, to 7 per cent on 5 September and to 6 per cent effective 12 September 1997. Another 2 percentage point reduction of the liquidity reserve had been scheduled on a staggered basis, down to 5 per cent on 15 October and to 4 per cent on 15 November. These adjustments would have effectively brought the total reserve requirement to 17 per cent.

The resilience of the Philippine banking sector was reaffirmed through its management during this period of extraordinarily tight monetary conditions.

Reduce Foreign Exchange Demand

Five key measures were implemented.

i) Taking advantage of the increased volatility, the spread on the foreign exchange market run by the Bankers Association of the Philippines was increased from one to 4 per cent following the float on 11 July 1997. The spread was reduced to 2 per cent on 31 July 1997 as the volatility in the foreign exchange market returned to more normal levels. It was subsequently abandoned on 6 August 1997.

ii) Cut from 20 per cent to 10 per cent the allowable level of foreign exchange assets relative to their capital that could be held by banks (announced 22 July 1997 with full compliance by 25 July 1997). This measure was made effective for three months and was aimed at inducing the banks to sell dollars and reduce speculation in the foreign exchange market. On 31 July, this level was further reduced to 5 per cent or $10 million, whichever was less. The bank's oversold dollar position, meanwhile, was at 10 per cent of capital. Effective 10 September 1997, the central bank required that banks include transactions made by their affiliates in computating their foreign exchange positions.

iii) Tightened rules on the use of derivatives, particularly non-deliverable forwards (NDFs) to curb speculation in the foreign exchange market on 22 July 1997. Banks need to seek prior approval of the Bangko Sentral whenever they sell currency to financial institutions and investors abroad without full delivery of principal.

iv) Required all banks engaged in derivative trading to submit an inventory of their outstanding contracts to sell or purchase foreign exchange with no delivery of principal (NDFs) not later than 25 July 1997.

v) The six foreign banks which are the largest participants in the foreign exchange market (accounting for about 40 per cent of the volume) "voluntarily" agreed to stay out of the foreign exchange market run by the Bankers Association of the Philippines to ease the demand for dollars. Foreign exchange requirements would

still be provided to their customers out of the foreign banks' own reserves rather than out of the central bank reserves — enacted 29 July 1997 and lifted on 11 August. Volumes rose from $60 million per day during the embargo to the more normal levels of over $100 million per day (foreign exchange volumes are normally $120 to $150 million per day).

Contain Concerns About Asset Price Volatility

Real Estate

Commercial banks were required to limit their real estate loans to 20 per cent of their loan portfolios. At the same time the maximum amount of a real estate loan was reduced from 70 per cent to 60 per cent of the appraised value of real estate (4 June 1997).

Replenish Reserves to Restore Confidence

Government accessed the IMF's Emergency Financing Mechanism (EFM), adopted in September 1996, and as requested an extension of the Extended Fund Facility and the utilisation of the undrawn balance. The initial drawdown amounted to $712 million to augment foreign exchange reserves, and a second drawing of $344 million was available in November 1997, if needed, based on 30 September 1997 performance targets.

Appendix 2

South East Asian Currencies Float

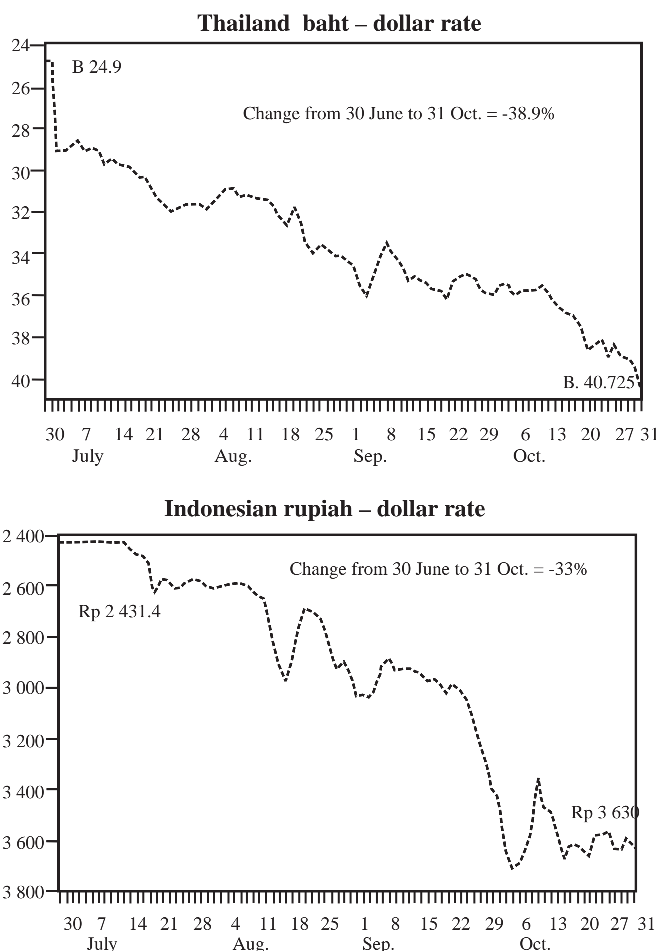
A transformation of South East Asian APEC economies to a region of floating exchange rates began on 2 July 1997 when Thailand was forced to float its currency. This led to a sharp depreciation of the Thai baht by almost 15 per cent in the first week alone. The Philippine peso, the Indonesian rupiah and the Malaysian ringgit also depreciated gradually during that week. The Philippine peso continued to depreciate after adopting a floating exchange rate regime on 11 July; this was followed by Indonesia, which had previously had the most liberal exchange rate regime in South East Asia and which moved to a floating system on 14 August 1997. Over this period, Bank Negara in Malaysia also gradually reduced its intervention in foreign exchange markets.

Between July and October, the exchange rates of South East Asian APEC economies have depreciated considerably against the US dollar; for example, by 31 October the baht had depreciated by over 38 per cent to its end-June value, followed by between 24.2 per cent and 33 per cent for the peso, ringgit and rupiah (Figure A2). During the past year, the German mark and the Japanese yen also depreciated significantly against the US dollar though over a longer period of time.

In an attempt to stem outflows of foreign capital, Indonesia, Malaysia, the Philippines and Thailand (the ASEAN-4 economies) increased interest rates sharply. Indonesia also announced measures to encourage foreign investors by increasing the limit on foreign ownership of shares. Malaysia, initially (27 August 1997) put restrictions on short-selling 100 blue-chip stocks and established a $20 billion fund to prop up the stock market. These measures were lifted on 4 September. The Malaysian government also placed some major infrastructure projects on hold.

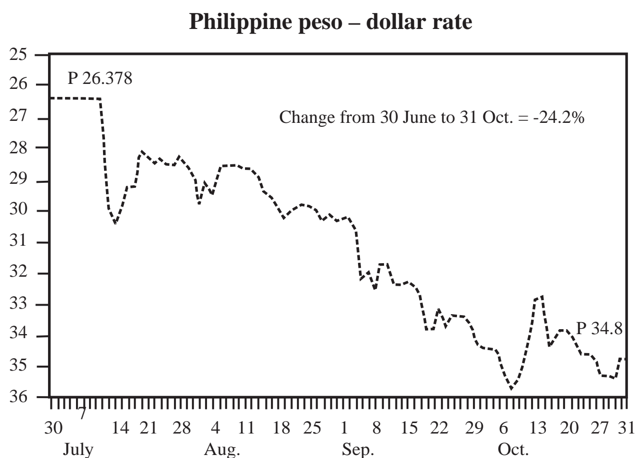
The reason for the current difficulties is a sharp export slowdown due mainly to the sharp fall in prices of semiconductors and other electronic products combined with inappropriate policy and institutional responses to large inflows of foreign capital. The present currency crisis followed the rapid integration of the ASEAN-4 economies into global capital markets, which magnified the costs of inconsistent exchange rate and monetary policies (exchange rates remained pegged to the dollar) and these inconsistencies were compounded by weak institutions and regulations (which allowed banks to increase rapidly the riskiness of their portfolios).

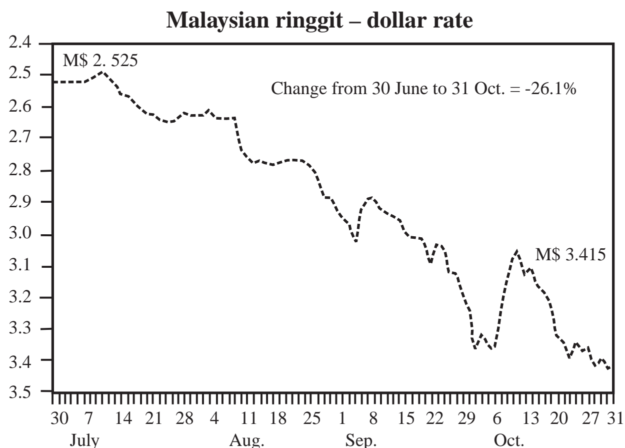
Figure A2. **Exchange Rates Against the Dollar**
(30 June 1997 – 31 October 1997)



Contagion, or spillover effects, of the currency crisis have been felt far beyond the ASEAN-4 economies as currencies in Hong Kong, China, Chinese Taipei and Korea have also been affected. In terms of the impact of the crisis on economic growth, on the one hand the higher interest rates to prevent large capital outflows will have a dampening effect on investment and economic growth, but on the other hand the large currency depreciations should improve competitiveness and current account positions and, ultimately, growth.

Figure A2 end. **Exchange Rates Against the Dollar**
(30 June 1997 – 31 October 1997)





Source: Asian Wall Street Journal.

The emerging APEC economies need to pursue vigorously policies that will enable them to benefit from global capital flows while at the same time minimising the dangers of financial crisis by following more consistent and appropriate policies. Instead of relying on fixed exchange rates for an anchor, many emerging APEC economies will be targeting inflation reduction through money growth targets allowing the exchange rate to move in response to basic market conditions. Fiscal policy in many of these economies continues to be restrictive and therefore will support this tight monetary stance.

Emerging APEC economies are also addressing the underlying weaknesses in the institutional and regulatory framework in their banking systems, particularly weaknesses in credit appraisal, prudential standards and supervisory capabilities, as well as issues related to lack of transparency. These economies are also developing capital market infrastructure and institutions, as well as reforming state enterprises and state banks, and making public sector institutions more profit-oriented.

Appendix 3

Core Principles for Effective Banking Supervision (Basle Core Principles)

Preconditions for Effective Banking Supervision

An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Licensing and Structure

The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.

