EMERGING ECONOMIES TRANSITION

Development Centre Seminars

Achieving Financial Stability in Asia

INTERNATIONAL DEVELOPMENT

Edited by Ramesh Adhikari
and Ulrich Hiemenz

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Ramesh Adhikari and Ulrich Hiemenz

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

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Foreword

This publication was undertaken in the context of the International Forum on Asian Perspectives, jointly organised by the Asian Development Bank and the OECD Development Centre. It forms part of the Centre's research programme on *Capital Flows, Financial Crises and Development*, and the Centre's External Co–operation activities. The Forum held its fifth meeting in Paris on 28th and 29th June 1999. Contributions to that meeting are included in this volume.

Table of Contents

Preface
Jorge Braga de Macedo and Tadao Chino 7

Welcoming Remarks
Ulrich Hiemenz 9

Welcoming Remarks
Tadao Chino 11

Introduction
Colm Foy and Helmut Reisen 17

PART ONE
FINANCIAL SYSTEMS AND STABILITY

On Reforming the International Financial System: An East Asian Perspective
Yung Chul Park 23

Towards a Sustainable Financial System: A Role for the Financial Stability Forum
Andrew Crockett 29

Indonesia: the Road to Recovery
Farid Harianto 35

Towards a Sustainable Financial System: Analysis and Prospects
Mats Karlsson 37

Towards a Sustainable Financial System: The Malaysian Situation
Abdul Aziz Mohd. Yaacob 41

New Approaches to the International Financial System
Jean–Jacques Rey 51

The Road to Reform: A Role for Europe, a Role for France
Philippe de Fontaine Vive 57

Prospects for a Stable Financial System: A Dose of Realities
Roberto F. De Ocampo 63

International Financial Stability: The Contribution of the OECD Principles of Corporate Governance
Joanna R. Shelton 71

Part Two
Policies for Recovery and Crisis Prevention

Policies for Crisis Prevention
Helmut Reisen 79

Banking Sector Reforms: Recovery Prospects and Policy Issues
Ramesh Adhikari and Soo-Nam Oh 105

Post-Crisis Issues in Asian Capital Markets
Arvind Mathur, S. Ghon Rhee and Christine Wallich 127

Corporate Governance and Restructuring in East Asia: An OECD Perspective
Richard Frederick, Mats Isaksson and Stilpon Nestor 147

Programme 165

List of Authors and Participants 171

Preface

Created in 1995 by the Asian Development Bank and the OECD Development Centre, the International Forum on Asian Perspectives has been bringing together experts and concerned participants from Asia and the OECD area for five years. The experts' meeting of the Forum provides an opportunity to consider issues of pressing importance which are impacting on Asian economies and to combine resources to seek new responses to the challenges facing the region. A major feature of the Forum is an open meeting, hosted by the French Ministry of Finance, in which leading figures from the worlds of politics, administration, academia, business and the media join with the experts to exchange views.

Following the financial crisis which struck the region in 1997 and then spread around the world, the fifth Forum concentrated on evaluating aspects of the crisis and reform efforts. It was generally agreed that, while domestic reforms in individual economies are essential, the international financial system itself requires attention, if such crises are to be minimised in the future. On the domestic front, banking systems and financial structures generally need to be made more efficient to bring them into line with internationally agreed standards. Balance sheets need to be strengthened, and a reliable judicial system should support institutional reforms designed to restore confidence, both at home and abroad. Strategy and progress in achieving these goals is the subject of several contributions to this volume.

The Forum discussed a number of initiatives aimed at reducing volatility in international financial flows and enhancing stability. Certain existing measures, such as those for bailing in foreign creditors, can be implemented more widely, while new structures to promote international financial stability through information exchange and international co–operation in financial supervision and surveillance, can help to implement better supervision of capital flows. All such measures must, of course, promote voluntary and responsible participation on the part of emerging economies.

The Fifth International Forum on Asian Perspectives demonstrates the depth of commitment of both our institutions to work together to create a better understanding of Asian economic matters. In the aftermath of the global financial crisis, it is essential to continue to seek remedies for the institutional defects which allowed the crisis to happen. It is thus important to sustain the reforms already under way and to design others.

Jorge Braga de Macedo
President
OECD Development Centre
Paris

Tadao Chino
President
Asian Development Bank
Manila

January 2000

Welcoming Remarks

Ulrich Hiemenz

The situation we are facing in the Asian economies today is certainly somewhat more encouraging than in 1998 when the Fourth International Forum took place, but there are still quite a number of remaining issues which have to be resolved and which are fare from being clear cut. What has been achieved and what we have seen in the most of the affected countries is that a certain level of economic stabilisation has been achieved, growth rates, particularly in the last six months, have returned to the positive range and international financial capital has begun to flow back into the region. This is reassuring in that these very encouraging signs have been the results of reform efforts, very rigorously undertaken in most countries of the region and supported by the international economic community. There was substantial progress with financial and corporate sector reform. Competition and governance policies have seen important changes. There were trade policy reforms and, last but not least, social sector reforms which have attenuated the effects of the crises on the poorer sectors of the population. The willingness with which Asian countries have dealt with the harmful effects of the crisis is part of the reason for the return of private capital flows to the region. These have not become a flood — and we should beware that they should not do so — but they do represent a surprisingly rapid return of confidence on the part of the private sector.

Let us not forget, while we ponder these positive aspects of the recent twelve months, that it was the waxing and waning of private capital flows which precipitated the crisis in the first place. In the papers which follow, we will be looking at how new rules of the game can be introduced in order to encourage capital flows with stability.

Turning to the crisis itself, despite of all the positive developments, it would clearly be too early to conclude that instability has ceased and that similar events will never occur again. The reform process which we have seen so far has been uneven in a number of areas. Let me just mention a few without claiming to cover the whole range of problems we are facing.

Certainly there has been very slow progress in corporate restructuring. While efforts have focused on the financial sector, there remains a sizeable backlog of structural adjustment to be undertaken in the corporate sector. This adjustment needs to be seen in the light of the need for general attention to improvement in corporate governance. Work has begun on this to some extent, but more progress has to be made in the adoption of new corporate governance principles in the commercial sector. The OECD has offered a noteworthy contribution to this process in its *Principles of Corporate Governance*, published earlier this year, and one of the papers presented to this conference, that by Richard Frederick, Mats Isaakson and Stilpon Nestor, makes particular reference to the role of corporate governance, or the lack of it, in the Asian crisis.

Secondly, reforms have so far relied on public sector money and very little on money from the private sector. This imbalance could create more systemic problems which would or could negatively reflect on the future behaviour of private investors. It is important that the private sector itself should accept its responsibilities in this domain. In both restructuring and the reform of corporate governance, the long–term beneficiaries will be in the private sector. In addition, private investors recognise the need for reform and the volatility of flows can only be contained if such reform seems to promote sustainable stability.

Thirdly, there maybe conflict between measures which have been taken to overcome the immediate impact of the crisis and the longer–term objective of preventing future crises. It is of primary importance, for example, that palliatives provided by international lending institutions do not give the impression that the impact of future financial upheavals will automatically be softened by such measures. Measures to reassure the international financial market should not be taken as guarantees for any investment, no matter how ill–advised or foolhardy. A proper balance needs to be found between short–term action to end this particular emergency and long–term reforms designed to reduce the likelihood of breakdown in the future.

Finally, it is not yet quite clear what kind of precautions and measures need to be taken on the side of the lenders, meaning on the side of the financial institutions in the OECD countries, to lessen the threat of future crisis and reduce the effect of the current one. What was clear in recent months in Asia is that financial inflows were insufficiently matched to the strength or, rather, weakness of the domestic financial systems for which they were destined. This mismatch led to overbalancing of the domestic system, precipitating the crisis. Do we need a new global financial architecture, new rules of the game? I am sure that we will get some additional insights from Andrew Crockett on this aspect.

This list is not intended to be exhaustive, but demonstrates the magnitude of the problems confronting economic reconstruction in Asia and finding a sustainable end to the financial crisis. In bringing together experts and political and economic figures from Asia and from European OECD countries, the International Forum on Asian Perspectives provides a unique opportunity for these crucial questions to de debated. It is the Asian Development Bank and the OECD Development Centre's contribution to the search for an end to turbulence and a return to stable economic growth in Asia.

Welcoming Remarks

Tadao Chino

The theme of the 1999 forum is "Towards a Sustainable Financial System: Analysis and Prospects". It rightly embraces the challenges that Asia faces as it emerges from financial crisis. As the Asian crisis indicated, a sustainable financial system in Asia is important not only to the Asian region itself, but also to Europe and the other regions in an increasingly integrated global economy. Also Asia needs a resilient and stable financial system to sustain its past hard–earned achievements in poverty reduction and to continue to raise the quality of life of all people in the region.

The Asian Financial Crisis

Some basic principles are worthy of comment when considering the crisis. They are:

— the Asian financial crisis had more to do with capital account imbalances than with current account imbalances;

— it was private–sector–driven rather than public–sector–driven;

— it was largely due to structural weaknesses in the financial and corporate sector, rather than weaknesses in macroeconomic fundamentals; and

— there was a mismatch between the rapid growth of capital flows and slow development of institutional capabilities.

What then are the major lessons to be drawn from the crisis?

— First, sound macroeconomic fundamentals are insufficient on their own to achieve sustained economic growth; structural factors were seen to have played a decisive role in the Asian crisis.

— Second, for developing countries to reap the benefits of an open capital account, greater attention should be paid to the regulatory framework and institutional capacity in the financial sector and to the sequencing of financial sector reforms.

— Third, it is vital to develop domestic capital markets in Asia. A well–functioning capital market can mobilise long–term capital and encourage more efficient allocation of resources under market scrutiny. It can also alleviate over–dependence on foreign capital for financing domestic investments and mediate the currency and maturity mismatches.

— Fourth, the Asian crisis poses a new challenge to the international financial system. In essence, what is needed is a system that enables international financial institutions to back up the heavily affected countries with sufficient amounts of liquidity.

— Fifth, there is a need to consider an international financial architecture that could better monitor international capital flows, whose reversal has proven to be devastating for capital–receiving countries.

— Sixth, monitoring mechanisms need to be enhanced not only at the national level, but also at the regional level to minimise the risks of contagion.

— Lastly, the Asian crisis also calls for a public–private partnership in crisis management and crisis prevention.

There are encouraging signs of recovery from the crisis. Exchange rates have been stabilised. Interest rates have come down. Foreign exchanges reserves have increased substantially, and stock prices are rebounding. Foreign investors have started coming back, albeit slowly.

This process of recovery is supported by structural reforms, such as improvements in legal systems, prudential regulations, and supervision in the financial sector. Continued structural reforms are necessary to solidify and sustain the macroeconomic stability and contribute to economic growth in the long term.

Towards Building A Sustainable Financial System

Though governments in the crisis–hit Asian economies have adopted macroeconomic stabilisation programmes, and policy and institutional reforms, the banking and corporate sectors, where the crux of the problem lies, will take time to recuperate. Further, given the banks' weakness and fears of further risky lending, it will not be easy even for good corporate borrowers to recover access to credit.

The corporate sector will require effective debt resolution and restructuring. Further, as the crisis was largely private–sector–driven, private–sector participation in crisis resolution and prevention is crucial. The scale of the problem, and the large numbers of both creditors and debtors, means that resolution and recovery will have to be collaborative: both public and private sectors will have to contribute. Governments, the private sector and the international donor community, all have important roles to play. Multilateral and regional initiatives may be useful.

What should the governments do? Improving macroeconomic management and removing structural weaknesses are a precondition for achieving a sustainable financial system. The governments in the crisis–hit economies must therefore seriously continue the reform process.

There are many policy issues that need to be addressed in building a resilient and sustainable financial sector in the Asian economies. The most important ones are:

— financing of banking sector restructuring, in particular, resolution of non–performing loans;

— development of a conducive legal and regulatory framework and strengthening of prudential regulation and supervision, and corporate governance;

— privatisation and commercialisation of state–owned banks; and

— development of domestic capital markets.

What should the private sector do? The private sector should join hands with the public sector in both crisis management and crisis prevention. The private sector could enhance governance, transparency and information disclosure. Like the public sector, the private sector should, for example, also adopt international standards in the area of transparency and good governance, and ensure a stronger due diligence and better risk management in their operations.

What should the international donor community do? Certainly, government commitment is a precondition to any measures in resolving a crisis, but, to implement the reform measures, governments also need financial resources and technical support from the international donor community. The ADB has provided emergency assistance to the crisis–hit Asian economies, in close collaboration with the International Monetary Fund and the World Bank and various bilateral institutions.

International donors can also help improve legal infrastructure and enhance institutional capacity building for the financial sector. Considerable effort has already been made in this area. For example, the ADB has conducted two regional studies to develop best legal practices for insolvency and secured transactions. The Bank has provided a technical assistance loan of $50 million to Indonesia for capacity building of financial governance, a similar technical assistance loan of $15 million to Korea, and technical assistance for strengthening information disclosure and compliance to Thailand. In collaboration with APEC, the ADB has provided a significant amount of technical assistance to the Asian and Pacific economies, including training of bank supervisors and securities regulators. Governments in the respective countries will be encouraged to implement those identified best practices. The recent initiatives of the IMF, the Bank for International Settlements, and the International Organisation of Securities Commissions are also commendable. They include a code of good practices on fiscal transparency, and a draft code of good practices on transparency in monetary and financial policies.