The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Prudential Regulations and Requirements

Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of Ongoing Banking Supervision

An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Information Requirements

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

Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

Cross-border Banking

Banking supervisors must practise global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

The Role of Pension Funds in the Stabilisation of the Domestic Financial Sector

Monika Queisser

Introduction

The 1997 Asian crisis has painfully demonstrated the overriding importance of having a transparent, stable, well–regulated and supervised domestic financial sector. While much attention is being given to improving the operations and regulatory framework of the banking sector, the role of domestic non–bank financial institutions and their potential contribution to strengthening the financial sector is rarely discussed. This paper argues that there is a dynamic interaction between pension funds and financial sector development and suggests that, under certain conditions, institutional investors can contribute to making the financial sector more resilient to crisis.

In order to examine how this dynamic interaction works, it is useful to recall the functions of a financial system and the channels through which potential effects are transmitted. As summarised by Levine (1997) financial systems have five basic functions: to facilitate the trading, hedging, diversifying, and pooling of risk; to allocate resources; to monitor managers and exert corporate control; to mobilise savings; and to facilitate the exchange of goods and services. Can pension funds and other institutional investors affect financial systems in a way that enables them to carry out these functions better?

This chapter tries to answer this question by reviewing the interaction between pension funds and the development of financial sector infrastructure, the impact on securitisation and resource allocation, the impact on asset price volatility, the effect on corporate management and control as well as the potential contribution of pension funds to the management of capital flows. Essentially, this is a stock–taking exercise which reviews the conceptual issues and discusses the scant empirical evidence of emerging economies to date.

The paper finds that the only clearly stabilising impact of pension funds is their contribution to the development and modernisation of the financial sector infrastructure. In all other areas, pension funds could have stabilising as well as destabilising effects, depending on the initial conditions, the regulatory framework and the behaviour of other market participants. It thus identifies an important role for policy–makers to design an appropriate framework within which pension funds could strengthen the financial sector.

The Impact on Financial Sector Infrastructure and the Quality of Services

The debate on the relationship between pension funds and financial sector development resembles the discussion on the chicken and the egg: which was first? Is a developed financial sector necessary to establish pension funds or will pension funds promote the development of the financial sector? Cross–country experience, particularly in those developing countries which have undertaken pension reform, seems to indicate that there is a dynamic interaction between pension funds and financial sector development.

As institutions which engage in financial contracts, pension funds, like other financial intermediaries, contribute to a reduction of information, monitoring and enforcement costs by pooling risk. Instead of monitoring the risk of their investment individually, savers can delegate this function to the intermediary which reduces costs and improves the allocation of resources (Diamond, 1984). However, pension funds are different from other financial intermediaries because they typically engage in long–term financial contracts. These contracts may last several decades as they extend beyond the active contribution and accumulation phase, continuing through the retirement phase when beneficiaries are drawing benefits from the fund. Thus, contrary to mutual funds which manage assets that can be withdrawn at any time, pension funds mobilise savings which are available for long–term investment in the domestic economy.

Through this mobilisation of longer–term savings, pension funds can stimulate and accelerate the deepening of capital markets and the establishment of a modern financial infrastructure. As the experience of the Chilean and the more recent pension reforms in Latin America shows, this dynamic interaction will be particularly pronounced if pension funds are introduced as part of a systemic pension reform, if participation in the funds is mandatory for a large part of the labour force and if the contribution rate is set at a level that leads to rapid capital accumulation. Table 1 shows the assets of pension funds as a percentage of GDP in selected countries. It is interesting to note that the Chilean system's assets have reached a level close to those in Malaysia and Singapore despite the fact that the funded system was started only in 1981, whereas the pension systems in the latter two countries were established in the 1950s.

Table 1. **Pension Fund Assets (12/97)**

	Total assets ($ billion)	% GDP
Argentina	8.8	2.8
Chile	32.9	44.1
Colombia	1.2	1.3
Mexico	0.7	0.2
Peru	1.5	2.1
Uruguay	0.2	1.0
Malaysia (end–96)	31.3	47.1
Singapore (end–96)	46.3	55.6

Sources: Queisser (1998*b*), Asher (1997).

An important prerequisite, however, is a solvent banking system and a reliable protection of investors' property rights (Rojas–Suarez and Weisbrod, 1996). Without reliable custodial services and confidence in financial supervision, pension fund participation should not be mandatory and systemic pension reform should probably be postponed until these basic elements can be guaranteed. If these conditions are met, the growth of pension funds can increase the demand for and, subsequently, the supply of modern accounting standards, auditing procedures, as well as faster and more reliable clearing and settlement mechanisms, for custodial services and legal support for financial transactions. By promoting the improvement of financial and related services, pension funds can contribute to the reduction of volatility in emerging markets[1]. The demand for improved services, however, does not come automatically. If pension funds are insufficiently regulated and supervised, pension assets may accumulate without any increased demand for accounting and auditing. The stricter the requirements and standards of the supervisors and regulators are, the higher the demand of pension funds for specialised services will be. The dynamic interaction is also affected by the investment behaviour of the pension funds. If pension funds invest primarily in government bonds or if they "sit" on their shareholdings and do not engage in securities trading, the demand for clearing and settlement services will hardly increase.

The accumulation of pension assets can also stimulate the professionalisation of investment management and lead to the development of new financial instruments. As the assets of pension funds grow, the demand for more sophisticated financial products increases. The experience of the United States and the United Kingdom shows that pension funds promote the development of innovations such as derivatives, portfolio insurance and indexed instruments (Davis, 1993). This effect is more likely to materialise if the assets of the pension funds are under competitive investment management. It does not necessarily mean that the pension fund administration itself will have to be privatised along the lines of the Chilean model with management companies competing

for customers. Administration could also be centralised in a public sector agency such as the provident funds in Singapore, Malaysia and other countries, as long as asset management is in the hands of competing investment professionals who have an incentive to provide high quality services at the lowest possible cost. The professionalisation of investment management will lower transaction costs and lead to higher efficiency from which not only pension funds but the entire financial sector will benefit.

The modernisation of the financial infrastructure can be accelerated through the internationalisation of financial services. Internationalisation relates both to the degree of capital account liberalisation and to domestic financial deregulation. In a review of country experiences, Claessens and Glaessner (1998) find that internationalisation of services helps build more robust and efficient financial systems and that this effect is almost independent of the initial state of development of the domestic financial system and the openness of the capital account. Foreign providers of financial services bring in modern techniques, cutting–edge expertise and international practices and standards. The Latin American pension reforms show that the transfer of knowledge and technology is particularly effective if these providers are associated in joint ventures or other forms of partnerships with local firms.

The growth of the pension fund sector will accelerate the development of related financial services such as securities rating and life insurance. Many countries with compulsory pension funds allow pension funds to invest only in rated securities. Where no rating agencies are present like, for example, in some of the Latin American countries which recently reformed their pension systems, this function is initially performed by government councils until a rating industry is built up. In the insurance industry, the positive impact is particularly pronounced in the case of defined contribution pension plans because such plans offer no insurance against the risk of outliving one's accumulated retirement balance. Thus, there is an increased demand for annuity contracts provided by private life insurance companies. The example of Chile illustrates the impact of pension funds on the development of the life insurance industry, in which the number of life insurance companies increased from 9 in 1988 to more than 20 at present. The volume of annuity premiums in Chile has soared from $51 million in 1987 to an estimated $1.1 billion at the end of 1996[2].

The annuity business, in turn, may promote the development of another financial innovation. Depending on the type of annuity contract, a pensioner is exposed to several risks. In a fixed annuity contract, the insurance company commits itself to paying a fixed, usually nominal pension until the pensioner dies. Thus, while the insurance company assumes the demographic and the investment risk, the pensioner is exposed to the risk of inflation, unless the annuity is contracted in real terms, i.e. indexed to inflation. Annuities with inflation protection need adequate investment instruments to back the indexation, commonly CPI–indexed government securities. Very few countries have wide ranging financial sector indexation as in Chile, so there are not many private sector issues which are indexed to inflation[3]. Even CPI–indexed government bonds are currently only available in a small number of countries: the United Kingdom, Canada, Finland, Israel, Brazil, Chile, Mexico, and, recently, in the United States (Valdés–Prieto, 1998).

Finally, a less measurable but very important potential effect of pension funds and other institutional investors is the improvement of regulation, transparency and information disclosure in the financial sector. Latin American countries illustrate how systemic pension reforms can spillover to other areas of the financial sector. In most of the reform countries, the regulatory framework of the securities and insurance markets was overhauled simultaneously with pension reform and providers of financial services are now required to disclose information according to international standards. In Chile, for example, the pension reform of 1981 triggered the following changes in securities and insurance regulation during the second half of the 1980s: obligation of controlling shareholders of public companies to report their share transactions, introduction of risk–rating agencies for bonds, extension of solvency regulations for life insurance companies to consider exchange risk, banning insurance companies from investing in securities issued by affiliates, and adjustment of solvency regulations to consider duration mismatch (Diamond and Valdés–Prieto, 1994).

The financial data required by the supervisors in Latin America is accessible to the public; fund unit values, rates of return and other data are published daily in the major newspapers. The continuous monitoring of financial indicators by supervisors, analysts, and specialised information services facilitates the establishment of early warning systems. The development of reliable public information systems can help to build confidence and trust in the financial sector among the population and thus contribute to the reduction of volatility[4].

In this context, it is important to stress the importance of independent and competent financial sector supervision. It is clear that pension supervisors can only perform their task effectively and efficiently if there is a strong government commitment to enable independent and impartial supervision. Failures of pension funds and, more broadly, financial sector supervision have occurred even when supervisory agencies were staffed with competent and qualified experts; in most cases, failures were due to a lack of independence and political clout of the supervisory agency.

Pension Funds, Securitisation and the Impact on Financial Intermediation

As already noted, the growth of pension funds can stimulate the growth of markets for government and corporate debt as well as the stock markets and thus contribute to the deepening of capital markets. The extent to which pension funds demand different types of securities depends on several factors: the type of fund, the maturity of the pension plans, and the regulatory framework in which the fund operates. Managers of defined contribution pension plans do not have predefined liabilities and will thus strive to achieve the highest risk–adjusted returns possible; managers of defined benefit plans, however, will design their portfolios in order to achieve a certain degree of asset–liability matching to ensure that the plan will be able to deliver the promised benefits. Immature pension plans with a large number of young participants and few workers close to retirement, for example, are likely to demand a

larger share of equities in their portfolio while more mature plans will prefer a higher share of fixed–income securities to avoid large fluctuations shortly before workers enter retirement.

Pension fund regulations are a major determinant of the impact that pension funds can have on securities markets. Rules that require pension funds to invest a certain share of their assets in government bonds or which limit pension funds' choices to a small number of authorised shares will reduce the demand for equities. Further, the funding requirements, and accounting and asset valuation rules also have a strong impact on the investment decisions of pension fund managers. In the United Kingdom, for example, assets and liabilities of pension funds are valued at the "actuarially assessed value"; the actuary calculates the present value of the projected cash flows from returns on assets using a long–term interest rate assumption. Equities and bonds are valued by using the same method and interest rate. Liabilities are also calculated by discounting the projected benefit payments at the same long–term interest rate. The valuation method thus smoothes short–term market movements and makes it much easier for pension funds to hold more volatile assets such as equities.

Griffin (1997) shows that the countries in which pension funds hold the highest percentages of their assets in equities (Ireland, South Africa, Canada, Australia) all use the same accounting and valuation standards as the United Kingdom, where pension funds hold 80 per cent of their assets in equities. In the Netherlands, on the other hand, where only 23 per cent of assets are invested in equities, pension funds keep bonds and real estate at book value and equities at market value, while pension liabilities have to be discounted at a uniform 4 per cent interest rate. This means that equities introduce a high degree of volatility into the portfolio while the value of the other assets and of the liabilities is very stable. Thus, the valuation rules appear to have an impact on the decision to invest a lower percentage of pension funds' assets in equities in the Netherlands; at the same time, however, the past real rates of return on bonds have been comparatively high in the Netherlands while in the United Kingdom real returns on bonds have been negative over a long period due to high inflation.

Table 2 shows that equities account for about 30 per cent of pension funds' investment in Argentina, Chile and Peru. Moreover, pension funds were a driving force in the development of the mortgage market.

Table 2. **Portfolio Composition of Private Pension Systems in Latin America (end–97)**

	Government securities	Deposits	Mortgages	Bonds	Equities	Other
Argentina	46.6	17.5	--	3.7	28.3	3.8
Bolivia	–	–	–	–	94.6	5.4
Chile	39.2	12.0	16.9	3.3	27.4	1.2
Colombia	20.1	15.5	2.8	43.6	2.3	15.7
Mexico	99.0	–	–	–	–	1.0
Peru	0.7	26.6	6.8	32.1	34.0	0.2
Uruguay	80.3	18.2	0.0	0.0	0.0	1.6

Source: Queisser, 1998*b*.

Valuation rules have less of an impact in defined contribution plans since there is no requirement to match assets and liabilities. The assets of defined contribution pension plans are usually “marked to market”, i.e. valued at current prices, every day. The use of market prices generates larger fluctuations in the pension funds’ portfolios but avoids the creation of large hidden reserves which would disadvantage workers who leave and transfer their assets to another fund. Most Latin American countries have mandated daily valuation at market prices. For non–traded assets, such as real estate, the supervisory agencies usually define a valuation method which pension funds must apply. In some Eastern European countries, the savings account principle is applied to pension funds which means that book values are used for asset valuation. Income accrued but not received and unrealised capital gains are not taken into account, which leads to the generation of hidden reserves (Vittas, 1996).

Since pension funds typically hold assets over a longer time than other financial institutions, the growth of the pension fund sector can be expected to lead to a term–transformation of savings. The pension funds’ demand can stimulate the development of a market for longer–term securities. Evidence from Latin American reform countries shows the growth of pension funds has promoted asset–backed securitisation.

In this process, personal housing, consumer or credit card loans are sold off the books of banks to a trust which, in turn, issues securities against these loans. Institutional investors such as pension funds, mutual funds and insurance companies are particularly interested in such asset–backed securities since these institutions themselves do not have the expertise and information to assess loan risks and collect repayments directly. Securitisation can therefore be expected to have a stabilising impact on the banking sector as the loans are monitored by separate specialised entities. More broadly, this process can also increase trust in the financial sector as institutional investors are provided with long–term securities instead of engaging in direct lending. The importance of securitisation is underlined by the disastrous performance of the housing finance and personal loan programmes offered by pension funds and social security systems in many developing countries. Typically, these programmes provided members with loans at very low interest rates and encountered serious problems in the collection of payments, leading to a rapid depletion of pension reserves[5].

The impact of institutional investors on the provision of venture capital and financing of small and medium–sized enterprises is less clear. Institutional investors may prefer to concentrate on the shares of larger, well–reputed enterprises instead of getting involved in riskier start–ups. Like in the case of unsecuritised assets, it may be preferable and in the interest of the pension funds’ members to invest via intermediaries such as specialised venture capital companies instead of choosing individual enterprises with uncertain standing and difficult–to–predict future earnings.

A further benefit of moving to a securities–based system is the diversification of risk. Bank–intermediated systems can lead to the creation of conglomerates and groups with many interrelated financial and non–financial institutions between which transactions are unlikely to be effected at market terms and conditions. The absence

of price signals will lead to the misallocation of resources and to a bundling of risk. Intermediation through different channels will improve resource allocation since corporate bond and equity markets will give price signals which reflect risk levels and provide information to market participants.

The increasing securitisation induced by the demand of institutional investors raises two questions *i)* Will this process change the financial systems of countries which are still largely dominated by banks? *ii)* Would such changes have a stabilising or destabilising effect on the financial sector as a whole? It does seem inevitable that the banks' position will be weakened to some degree when companies start turning to the capital markets for financing instead of borrowing funds from the banking system. However, it is less certain that the development of pension funds will "overturn" bank–dominated systems and inevitably lead to the convergence with Anglo–Saxon, i.e. securities–based, intermediation structures (Davis, 1995).

The structure and evolution of a financial system depends on the stage of a country's development (Demirgüç–Kunt and Levine, 1996) and on the overall economic system. Securitisation will only change the financial system if the public and private agents are willing to change the ownership and control structures of the current systems. In countries where the government and private sector wish to retain existing structures, the experience with pension funds in the United States and the United Kingdom will not necessarily be replicated (Bisignano, 1997). If company ownership is concentrated in the hands of a few families or closely held groups which refuse to open up to a larger number of shareholders, securitisation will have only a limited effect on bank–dominated systems. However, as the example of Chile and of the second–generation pension reforms in Latin America show, governments pursuing privatisation policies can instrumentalise pension funds to facilitate the transfer of state–owned enterprises to the private sector (Queisser, 1998*b*).

If a financial system moves from bank– towards securities–based intermediation, the process may destabilise the financial sector, at least in the short to medium term. Banks trying to compensate for the loss of business may be tempted to engage in riskier lending which would lead to financial sector destabilisation. Banks may also refuse to bail out troubled enterprises as their participation in the companies is reduced and their importance as strategic stakeholders declines. This evolution, however, would be a logical and temporary consequence of the transition to a market–based system; eventually, institutional investors would become important shareholders and more stability would be reached, albeit within a changed structure.

An interesting issue in this context is whether pension plans themselves may be affected by the process of moving to a securities–based system. Some countries with bank–dominated financial systems like Japan and Germany still rely heavily on book reserves for their supplementary pension plans. Under a book–reserve scheme, an employer makes binding commitments to employees to pay future retirement benefits. The company forms pension reserves in form of liabilities on the balance sheet and the reserves can be reinvested in the company. But transition towards a market–based financial system and the resulting changes in companies' governance coupled with the

increasing globalisation of the financial markets will require more transparency and accountability *vis–à–vis* shareholders. Since large reserves for self–financing cannot be justified by lack of external financing anymore, the book–reserve schemes are bound to come under pressure from investors. With more diversified ownership, companies will likely have more difficulties to obtain resources in the event of underfunded pension plans than with a bank–dominated system where the banks are represented both as shareholders and creditors on the company boards. Thus, this process may lead to a decline of book–reserve schemes and promote the establishment of external pension funds.

Even in a securities–based intermediation system, however, banks will continue to play an important role with a stronger emphasis on their prime functions of providing liquidity to the financial system and offering clearing and settlement services. Moreover, the experience of the recent pension reforms in Latin America shows that banks are prominent players in the private pension business; even in countries where banks are prohibited from directly owning pension fund management companies, they participate indirectly through the formation of holding companies. Therefore, as Davis (1995) predicts, it seems realistic to expect that the growth of pension funds will weaken but not wholly compromise the banks' position in countries with bank–dominated financial sectors.

Pension Funds, Investment Behaviour and Asset Price Volatility

International institutional investors have been blamed for increasing asset price volatility by acting as speculators during the 1995 Tequila crisis and during the 1997 Asian crisis. One potential beneficial effect of a domestic pension fund sector and a more solid domestic base of institutional investors could be to reduce asset price volatility, particularly at times when international institutional investors are pulling out of the country. The relative calm that Chile has enjoyed during the 1995 and 1997 financial crises suggests that domestic pension funds can play an important role as a domestic stabiliser and reduce a country's vulnerability to volatile capital flows. Domestic pension funds have an information advantage and may behave less erratically than foreign institutional investors, which tend to treat emerging markets stocks as an asset class and do not distinguish sufficiently between individual markets and even less between individual stocks (Aitken, 1996).

Still, what evidence is there that a large base of domestic institutional investors will actually stabilise asset prices? In many countries, large institutional investors, in particular pension and mutual funds, invest their assets in similar if not practically identical portfolios. There are several explanations for this observed "herding behaviour" of institutional investors[6]. One reason is that pension fund managers may intentionally base their investment decisions on the portfolio composition of the other funds in the market, thus establishing the average performance of the industry as their benchmark. Such behaviour is a consequence of the agency problem: since pension fund managers are controlled by the board trustees and frequently evaluated against each other, the upside potential of deviating from the average may weigh less for

managers than the risk of underperforming the market[7]. This behaviour may be reinforced by monitoring practices. Griffith–Jones (1996) points out that pension fund managers in the United Kingdom are usually given three–year mandates and are monitored on a quarterly basis whereas US managers have mandates of one to two years and are monitored monthly; with a short–term planning horizon it is not worth the risk for managers to deviate from the average by which their own performance will be measured. Another factor may be investment regulations which limit the amount of admitted investments and penalise pension funds straying from the average performance (Shah, 1997). In most Latin American countries, for example, pension funds are required to reach a minimum rate of return defined as a band around the average performance of the industry; in other countries, such as Singapore and Switzerland, minimum rates of return are defined in real or nominal absolute terms. Such regulations may lead managers to stick to a reference portfolio[8].