Further, regional initiatives can be useful. Regular monitoring and peer review of financial and economic developments by multilateral or regional institutions are some of the measures that could help prevent crisis in the future.

The Role of the ADB During and Beyond the Crisis

The immediate support by the ADB to crisis–hit economies in response to the outbreak of the crisis has been timely and necessary. However, financial sector reform, for example, in these economies is far from being completed. The ADB will therefore need to continue assisting these economies in further reforms.

The ADB has been actively involved in helping its member countries in crisis management. Because of its familiarity with the crisis–hit economies the ADB handled crisis management with confidence. The Bank provided large–scale assistance to Indonesia, Korea, and Thailand, and we followed a multi–pronged approach. This included financial and corporate sector reforms, strengthening of legal frameworks, mitigation of social impacts, technical assistance to support the implementation of reform packages, and financial assistance to mobilise additional private capital for the region.

Further, the ADB has actively participated in the New Miyazawa Initiative and the Asian Growth and Recovery Initiative. The New Miyazawa Initiative and the ADB are co–financing many sector policy reform packages. The ADB is also administering the Asian Currency Crisis Support Facility worth 367.5 billion Japanese yen, (approximately $3.3 billion). This facility is expected to leverage, through guarantees, more funding from international financial markets to support economic restructuring and alleviate the social adjustment pain of the crisis–hit economies.

The ADB has recently established the Regional Economic Monitoring Unit to help our member countries build the capacities they need to detect better and respond more effectively to looming vulnerabilities. In this context, at the request of the Association of Southeast Asian Nations, the ADB has provided considerable technical support to the ASEAN Surveillance Process. The ADB is also setting up an Asian Recovery Center in collaboration with Australian Government. The Center will consolidate, disseminate, and exchange timely information on economic and social development.

A major challenge for the Asian region and the ADB is to reduce poverty. Asia is the home to most of the world's poor. More than one billion Asians or, roughly, one third of the region's total population, live in absolute poverty. The financial crisis has aggravated this situation. Considering this reality, the ADB is committed to rebuilding a secure future for Asia by financial and corporate restructuring, by developing effective social safety nets and by promoting efficient, equitable and sustainable economic growth.

The ADB has directed a substantial amount of its lending to mitigate short–term adverse social impacts in Indonesia and Thailand. The policy reform packages have helped protect school enrolments, health and nutritional status, and access to family planning services of vulnerable groups, as well as the quality of health and education services. At the same time, the packages have created part–time job opportunities for more than a million households through small–scale public works. The Bank's community and local government development programme in Indonesia will improve governance by supporting decentralisation of basic services, including provision of basic infrastructure for poor villages and alleviation of poverty in participating districts and villages, through capacity building and community empowerment. More ADB assistance is planned for social protection programmes in the near future.

In view of the severe social impact of the crisis, the ADB will also strengthen its assistance to directly address the poverty problem in the region. At the Bank's 32nd Annual Meeting of the Board Governors, I underscored that the overarching goal for Asia and the Pacific and for the ADB is to reduce poverty and improve the quality of life of all people in the region. The ADB is now preparing a new poverty reduction strategy in collaboration with its member countries. The new strategy will reflect, among other things, the importance of sustainability of gains in poverty reduction. It must be also emphasised that sustainable growth is indispensable for sustainable poverty reduction.

Conclusions

Macroeconomic stability in crisis–hit Asian economies is improving, and efforts are under way to strengthen the financial sector. There are good prospects for full recovery from the crisis. However, long–term sustainability will largely depend on success in structural reforms, particularly in the financial sector and the corporate sector.

The ADB is committed to reducing poverty and improving the quality of life of all people in Asia and the Pacific region. To achieve this, however, we need to have a sustainable financial system. All parties concerned — governments, the private sector, and the international donor community — to play their roles effectively in building a sustainable financial system in Asia.

Introduction

Colm Foy and Helmut Reisen

The 1998 International Forum on Asian Perspectives turned its attention to the prospects for financial liberalisation in Asia; the 1999 edition, upon which this book is based, concerned itself with reform and restructuring both of the domestic economies of the region and of the international financial architecture. In the year since the last Forum, much has improved in Asia: a measure of stability has returned; international capital flows are again moving into the region; and a number of steps have been taken towards reform. Asian governments have acted quickly and often in partnership with international institutions to reform their trade and investment policies and to implement social policies designed to protect the poorest and most vulnerable groups of society from the worst effects of the crisis.

If we maintain, and we would, that exchanges of capital in and between regions are good for growth; and if we support the argument in the same context that market openness is essential for such financial flows to happen, then we also have to look at ways of building more safety into the international financial system. In this system, of course, there are two parts: the international environment and the national context. It has become commonplace to attribute much of the responsibility for the Asian financial crisis of the end of the 20th century on the failures of national institutions and authorities in the receiving countries. There is, however, more to the question than that.

On the domestic front, Asian economies before the crisis looked almost ideal: not only were they very stable, but their openness and high levels of national savings attracted large inflows of foreign financing and led to unprecedented growth levels. Their attraction, however, outshone more sinister shortcomings: weak corporate governance; loose regulation of the financial sector; heavy reliance on bank lending; excessive government interference in credit allocation; insufficient attention to exchange rate risk; and disorderly sequencing of reforms.

The international financial environment itself proved to be entirely conducive to wild swings in flows. The end of the 1990s witnessed the last of a trend of volatile movements in capital flows: excessive inflows scrambled over each other to escape, once the atmosphere had turned sour. How this can have happened remains a central element in understanding the Asian crisis and is germane to an appreciation of those

which have gone before. If there was fault on the side of the national authorities in the receiving countries, an international environment in which such wild swings were possible contributed as much to the genesis and aggravation of the Asian crisis.

Domestic Reform Imperatives

The signs of recovery evident in most Asian countries at the dawn of the 21st century are encouraging, but are still only signs. In most countries, the financial systems were severely shaken; banks were forced to cope with the after–effects of non–performing loans and worthless asset books. In the private sector, corporate insolvency was rife. Progress towards resolving the banking sector's problems has been measurable and positive in most countries as a result of prioritisation by both national governments and international institutions. Similar, but less comprehensive progress has been made in corporate restructuring. The groundwork is thus being laid for introducing a more stable national environment, in spite of hurdles which include the sheer size of the problem and the strain placed on government fiscal resources.

There is also a trade off between speedy reform and comprehensive, long–term reform. Those economies which have acted quickly to bring new players onto the field and to inject fresh capital, while facilitating exit through better bankruptcy procedures, face an additional implementation problem, due to a shortage of oversight structures and trained staff. Procedures thus have to be simplified to the point where they may no longer be comprehensive.

The biggest issue, however, is corporate governance. This is the key to restoring market confidence on both the international and domestic level; without such confidence, complete recovery will remain a chimera. The practice by which corporate entities were managed according to discrete rules and between small insider groups must be brought to an end. In some cases, such a process will require a complete review of corporate culture, a review which has already begun in some countries. It has been and will be aided by global codes of conduct, such as the Basel Core Principles for Bank Supervision, the IMF Data Dissemination Standards and the OECD Principles of Corporate Governance, which could be used as benchmarks in the future when they can achieve international legitimacy through, for example, wide consultation within and across representative country groupings.

None of these reforms will be possible or sustainable without political will and changes to politico–economic cultures. The belief that autocracies were somehow conducive to economic growth has been razed by the Asian crisis which revealed that their oligopolistic tendencies and occult management procedures drained confidence and led to inflexibility, besides being profoundly undemocratic.

There is evidence that corporate and political management structures are changing in the crisis–hit countries. In Indonesia, for example, the banking system is being cleaned up and its practices made more open; corporate balance sheets are being reformed to conform to international standards; and exit procedures are being redefined and refined. A similar menu is being adopted in Korea, in Thailand and in Malaysia.

International Reform Imperatives

Experience of financial crises in the recent past has demonstrated the urgent need to reform the global financial system. Despite a relative calm which descended on international markets with the closing of the 21st century, exemplified by a return to positive growth figures for most of the Asian crisis countries, there remains an urgency to create a more robust world financial environment which will be more resistant to breakdown and emergencies in the future.

While not discounting the weaknesses of individual countries listed above, defects in the world financial system encouraged large–scale flows into these countries and, once the difficulties became apparent, allowed those flows to be reversed, virtually overnight. This volatility then led to panic, to herd behaviour, to currency crashes and to contagion to countries not directly concerned with the origins of the crisis. The majority of these volatile flows were from private sources, and there is more than a suspicion that a collapse was anticipated, leading to the remarkable reaction to it when it came.

A global approach to the problem of the volatility of international financial flows is being taken by the Financial Stability Forum. The Forum is concentrating on three, main areas of action: abrupt portfolio changes caused by leveraging of long–asset positions by investors and, increasingly by banks engaged in proprietary trading activities; the role of offshore centres in dissimulating the true origins and destinations of flows, and in tax–induced misallocation of global flows; and the role of short–term flows, particularly bank credit, in repeated boom–bust cycles of emerging–market lending.

By closely examining the market behaviour of highly leveraged institutions, offshore centres and short–term capital flows, the Stability Forum is likely to issue concrete and realisable recommendations on how to improve capital–flow statistics and prudential standards in lending and borrowing countries aimed at stabilising financial markets.

More attention is also being given to existing structures of financial regulation. The Basel Accords, which weight risk by category of bank lending, have been shown to distort cross–border bank lending towards the short term, towards interbank lending and towards a pro–cyclical impact. They may have been, therefore, more part of the problem than of the solution. Successful revision of the Accords, however, will largely depend upon the quality and timeliness of the sovereign ratings on which they will depend.

Meanwhile the recommendations of the Rey Report produced by the Group of Ten for the resolution of sovereign liquidity crises are being re–examined. The Report advocates “bailing in” foreign private creditors during crisis episodes, rather that bailing them out through, for example, the conversion of private into public debt. One way of doing this would be for the IMF to lend into arrears to private creditors, while writing collective action clauses into debt contracts. For its part, the Paris Club is making public concessions on debt principal and service payments contingent on a degree of debt reduction by private creditors, and the IMF has established a Contingent Credit facility for pre–defined liquidity support.

Clearly, there are technical problems associated with involving private creditors in crisis resolution. Not the least of these is the difficulty of establishing contingency reserves prior to any crisis and allocating participation rates. There is also resistance from commercial banks who see the prospect of public proved as an important part of their risk calculations. On the other hand, "bailing in" private creditors will reduce the moral hazard in international financial markets implied by public bailouts.

Finally, there is the virtual certainty that measures to include the private sector in crisis resolution and prevention will restrain private flows to emerging markets. This would seem to go against the orthodoxy that such flows should be maximised to finance growth and long–term stability. The immediate past, with its clutch of crises, however, demonstrates that the quantity of flows must be set against the quality of flows. Hot money has been seen to contribute to volatility and is thus a source of crisis risk whose reduction would be beneficial to all in the international financial system.

All the measures to deal with flaws in the international financial architecture we have so far mentioned, and which were represented at the Fifth International Forum on Asian Perspectives, imply decisions on the part of originating economies. It should not be forgotten, however, that the legitimacy of international decisions depends on the participation of all concerned countries. It is imperative that more representation from Europe and emerging markets be made and heard in international forums designed to rationalise the global financial system. This is something which could be achieved on the basis of regional groupings, where economies share similar problems and dangers. What is called for, in sum, is a fresh approach to representation, stimulating a genuinely global approach.

Conclusion

The 1999 International Forum on Asian Perspectives, with its unique mix of policy makers, academic experts and specialist economists from the two organising bodies, came to the conclusion that the return of positive growth trends to most of Asia was encouraging, but insufficient to justify the conclusion that the crisis is definitely over. The country experiences cited in this volume and the research papers gathered here point to an appreciation of the contemporary situation as still fragile.

Domestic reforms to the financial structure and to corporate procedures are part of a larger skein of measures required to re–establish solidity and confidence in countries receiving financial flows and to enable those countries to use such flows to enhance growth prospects. On the international level, action is urgently needed to provide a credible and legitimate regulatory environment designed to encourage productive financial flows and to discourage destabilising hot money. The immediate task for the international financial community is to provide the means in terms of structures and policy advice to allow the two halves of the problem to reach a stable and long–term solution. While, clearly, perfection is unattainable, the more dangerous imperfections can and should be reduced.

Part One

Financial Systems and Stability

On Reforming the International Financial System: An East Asian Perspective

Yung Chul Park

The crisis countries in East Asia, particularly Korea and Thailand, have been able to engineer very impressive recoveries from the crisis that pushed them to the brink of debt default and total collapse. Exchange rates have been stabilised, interest rates are now single digit, and stock markets have seen a sharp rebound in these countries. With the return of consumer confidence, there has been a surge in domestic demand, which is currently supporting robust growth with price stability and a strong current account surplus.

What developments have turned around East Asian economies in recent months? More than anything else, East Asia's commitment to a market orientation has contributed to the recent recovery and economic reform in the region. This commitment has created the expectation that East Asia will emerge from the crisis with more efficient and stable financial and corporate sectors than they possessed in 1997. This expectation of change has been instrumental in restoring East Asia's relations with the international financial community, which has in turn led to a surge in both FDI and the inflow of foreign portfolio capital. Of course, Paul Krugman would not agree with this assessment of recent economic developments in East Asia.