On the other hand, herding behaviour may simply reflect the fact that institutional investors as a group have better access to information and are in a superior position to process such information than other market participants. If this is the case, herding behaviour would be rational as institutional investors are only reacting in the same way to exogenous market signals. Whether herding behaviour of pension funds stabilises or destabilises securities markets then depends on the situation in the market. Pension funds will have a stabilising impact if their investment decisions contribute to a faster adjustment to equilibrium prices. This could occur when retail investors are behaving irrationally and pension funds are countering such irrational moves in their investment strategies by practising negative feedback trading, i.e. selling winners or buying losers. Destabilising effects, however, will result if institutional investors engage in trend–chasing and positive feedback trading by buying winners and selling losers or in window–dressing by taking well–performing stocks into their portfolio to avoid being criticised by the trustees (Lakonishok, Shleifer and Vishny, 1991). Such behaviour will increase asset price volatility and cause bubble–like booms or busts. The overall impact of pension fund growth on asset price volatility will depend on whether all institutional investors are following the same strategies, in which case booms and busts can be expected, or whether the strategies adopted by the different institutional investors offset each other, which would result in a reduction of volatility.

A study by Lakonishok, Shleifer and Vishny (1991) examined the investment behaviour of US pension funds and found no herding behaviour with respect to investment in large stocks; some herding was found for the investment in small stocks, which is in line with expectations as there is less information on small stocks in the market. Pension funds might decide to sell losers in order to avoid embarrassment but might feel more confident holding on to large blue–chip stocks even if share prices are temporarily declining. Thus, at least for investment in US equities, pension funds were not found to have a destabilising impact.

There is a difference between the investment behaviour and potential impact on volatility of defined benefit and defined contribution plans. Defined benefit plans can introduce volatility through a less stable stream of contributions. Blake and Orszag (1998) find that employers' contribution holidays in defined benefit plans tend to

lower equity prices in the United Kingdom; as the inflow of contributions is temporarily interrupted and pension assets are primarily invested in equities, prices will fall. On the other hand, the trend towards defined contribution pension plans may also increase volatility since such pension funds tend to behave more like retail investors focusing on short–term returns, particularly if plan members are free to move their assets between different funds, which increases competition for short–term performance between funds. Finally, as already discussed, the maturity of pension funds will also influence the volatility of assets prices; as plans mature, managers will switch from equities to fixed–income securities, which will entail a decline of equity prices and an increase in bond prices. This, in turn, may trigger further adjustment mechanisms as companies may find it beneficial to change their financing structures (Blake and Orszag, 1998).

Since the second–generation Latin American pension reforms have not been in place for a sufficiently long time and the large public pension funds in Singapore and Malaysia[9] are invested predominantly in government securities, Chile is the only emerging economy which presents some evidence of pension funds' impact on asset price volatility. In Chile, pension funds have been allowed to invest in equity since 1985. From 1990 to 1992, equity holdings increased from 11 to about 28 per cent of assets and stabilised around that level thereafter. This increase was primarily due to an increase in stock prices of almost 300 per cent . While such price increases seem to point to a bubble caused by the pension funds' demand for equity, there are several reasons to reject this hypothesis. Since the pension funds were allowed to hold only 30 per cent of their assets in equity, several of the funds reached this limit through the price increases and had to sell shares. Further, the pension funds were only allowed to invest in a small number of equities authorised by the Superintendency but the price increases were not limited to the authorised stocks. Therefore, the price increases appear to be mostly the result of a large reduction of the country risk premium and international arbitrage (Diamond and Valdés, 1994).

Pension Funds and Corporate Governance

The Asian crisis has shown that more transparency and disclosure of financial and economic data are of paramount importance for the stability of the financial sector and the economy as a whole. Institutional investors can contribute to improving flows of information and can increase pressure for better corporate governance and more accountability of managers. By pooling the interests of individual members pension funds can exercise considerable power over company management through shareholder activism and constitute a counterweight to family holdings or banks represented on the boards of companies.

Historically, however, corporate governance activities of pension funds have been rather limited. Pension funds in the United States and the United Kingdom have often preferred "exit", meaning the sale of shares in badly performing companies, over "voice", i.e. direct involvement in the respective company with the objective of improving corporate management and performance. In other countries with a strong

presence of pension funds such as the Netherlands, Switzerland and the Scandinavian countries, pension assets were and are still predominantly invested in government securities. This investment pattern made the pension funds' role in corporate governance insignificant (Vittas, 1996).

There are several reasons why pension fund managers are reluctant to become involved in corporate governance. Pension funds have no specific business expertise and no comparative advantage in assessing and influencing companies' management decisions; active involvement would thus require substantial investment in human capital as pension funds would need to acquire those skills. A second reason involves free–rider problems: any gains a pension fund might reap from a more active participation in company management must be shared with the other investors in the company, including institutional investors competing with the pension or mutual fund managers. Third, pension fund managers may prefer the option of a quick exit and higher liquidity over board representation and greater involvement in corporate management which restricts liquidity. Therefore, rather than engage in costly business monitoring activities with the objective of increasing shareholder value, fund managers will tend to sell shares. This tendency is even more pronounced in the case of take–over bids. Pension funds have a strong incentive to support the predator since the share price rises with bidding and is almost certain to fall if the bid fails (Blake and Orszag, 1998; Macey, 1997).

However, as assets grow and pension funds become significant investors in the market, they will be forced to exercise more voice. Once pension funds have reached a critical size and become collectively dominant shareholders, choosing the exit option by selling the shares will disrupt the entire market and move prices. Thus, the observed trend in Anglo–Saxon countries towards more voice is due to a decline of institutional investors' possibilities for exit. In addition, the regulatory framework for pension funds' duties and proxy voting has a strong influence on pension funds' behaviour as shareholders[10].

If shareholder activism increases in other countries following the experience of the United States, will this lead to improved performance of companies? The evidence from the United States is not conclusive on this point and there is no consensus among academics and practitioners on how well or badly the system of corporate governance is working. The results of a wide range of studies are inconclusive: they have found a positive impact, a negative impact or no effect of shareholder activism on corporate performance (Romano, 1997). Moreover, there are no clear conclusions with respect to the impact of take–over activities. While advocates see the take–over threat as an effective means of controlling managers and the take–over itself as increasing companies' efficiency, critics claim that take–overs are destabilising, very expensive, and inefficient since they may provoke defence mechanisms which drain the targeted company's resources without improving efficiency.

The existence of large institutional investors does not automatically entail an improvement of corporate governance. As discussed earlier, the effect depends on the degree of securitisation and the extent to which pension funds become important shareholders in the first place. Additional factors are the structure of the enterprise sector, and legislation and regulations concerned with pension funds' activities. The extent to which pension funds become involved in corporate governance activities also depends on the corporate governance of the pension funds themselves. If there is little disclosure and pension fund members do not receive detailed information on the funds' investment policies, there will be less pressure for high returns and, consequently, less pressure for the funds to engage in corporate governance activities. Therefore, public pension funds such as the provident funds in Singapore and Malaysia, which are completely under government control and disclose very little information on their investment policies, are likely to be less involved in company management issues.

Pension Funds and Exchange Rate Stabilisation

The Asian crisis has triggered an intense debate on the appropriate strategies and instruments for the management of capital inflows and exchange rate stabilisation. In this context, another potentially beneficial impact of developing pension funds and a sound base of domestic institutional investors can be identified. As the example of Chile shows, pension funds can be used to facilitate domestic securities operations of the monetary authorities and can thereby contribute to the stabilisation of the real exchange rate.

After the deep crisis and near collapse of the financial sector in 1982, the Chilean government took over most of the external debt incurred by the private sector. Thus, the Chilean government had to mobilise the resources for the large external transfers necessary to service this debt which means that private sector savings had to be transferred to the public sector. The external debt problem was addressed with a range of measures, the most important being fiscal adjustment policies. Compared to other Latin American countries, however, Chile was at an advantage since the government was able to tap the domestic capital market by using the pension system. In 1981, Chile had reformed its public pay–as–you–go pension system and replaced it with a fully funded privately managed system of pension funds. As pension fund assets were rapidly accumulating, pension funds were developing an increasing demand for securities.

Thus, the government was able to place public debt without having to offer the high interest rates witnessed in other Latin American countries during the debt crisis. In addition, since the securities issued by the central bank are indexed, like most other long–term financial contracts in Chile, the pension funds were guaranteed a real rate of return (Fontaine, 1997). A further factor for the pension funds' willingness to hold

central bank paper is that the investment regulations restricted the funds' portfolio choices and therefore practically guaranteed a certain amount of investment in these securities.

Since the end of the 1980s, however, the Chilean government was confronted with the opposite problem, i.e. large capital flows streaming into the country. Again, it appears that pension funds were instrumental in managing these capital inflows and stabilising the real exchange rate. To prevent an appreciation of the peso, the central bank intervened directly in the exchange market by buying the inflowing foreign exchange and later sterilising the intervention by issuing central bank debt. The cost of sterilised interventions depends on the difference between the return earned on foreign reserves and the interest payable on debt issued by the central bank. In some countries, weak capital markets or political factors do not permit the central bank to place debt at reasonable costs. But the existence of a solid base of institutional investors demanding government securities and a deep capital market again facilitated the placement of government debt in the private sector and lowered the cost of sterilisation to the central bank (Fontaine, 1997).

In assessing the pension funds' role in macro and exchange rate stabilisation, however, it has to be recognised that the Chilean government dealt with the exchange rate and capital flows by using a whole range of policies such as fiscal adjustment, import tariffs and trade policies, indexation of the financial sector, privatisation and other measures. Since pension funds were only one of the factors contributing to the successful exchange rate management, it is impossible to isolate and quantify the impact and contribution of pension funds, for example, to the lowering of sterilisation costs. But it is reasonable to conclude that systemic pension reform and the development of a base of institutional investors led to a deepening of Chilean capital markets and facilitated the management of capital inflows.

Conclusions and Policy Implications

The discussion of the interaction between pension funds and financial sector development shows that pension funds can have both stabilising and destabilising effects on the financial sector. The only clear and definite stabilising effect appears to be the contribution of pension funds to the development, modernisation and efficiency of the financial sector's infrastructure. The potential benefits of developing a base of institutional investors for the improvement of financial services are large. Whether they will actually materialise, however, depends the conditions under which pension funds operate. In order to maximise the positive impact on financial sector infrastructure in emerging capital markets, pension funds should *i)* be introduced as part of a systemic pension reform, *ii)* be mandatory for formal sector workers[11], *iii)* have a sufficiently high contribution rate, *iv)* be invested at least partially by competing investment managers with participation of international providers, and *v)* be subject to tight regulation and close supervision.

The last point in particular is controversial. Some experts (Shah, 1997; Blommestein, 1997; World Bank, 1997) believe that detailed regulations, especially asset restrictions and rate of return guarantees, introduce market distortions and thereby limit pension funds' contribution to capital market development. If pension funds were free to choose their investments and subject only to the "prudent man" rule as it is applied in many Anglo–Saxon countries, the positive impact of pension funds on financial sector development would be much greater.

Pension funds, however, are different from other forms of financial intermediaries since they have not only a financial and economic role but also an important social function. While pension funds can be instrumental and helpful in fostering financial sector development, their primary function remains the provision of retirement income to workers. All other functions or effects of pension funds on capital market development, on the insurance industry or on privatisation policies, however beneficial they may be, are subordinate objectives of pension fund development. What matters to workers is the quality and reliability of their pensions. In defined contribution schemes this requirement translates to the goal of the highest possible risk–adjusted returns. Particularly where pension funds are mandatory, the state has a special responsibility to ensure retirement income security by making funds subject to a clear set of rules, providing workers with the information they need to understand the institutions to which their savings are entrusted, and supervising the pension funds' operations. If a government is unable to provide this protection, capital market development should be pursued through other policies and reliance on pension funds should be postponed to a later stage.

Furthermore, this discussion has shown that the impact of pension funds on financial intermediation, on the volatility of asset prices and on corporate governance is unclear. In all three areas, pension funds could have stabilising as well as destabilising effects on the financial system. Again, regulation is an important determinant of which direction the pension funds' influence takes. Pension funds could play a major role in the move from a bank–dominated to a securities–based system. But the actual effect depends strongly on the pension funds' investment behaviour as well as on the willingness of private and public agents to accept a dilution of ownership and control and thus accommodate the move to a securities–based system. If such a move occurs, temporary destabilisation can be expected during the process of adjusting to a new structure. It seems safe to conclude, however, that under all intermediation scenarios the banking sector will continue to play an important role.

Asset price volatility might be reduced or increased through a base of institutional investors depending on the situation in the market. If institutional investors contribute to a faster adjustment of prices to the equilibrium level, their impact would be stabilising. In emerging markets where individual investors may not have sufficient information and knowledge and may thus react irrationally, institutional investors could have a stabilising impact on asset prices due to their better access to information and greater ability to analyse and process this information. Anecdotal evidence for Argentina, for example, indicates that the contagion effect of the Asian crisis on the

domestic stock market was limited through the pension funds investment behaviour which countered the reactions of individual investors. At the same time, the danger of bubbles seems greater when institutional investors are engaged in small markets with only a limited range of investment choices.

Based on the experience of US and UK pension funds' involvement in corporate governance, no major effects can be expected in emerging markets in the short or medium term. As pension assets will build up gradually, the potential for corporate governance will increase but pension funds are likely to prefer the "exit" option, i.e. to sell shares in poorly performing companies, as long as it is available. Even in Chile where pension funds' assets amount to about 40 per cent of GDP, pension funds have thus far hardly engaged in corporate governance activities. If pension funds are fully controlled by the government, like the provident funds in Singapore and Malaysia, corporate governance activities in the private sector are even less likely. This points to the importance of addressing the corporate governance of the institutional investors themselves.

Finally, the example of Chile shows that pension funds can facilitate the management of capital flows. Although the pension funds were only one of the factors contributing to Chile's successful exchange rate management, systemic pension reform and the development of a base of institutional investors led to a deepening of the capital markets and thereby facilitated the management of capital inflows.

Since there are only few emerging economies where pension funds are playing a significant role, there is little empirical evidence as yet. The pension reforms in Latin America and in transition economies, however, will lead to a rapid build–up of pension assets and will provide empirical evidence on the pension funds' role for financial sector development. The analysis of this evidence and the implications for policy makers in emerging economies will be part of the Development Centre's research programme in the coming years.

Notes

1. Rojas–Suarez and Weisbrod (1996) examine the volatility of financial systems in Latin America and find that it is closely related to problems in regional accounting and legal systems.
2. The Chilean authorities allowed early retirement in 1988 which triggered a high demand for annuities as workers retired from the newly defined contribution system. For details see Queisser (1998*b*).
3. Diamond and Valdés (1994) estimate that only about 3 per cent of the AFPs' portfolio was exposed to inflation risk in 1992.
4. Aizenman and Powell (1997) find that the interaction of uncertainty, poor legal enforcement capabilites and imperfect information in the banking sector account for the severity of the effect of volatility on emerging market economies and suggest that a useful policy measure to reduce volatility would be the establishment of a public or subsidised credit bureau.
5. For details on this issue see World Bank (1994).
6. For a discussion of the reasons for investment herding behaviour, see Scharfstein and Stein (1990), Lakonishok, Shleifer and Vishny (1991), Shiller and Pound (1989), Aitken (1996).
7. The agency problem of professional money management is further explored in Lakonishok, Shleifer and Vishny (1997) and for UK pension funds, in Blake and Orszag (1998).
8. The impact of the Chilean minimum rate–of–return regulations on herding behaviour was examined in a recent study by Ramirez Tomic (1997). This study found that herding had actually decreased slightly after the fluctuation band around the minimum rate of return was narrowed, thus providing no confirmation of the hypothesis that this regulation is the main reason for the uniformity of pension fund portfolios.
9. Nevertheless, an interesting example of pension funds' influence on asset prices comes from Malaysia. In 1997, the Malaysian government decided to set up a fund of 60 billion ringgit (about 25 per cent of GDP) to be financed partly out of reserves of the Employee Provident Fund, other pension funds and through the issue of government bonds. This fund's objective is to buy shares of Malaysian companies traded on the Kuala Lumpur Stock Exchange at above–market prices. (Asher, 1997).

According to press reports, this controversial scheme appears to be used to recapitalise the banking sector and bail out companies in which public institutions have strategic shareholdings. See the *Asian Wall Street Journal*, 5–6 March 1998.

10. Davis (1995) points out that ERISA regulations on voting as fiduciary duty and social activities of shareholders constituted the turning point in corporate governance activities of US pension funds.

11. A first cross–country analysis of the empirical impact of funded pensions on aggregate savings finds that to stimulate savings it is important that funded pension schemes are mandatory, that tax exemptions on pension returns are limited to low savers, and that borrowing against the accumulated mandatory pension assets is discouraged. See Bailliu and Reisen (1997).

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The Benefits of Trade and Investment Liberalisation: Financial Services

Pierre Sauvé[1]

East Asia After the Crisis: Staying the Course of Open Markets

The major economic turmoil experienced by a number of East Asian economies during the past year has provoked a lively debate over its potential impact within the region and beyond. Although it is still difficult to forecast the consequences of the crisis with precision, it is obvious that confidence in the continuous smooth development of worldwide economic integration has been shaken. This will increase anxiety in some segments of civil society around the world about the potential pitfalls of globalisation and the downside of greater economic integration, a subject to which the OECD has recently devoted much attention[2].

One of the worries associated with the economic and financial crisis in Asia is whether economic hardship will make the region's governments less open to pursuing liberalisation of trade and investment. There might be a temptation to reconsider the process of gradual liberalisation that has been underway for some years, including in the financial sector, as a result of collapsing export growth (due to the exporters' difficulties in obtaining credit for working capital and for purchasing imported intermediate goods and services with sharply depreciated currencies), and the serious growth of unemployment as economies slow. There have already been calls for slowing down or reining in liberalisation policies (particularly as regards capital flows), at least until the required adjustments to domestic economic and regulatory policies in affected Asian countries have been implemented and begin to prove their effectiveness.

In the context of major macroeconomic and financial instability and real social dislocation, it is obviously more difficult for Asian governments (and their OECD counterparts) to keep markets open, resist calls for protectionist measures, accelerate the pace of structural and regulatory reforms and make new commitments for further trade and investment liberalisation. This makes it more vital for governments to be clear about what trade and investment liberalisation can and cannot do, and be held responsible for. It is equally important to explain more clearly and forcefully how greater openness to trade and foreign direct investment is far more likely to help resolve current problems than to aggravate them.

A useful starting point in this regard is to be clearer about the forces underlying the tremors felt by East Asian economies over the past year. The consensus view tends to regard such problems as arising from the interaction of a number of financial and structural weaknesses. These include the misallocation of resources associated with directed lending, political favouritism, over–leveraged corporate balance sheets, non–performing bank loans, inadequate prudential supervision, growing current account deficits (often associated with unproductive domestic investments), currency appreciation, herd behaviour by foreign portfolio investors, and moral hazard problems arising from implicit government guarantees on external borrowing.

Observers agree almost unanimously that the crisis cannot be ascribed to trade and FDI liberalisation in the countries concerned. On the contrary, had liberalisation efforts been accompanied and bolstered by the greater transparency, predictability and competitiveness that should come with liberalisation of trade and investment, it is generally believed that the crisis might have been less likely or, at least, have been less serious. Nowhere is this truer than in the financial sector, whose inefficiencies have been highlighted in a number of East Asian countries during the past year.

It is therefore not altogether surprising — and indeed heartening — that rather than lessening support for open markets, the policy response to the Asian crisis has, if anything, been the opposite. At the last Asia–Europe summit meeting in London and more recently at the WTO’s 50th anniversary ministerial gathering, Asian leaders agreed that maintaining open markets was an essential ingredient of recovery in the region. Asian governments have similarly not demurred from the longer–term commitment to establish a regional free trade and investment area in the Pacific with their partners in the Asia–Pacific Economic Co–operation (APEC) Forum and they have also agreed to reap earlier liberalisation harvests by identifying a list of sectors in which tariff–free trade should be achieved on a priority basis.

It is probably reasonable to expect that the crisis will compel governments to open their markets further and remove distortions which inhibit growth of trade and foreign direct investment activity. Insofar as the crisis leads to a more open environment in the longer term, it may even come to be regarded as beneficial from an economy–wide perspective[3]. Compliance with multilateral commitments and disciplines —particularly those of the IMF and the WTO — can play a significant role in this regard[4].

Reaching a WTO Agreement on Financial Services

This paper focuses on an issue that has received relatively less attention in discussions of the origins, effects and possible resolution of the Asian financial crisis. Financial arrangements in Asia began to unravel at a time when member countries of the World Trade Organisation had only just resumed talks aimed at completing (more than a decade after Uruguay Round was launched) the last outstanding item — and for many the apex — of the Round's ambitious agenda: liberalising cross–border trade and investment in financial services. It is significant that these negotiations were successfully concluded in December 1997 at a time of major financial turmoil in East Asia and when there was serious concern over the possible spillover effects of the crisis on the world's trade and payments systems[5].