Nevertheless, many people are now wondering how countries like Korea and Thailand, with strong economic fundamentals, could have become victim to a currency crisis in the first place. If succumbing to the crisis seemed unlikely, the turnaround of these economies has been even more surprising.

In a recent paper, Stiglitz and Bhattacharya point out that the focus immediately after the crisis broke out in East Asia was on the structural weaknesses of East Asian countries. Two years after the crisis, we know better than before that the original indictment against these Asian countries was unfair. Placing exclusive blame on structural weaknesses was contrary to sound theory or econometric evidence, because it did not pay due attention to the problems originating in developed countries, and because it did not acknowledge that even countries with sound economic policies could be buffeted by turbulence in international financial markets.

As for the causes of the crisis, a large number of recent studies have pointed to the weaknesses of the financial system, premature liberalisation of the capital account, and the limited flexibility of exchange rate systems in East Asia. In particular, these studies focus on the banking problem as the primary cause of the East Asian turmoil.

For more than three decades preceding the crisis, the East Asian countries had relied on the banking system as an instrument of industrial policy — as the means of mobilising savings and allocating them to strategic industries and favoured projects. This strategy was successful in that it had sustained rapid growth and industrialisation for a long period in East Asia, but it also resulted in a very weak and inefficient financial system, deficient in a number of respects.

During the early period of economic development when high–return investment opportunities were abundant in East Asia, the industrial policy of using the banks as instruments of resource allocation did not pose any serious problems of inefficiency. However, once profitable investments became exhausted, sustaining rapid growth required improving the efficiency of allocation through liberalising and opening domestic financial markets. Instead, the East Asian governments stuck to the old strategy of bank domination in which credit allocation was directed in a way that disregarded market signals. Inevitably, non–performing loans began to pile up at the banks and placed the solvency of these institutions at risk.

Krugman was the first to point out that East Asia was running into diminishing returns and that rapid growth was only being sustained by massive infusions of capital, much of which came from abroad in the form of short–term bank credits. Following this line of argument, it is even suggested that the East Asian governments decided to liberalise the capital account to facilitate borrowing from abroad. To make matters worse, as the argument goes, these East Asian governments did it backwards by deregulating short–term borrowing first.

The preceding argument loses much of its persuasiveness when looked at more closely. The financial inefficiency argument misinterprets internal and external developments that led to the crisis, tends to support the concerns of international lenders, and runs counter to theory and evidence.

Perhaps the fundamental question is whether by the mid–1990s the East Asian policy regime was crumbling under the inefficiencies of crony capitalism, bringing the period of rapid growth to an end. While this question is likely to remain controversial for a long time to come, at least one study — *The East Asian Miracle*, published by the World Bank in 1993 —was much more positive and optimistic about the East Asian policy regime.

Even before capital account transactions were liberalised and increasing volumes of foreign capital began to flow into East Asia, most East Asian countries were already growing at rates much higher than the rest of the world. In fact, it is this success, and the potential for future success that had attracted foreign capital into the region. Not only had there been both rapid growth and domestic stability, the rates of return on capital had been high before the crisis compared to the rates of return in other countries especially in the advanced countries. In fact, in most East Asian countries, the national

budget was balanced or generating a surplus and more importantly since the mid–1980s, all of these countries in the region had pursued policies of trade and financial liberalisation. Given these sound economic fundamentals and the region's commitment to liberalisation, foreign investors saw enormous opportunities to make money, and moved vast sums of money into the region. This massive inflow caused investment as a proportion of GDP in all of these countries to be significantly higher than it had been in the 1980s. At the same time, savings rates were stable, resulting in large increases in the current account deficits.

Therefore, it may not be correct to argue that East Asian countries were intent on borrowing heavily from abroad to meet the ever–increasing volume of capital needed to compensate for the losses in efficiency that were slowing economic growth. Certainly the assertion that these countries began liberalising the current account to facilitate capital inflows is at variance with the facts. In reality, East Asian countries were very reluctant to liberalise the capital account and trade in financial services in the early 1990s, though they were committed to doing so in the long run.

Most of the East Asian countries were cautious in opening money and capital markets, because their regulatory and supervisory systems were hardly comparable to those of advanced countries in terms of standardisation and effectiveness. A prerequisite to capital account liberalisation is the publication and transparency of the financial conditions of both banks and firms. None of the East Asian countries, however, was able to meet the information and disclosure requirements. Despite this weak capacity in prudential supervision and regulation, western governments were applying increasing pressure to secure rights of access for their financial firms in East Asia.

Although the western governments knew that accounting practices and disclosure requirements in East Asia did not conform to their standards, and that financial supervisory authorities in the region were incapable of enforcing rules and regulations, few western governments demanded the necessary reform to financial supervision. Instead, they were persistent in their demand for equal access and outright opening of domestic capital markets. Their justification for the persistence was that unless financial opening and liberalisation were carried out quickly, the inertia would become too great and these countries would never pursue liberalisation. They did not care to address the possibility that pell–mell liberalisation could invite speculative attacks and financial crisis.

If indeed the weakness of the bank–centered financial system was the fundamental cause of the East Asian crisis, can this argument be backed by theory and evidence? For example, can the lack of transparency and information disclosure be determined as one of the major causes of the financial crisis in East Asia? If it can be, how serious was the problem? Stiglitz and Bhattacharya show that increased transparency in the form of disclosure requirements is not needed, since markets can and do provide optimal incentives for disclosure. They also argue that under certain circumstances, information disclosure could exacerbate fluctuations in financial markets and precipitate financial crisis. It is also instructive to note that the Nordic countries (Sweden, Norway and Finland), which did not suffer from the non–transparency problem nearly as much as the East Asian countries did, could not fend off the crisis in the early 1990s.

Prior to the East Asian crisis, foreign lenders had access to much of the information needed for their investment decisions, including the information that balance sheets of banks and companies were not very reliable. Market participants either ignored or were not able to process the available information.

A more serious question than the transparency issue is why the East Asian countries had persisted with a bank–oriented financial system for so long before the crisis hit them, if the system was so inefficient, as it is argued these days? One of the reasons for this persistence may have to do with a theoretical justification for the bank–dominated financial system in East Asia and throughout developing countries. There is a vast literature on finance and development which suggests that the more pronounced the information asymmetries, the more preferable banking arrangements are to direct securities markets.

In developing economies, where informational problems are severe because accounting and auditing systems are typically less reliable, the role of banks is thus much more important than in advanced economies. In the course of development, institutions specialising in gathering and disseminating information appear, as do regulatory agencies that can enforce greater disclosure by firms. This makes it possible to develop bond and stock markets. In practice, however, banks have remained the dominant source of external financing both in advanced and developing countries.

Related to the bank–dominance is the implication that intermediaries are more efficient than open securities markets for supplying long–term finance to industry especially in developing countries. In fact, banks could lengthen the investment horizon of firms as the intermediary monitors the activities of its borrowers better than the markets. Banks can also enter repeated relationships with borrowers in order to mitigate informational distortions. This, in turn, can facilitate the provision of long–term credit[1].

In the last two years since the crisis occurred, numerous proposals have been put forward by G–7 and G–22 governments, multilateral organisations, and private institutions for the reform of the international financial system. From the point of view of East Asian economies, many of these proposals may not stand a chance of being implemented, in part because they do not fully reflect the lessons of the East Asian crisis.

These proposals begin with the premise that structural weaknesses in the East Asian countries and short–run macroeconomic imbalances were responsible for triggering and spreading the crisis through Asia and beyond. As such, these proposals focus on structural reforms in these countries, although our argument makes it clear that efforts to reform the international financial architecture should focus on the market failures that often cause financial panic and herd behaviour.

Over the last two years, short–term capital movements have been too volatile, and crises have been too contagious to be explained by the rational behaviour of market participants. Although it is now well–established that international lenders have as much responsibility for crisis as borrowers, one seldom hears any serious discussion as to whether and how lenders to emerging markets should be supervised or regulated.

Most proposals for a new international architecture advocate establishing a set of international standards and encouraging countries to adopt them. Many standards already exist: the Basel capital adequacy accord, IASC accounting standards, IOSCO principles of securities regulation, and the OECD standards of corporate governance. The IMF has developed SDDS and is preparing codes of fiscal practice and monetary and financial transparency. Since it may not be feasible from a standpoint of national sovereignty to establish and enforce strict global rules or to create global authorities such as a world central bank and world regulatory authority, setting and enforcing international standards are recommended as a second–best solution.

Unfortunately, however, major industrial countries, especially G–7 countries, have not been able to agree on specific standards on banking, corporate governance, disclosure, accounting and even the collective action clause in bond issues, because they understandably insist on those standards which will serve their interests. Andrew Crockett may disagree with us on this, but in most of the forums drawing up standards, including the Basel committee, emerging market economies (EMs) and developing countries (DCs) are not included or at best under–represented.

Even if the G–7, emerging market economies, and other developing countries could come to an agreement on international standards on accounting and other matters, there still remains the question of enforcement. Some proposals suggest that co–operation and co–ordination between different supervisory organisations should be strengthened for better enforcement. Others argue that the IMF should be entrusted with the role of monitoring and supervising compliance of its member countries with standards. Still others recommend that enforcement should rely more on incentives to induce countries to observe standards voluntarily.

The IMF does not have either the manpower or expertise to undertake detailed international supervision of financial and other standards of emerging market economies. Given this constraint, the IMF will have to create an incentive structure that directly links the amount of money a member can borrow to its banking and other standards. It has been also suggested that not only the IMF but also the financial regulators of advanced countries should help enforce standards by controlling access of EMs and DCs to international capital markets on the basis of their record of compliance.

Many EMs and DCs will find it difficult to accept these incentive–based proposals, because such schemes will invariably raise the issues of fairness and national sovereignty. If the incentive system is determined and administered by both the IMF and regulatory authorities of advanced countries, in reality this means that advanced countries can dictate the access of the developing countries to world capital markets and also to IMF credit facilities.

Incentives will necessarily differ among developing countries, since these economies cannot be lumped into a single group. This means that an incentive system may be susceptible to elements of arbitrariness, discrimination, and even bias. One cannot even discount the possibility that advanced countries could use the incentive scheme to achieve other objectives.

The GATT member countries took seven years to negotiate an agreement on new rules for more open trade in goods and services and to create the WTO in the Uruguay Round (1986–93). Standards are not rules, but if the member countries of the IMF cannot agree on setting and enforcing standards, then a negotiation process like the Uruguay Round may be an alternative solution. This may be particularly necessary if the interests of advanced countries and EMs and DCs diverge.

The G–7 countries could take the initiative of starting a process of negotiation among the IMF members for introducing international standards. The negotiation may not take as many years as the Uruguay Round did, but it will nevertheless have to go through an arduous and a very protracted process of settling the differences between advanced countries and developing nations. Such a negotiation process will be costly, but unless the IMF member countries come to an agreement on common standards, one cannot ensure the compliance of firms, banks, and governments of developing countries.

Note

1. Coming at this from the other direction, Mayer argues that competition in financial markets can have time inconsistency costs that result in a decline in long–term financing. Yanelle shows scale economies and Bertrand oligopolistic competition that imply unfettered.

Towards a Sustainable Financial System: A Role for the Financial Stability Forum

Andrew Crockett

The crises that have plagued the world economy over the past decade or more cannot be considered an acceptable feature of the international financial system. Now that the crisis in Asia is, thankfully, receding we must be careful not to lose our sense of urgency in dealing with the sources of financial market instability. We have to tackle the root causes of market failure and build a more robust financial system for the future. This does not mean abandoning the trend towards liberalisation or questioning the value of the integration that has occurred in world trade and capital markets. There is no doubt that integrated international capital markets have, on balance, had enormous benefits for all countries, in particular capital–receiving countries. They have permitted the rapid spread of managerial and technical innovations; they have provided additional resources to countries where investment opportunities outstrip savings; and they have been a source of macroeconomic discipline, making it harder for countries to pursue unsustainable policies. All of those things are desirable and beneficial consequences of an open capital system.

At the same time we have to recognise that open capital markets have brought with them sources of instability that need to be dealt with if we are going to maintain popular support for a liberal economic system. These shortcomings include excessive volatility in capital flows — when times are good, much larger inflows than can be justified by the absorptive capacity of the capital–receiving countries, and abrupt reversals when confidence, for whatever reason, falters. Another source of instability has been weaknesses in financial systems, with major adverse consequences domestically as well as internationally. More than half of the IMF member countries have encountered significant financial sector problems over the past couple of decades and in fifteen or more countries, the resolution costs exceeded 10 per cent of GDP. Lastly, there is the issue of contagion. It is hard to accept that countries whose macroeconomic performance has been relatively sound should suddenly be affected by developments in economies to which they have scant relation. Contagion occurred within the Asian region, but recent experience demonstrates that it can also be transmitted to other continents with very limited trade linkages with the initially affected region.

How can these problems be dealt with? Do we need a completely new international architecture? This may be more a matter of semantics than of substance. Most of the calls for a new architecture do not suggest abandonment of the basic rules by which the international financial system is managed. Nor do they imply that we should create new institutional structures to replace the existing institutions such as the IMF, the World Bank or, for that matter, the OECD and the BIS. But what they do mean is that the market failures, which have given rise to instability in the international financial system, have to be addressed. The focus of my remarks will therefore be on how to make existing arrangements work better, rather than on creating new structures.

How can one avoid, or at least reduce the incidence of financial crises, and deal with them better when they arise? First of all, we have to understand the sources of financial vulnerability. Let me start with macroeconomic uncertainty. It has been said that macroeconomic performance in the Asian countries was quite good, and in terms of fiscal and monetary policies that is certainly true. But in an integrated financial world, with open capital markets, the standard to which macroeconomic policies have to be held is higher than in a world in which capital markets are less integrated and capital restrictions are more prevalent. This applies particularly to exchange rate policies. It is much harder to maintain a fixed but adjustable exchange rate regime in circumstances where there is high mobility of capital, and therefore a much greater ability on the part of investors to translate doubts about medium–term sustainability of an exchange rate into immediate market pressure.

One of the lessons of the recent crisis is that fixed exchange rate regimes are very hard to manage unless there is a considerable degree of domestic structural flexibility, more than currently exists in most countries. Thus another of the lessons of the crisis is that we need to see macroeconomic policies in terms of the consistency of the exchange rate regime with the degree of flexibility of the domestic economy, as well as with monetary and fiscal policies.

Apart from macroeconomic policies the most potent source of market failure has been in financial systems. Structural weaknesses in the financial sector have contributed to most of the phenomena referred to earlier: volatility of capital flows, contagion, and the interaction of currency and financial crises.

How to strengthen domestic financial systems? This is going to be one of the major focuses of reform efforts. To address the issue, it can be helpful to think of the financial sector as being composed of three pillars: the **institutions** (banks, investment houses, insurance companies) that are the major actors in the financial system, the **markets** in which they interact, and the **infrastructure** within which financial transactions take place. Let me just say a few words on each of them.

As far as the institutions are concerned, we know from the experience of recent years that the prudential behaviour of financial firms, both in emerging market countries and in industrial countries, has fallen short of what could be desired. We therefore need to have risk management practices that are better attuned to the vulnerabilities of financial activity than we have had. In the case of the Asian countries, the practices

which grew up over the years that permitted currency and maturity mismatches in portfolios, that allowed relationships between borrowers and lenders to become too close, and that were based on weak accounting systems — all of those contributed to a vulnerability that, when a currency crisis emerged, exacerbated and intensified it. So strengthening the institutions that make up the financial system has to be a central focus of the efforts to build a more robust domestic and international financial system.

There were also weaknesses in markets. In many Asian countries, organised securities markets were lacking or were small in size. Over–the–counter markets, such as the interbank market, therefore played a larger role. But these were handicapped by a lack of transparency that gave rise to familiar problems of illiquidity and herd behaviour.

One also needs to deal with the infrastructure in which financial transactions take place. Mention has already been made of accounting practices, corporate governance, and so on. The legal and infrastructural framework for transactions has been a source of weakness in a number of countries. We have become particularly aware of it in the crisis in East Asia, but also in Russia and indeed in other countries. Efforts also have to be devoted to strengthening accounting systems so that financial claims and liabilities adequately reflect underlying value; to improving legal structures, in particular bankruptcy law, so that asset holders can more easily value impaired assets and realise claims on failed enterprises; to modernising corporate governance practices; to making payments and settlement systems more robust.

What are the practical means by which weaknesses in financial institutions, in infrastructures, and in markets can be tackled? There are two principal approaches, which are complementary. One is enhanced transparency. This has been talked about a great deal in recent years. Transparency helps markets work better. It prevents excessive risk taking. Lack of information is the root of misvaluation and then the sudden changes in prices or in market trends. In several cases in recent years, lack of information about the foreign currency position of the authorities in countries that were subsequently affected by crises was one of the factors contributing to the severity of the crisis when it eventually hit.

The other pillar on which the effort will probably be based is improved standards of regulation, through the codification and dissemination of best–practice procedures. Several examples of this approach can be mentioned. For example, there is the code of corporate governance being developed by the OECD, there is the Basel Committee's core principles for banking supervision, there are standards being developed by the international accounting standards bodies, and there is the IMF's special data dissemination standard, among others.

All of these, of course, need some kind of monitoring and enforcement to ensure that agreed standards are implemented and adhered to. In the area of banking supervision we have found that peer pressure and market forces are a potent force for ensuring the more generalised adoption of standards that initially are developed by a relatively limited number of countries. In his remarks, Yung Chul Park complained

that the bodies setting standards have traditionally been representative only of the industrial countries. It is true that for standards to be truly acceptable they have to have a legitimacy across all countries which are being asked to observe them. This complaint has been addressed, in part, by involving, through consultation, a much wider range of participants in the preparation of the standards than were engaged before. One could go further and develop standards in a body representing all the 182 member countries of the IMF. However, we know from experience that is not a practical way of getting agreed–upon standards. It is more effective to do it in a relatively small group, but means have to be found of ensuring that the small group has a degree of legitimacy through the openness to contributions from outsiders.

Financial systems would be strengthened by promoting transparency and by developing and implementing higher standards of practice, prudential and otherwise. Given the wide range of international organisations and standard–setting bodies, this will inevitably be a rather decentralised effort. How can it be given the necessary degree of coherence? This is where the Financial Stability Forum comes in. The Financial Stability Forum is one of the institutional innovations asked for by the G–7 following their consideration of the lessons of the recent crisis. The Forum was established in February of this year by the G–7 finance ministers and central bank governors. It comprises senior representatives of finance ministries, central banks and regulatory authorities from the G–7 countries. It includes, in addition, all of the international organisations and regulatory groupings that are involved in financial stability matters, that is to say, banking supervisors, insurance supervisors, securities supervisors, the IMF, the World Bank, the OECD and one or two specialised committees. This makes it a rather unwieldy body. Initially it included 36 individual representatives and following the recent G–7 summit, the Forum has been broadened further to include representatives from Australia, Hong Kong, the Netherlands and Singapore.

The purpose of the Forum is to identify vulnerabilities in the international financial system and to consider ways of dealing with them. It will act as a co–ordinating mechanism, to bring together and to improve information exchange and decision making amongst the international organisations and regulatory authorities. It will not have any formal powers itself.

At the Forum's constitutive meeting in April, three areas were identified as important sources of vulnerability in the international economic system and working groups were set up to make proposals for dealing with them. The three areas were: the impact of highly–leveraged institutions; the role of offshore centres; and short–term capital flows. We have tried to constitute working groups that are sufficiently broad–based to include a variety of shades of opinion and expertise while small enough to be effective. For example, the Working Group on Capital Flows includes senior officials from Malaysia and Chile, both of which have relevant (though different) recent experience with measures to influence or control capital flows.

What do can we expect to come out of the working groups? The aim is not simply to produce analytical reports; in line with the request of ministers and governors, the working groups will provide concrete, implementable recommendations. The Forum's membership should give political impetus for their adoption.

Substantively, what might the recommendations be? The work is at a relatively early stage and it would not be appropriate to prejudge what might come out of it. We might, however, see proposals for improved transparency and disclosure which would help stabilise markets and reduce volatility by providing information necessary for more informed decisions. We could also imagine that the Forum should suggest prudential standards both for banks and financial institutions in lending countries and in borrowing countries. For example, it might be considered whether borrowing countries should adapt their prudential oversight of the placement of foreign exchange currency inflows. If one of the problems in the past has arisen as a result of short–term borrowing in foreign currency being translated into long–term lending in local currency, there is obviously a mismatch problem. It may well be that we would like to urge the banking supervisors to develop techniques to deal with that.

The working groups should present progress reports by the autumn of 1999 and be in a position to present final recommendations by April 2000. If we do that we will maintain the momentum of the Financial Stability Forum. It is also intended that the Forum should be a continuing opportunity for exchange of information, analysis and assessment, amongst its members on the way in which the global financial system is evolving. In this respect, one could perhaps make a comparison with Working Party No. 3 (WP3) of the OECD. The WP3 was constituted in the early 1960s as a means of monitoring vulnerabilities in balance–of–payments positions and the adjustment process. It still reviews, on a regular basis, the macroeconomic evolution of the global economy.

Nowadays there is a greater focus on vulnerabilities arising in financial systems rather than on those based on balance–of–payments disequilibria. The Financial Stability Forum could conceivably play a similar role to WP3 in bringing together those who are concerned with financial (as opposed to macroeconomic) stability. If successful, this would make it easier for all to understand the impending threats to financial stability, to act in advance of crises and hopefully in the long run to minimise the impact of such crises, with all the social and economic costs that they have had.

Indonesia: the Road to Recovery

Farid Harianto

At the onset of the Asian financial crisis, the Indonesian banking system suffered from a number of significant defects and problems. These included high levels of non–performing loans, reaching up to 80 per cent of the total; too–close a relationship between lenders and borrowers, leading to a concentration of ownership; mismatches in assets and liabilities in loan terms, their maturities and the currencies in which they were expressed; massive breaches of prudential regulations, poor governance, little close–up supervision, and poor enforcement of those regulations which were in operation. These defects imply an enormous cost of bank restructuring which amounts to over 63 per cent of GDP.

In the light of the situation, determined political restructuring was necessary in order to demonstrate commitment to reform. The political system itself was in serious need of reform in order to make it more representative and this has implied restructuring the political institutions themselves. Political actors and the population had to be prepared to express themselves through the process in order to form an alliance which, following elections, would be ready to support post–crisis economic policies and compliance with IMF requirements for funding economic reform and restructuring. By June 1999, some important reforms had already been undertaken. These include: introducing a disciplined monetary policy; ensuring prudence in fiscal policy by, for example, reducing subsidies; banking sector reform and resolution, bank shareholder recovery; and asset sales. Three major areas of action still required further efforts. They were: reform of bankruptcy laws and the commercial court; corporate debt restructuring; and the implementation of the privatisation plan.

In the banking area, specifically, the government's Bank Restructuring Agency (IBRA) was set up to oversee the process of reform. Since not all banks were equally hurt by the crisis, the IBRA analysed the economic conditions of Indonesian banks in order to identify those which could be described as having irrevocably failed. Those institutions which were deemed to have "survived" were recapitalised, while those considered to be still viable, but too weak to continue as separate units were taken over or merged by the IBRA. Failed banks were closed and their assets and loans liquidated or transferred to the survivors. The IBRA also monitored the sale of corporate assets in order to recover related–party borrowing.

These activities, covered by the banking law of November 1998 which was implemented in March 1999 and granted the IBRA all extraordinary powers necessary to achieve its objectives, resulted in resolution strategies for 100 per cent of Indonesia's banking sector. The outcome, again by June 1999, was the recapitalisation of nine banks, the merger of four state banks, the IBRA's takeover of 11 institutions and 66 closures. In addition, negotiations for the sale of Bank Bali to Standard Chartered were under way. Over $18 billion in assets had been transferred to the IBRA's asset management arm and the first asset sales were being completed. An agreement had been reached with shareholders to repay Bank Indonesia emergency liquidity credits and 215 companies with a total transfer value of $10.4 billion had been taken into holding companies. Bank holdings, including those taken over by the IBRA, those recapitalised with government assistance and state owned–banks are to be disposed of either wholly or partially through domestic or international privatisation over the next few years. This will amount to the transfer of loans totalling over $26 billion.

Financial asset sales, of which consumer loans constitute 88 per cent of the total and commercial/corporate loans the rest, will be carried out in order to create the least disturbance possible through conserving a maximum of business structures and the employment which goes with them. The IBRA will be responsible for analysing and sorting loans to establish a strategy identifying those loans which can realistically be serviced and limit foreclosures to a minimum. The final objective is to create a new "loan culture" in which those who can repay will feel obliged to do so and thus establish a healthy financial sector capable of creating wealth. Strict rules of governance will be applied to financial asset sales to ensure that they are transparent and do not simply result in recreating the closed corporate culture of the past. The same philosophy applies to the holding companies which will be disposed of within a four–year time frame as full companies to avoid break up and asset stripping.

The progress made so far indicates that the IBRA is making substantial headway in reaching its objectives. Banking sector reform and restructuring are on track and the IBRA is able to add corporate debt restructuring to its priorities. Preparation for substantial asset sales is well under way and the Indonesian economy shows signs of being on the road to recovery. However, some formidable challenges remain. Not least of these is servicing the cost of bank restructuring, estimated at $68.5 billion, a sum which, as we have seen, amounts to 63 per cent of GDP. Some of this will be met through the capital market, which itself will require restructuring and revitalising. The real sector will need to be given a boost and the incentive regime will need to be reviewed and relaunched. Finally, the country needs to take on board a political economy of restructuring, where the hard choices to be made can be accepted as part of the goal of reform and modernisation that is necessary for the crisis to be put into the past and avoided in the future. The measures taken so far or still in the pipeline demonstrate Indonesia's commitment to genuine reform and, thus are the best hope that the country can emerge strengthened and prepared for future shocks to the regional or global economy.

Towards a Sustainable Financial System: Analysis and Prospects

Mats Karlsson

"Asian perspectives" are of course not only Asian. They affect all of our countries. In the Swedish government and parliament we have just completed a major endeavour to focus on our strategic interests in relation to Asia. Believe it or not, it is uncommon for a foreign ministry to do this transparently in an integrated fashion. We looked at five areas: trade and economics, poverty and quality of life, democracy and human rights, environment, and security. After a year or two, 1 500 pages, long discussions with business, NGOs and academics, it was clear that the future of European and other children will be significantly affected by the choices now being made by Asian societies. This is a compelling reason for listening carefully to each other and thinking creatively together.