A notable feature of the WTO negotiations on financial services was that they did not take place in the usual context of a multisectoral and multi–issue negotiating round. This had been the original intention, despite the manifest reservations of finance ministry, central bank and other supervisory officials, but failure to complete the negotiations before the end of the Uruguay Round effectively turned financial services into a single–sector negotiation (see Box 1).

Box 1. **A Long, Winding Road: Completing the WTO Financial Services Agreement**

Mid–December 1997 was set as the deadline for completion of WTO negotiations on financial services after the expiration of a July 1995 interim agreement on financial services. This interim arrangement had been put together after agreement could not be reached in this area by the time the curtain fell on the Uruguay Round negotiations in Marrakech at the end of 1993. The lack of agreement was due to divergent expectations on the scope of tangible liberalisation commitments (a fate shared at the time by GATS talks on maritime transport and basic telecommunications services as well as on conditions governing the temporary movement of service suppliers). At the time, a number of Asian and Latin American WTO members had agreed to undertake (or "schedule" in GATS terminology) liberalisation commitments which they deemed to be appropriate for developing or emerging economies. These offers were considered inadequate by a number of OECD countries, chiefly the United States, whose private sector had higher expectations in the light of the significant political investment it had made in the negotiating process since the early 1980s. It was thus agreed to extend the negotiations for a further 18 months. In June 1995, 43 WTO members (counting the 15 countries of the European Union as one) improved on their earlier commitments, in some cases substantially, but it was still impossible to reach a permanent MFN–based agreement acceptable to all the major players. Unwilling to tolerate the free riding and loss of negotiating leverage that would result from a financial services agreement not based on the most–favoured–nation principle enshrined in the GATS, in June 1995 the United States chose to retain the option of negotiating bilateral agreements rather than concluding a binding multilateral agreement (Key, 1997).

This tended to divide countries into two camps: those looking for export gains (mostly OECD countries, and the United States in particular) and those concerned chiefly with enhancing (or not) conditions of competition in domestic financial markets (most developing countries, including in Asia)[6]. Genuine concerns were expressed that the absence of any possibility for cross–sectoral trade–offs would dampen prospects for a liberalising outcome in the sectoral talks (Sauvé, 1997). Rather than lessening liberalisation prospects, the severity of the financial crisis proved a catalyst, prompting many hitherto reluctant governments of emerging countries (including in East Asia) to undertake major new commitments or, at least, to lock in the degree of financial sector openness achieved in recent years (see Box 2).

Box 2. **What the WTO Financial Services Negotiations Achieved**

The WTO negotiations on financial services concluded successfully on 12 December 1997 after WTO members agreed to bring trade and investment in the sector under multilateral disciplines on the basis of permanent and full most–favoured–nation treatment. The agreement was a significant improvement over the interim agreement concluded in 1995. At that time, only 43 countries (with the EU counted as one) had put liberalisation offers on the table. The December 1997 outcome can be seen as vindicating the hard line of the US government and the US financial industry, although a desire to escape blame for yet another missed deadline and the advent of the crisis in Asia did temper US public and private expectations somewhat.

The December 1997 agreement covers more than 95 percent of the trade in banking, securities, insurance and information services as measured in terms of revenue. In all, 102 of the 132 member countries of the WTO now have multilateral commitments in the sector, including 70 improved commitments for opening markets made during the last round of negotiations. According to US Treasury and WTO estimates, these commitments encompass $17.8 trillion in global securities assets; $40 trillion in world banking assets (of which $8.6 trillion of foreign assets of deposit banks); and $2.2 trillion in gross insurance premiums[7].

The results of the latest round of talks are part of a protocol which governments can endorse until 29 January 1999. The agreement will come into force on 1 March 1999. Under the terms of the WTO's "built–in agenda" agreed upon at the Uruguay Round's conclusion in Marrakech in December 1993, a comprehensive set of negotiations under the General Agreement on Trade in Services (GATS), including all financial services, will resume no later than 1 January 2000.

An important policy lesson emerging from the Asian crisis is that the binding nature of liberalisation commitments in the WTO provided countries with a tailor–made opportunity to reaffirm and/or deepen their commitment to market openness and to restore investor confidence at a critical juncture. In the words of WTO Director General Renato Ruggiero: "With so much of the world facing economic turbulence,

negotiators from all WTO Member states have shown once again the courage and commitment to pursue the policies of liberalisation which are essential to economic stability, growth and development. It is only through the WTO's rules, agreed by all its Members, that business can best gain the certainty needed to plan their future international activities"[8].

The Outcome of Financial Services Negotiations in the GATS

The December 1997 agreement promises to open financial markets to an unprecedented degree. It should help foster the development of financial markets worldwide, especially in developing countries (recalling that those countries whose markets are most closed to foreign competition stand to reap the greatest welfare gains in relative terms), and help create firmer foundations for sustained growth. Many developing countries in Asia and elsewhere had already begun the process of financial sector liberalisation, but previously had hesitated to lock in such measures. The WTO agreement allows members to lock in that progress under conditions of greatly improved transparency and legal predictability, providing both permanency to domestic reform efforts and a basis for progressively extending such reforms in the future.

Looking at commitments secured across financial market segments, 52 WTO members have guaranteed broad market access terms across all insurance sectors — encompassing life and non–life insurance, reinsurance, brokerage and auxiliary services, while another 14 members made commitments to open significant subsectors of the industry. Fifty–nine countries will now permit 100 per cent foreign ownership of subsidiaries or branches in banking, while 44 countries will do the same in the securities sector (US Treasury, 1997).

Aadytia Mattoo (1998) of the WTO secretariat recently completed a very thorough assessment of the commitments undertaken in insurance and banking services by 105 developing and transition economies under the December 1997 agreement. Some of his main findings, particularly as regards countries in Asia (a region defined as encompassing 25 countries, including Turkey and Israel) as well as the economies of South Asia, Southeast Asia and the Pacific follow.

In the area of insurance services, over half the countries surveyed, accounting for 95 per cent of the combined GDP of non–developed WTO members, made commitments on direct insurance services. Participation was highest in Eastern Europe, where all WTO members made commitments. In Asia, the 17 countries making commitments accounted for 95 per cent of the regional GDP. As may be expected, there are significant differences in commitments among the countries concerned. As in the OECD area, most developing countries (including in Asia), eschewed liberalisation commitments on cross–border delivery of insurance services, so that foreign direct investment, or "commercial presence" in GATS terminology (and the greater regulatory and supervisory proximity it involves), is by far the preferred route for guaranteeing access to domestic markets for direct insurance services. The study

shows that the number of commitments to open markets fully to foreign insurers is higher in Asia (7 out of 17 committing countries) than in Latin America (3 out of 18), the region where most other significant emerging economies are found. A comparison of the two regions' restrictions shows that Latin American countries were more reluctant to guarantee free entry while Asian countries were more reluctant to allow full (or majority) foreign ownership.

Turning to banking services, Mattoo reports that commitments in core banking services (accepting deposits and lending of all types) were generally greater than in insurance, as nearly two–thirds of the countries surveyed, accounting for 97 per cent of the aggregate GDP of non–developed WTO members, scheduled commitments. As with insurance, participation was again highest in the transition countries of Eastern Europe. Asian and Latin American participation in banking was only marginally greater than in insurance.

The number of liberal commitments on cross–border trade in banking services (both consumption abroad and the cross–border supply of services) was markedly higher than in insurance. This reflects the more internationalised nature of the banking industry and the generally higher level of regulatory comfort brought about by closer international co–operation among bank supervisory authorities. The number of fully liberal commitments for foreign investors were broadly comparable to those observed for insurance, with 26 countries which account for over a fifth of participants' GDP. Asia stands out as the only region where fewer countries assured full openness on foreign investment (commercial presence) than on cross–border supply, its banking commitments on the whole conferring less commercially meaningful foreign access to domestic markets than is the case in Latin America. The nature of restrictions maintained in the two regions is broadly similar to that found in insurance, reflecting greater Asian concerns over the nationality of bank ownership and the Latin American countries' greater desire to limit bank entry. In Asia, entry limitations are accompanied by restrictions on foreign equity in ten countries (among which are Indonesia, Korea, Malaysia, the Philippines and Thailand). A further difference worth noting is the greater tendency of Asian countries to place numerical restrictions on branches of foreign banks.

As is typically the case in trade agreements covering "new" issues, particularly those that encompass regulatory impediments to trade and investment, the great majority of commitments scheduled under the GATS represent a standstill, i.e. a locking in of the regulatory status quo. Though it is technically incorrect to describe standstill undertakings as liberalisation commitments, one should not discount the importance of establishing a floor from which future negotiating rounds can seek to roll back barriers to entry and competition in financial markets. Consolidating the status quo also has commercial value as it contributes to market predictability (to which foreign investors attach considerable importance) while signalling a commitment to the trading system. Furthermore, for a number of countries (most notably economies in transition), the status quo itself locks in quite recent liberalisation initiatives, either decreed unilaterally (most often) or in response to requests made by trading partners during the course of the GATS negotiations (Mattoo, 1998).

More troubling was the decision, permissible under the GATS' somewhat convoluted "hybrid" approach to scheduling liberalisation commitments (which combines a positive list of covered services with a negative list of non–conforming measures restricting trade and investment in covered services (see Hoekman, 1995; Sauvé, 1996; and Bosworth and Snape, 1997), to bind at less than the regulatory status quo, an option exercised by a number of Asian countries. The Philippines, for example, did so with respect to foreign equity participation in commercial banks, binding at 51 per cent when domestic law already allows 60 per cent. Korea also stopped short of reflecting in its GATS schedule all the current and future liberalisation commitments made in the context of its accession to various OECD instruments (e.g. the Codes on Capital Movements and on Current Invisible Transactions and the National Treatment Instrument). The gap between several Asian countries' bound commitments under the GATS and the current regulatory situation has increased further as a result of recent liberalisation measures required as part IMF rescue packages[9].

Among the possible reasons for scheduling commitments at less than the regulatory status quo is that it allows countries to retain some negotiating coinage which can be "spent" in future negotiating rounds. It may also have signalled the uneasiness of certain Asian countries with respect to the level of liberalisation already achieved, and hence a desire to be unconstrained by multilateral disciplines in reining in liberalisation measures (if the crisis prevailing at the time of negotiations deepened further). While both factors were probably operating, it should be recalled that most countries in the region improved their "liberalisation" offers over what had been put on the table in 1995.