In Chancellor Gerhard Schröder's pre–Cologne Summit statement to the Bundestag there was a key passage: "Overcoming the divide between the poor and the rich regions of the world remains the greatest international challenge on the threshold of the 21st century". The new German government is serious about this, as demonstrated by the Cologne Debt Initiative, which revives the great vision of Willy Brandt. One should recall the path–breaking report on globalisation by the Brandt Commission 20 years ago and the Pearson Report of some 30 years ago. The latter observed "the widening gap between the developed and the developing countries has become the central problem of our times".

Over the past 30 years the process of globalisation has increased interdependencies and the risk of contagion, while the bottom line has remained the same. New UN statistics in *The Human Development Report* show that during this period the income gap between the world's richest fifth and the world's poorest fifth has more than doubled to 74 to 1.

For years people have been heartened by — or themselves contributed to — the progress of "emerging" economies, as the most successful of the middle three–fifths are called. Spectacular growth has reduced poverty and improved the opportunities of

hundreds of millions of individuals and families. It has given those in emerging economies the courage to believe that it is possible to overcome poverty and share a world more equitably within a lifetime.

That still remains true. Some of the countries that were hit hard by financial crisis, but drew the right conclusions and managed their political challenges, are surprising many by the speed of their recovery. Nonetheless, pessimism about the worldwide picture is understandable. After all, tens of millions were thrown back into deep poverty overnight in countries that were among the most successful in the developing world. Many of these people will not recover. A decade of difficult times can do irreparable damage to a family or a child.

Impatience with a lack of progress, frustration with persistent gaps and exasperation with the arrogance of elites may offer opportunity to those would seek rational radical change as well as those who thrive on people's fear, populists of various hues.

The crisis has made us see the market differently. The debate is no longer between those who favour the market and those who would deny the market its role. A functioning free market offers more people more opportunity and capacity to shape their lives than any other way of organising an economy. The actual choice is to between a free market that benefits the society and one that becomes captive.

A market can be free in the everyday sense of the word, and yet be captive to the interests of a few. This is not only unjust, but it makes the market much more vulnerable. Around the world we have seen what this means for people. In Indonesia, they call it KKN (corruption, collusion and nepotism). In Russia privatisation dominated by the *nomenclature* has meant that the market economy has worsened living standards for the vast majority of people, creating a deep distrust of what is going on.

The choice between social and captured markets is relevant worldwide, in the developed and the developing world alike, but countries in transition and emerging markets are more vulnerable. More developed markets may be where they are because they have managed this choice better, but there remains a tendency for elites to secure a disproportionate share and protect their interests from competition.

The difference between a social and a captured market is reflected in the public responsibility that is taken in the polity that goes with the market, public policies in a broad sense and the societal institutions that underpin them.

Social policy, human development policy, is at the core of sustainability. The choices to be made are "hard" because they must respect fiscal limits or because social policies need to avoid bad incentives; but they also hard because of being intrinsically linked to the financial system and together form part of the basis of a functioning market economy.

This point belongs in a discussion of a sustainable financial system for the following reasons:

— first, because human development is the objective of any system, and no system will be politically sustainable if it does not deliver;

— second, because social cohesion, societal trust, seems to be the key intangible ingredient in recipes for institutional maturity and respect for the rule of law;

— third, because a high level of human development is a key to high productivity.

This last reason is relevant to the implications of a financial crisis because:

— the human cost may be less dramatic; and

— the potential for quick recovery better.

In devising the financial framework in which an economy is to develop, a country's leadership should remain concerned about the link to the social sphere. The financial and social spheres are, to use the metaphor of World Bank President Wolfensohn, the two sides of the balance sheet of development. Sweden used to be at the top in world in GDP per capita tables. No doubt we mismanaged our model. By the early 1990s we were badly enmeshed by the financial turmoil in Europe. A deep banking crisis, a fiscal crisis and skyrocketing interest rates were the result. Output fell and unemployment tripled. In the 1980s, as Sweden became rapidly exposed to global financial markets, financial sector wisdom had been, the more open our markets were the better, and the quicker the better.

We learned a lot. Our focus on human development played an unrecognised role. Even as inequality grew and incomes fell, we struggled to maintain social systems, and did so, more or less. Today, the human development ranking of Sweden remains much higher than our ranking by GDP; our human poverty index — Amartya Sen's improved index that better captures exclusion — is the lowest in the world. That is a good thing in itself, but our investment in social development and inclusion was also instrumental in enabling us to overcome our crisis. (That could be tested by academic analysis.) We made a fast turnaround, with strong macroeconomic balances, healthy growth and rapidly increasing employment. It was possible to mobilise strong support for the difficult, hard choices that were necessary. Among them was a fully overhauled pension system, a modified "pay–as–you–go" system, perhaps the first such overhaul in Europe.

Appropriately anchored in domestic reality and intelligently managed, a track record of high social investment will turn out to be an asset not a liability in times of crisis. This is the core of the "third way" debate in Europe, America and elsewhere: strong markets require a strong social dimension.

The Asian crisis paved the way for a discussion about a new international financial architecture. It opened a window of opportunity to boost global economic governance. A global village needs its architecture, its town planning, its fresh water and sewage treatment, but the concept of governance is preferable to that of architecture. If we have learned anything, it is that when crisis strikes, the dynamics of decision making are put to the test as much as the particular institutional structure.

Around the world rapid global economic integration is far exceeding political integration. There are strong forces of change at work, which are not balanced by a common system of standards, regulations and contingency practices for dealing with shocks, instability and other negative effects.

Globalisation challenges us to fight “bad” global and regional public practices, while there is a rapidly expanding demand for the provision of public “goods”, from mundane everyday issues to knowledge and security. Financial stability should be treated as a global public good. Its opposite, instability, is certainly bad.

Steps have been taken: in particular the creation of the Financial Stability Forum linked to the Bank for International Settlements, and not just automatically to the IMF.

Governments today meet in an array of global institutions dealing with finance, development, trade, the environment, migration etc. While there are growing links between them, it is still possible for governments to say one thing in one forum, another thing in another forum, and in the worst of cases, speak with double standards. This can be true both of countries of the North and of the South.

Beside the global institutions, we have the dynamic regional ones, NGOs and business groups. This meeting of global private actors and the emerging global civil society should be seen as integral to global governance.

Thus the institutions to match our interdependence exist. There is a risk that as this financial crisis recedes, pressure will diminish, and there will be insufficient progress towards good governance.

The 1999 G–7/G–8 meeting made two important suggestions. One was to turn the IMF Interim Committee into a standing “International Financial and Monetary Committee” and the other was to establish “an informal mechanism for dialogue among systemically important countries, within the framework of the Bretton Woods institutional system”.

What we need at the apex of governmental interaction are ways of ensuring leadership and cohesion. This means creating more practical forums for political leaders to see what needs to be done.

Globalisation demands that our democratically elected leaders also be held accountable in the context of interdependence. Certainly, we need to move step by step. We do not need useless meetings, but it should be clear to everyone that our governments do need improved institutional forums to manage affairs, ensure coherence and look ahead.

If the financial crises of the 1990s will have forged such changes, something good will have come out of them. But we are not there yet.

Towards a Sustainable Financial System: The Malaysian Situation

Abdul Aziz Mohd. Yaacob

When the devaluation of the Thai baht in mid–1997 sparked regional capital flight, stock market collapse and the erosion of investor confidence, Malaysia withstood the early shocks better than Thailand, Indonesia and Korea. In large part, Malaysia's relative strength was due to its lower exposure to extemal debt. Although foreign capital did leave the country as the economic crisis spread across the region, an adequate level of foreign exchange reserves was maintained. A serious balance–of–payments crisis was therefore avoided.

Malaysia's economic fundamentals and regulatory and banking standards were much stronger compared with many in the region: inflation was low; the level of savings was high and there was a high degree of openness to intemational trade and foreign investment, while the external debt was low and the fiscal position was strong. In addition, Malaysia had already operated a floating exchange rate regime since 1973. The international financial institutions, including the international rating agencies, acknowledged these positive features. Despite these strong fundamentals, however, investors did not differentiate the risks in countries in the Asian region.

No doubt there were some areas of concern: the high loan to GDP ratio, the deficit in the current account of the balance of payments, certain large development projects and strong credit growth. Malaysia recognised these areas of vulnerabilities and had introduced various measures since 1996 to address them.

As the crisis evolved, Thailand, Korea and Indonesia came under IMF–supported adjustment programmes. Although Malaysia was not under an IMF programme, it initially closely followed policy prescriptions of tight fiscal and monetary policies. Government expenditure was cut and several large projects were deferred as part of the fiscal discipline to run a surplus. To complement the tight fiscal policy, monetary policy was focused on maintaining high interest rates to reduce pressures on the currency. Prudential regulations were also strengthened to ensure that banks remained sound to avoid any likelihood of systemic failure.

Policy Responses and Crisis Prevention

As circumstances changed, policies were adjusted or modified. Throughout, however, the objectives of policies remained unchanged: maintenance of price stability while avoiding a further contraction of the economy.

As mid–1998 approached, it became clear that GDP growth would contract substantially. As a result, strategies that had been put in place immediately after the onset of the crisis were reassessed, and the National Economic Action Council (NEAC) announced a comprehensive National Economic Recovery Plan (NERP).

Policy responses were refocused on counter–cyclical measures to avoid a recession–deflation spiral. The fiscal policy stance changed from surplus to deficit budgeting. Recognising the limited capacity of the private sector due to liquidity problems, it was decided in early 1998 that the public sector would have to bear the major burden of stabilising domestic demand. Successful fiscal consolidation that had been carried out since 1982 gave greater flexibility to the government to adopt an expansionary fiscal stance. For 1999, the fiscal deficit is targeted at 6.1 per cent of GNP, considered manageable, and will be funded from non–inflationary sources, mainly domestic savings. Other fiscal measures included selective increases in infrastructure spending, establishing funds to support small– and medium–scale enterprises, higher allocation for social sector development, as well as reduction in taxes. Careful programming of additional expenditures is expected to generate high multiplier effects, but without rekindling inflationary pressures at the same time, preserving the improvement in the current account position of the balance of payments.

Monetary policy was eased against an environment of relative price stability. However, the volatility in the financial markets persisted, arising from several external developments that undermined progress on the domestic front. These developments included the political and economic situation in Indonesia and the events leading to the devaluation of the Russian ruble. Speculative attacks on the ringgit and stock market persisted, posing a major obstacle to the government's efforts to stabilise the economy. Given the continued adverse external environment, selective exchange control measures were introduced on 1 September 1998 to de–internationalise the ringgit and to stabilise short–term capital flows. On 2 September 1998, the ringgit exchange rate was fixed at RM 3.80 against the dollar.

Complementing the selective exchange controls, were other measures introduced to improve the liquidity of the banking system and for the intermediation process to generate lending to viable businesses. Monetary policy was further eased: rates were brought down to levels prevailing at end–1996. In implementing the controls, the government responded to concerns of foreign investors over the 12–month holding period on capital flows, replacing it with an exit levy on capital gains in February 1999.

Overall, the selective exchange control measures resulted in greater stability in the currency and stock markets and the financial system. Malaysia did not default on its external payments obligations.

The comprehensive economic recovery programme is beginning to yield positive results. The trade balance position continued to register another substantial surplus of RM 15.8 billion in the first quarter of 1999. International reserves increased to RM 118.8 billion or $31 billion ($20 billion in August 1998) sufficient to finance 6.9 months of retained imports. With the steady improvement in economic fundamentals, consumer and investor confidence regained strength.

Banking Sector Reform

The banking sector was fairly resilient when it entered the financial crisis in 1999. Aside from the limited exposure to foreign debt, there were a number of other advantages. The legal system had effective bankruptcy and foreclosure laws that helped prevent a rise in strategic loan defaults which were a significant source of non–performing loans (NPLs) in some other crisis–affected countries. The banking sector in Malaysia was well capitalised with risk–weighted capital adequacy ratios (RWCR) exceeding 10 per cent mid–1997. As of May 1999, the RWCR of the banking system has increased to 12.3 per cent.

A consistent and strong supervisory role by Malaysia's central bank, Bank Negara, over banks' loan portfolios since the experience of the 1986 recession, enabled it to react quickly to the worsening conditions in the banking sector. Nevertheless, the protracted nature and severity of the crisis placed the banking sector under considerable stress.

Institutional Framework for Financial Sector Restructuring

To ensure healthy development of the banking system and to address weaknesses, the government began an overall restructuring plan in the early 1990s. The plan was to:

— create a core of strong domestic banking institutions to compete effectively and secure a fair market share in the domestic and regional markets;

— broaden and deepen the financial markets, while strengthening the financial infrastructure;

— improve the overall efficiency and competitiveness of the banking sector; and

— accelerate development of the bond market and promote securitisation to reduce concentration of risk in the banking sector.

In the wake of the crisis, the immediate efforts were directed at ensuring that banking institutions continued to play their primary role in the economy of lending money to support the requirements of the real sector of the economy. To strengthen the banking system further, prudential regulatory and supervisory standards were enhanced and greater disclosure of the financial condition of banking institutions was promoted. Malaysia had already adopted 22 of the principles of the Basel Committee on Effective Supervision and work is now proceeding on adopting the remainder.