Another source of concern is the fact that Asia was the only region in which GATS negotiators had to contend with the problem of forced divestiture. This reflected the financial indigenisation policies pursued by a number of countries in banking and insurance services, making the regimes relating to foreign ownership and legal forms of commercial presence more restrictive than when foreign firms first entered the market (a problem foreign insurance companies also currently encounter in China). This problem was most acute in the case of Malaysia, where foreign stakes in existing insurance companies are not grandfathered under a 1996 law that compels foreign ownership to be reduced to 49 per cent by 1998 and limits new foreign acquisitions to 30 per cent[10].

Summing up, the picture that emerges is somewhat sobering: the liberalising content of the commitments by East European and African countries is deeper than those of Asian and Latin American countries. As regards the latter two "emerging" regions, the evidence suggests that Asia has on the whole made more liberal commitments on insurance services, whereas Latin America is more open to foreign competition in banking. Despite the recent trend towards greater market openness in Asian financial markets, the outcome of the GATS negotiations suggests that there is still considerable caution concerning a rapid opening of the sector to outside competition. Much of this obviously was due to the turbulent financial conditions at the time of the negotiations. Still, concerns linger over the ability of local financial institutions to survive the advent of increased foreign competition, and a road map for achieving an APEC–wide pledge for removing all trade and investment impediments in the sector

by 2020 has yet to emerge. The licensing of foreign financial institutions in many countries continues to be more restrictive for new branches or wholly owned subsidiaries; the product range of foreign financial institutions (particularly as regards the supply of new — and innovative — financial services) in most countries continues to be restricted; and access to automatic teller machines (ATMs) and to payments and clearing systems is often more limited or tightly regulated for foreign firms (Woolcock, 1997)[11]. In the domain of securities, foreign operators note the following key barriers to market access in the Asian region: lacking rights of establishment, ceilings on foreign investment, restrictions on the introduction of new products, discrimination against foreign companies in initial equity offerings, restricted access to membership in stock exchanges, strict foreign exchange controls, and non–transparent regulations and excessive administrative discretion in licensing[12].

The Way Forward: The Case for Open Financial Markets

While the December 1997 agreement is a landmark achievement whose timing could hardly have been better, the above observations suggest that it was only the beginning, a first stage in what is likely to be a long journey towards achieving more internationally competitive financial markets. This is especially true of countries in Asia, many of which have long been reluctant to open up the sector to greater competition from outside and whose financial sector commitments under the GATS are in many instances lower than the level of economic and financial development in the region would appear to warrant (Claessens and Glaesnner, 1998; Woolcock, 1997; Sorsa, 1997; Dobson and Jacquet, 1998).

Thus it is useful to recall the strong case for further liberalisation of trade and investment in the region's financial sector, especially in the current climate of uncertainty and when the influence of financial and real aftershocks cannot be fully discounted. In stating the case for greater financial market openness, it is important to assuage a number of concerns or misgivings that tend to surface in policy debates over the pros and cons of market opening and which the recent events in Asia have clearly revived. Six of these issues deserve particular mention.

First, *measures that restrict trade and investment in the financial sector and which retard its innovation and adoption of the best production methods impose real costs on domestic economies.* Cross–country empirical evidence suggests that the limited degree of financial openness offered by Asian economies to date has been costly in terms of slower institutional development, more expensive financial services and greater financial system fragility. The costs of financial services and the fragility of domestic financial systems in eight Asian countries were found to be negatively related to the degree of openness of the domestic market to foreign financial operators. Conversely, the efficiency of providing financial services and the institutional development of the financial sector were shown to be positively related to openness (Claessens and Glaessner, 1998).

Second, *the case for open markets in the financial sector is as robust as in any other sector.* In all likelihood, it may even be stronger, given the central role performed by the financial sector and its influence on overall economic growth and efficiency. Just as the removal of trade barriers affecting goods encourages specialisation according to comparative advantage and encourages formerly protected producers to increase efficiency, foreign involvement in markets for financial services can lead to an improvement in the functioning of domestic financial systems. The tangible economy–wide benefits of trade– and investment–induced competition in financial services has been documented in an abundant literature (see Box 3). From the standpoint of market access — i.e. liberalisation of trade and foreign direct investment — there is nothing inherently "special" about the financial sector suggesting that financial institutions should be domestically owned and controlled, or shielded from foreign competition. There is scant evidence to back up fears — often expressed as a need for protecting infant industries or safeguarding sovereignty — that foreign financial institutions might come to dominate the domestic industry, that they are inherently footloose, or that they will "skim the cream" by concentrating solely on profitable market segments. Experience shows that some of the potential costs of market liberalisation and legitimate concerns arising from liberalisation can be minimised in ways other than by restricting entry of foreign financial firms or inhibiting the cross–border provision of financial services.

Third, *GATS' commitments in the financial area do not in any way question or impair what are universally regarded as the sector's unique features*, i.e. the fiduciary nature of many of the functions financial institutions assume and the need for governments to take prudential measures to ensure the integrity and stability of domestic financial systems, so long as these are applied in a non–discriminatory manner and do not constitute a disguised restriction to trade and investment. Liberalisation of financial services trade and investment under the GATS cannot serve to undermine the conduct of macroeconomic policy. Several of the Agreement's provisions explicitly respond to such regulatory concerns. There are provisions dealing with the so–called "prudential carve–out", the explicit exclusion from the scope of the GATS of services supplied in the exercise of governmental authority (including those dealing with monetary or exchange rate policies), as well as the possibility of resorting (non–discriminatory) to temporary safeguard measures in the event of serious balance–of–payments disequilibria. In addition, the incorporation in the GATS of the principle of "progressive liberalisation" reflects a collective acceptance that liberalisation under the WTO will necessarily be a gradual process. As noted in the preceding section, Asian governments made full use of the GATS' built–in flexibility on the liberalisation front in the latest financial services negotiations. They can and should do the same in the next negotiating round, especially since the GATS provides them with the opportunity to pre–commit or phase–in future market opening commitments in a way that signals to foreign investors and domestic institutions the desire to lock in reform efforts (and thus prevent subsequent policy reversals) and to prepare for (and adjust to) a more competitive market environment. Equally important, pre–committing to future liberalisation provides regulators with a clear timetable for developing and/or strengthening the necessary supervisory framework (Mattoo, 1998).

Box 3. **The Benefits of Open Financial Markets**

There will be both static and dynamic gains from trade and investment in financial services, just as there are gains from opening up trade and investment in goods and other services. Two broad categories of benefits are worth emphasising: first, easing access to foreign savings can contribute to financing a higher level of investment; second, competition with foreign financial institutions and more liberal conditions governing foreign entry can produce efficiency gains and promote technology transfers, thus leading to a modernisation of domestic financial systems and an improvement in the quality of investment. Perhaps the most important benefit conferred by an open financial system stems from the positive spillover effects on savings and investment and on the allocation of productive resources. By increasing the rate of capital accumulation and by increasing the efficiency with which capital, technology and labour are combined in production, it follows that financial systems which provide better services also contribute more to economic growth and development. By increasing the efficiency of financial intermediation, greater openness heightens the financial system's ability to direct funds where the marginal product of capital is highest.

Increased competition lowers the cost of financial services for households, businesses and governments, and, moreover, it eases access of firms, that of small and medium–sized enterprises in particular, to sources of external financing and financial innovation. It thus raises the overall competitiveness of the non–financial sector. Levine (1996) and Claessens and Glaessner (1998) argue that liberalising foreign bank entry can significantly bolster financial development. Foreign intermediaries can be expected to provide services of a higher quality at lower costs, to spur improved quality and cost–cutting in the domestic banking sector, to promote better accounting, auditing, risk management and rating institutions, and increase pressures on governments to enhance legal, regulatory and supervisory systems and lead to better disclosure rules. Liberalising entry also improves access to international capital markets and can also contribute substantially to the development of a skilled domestic labour force in the sector (Jacquet, 1997). Finally, liberalisation can also help countries build up an export sector in financial services, an expressed desire of a number of economies in Asia (e.g. Singapore, Hong Kong and Malaysia).

Fourth, *it is important to be clear about the differences between trade and investment liberalisation on the one hand, and capital account liberalisation on the other.* Trade and investment liberalisation address discriminatory measures and barriers to market access affecting the ability of foreign financial institutions to compete in domestic financial markets. Capital account liberalisation involves removing capital controls and restrictions on the convertibility of a currency. The Asian crisis (and before it the Mexican peso crisis of late 1994) has clearly given capital account liberalisation a bad name. Concerns over the potentially destabilising effects of high and increasing capital mobility, particularly short–term flows, have fuelled a lively debate over the desirability of a regulatory (and a mobility–restraining) response[13].

However, it would be wrong to delay trade and investment liberalisation on such grounds. As the case of Chile has shown, adopting non–discriminatory conditions of competition does not require moving to a fully open capital account. Nevertheless, the degree of capital account liberalisation will have some bearing on the potential gains and benefits from greater market access. A number of cross–border financial transactions simply could not be carried out without some degree of free capital movement. Pressures to curtail capital restrictions are unlikely to abate since cross–border transactions are expected to experience strong future growth in the wake of the electronic commerce revolution. Reducing controls on international capital movements can help to lower the cost of capital by facilitating access to foreign savings and permitting greater risk diversification. The quality of a country's financial system is a key factor in helping reap the gains — and mitigating the potentially adverse consequences — arising from greater capital mobility[14]. Capital account liberalisation thus needs to be accompanied by, and can usefully complement, the strengthening of domestic financial systems. Experience shows that a greater presence of foreign financial institutions can assist in this task insofar as foreign operators transfer improved systems of risk management to host countries' financial systems (Levine, 1996).

Fifth, *the twin processes of opening up financial markets to foreign competition and efforts at domestic financial reform should be carried out in tandem.* Indeed, it is essential that market opening be seen as part of the domestic reform effort[15]. Recent work at the OECD and elsewhere on the economy–wide and sectoral dimensions of regulatory reform in the financial sector has shown that a pro–competitive domestic regulatory framework can play a key role in helping spread the gains resulting from opening up to the outside world[16]. *A contrario*, countries and domestic financial institutions that are saddled with excessive and burdensome regulations will likely be at a competitive disadvantage and thus will likely resist efforts to open markets. Domestic reform efforts should focus on the twin objectives of allowing market forces to assume greater prominence in credit allocation decisions and changing the nature of state intervention more broadly[17]. Openness to foreign competition complements such efforts by encouraging domestic firms to be more efficient, to broaden the range and quality of services and lower their costs, and to tap into the best production and marketing methods and technologies available abroad. Studies show that foreign entry can enhance the quality of domestic regulatory frameworks by creating a constituency for sound macroeconomic policies, improved regulation and supervision, better disclosure rules, and improvements in the legal framework for the provision of financial services (Claessens and Glaessner, 1998).

Finally, *it is important to assuage fears that financial crises are the inherent consequence of domestic financial reform and financial market opening.* As noted earlier, much of the recent financial turmoil in East Asia can be traced to home–grown factors, including the lack of a well–functioning system of prudential oversight. Yet, market liberalisation and economic turmoil are often perceived as being closely associated. As with trade and investment liberalisation in general, such perceptions tend to fuel a steady erosion of public support for policies that promote further market integration. These popular perceptions are not altogether groundless. Indeed, one recent

study of banking crises found that in 18 of 25 cases reviewed, financial liberalisation (in the sense of mainly involving domestic regulatory reform) had occurred during the five years prior to the crisis (Kaminsky and Reinhart, 1995). However, looking at the factors that lie behind 29 of the world's largest bank insolvencies during the past 15 years, another study identified poor supervision and regulation as the chief culprit in 26 cases (Caprio and Klingebiel, 1996). The fact that recent important banking crises have occurred in countries that until recently had taken a very timid stance with respect to foreign opening (e.g. Mexico, Japan, Korea) suggests that foreign opening, per se, cannot be held responsible for banking and financial crises. These results underscore the observation that opening markets to foreign competition requires a concomitant strengthening of the supporting institutional framework (Herring and Litan, 1995; Goldstein, 1997). A key lesson of the Asian crisis is that the role of sound, credible and effective supervision and prudential regulation cannot be overemphasised as a core ingredient of financial market opening. Financial reform, whether domestic or international, always and everywhere entails risks. This is especially true if governments seek to regulate financial systems after reforms in the same way as did they did before reform, with institutions and supervisory systems that have not been modernised and strengthened to evaluate the risks inherent in a more complex, market–oriented, environment. Again, experience has shown (for instance, in the aftermath of Mexico's 1994/95 peso crisis) that the presence of foreign financial institutions can be instrumental in helping host countries to navigate troubled waters better (Dobson and Jacquet, 1998).

Notes

1. The author is with the OECD Trade Directorate, Paris. The views expressed in this paper are personal and should not be attributed to the Organisation for Economic Co–operation and Development or its Member countries. The author is grateful to Gerhard Abel, Julian Arkell, Pierre Jacquet, Sydney J. Key, Jungsoo Lee, Patrick Low and Monika Queisser for helpful comments and discussions, and to Meg Lundsager and Linda Schmid for providing useful documentation.

2. See OECD (1998*), Open Markets Matter: The Benefits of Trade and Investment Liberalisation*, Paris. See also OECD (1997), *The World in 2020: Towards a New Global Age,* Paris.

3. Of course, such a message will be of little consolation to those in the front line of adjustment. Liberalisation is not a painless process. Indeed, there can be no lasting structural change without adjustment costs. Experience shows that such costs must in most cases be borne before the gains of market openness can be reaped. Thus policy–makers face the challenge of taking into account distributional issues and transitional costs by designing policies aimed at easing adjustment to changing economic circumstances. A central message of recent OECD work on the benefits of trade and investment liberalisation is that the price of trying to suppress these changes would be to reduce economic growth and be socially regressive. This presents Asian governments with important challenges because safety nets and systems of social protection are insufficient, and because most of them are addressing problems of rising unemployment and sharply decelerating growth for the first time in several decades.

4. For example, Indonesia had little choice, under the terms of its IMF rescue package, on agreeing to remove a number of monopolies and to end discriminatory privileges for its national automobile programme, against which there had also been a recent WTO ruling. More broadly, countries that have turned to the IMF for help have had to increase liberalisation of investment regimes, particularly in the financial sector as part of far–reaching reforms in banking and capital markets. South Korea, for example, agreed to open up banks to foreign ownership and allow take–overs of industrial companies by foreigners.

5. See the statement by Deputy Secretary of the Treasury Lawrence H. Summers before the US Senate Committee on Finance, reported in *Treasury News*, RR–1295, 4 February 1998.

6. It is probably fair to place Japan in both camps.

7. All figures relate to year–end 1995.

8. Quoted from "*Successful Conclusion of the WTO's Financial Services Negotiations*", Press Release 86, 15 December 1997, World Trade Organisation, Geneva.

9. This begs the more controversial question of whether WTO members should be compelled to reflect IMF–brokered liberalisation undertakings in their WTO schedules of commitments. Not only would such a requirement help achieve greater (and speedier) multilateral liberalisation, it might also encourage the pursuit of sounder policies in the first place so as to avoid such twin conditionality. While such linkages might well elicit some degree of political support, notably in the US Congress, they would likely also raise concerns over the risk of undermining the consensual nature of liberalisation undertakings achieved under the WTO.

10. Failure to resolve this problem prompted the United States to lodge an MFN reservation allowing it to deny the granting of new licenses in insurance services to countries that maintain such practices.

11. In addition to the above barriers, Claessens and Glaessner (1998) usefully draw attention to a range of access–inhibiting legal barriers, some of which are specific to the financial sector and others which apply more broadly to all sectors. The latter include restrictions affecting the mobility of highly skilled foreign personnel, who are critical in the financial sector. Preferential access to central bank financing for domestic credit providers may similarly place foreign financial operators at a competitive disadvantage. Furthermore, financial intermediation depends crucially on the quality and cost–effectiveness of a host of auxiliary services, notably accounting, legal, consulting, telecommunications services, many of which are only partially open to foreign competition.

12. See "Securities Industry Association says WTO financial services deal should cover key Asian barriers", in *Inside US Trade*, 24 January 1997, p. 15.

13. Martin Wolf (1998), "Flows and Blows", in the *Financial Times*, (3 March). See also Institute for International Finance (1998), *Capital Flows to Emerging Market Economies*, Washington, D.C.; and Jagdish Bhagwati (1998), "The Capital Myth", in *Foreign Affairs*, (May–June).

14. By being a source of stable funding in the face of significant market turbulence, and by introducing (higher) global standards and practices in risk assessment and management.

15. Not only is market opening one of the dimensions of reform, but it interacts with all regulations that affect the functioning of domestic financial systems in developing countries: interest rate and security market regulations, quantitative investment restrictions on financial institutions, credit allocation policies, line–of–business regulations, restrictions on ownership links among financial institutions, controls on international capital movements and foreign exchange transactions.

16. See OECD (1997), *The OECD Report on Regulatory Reform – Synthesis*, Paris.

17. The main challenge is not so much one of *reducing* the state's role, much as that may be desirable in some instances, but rather of changing the *nature* of state intervention in the financial sector. While *direct* forms of government intervention (i.e. directed lending programmes) should be curtailed, recent events in many emerging markets underscore the importance of strengthening the prudential function of financial market supervision

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Fourth International Forum on Asian Perspectives

PROGRAMME

Fourth International Forum on Asian Perspectives

Experts' Seminar

Tuesday, 2nd June 1998

Session I: Opening and Introduction

Co–Chairs of the Forum	Jean Bonvin, President, OECD Development Centre Mitsuo Sato, President, Asian Development Bank
Co–Chairs of the Seminar	Jungsoo Lee, Chief Economist, Asian Development Bank Ulrich Hiemenz, Director for Co–ordination, OECD Development Centre

Session II: Financial Crisis in Asia: Is Financial Liberalisation the Villain?

Presentation:	Douglas H. Brooks, Senior Economist, Asian Development Bank Co–author Soo–Nam Oh, Economist, Economics and Development Resource Center
Discussants:	Charles A. Pigott, Principal Administrator, Non–Member Economies Division, OECD Economics Department Masaru Yoshitomi, Vice Chairman, Research Institute, The Long–Term Credit Bank of Japan, Inc, and Professor of Finance at the University of Pennsylvania

Session III: Using the Market to Build Resilient Financial Systems

Presentation:	Paul Dickie, Director, Infrastructure, Energy and Financial Sectors Department (East), Asian Development Bank Co–author Marian Bond, Financial Sector Consultant Infrastructure, Energy and Financial Sectors Department (East), Asian Development Bank
Discussants:	John Thompson, Head of Financial Markets Division, OECD Directorate for Financial, Fiscal and Enterprise Affairs Alec Tsui, Chief Executive of Hong Kong Stock Exchange

Session IV: The Role of Pension Funds for Domestic Financial Stabilisation

Presentation: Monika Queisser, Administrator, OECD Development Centre

Discussants: Cayetano Paderanga, Member, Monetary Board, Professor at the University of the Philippines, (former Head, National Economic and Development Authority)

E. Philip Davis, Deputy Division Head, European Monetary Institute, Frankfurt/Main, Germany

Session V: The Benefits of Trade and Investment Liberalisation: Financial Services

Presentation: Pierre Sauvé, Principal Administrator, Trade Policy Linkages and Strategies, OECD Trade Directorate

Discussants: Jungsoo Lee, Chief Economist, Asian Development Bank

Patrick Low, Chief Economist, World Trade Organisation

Conclusions

Jungsoo Lee, Chief Economist, Asian Development Bank

Ulrich Hiemenz, Director for Co-ordination, OECD Development Centre

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Bernhard Fischer, HWWA Institute for Economic Research, Hamburg
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Françoise Nicolas, Institut Français des Relations Internationales – IFRI, Paris
Mathew Panikar, Reliance Group, London
Augustine H.H. Tan, The National University of Singapore

Public Conference

Wednesday, 3rd June 1998

Inauguration Francis Mayer, Head, International Affairs Unit, Treasury Department, Ministry of Economy, Finance and Industry, France

Welcoming Remarks by Co-Chairs of the Forum

Jean Bonvin, President, OECD Development Centre

Mitsuo Sato, President, Asian Development Bank

Session I: Panel Followed by Open Discussion

Chair: Jean Bonvin

Masaru Yoshitomi, Vice Chairman, Research Institute, The Long-Term Credit Bank of Japan, Inc, and Professor of Finance at the University of Pennsylvania

Mario Draghi, Deputy Finance Minister, Italy, and Chairman G–10 Deputies

Alec Tsui, Chief Executive of Hong Kong Stock Exchange

Kumiharu Shigehara, Deputy Secretary-General OECD

Session II: Panel Followed by Open Discussion

Chair: Mitsuo Sato

Soogil Young, Ambassador, Delegation of Korea to the OECD

Benoît Cœuré, Economic Advisor to the Director of the Treasury, Treasury Department, Ministry of Economy, Finance and Industry, France

Cayetano Paderanga, Member, Monetary Board, Professor at the University of the Philippines, (former Head, National Economic and Development Authority)

Klaus Regling, Director General, Federal Ministry of Finance, Germany

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