By mid–1998 in the face of deteriorating economic conditions, the government created an institutional framework for financial sector reform. Danaharta was established as an asset management company in May 1998 to acquire NPLs from banking institutions in order to strengthen the latters' balance sheets and to enhance their ability to lend. Thus far, Danaharta has issued RM 7.9 billion nominal value bonds to financial institutions in two series in exchange for NPLs.

Danamodal, a special purpose vehicle with the purpose of recapitalising financial institutions whose capital adequacy ratios fall below 9 per cent was established in July 1998. In those financial institutions in which Danamodal injects capital, it obtains equity and appoints a minimum of two directors to the board, enabling Danamodal to promote operational restructuring.

The last component of the restructuring framework was the Corporate Debt Restructuring Committee (CDRC) which was established in August to facilitate restructuring of corporate debt which, as in the "London Rules," would be conducted outside of the courts. Voluntary agreements between creditors and debtors could thus be facilitated.

Progress of Financial Sector Restructuring

As of 31 May 1999 Danaharta had acquired RM 27.9 billion in gross value of NPLs, out of a total of RM 77 billion (6–month classification of NPLs), from 52 financial institutions. Danaharta also managed, on behalf of Bank Negara Malaysia, RM 13.3 billion in gross value of NPLs.

Danamodal injected RM 6.2 billion into 10 financial institutions mainly in the form of Exchangeable Subordinated Capital Loans (ESCL). It had also placed directors into the recapitalised banks to effectively facilitate lending recovery.

In addition to these developments, two large bank mergers are in progress. The number of finance companies is expected to decline from 39 to 16 by the end of 1999. With an adequate legal system and a well–structured institutional framework for bank recapitalisation in place, the prospects for successfully carrying out the restructuring of the financial system are encouraging. Malaysia should be able to finance its bank recapitalisation using internal resources even if extemal funding were unavailable. The use of zero–coupon bonds by Danaharta and Danamodal has reduced the immediate budget constraints and should prove a successful strategy in bridging the funding gap. More broadly, efforts by Danaharta, Danamodal and CDRC have enabled banks to concentrate on current lending and not become overly occupied with managing their NPLs.

Corporate Sector Restructuring

Institutional Framework for Corporate Restructuring

Through the CDRC, a platform was provided for both borrowers and creditors to work out feasible debt restructuring schemes without having to resort to legal proceedings. Initially, an increasing number of borrowers in financial difficulty had sought legal protection rather than negotiate for loan restructuring. Creditor Committees comprising banking institutions have been formed to work out the debt restructuring, based on market–driven principles to ensure a win–win situation for both the borrowers and the creditors. If negotiations under CDRC could not obtain consensus among the banking institutions, Danaharta would assist by buying over NPLs from the dissenting banking institutions thereby facilitating the restructuring process.

For small corporate borrowers undertaking restructuring of their operations, a Loan Monitoring Unit has been set up in the central bank to assist borrowers with total outstanding debt of less than RM 50 million. Such borrowers could also use the Danaharta route. In addition a Rehabilitation Fund for Small and Medium Enterprises (SME) was set up in 1998 to assist in the restructuring of viable SMEs.

Progress of Corporate Restructuring

While the process for corporate debt resolution is in place, debt workouts and operational restructuring through CDRC have been slow. The key challenges are detailing the warehousing and disposal strategy and process for Danaharta, speeding up debt workout and operational restructuring under CDRC. CDRC is expected to have a life span of two years and expects most of the restructuring work to be completed by end–1999.

As at 17 June 1999, it had received indications of interest from 60 companies with a total debt of RM 32.57 billion. CDRC is seeking to restructure debts through the issue of bonds, which would remove these debts from the banking sector. Apart from issuing bonds, many companies are expected to engage in debt–equity swaps.

The agenda is to strengthen skills for corporate restructuring in Danaharta and the CDRC and to ensure that financial restructuring is accompanied by operational and ownership restructuring. Danaharta would provide details on its asset disposal strategy and would maintain transparency and burden sharing in the restructuring process.

Enhancing Standards of Corporate Governance

The financial crisis revealed the inadequacies of public and private sector governance and emphasised the importance of good governance in both the developed and emerging markets. Efforts to enhance standards of corporate governance in Malaysia began before the crisis. Regulators have been reviewing and strengthening various laws, regulations and rules aimed at enhancing standards of corporate governance. These efforts, however, have been piecemeal in nature. In April 1998, the government formed a high–level Finance Committee on Corporate Governance that brought together top–ranking members of the government, the corporate sector, industry organisations and regulatory agencies to undertake a comprehensive review of corporate governance in Malaysia.

On 25 March 1999, the Finance Committee released a report that made specific recommendations on strengthening the statutory and regulatory framework for corporate governance, and to enhance the self–regulatory mechanisms for good governance, including the development of codes of best practices. In formulating best practices on corporate governance, the Malaysian view is that a code, whose formulation and adherence is monitored and regulated by the industry, is preferable to government intervention and would be more enduring. The Finance Committee's Report also highlighted the need for training and education programmes to ensure that the framework for corporate governance has human and institutional capital support. More importantly, training and education should inculcate the philosophy and culture of good corporate governance among market participants, in particular boards of directors. Additionally, during its year as Chairman of the APEC Finance Ministers' process, Malaysia chaired the APEC Core Group on Corporate Governance. The Group's Report to the Finance Ministers last May now serves as a model for other markets within the regional grouping.

The release of the Report on Corporate Governance in Malaysia marks a beginning and not an end. The next stage is developing a comprehensive Action Plan.

Other Initiatives Aimed at Investor Protection, and Transparency and Disclosure

Steps are being taken to ensure that the issues of increased transparency and minority shareholder protection, higher standards of business and greater due diligence are addressed. These include strengthening rules on related–party transactions; enhanced corporate disclosure; and moving towards disclosure–based regulations.

Reporting and disclosure requirements for listed companies have been stepped up. Public listed companies must now provide quarterly reports of financial statements to help provide timely information to assist investors in their decisions and to increase

the accountability of public listed companies. Recent improvements have also been made to the "Policies and Guidelines on Issue/Offer of Securities" that was first introduced in 1995. In 1997, the Malaysian Accounting Standards Board (MASB) was set up, as a technically independent authority with the responsibility for the development of financial accounting and reporting standards in Malaysia.

Capital Market Development

Measures to strengthen the capital market have focused on maintaining systemic stability, strengthening market intermediaries; rehabilitating the securities industry; and improving market transparency and corporate governance.

In order to strengthen the Malaysian capital market's resilience to systemic instability, the Securities Commission, in consultation with derivative market institutions, has devised an early warning system which enables the derivative exchanges and clearing house to monitor the capital and liquidity positions of the futures brokers. To address concerns of investors that they were inadequately protected, as well as, minimise the potential for systemic risks arising from a "run" on a stockbroking company, the compensation fund was expanded to over RM 30 million from RM 14 million. A standby facility of half a billion ringgit for the stock exchange clearing system was also established to prevent failed trades.

Further efforts are currently underway to further reduce settlement risk by implementing a delivery versus payment (DVP) system.

Prudential standards in the Malaysian stockbroking industry have been raised through a new risk–based system of capital adequacy requirements which will replace the current system of minimum liquid fund requirements. This will bring rules on prudential requirements more closely in line with existing international standards.

Brokerages will benefit from a scheme which aims not only to resolve the problems faced by the stockbroking industry but also to address the banking sector's exposure to these brokerages. The scheme is also expected to facilitate recapitalisation and consolidation within the stockbroking industry.

Several changes have also been made to the Listing Requirements covering, among other things, a widening in the scope of rules; disclosure enhancements; improved voting rights; the appointment of corporate advisors; and greater directors' responsibilities. A new Malaysian Code on Take–Over and Mergers addresses previous deficiencies, enhances transparency and better protects the interest of minority shareholders. Rules on related–party and interested–party transactions have been reviewed to stop possible abuses by large/controlling shareholders in connection with related–party transactions.

Development of the Malaysian Bond Market

The development of an efficient corporate bond market is vital to the overall development of the financial infrastructure of Malaysia. During the 1990s, the authorities took several initiatives to set the pace for the orderly development of the private bond market. The rating Agency Malaysia Berhad was established in November 1990 as part of this process. In September 1996, the Malaysian Rating Corporation Berhad was set up. Rating for all domestic bonds has been obligatory since May 1992. Efforts were also directed towards developing a trading, clearing and settlement system for private debt securities (PDS) Confirmation of trades and settlement of cash and securities transfers have become fully automated. This system was further upgraded in January 1996 to serve as the central depository and paying agent for all unlisted bonds. In order to establish a benchmark, the Khazanah Nasional Berhad, a wholly owned subsidiary of the government and an investment holding arm of the government, was mandated to issue benchmark bonds on a regular basis.

Lack of information in the market has been often cited as a reason for the slow development of the secondary market. To address this problem the Bond Information and Dissemination System (BIDS) was launched in October 1997 to provide a comprehensive database on the debt securities market. The information in BIDS, in particular, the indicative buy–sell quotes and last done price information, has added to market transparency and efficiency, thereby enhancing liquidity in the market.

As the issuance of debt securities increases and an increasingly more realistic benchmark yield curve evolves, a significant improvement in the volume of interbank dealings, market trading activities and pricing of bond issues would evolve. The aim is to achieve a more active secondary market with the existence of the Bond Information and Dissemination System and the implementation of the Real Time Electronic Transfer of Funds and Securities in July 1999 to provide an efficient mechanism for clearing and settlement of debt securities. A revised set of Guidelines on the Issuance of Private Debt Securities and the Code of Conduct and Market Pratices for the Bond Market will streamline PDS trading practices and procedures and facilitate the orderly development of the market. Guidelines on Asset Backed Securities will be introduced, which apart from diversifying risks from the banking system, will widen the spectrum of paper available for investment in the market.

Conclusion

The measures taken by Malaysia in response to the crisis are aimed at recovery with reforms. Most are market–led and based on stimulating investor confidence by providing stability and facilitating growth through fiscal, monetary, exchange rate, capital market and corporate governance policies. Since undertaking the measures the results have been positive. Future development in respect of policy responses will continue to be pragmatic to build on the recovery, reinvigorate growth and provide benefits to investors, consumers, other market participants and the economy as a whole.

Table 1. **Malaysia: Key Economic Indicators, 1996–99**

	1996	1997	1998	1999e
Real GDP (% growth)	10.0	7.5	–7.5	1.0
Agriculture (% growth)	4.8	0.4	–4.5	–
Mining (% growth)	2.9	3.0	1.8	–
Manufacturing (% growth)	18.2	10.4	–13.7	–
Construction (% growth)	16.2	10.6	–23.0	–
Services (% growth)	10.1	9.9	–0.8	–
Gross National Saving (% of GNP)	38.9	39.4	41.9	–
Balance of trade (RM billion)	–0.3	–0.05	58.4	22.0 (Jan–Apr)
BOP current account				
(RM billion)	–11.2	–15.8	+36.8	+29.5
(% of GNP)	(–4.6)	(–5.9)	(+13.7)	(11.0)
External reserves ($ billion)	27.7	21.7	26.2	31.3 (15 June)
(6 months of retained import)	(4.4)	(3.4)	(5.6)	
Fiscal balance (% of GNP)	0.8	2.5	–1.9	–6.1
Total external debt				
(RM billion)	97.8	170.8	161.9	170.6
(% GNP)	(41.2)	(64.0)	(60.2)	(63.5)
Short–term external debt (RM billion)	25.1	43.2	28.5	28.5
Debt service ratio (%)	6.2	4.7	6.0	5.2
Inflation	3.5	2.7	5.3	<4
Unemployment	2.6	2.6	3.9	4.5*

e = Estimates.

* This is based on BNM 1998 Annual Report. However, if the recovery of the economy strengthened, the unemployment rate for 1999 could be less than 4 per cent.

Recovery Indicators (Q1 1999)

Trade balance: surplus of RM 15.8 billion in first quarter due to export improving by 4.6 per cent in $ terms.

Forex Reserves: increased to $31.3 (15 June 1999), sufficient to finance 6.9 months of retained imports.

Inflation: moderated to 4 per cent (5.4 per cent, Q4 1998).

Manufacturing Output: Increased by 4.6 per cent in February and March 1999.

Passenger cars and commercial vehicles sales picked up.

Overall financial position of the Federal Government recorded small surplus.

Greater stability in the financial market: KLCI has improved 202.6 per cent from a low of 262.70 on 1 September 1998 to 794.83 on 23 June 1999.

Market capitalisation has recovered 182.1 per cent from RM 181.5 billion to RM 512 billion in the same period.

Real GDP: –1.3 per cent (–10.3 per cent, Q4 1998).

New Approaches to the International Financial System

Jean–Jacques Rey

One of the side effects of the Asian fiancial crisis has been the emergence of the concept of the need for "a new architecture of the international monetary system". While the bricks of the new architecture are piling up, it is unclear that this ambiguous terminology adequately describes what is being built or rebuilt. We need to unbundle this architectural undertaking into three quite different types of action, and then dwell on the third one, which will eventually lead to a discussion of the state of play with respect to the involvement of the private sector in crisis resolution in particular.

The starting point is the formidable acceleration of international financial activity which occurred in the last decade of this century, through increased volumes of financing, through greater geographical dispersion of capital flows, and through the innovative extension of the available instruments. These trends have been well documented. They have brought with them considerable benefits, but at times, serious casualties have been observed. Obviously, something had to be done to maximise the benefits of the free flow of capital, and yet limit the risks.

One type of reaction is of a political and institutional nature. An effort has been made to adapt the geography of international co–operation and deliberations so that those countries most involved in the problems raised by recent developments would have a say in the design of appropriate remedies.

The emergence of such groupings as the G5–22, G–26, G–33 reflects this concern. Although the selection process may not have been a model of transparency, at a time when transparency is advocated everywhere else, it must be recognised that there are reasons to revisit the distribution of seats around the tables of international monetary co–operation. One reason derives from the importance of the newly emerging countries for the stability of the international financial system. European monetary union also upsets the traditional hierarchy of representation in international institutions, however, redistribution will require very skilful architects and a good deal of caution.

Another set of reactions lies in the wide range of initiatives taken to bring about a greater degree of discipline, responsibility and transparency in the financial behaviour of market participants. Core principles, best practices, codes of conduct are emerging in a number of fields closely related to financial intermediation. Tighter supervision or oversight is being recommended. Measures to enhance transparency and disclosure are being worked out or prescribed in order to stimulate market discipline. Ways of strengthening financial infrastructures are being proposed.

This set of initiatives is gradually building some sort of international financial organisation, akin to the emergence of the set of international trading rules under the aegis of the GATT, 50 years ago. Surely, the set of rules and practices applicable to the capital account is much less structured and institutionalised than those applicable to the current account, but rightly so, and one might look at the creation of the Financial Stability Forum as a sort of common institutional roof for that activity.

Let us turn to yet another level of consideration, consisting of assessing the extent to which the most traditional areas of concern to the international monetary system need to be revisited to take account of new developments. These areas are, apart from the general conduct of macroeconomic policies: the exchange rate system, the issue of convertibility for current and capital payments, and the provision of liquidity to face balance–of–payments strains.

There is little to say about the conduct of macroeconomic policies, short of writing volumes on the subject. Sound domestic policies have always been the most important part of a smooth functioning of the international monetary system, even when the current account was seen as the prime mover of any serious external imbalance. Now that the financial account is assuming such significance in rocking the boat, getting fundamentals right is even more important. Admittedly, more can be at stake than macroeconomic policies, as structural features of the economy are also looked at as part of the so–called “fundamentals”. An additional incentive for getting fundamentals right is now the newly created IMF contingency credit line, whose benefits presuppose a satisfactory record in this respect.

On exchange rates, one view holds that the strength of capital flows increases the vulnerability of any system of pegging, and points in the direction of so–called corner solutions, namely either floating or very strict anchoring arrangements, such as currency boards, dollarisation or monetary union. Experience shows that over time, the number of adjustable pegs among the exchange rate arrangements reported to the IMF has substantially decreased: their share has declined from over 50 per cent in the 1980s to less than one third by now. Recent events have contributed to this trend.

Nevertheless, it would be wrong to preach a new orthodoxy in this respect. While the importance of capital flows dictates careful attention to the adequacy of exchange rate arrangements, the conditions required to run successful corner solutions may not obtain. Currency boards, for instance, require sound banking systems, capable of absorbing large interest rate shocks, and quite flexible wage–price behaviour to absorb shocks in the real economy. Floating exchange rates can be afforded by relatively

closed economies, but may transform the exchange rate in a sort of permanent source of first– or second–round exogenous shock to the economy where international trade and investment contribute to a large part of domestic activity.

In the end, all exchange rate arrangements are worth what the underlying policies are themselves worth. Sometimes, the vulnerability of the peg does not rest so much with the pegging, or even with the underlying policies, but with the selection of the peg itself. Pegging to a single world currency has the merit of simplicity and reputation, but it may have a weak relationship to the fundamental needs of the country.

All in all, the IMF provisions which allow for any exchange rate system to qualify would seem to remain appropriate. The choice made by the authorities of the country, however, would usefully be regarded as a matter of international interest, rather than national discretion, and be open to regular scrutiny.

The cautious approach, appropriate when selecting exchange rate regimes, can be extended — and indeed now seems to be prevailing — to the issue of whether capital flows should be liberalised across the board, or may at times be usefully subjected to restrictions of various kinds, be they maintained, or temporarily restored.

No one disputes the merits of the free flow of capital, as a matter of principle, just as no one disputes the increased difficulty of implementing efficient exchange controls, for any length of time; but that statement is about as useful as preaching the virtue of alcohol–free drinking and the dangers of absorbing whisky.

Liberalisation is still desirable, but should be conditioned on the appropriate financial environment; safeguard clauses or actions may have to be considered, but they should be used with caution.

There are specific issues which may deserve further consideration in this field:

— how can a country smoothly exit from restrictions on capital inflows when time erodes their efficiency (are there lessons from Chile?);

— is there a case for restricting private capital flows when a sovereign debt crisis looms in a country (are there lessons from Mexico?); and

— what is the role of extensive capital controls when the country seems able to inspire confidence because it has not used such controls to avoid sensible macroeconomic and structural policies (are there lessons from Malaysia?).

By far the biggest challenge to the traditional international monetary system resulting from booming financial activity lies in the provision of liquidity for facing temporary imbalances. Relative to the traditional practice of quota–based conditional assistance, we are now faced with three new features which have lent a completely new dimension to this type of activity:

— first, systemic risk has been recognised as a major challenge to the system, and one which the IMF cannot fail to address;

— second, more than 80 per cent of outstanding IMF credit, which is historically large, has been extended to six countries, representing just over 5 per cent of total quotas; and

— third, a new facility — the contingent credit facility — is now available from the IMF. While it is said to be conditional at the moment of granting the line, and conditional upon activation, it is also often described as a form of insurance contract for contagion-prone countries.

These are very strong commitments on the part of the multilateral public sector. They raise issues which cannot be dodged, and indeed were raised in the G–10 report on the resolution of sovereign liquidity crisis issued shortly after the last Mexican crisis, much ahead of the eruption of financial crisis in Asia.

Three such issues deserve particular attention:

— when private capital rushes into areas where big opportunities are seen, and then withdraws when expectations are disappointed, to what extent should the public sector step in to compensate for such withdrawals?

— how far can we move away from the traditional principle of equal treatment to deal with systemic cases in a way that is not afforded to others?

— as cross-border private flows of capital seem bound to continue to increase at high rates, while IMF and IMF–related resources are limited, both in an accounting and a political sense, how sustainable is the present approach, in the longer term?

Admittedly, the greater part of the answer to these questions lies in crisis prevention. Strengthening the international financial system by enhancing supervision and market discipline should go a long way towards improving the framework within which market operators take and manage risks. Even with spectacular progress in that direction, however, the system will continue to be faced occasionally with acute problems of moral hazard, unequal treatment, and resource availability.

The G-10 report did not have ready–made solutions for the resolution of financial crisis, nor did it deal with the full variety of sources for such events. It made the following still valid points: as a matter of principle, debt contracts are to be fulfilled, not breached; there are cases when this overwhelming principle becomes unenforceable; a case–by–case approach is called for in such circumstances.

To make sense of the case–by–case approach, it is of course important that the full range of options be available for assessment of their economic and distributional merits and drawbacks, and that the various parties involved in debt renegotiations have proper incentives to reach operational conclusions. The G–10 report did make a valuable contribution to the issue of private sector involvement from that perspective.

Two practical suggestions came out of this report and are still part of the current agenda.

First, the recent decisions taken by the Board of the IMF to enlarge the scope of circumstances in which the IMF would be prepared to "lend into arrears" is very welcome. This is essentially in line with suggestions made in the report. It does not prejudge future decisions, as each case will have to be assessed on its own merits, but given the conditions to be met for such a decision, the new IMF policy may help remove a bias in the incentive structure needed to conclude a negotiation.

Second, the suggestion to insert collective action clauses in the documentation for bond issues has not been acted upon, although it was taken up again in the relevant Willard Group report and endorsed by the G–7 Ministers in October 1998. The major reason is of course that it belongs to market operators to initiate the relevant move, and that they are far from convinced of the merits of the proposal.

Much of the skepticism and reluctance of private investors stems from the misperception that collective action clauses are the channel by which public authorities seek to shift the burden of debt work–outs to the private sector, and which may encourage debtors to relax the normal standards of debt service. That misses the point that, in many cases, the private sector is already bearing the brunt of payments difficulties in emerging countries, although in a very uneven way, depending on the nature and form of the claims involved. It also misses the point that debtors are usually recurrent borrowers who have a genuine interest in remaining current on their payments in order to keep access to external funds.

The point about collective action clauses is that, in any particular case where some debt rescheduling or debt reduction has become unavoidable, an orderly and equitable outcome may be out of reach if a particular class of creditors cannot be brought into the picture, not for good economic reasons, but merely by virtue of the nature and form of their claims.

Many technical issues need to be dealt with if the documentation currently used for bond issuance has to be changed, but they are by no means insurmountable, at least as far as the clauses on collective representation and majority voting are concerned. Collective action clauses are a regular feature under British bond issuance legislation.

The crux of the matter is not technical. We must strive for a recognition of the common interest of public authorities and the leaders of financial intermediation in securing a more robust framework for channeling capital across the world, as a going concern, and in operating a sensible disaster recovery scenario should an accident occur again.

The Road to Reform: A Role for Europe, a Role for France

Philippe de Fontaine Vive

What has the Asian Crisis Taught us about Asian Economies?

The Asian economies hit by the crisis had a number of common features:

— high savings and investment rates;

— heavy reliance on bank financing, owing to an institutional and regulatory environment that often discouraged long–term financing, particularly methods of financing that require no banking intermediation (lack of a local bond market, restrictions on the stock market listing of non–resident companies, restrictions on foreign direct investment). This situation led to an imbalance between resources (short term, in foreign currencies) and capital requirements;

— neglect of the exchange rate risk by economic agents (since the Asian currencies are strongly linked to the US dollar);

— government intervention in resource allocation, as a result of the extensive links between banks and large firms;

— inadequate control of the banking sector and a lack of transparency; and

— poor governance.

This does not mean, however, that there is only a single Asian model. China in particular, owing to the non–convertibility of its capital account, guarded against the risk of a sudden, large–scale retreat of foreign capital by relying primarily on the high level of domestic savings (40 per cent of GDP) and on long–term foreign financing (China is the world's leading recipient of FDI after the United States). Nevertheless, the lessons of the crisis induced China to launch reform in its financial sector, which presented the same structural weaknesses as those of the crisis–ridden countries: insufficient control and supervision of the sector, which led financial institutions such as GITIC to increase

their exposure to foreign exchange risk to dangerous levels; lack of accounting transparency; a mountain of bad loans due to the centrally planned policy of lending to state–owned enterprises, most of which are virtually bankrupt.

There is thus little point in saying that "the" Asian model has been called into question. What we can say, however, is that the development path followed in recent years resulted not only in extremely high growth rates but also in weaknesses that made it unsustainable. The growth path followed by the Asian economies involved increasingly risky investments, conducted through an ailing banking sector that did not have enough incentive to assess properly and to provide for its risk taking.

In late 1996, short–term bank loans made up 45 per cent of the external debt of Indonesia, Korea and Thailand, as against 33 per cent for the other emerging economies. Net foreign bank loans to these three countries reached $45 billion in both 1995 and 1996. In 1997, however, there was net disinvestment of $25 billion. Net private capital flows to the emerging markets fell from $133 billion in 1997 to $54 billion in 1998 and, according to IMF forecasts, should remain at this level in 1999. In contrast, FDI flows were remarkable stable, even in Asia. The importance of such stability can be seen in the fact that direct investment in 1998 accounted for 80 per cent of private capital inflows in Southeast Asia, 75 per cent in Latin America, 40 per cent in central Europe and 37 per cent in the Middle East.

As a result of the crisis, however, we are better placed to identify the causes of the vulnerability of the Asian economies, which will undergo radical changes during the current adjustment process.

Modernisation of the Legal Framework

The Asian crisis demonstrated the need for a modern economy to have a suitable legal and judicial system. The restructuring of private business debt in the countries hit by the crisis was held back by the need to establish or to improve the relevant legal framework (legislation on bankruptcy and the seizure of assets used as loan security, creation of commercial courts). Moreover, enforcement of this legal framework remains problematic, owing to the lack of training of commercial court magistrates and the persistence of political "meddling". Indonesia's reform of its bankruptcy laws had little effect, as the body of case law developed by the commercial courts proved to be systematically prejudicial to creditors' interests.

Strengthening the Social Safety Net

In their approach to the crisis, the international financial institutions paid close attention to how the burden of the current adjustment would be shared. The middle and working classes were hit by rising unemployment and falling real wages. Existing

social security systems proved inadequate to the task, and the development banks made a decisive contribution through their assistance in the definition and establishment of social safety nets.

Restructuring of Financial Sectors has Begun, but it will be a Long, Expensive Process

Most of the countries hit by the crisis have begun to restructure their financial sectors. Progress has been made in consolidating the stock of bad loans (recapitalisation of those banks which are considered solvent, processing of bad loans) and in bringing prudential regulations into line with international standards, but the cost of restructuring will be immense (as much as 50 per cent of GDP in some cases). The approaches adopted by Korea, Indonesia and Malaysia are based on a large–scale commitment of public funds in order to guarantee deposits, help banks raise their capitalisation ratios and recoup some of the losses realised on disposal of non–performing assets. As a consequence, public deficits and the stock of public debt are rising. Moreover, the restructuring of banking sectors is closely linked to resolution of the problem of private–sector debt (and in Korea, to the restructuring of the *chaebols* as well), which is moving much more slowly.

One positive effect of this restructuring is the emergence of national bond markets and the establishment of a banking system better able to play its proper role not only in financing enterprises but also in evaluating them.

What Lessons Can We Draw from the Crisis to Improve the Functioning of the International Financial and Monetary System?

The Asian crisis and the subsequent turbulence which has ravaged emerging markets for the last year and a half have revealed the shortcomings of the international financial system (both debtors and creditors) with respect to the prevention and resolution of crises. For this reason, the restructuring of the crisis–ridden economies should go hand in hand with renovation of the way the international financial system works.

The Private Sector must be More Closely Involved in the Prevention and Resolution of Crises

This approach has a sound economic basis. The call for a reduction of spreads in some emerging economies before the Asian crisis probably reflected an over–optimistic outlook, possibly due to the certainty that, whatever happened, official creditors and the international financial institutions would foot the bill. Greater involvement of the private sector should help to avoid situations in which private financial institutions have no incentive to gauge risk carefully, because they expect the international community to bail them out if a crisis hits.

In Korea and Indonesia, for example, the scope of negotiations included the maintenance of short–term financing for trade and the restructuring of interbank debt. The issue of private borrowers' debt to private lenders was in fact fundamental, since these relations constituted the financing base of the economy. The rescue plan for Brazil subsequently provided the first opportunity to make explicit use of this principle in the overall handling of a crisis.

The Paris Club, owing to its expertise in debt–related matters, clearly has a major role to play, and one which complements that of the IMF. When devising financing plans, under the principle of involving the private sector in crisis management, the Paris Club examines the bonded debt of the countries concerned or even considers how the financing of private projects affects the balance of payments. The importance of this issue lies in the additional room for manoeuvre that it provides for designing of international programmes in support of the crisis–ridden countries, as well as in the equity provided by such a principle.

The Capital Account Must be Opened Up in an Orderly and Gradual Manner

Liberalisation of emerging financial markets should be conducted gradually and methodically, with due consideration of the level of infrastructure — financial control infrastructure in particular — in the countries concerned. National financial systems must be robust enough to adapt to the volatility and the level of international capital flows.

Moreover, a well–ordered opening to international capital should give first priority to the entry of long–term capital and FDI. The advantages associated with FDI are well understood: greater stability, technology transfer and better corporate governance practices.

Better Relations with the Emerging Economies

The industrialised countries have a responsibility towards the emerging countries, especially to the poorest among them. The European Union alone provides 57 per cent of all official development assistance (ODA) worldwide. In absolute value terms, France is the second largest donor after Japan. In the multilateral sphere, the EU member states constitute the leading stakeholder in the World Bank and the Asian Development Bank. The recent re–creation of the International Development Association will allow for continued support to the poorest countries. At the bilateral level, the European Union and Japan each provide more than 40 per cent of total bilateral aid to Asia.

Industrialised countries should keep their markets open and should continue to provide substantial amounts of ODA, especially to the poorest countries. Dialogue with emerging countries is also in need of improvement.

Europe has considerable experience to share in several relevant areas: social considerations, supervision at the regional level (which is just beginning in Asia as well) and the co–ordination of economic policies.

Dialogue between industrialised and emerging countries is necessary not because it can make one group or the other any happier but because the Asian crisis has demonstrated the interdependence of our economies. This interdependence exists:

— first of all, among the Asian economies;

— second, among the emerging economies generally, since all of them suffered from a climate of mistrust which reduced their possibilities of obtaining financing; and

— third, between the industrialised and emerging economies, since financing conditions, raw materials prices and world demand are all channels through which these two groups affect each other.

Growth is a public good that belongs to the whole world, and we have a collective responsibility for preserving it.

Prospects for a Stable Financial System: A Dose of Realities

Roberto F. De Ocampo

The events of recent years, at the outset, seem to have left an impression in some quarters that central bankers have an almost unlimited capacity to contain financial shocks in a manner that ensures that widespread or systemic damage will never occur. That impression is not only mistaken, but it is potentially dangerous. It is dangerous in part because it can encourage excessive risk–taking, but it is also dangerous because excessive reliance on recurring central bank intervention to quell financial disturbances will, over time, reduce the effectiveness of such intervention. More importantly, and as we have seen in many countries, even optimal monetary and central bank policies and practices cannot out–muscle major shortcomings in other areas of economic policy.

Much of what we have seen over the past 20 years grows out of the fact that there is a subtle, yet powerful, link between open and competitive economic systems and open and more democratic political systems. However, if that link is to prove durable, economic performance must justify public confidence in the link. In turn, the public at large seems to understand that success in controlling inflation is directly related to prudent monetary policy.

The prominence of central banks is attributable not only to good macroeconomic performance, but also to a belief that central banks have played an important and constructive role in crisis management and containment.

Success and prominence, however, are not without their downsides, even in central banking. As noted earlier, one element of that downside is that success may breed a false sense of security that central banks can always solve every economic and financial problem.

More generally, despite the progress that has been made in most parts of the world over the past 20 years, major problems remain. To list just a few:

— widening gaps in income distribution in the United States and high unemployment in Europe;

— virtual stagnation in Japan for a number of years;

— large–scale poverty throughout virtually all of the so–called developing world;

— violent financial shocks with accompanying steep falls in economic activity in many emerging market countries; and

— recurring and threatening bouts of enormous volatility and illiquidity in national and global financial markets.

The above factors deserve mention not only because they are obvious matters of direct concern to practitioners and policy makers alike, but more importantly, because their cumulative weight represents a threat to the political will and the public support necessary to maintain the disciplined macro and structural policy initiatives that are central to the goal of broad–based gains in standards of living. There is a danger that unless we deal with these problems, the vital link discussed earlier between open and market economic systems and open and more democratic political systems will be eroded over time. Thus, a great deal is at stake in our collective ability to improve economic performance especially in those areas in which progress has lagged behind expectations. With that in mind, let us now turn to the issue of what might be done to manage better and avoid sovereign financial crises and financial market instability more generally.

Beginning with the LDC debt crisis of 1982 and continuing to this very day with the evident problems in Brazil, a long list of so–called emerging market countries have encountered serious financial shocks causing very sharp contractions in economic activity. Moreover, virtually every such episode has been accompanied by elements of contagion risk which has contributed to the spread of the problem to other countries having — or thought to have — similar problems and vulnerabilities. In most such cases, the nature and scope of the problem seemed to entail systemic dangers either within the country itself or on a regional or global scale. The threat of systemic danger has generally been of a nature to induce authorities within the country, or the international community more generally, to activate large and very costly stabilisation programmes typically structured around IMF programmes. Not surprisingly, the track record of these programmes has been somewhat of a mixed bag giving rise to vocal criticism of both them and the sponsoring institutions, as well as fresh efforts to understand better the causes and cures for these problems. Unfortunately, there are no easy answers to these questions.

Tolstoï, in Anna Karenina, wrote that “all happy families resemble one another, but each unhappy family is unhappy in its own way”. Well, financial crises are much like unhappy families. The crises that hit markets in East Asia was quite different from the one that struck Mexico in 1994–95 and that in turn was different from the one that hit a number of European economies and currency regimes in 1992–93.

The search for the causes of sovereign financial crises is somewhat frustrating because neat common denominators are not at hand. For example, the key characteristics of Latin America in the 1980s included: *i)* serious macroeconomic policy failures, *ii)* high inflation, *iii)* low savings rates, and *iv)* the government itself as the

dominant debtor. In Asia in 1997–98 by contrast: *i)* macro policies were generally respectable, *ii)* inflation rates were moderate, *iii)* savings rates were very high, and *iv)* the dominant debtors were private sector institutions. In other words. "cookie–cutter" attempts at generalised diagnostics or solutions are inherently flawed.

Having said that and looking more specifically at the Asia crisis of 1997–98, some generalities are valid. For example, in looking at the Asia situation, the following factors contributed in varying degrees to the problems in all of the countries that experienced the brunt of the crisis.

— stagnation and recession in Japan with the accompanying strength of the dollar versus the yen;

— large to very large current account deficits often financed by heavy reliance on short–term debt capital inflows;

— overvalued currencies together with a pattern of essentially fixed exchange rates;

— massive domestic financial leverage, especially in the corporate sector, and often in a setting of excess industrial capacity;

— fragile, if not very fragile, domestic banking systems together with under–developed banking supervision systems;

— widespread structural and institutional weaknesses that, among other things, contributed to an environment of questionable business practices; and

— a false sense of security growing out of years of very rapid growth.

Looking beyond Asia to Russia and Brazil, more country–specific problems such as falling commodity prices and large budgetary problems in Russia, and budget deficits together with a sizeable internal debt problem in Brazil, contributed to the problems in those countries. Finally, the unilateral debt moratorium declared by Russia in August of 1998 was widely seen as shattering the unwritten rules about international debtor–creditor relationships. Not surprisingly, this event triggered a sharp reaction as creditors — both domestic and foreign — commenced an across–the–board reassessment of the risks associated with emerging market exposures.

Putting the particulars of any specific case aside, in every major sovereign financial crisis, the cumulative weight of events triggered a crisis of confidence that resulted in massive liquidity problems and a consequent large drain on official reserves. In the worst cases, official reserves of individual countries were virtually exhausted, prompting large–scale official intervention typically in the context of an IMF financial support package.

In these circumstances, a lively debate persists as to: *i)* whether the problems in affected countries were primarily internal or external; *ii)* whether the crisis could have been managed more effectively, thereby reducing the costs of the adjustment; *iii)* whether IMF programmes helped cushion the crisis or, as suggested by some, made things worse; and *iv)* above all, what could have been done to avoid the crisis in the first place.

Beginning with a belief that the causes of the crisis were primarily internal, the answers to the second and third questions require some perspective and balance. Central to that perspective and balance is a proper understanding of the short–run consequences of the simultaneous presence of a large current account deficit and sharply depleted official reserves — the exact conditions present at the apex of the crisis in most sovereign financial breakdowns.

In these circumstances, virtually all observers would admit that one necessary element of the adjustment process must be a shrinkage of the current account deficit. However, what is sometimes neglected is that a decline in the current account deficit necessarily implies that the domestic savings gap must also shrink. But the domestic savings gap can only shrink by some combination of: *i)* a smaller budget deficit or a larger budget surplus; *ii)* the private savings rate increases and *iii)* the domestic investment rate declines. Importantly, any or all of these conditions must entail a reduction in economic growth. Moreover, both the contraction in economic activity and the fiscal costs associated with stabilising the domestic banking system will tend to raise the fiscal deficit, thus making a net shrinkage of the domestic savings gap all the more difficult to achieve.

In other words, once the crisis has struck, there is no reasonable path that does not entail significant downward adjustments in economic activity. Indeed, the issue is not whether the country will suffer, but, rather, whether it is possible to cushion the blow to some extent. But, until that cushion can be put in place, the immediate cash needs of the country are such that policy options in the short run are limited to one or some combination of the following:

— high domestic interest rates to help halt domestic capital flight and limit foreign capital withdrawals;

— partial or comprehensive moratorium on external debt;

— obtaining fresh money from private sources either directly or via debt restructuring; and

— obtaining new money from official sources.

Given the highly distasteful nature of all these short–run options, it is no wonder that most countries turn to official sources including the IMF to cushion the blow and obtain the necessary bridge financing as policy adjustments are framed and take hold.

There are opportunities to improve crisis management, but much — though not all — of the burden for better management lies with the policies of the troubled country. With regard to IMF programmes, there is no doubt that there is room for improvement. The IMF itself acknowledges that to be the case. Having said that, and granting that some miscalculations and misjudgements have been made, without the IMF things would have been worse — much worse.

In looking at the history of contemporary sovereign financial crises, if there is one thing that stands out above all others it is that our emphasis must lie with more aggressive efforts aimed at crisis prevention. Thus, the answer to the fourth question posed earlier is that we can, and must, do a better job of crisis prevention. In considering crisis prevention, several areas of endeavour are especially important. They are:

— continued, if not heightened, attention to macro policy fundamentals, especially those that promote low inflation and balanced budgets;

— immediate concerted efforts to strengthen domestic banking systems and bank supervisory policies and practices;

— intermediate–term programmes and policies aimed at structural reform and institution building in a wide range of areas, including legal and judicial systems, labour markets, education, health care, and the environment;

— improved transparency and disclosure for both public and private institutions;

— more aggressive and systematic approaches to risk analysis and management by both governments and private institutions, especially financial institutions;

— enhancements to IMF policies and procedures especially as they pertain to: *i)* efforts aimed at early intervention: *ii)* greater flexibility and tailoring of policy conditionality; *iii)* broadening the range of financing alternatives including considering selective and partial credit enhancements in support of private sector financing activities; and *iv)* greater transparency for the fund's own programmes and financial conditions;

— greater discipline on the part of investors and creditors, both internal and external;

— finding sensible ways to better manage and moderate short term debt capital inflows;

— promoting the accelerated development of national local currency debt and equity capital markets; and,

— strengthening governance, co–operation and administration of programmes among the major creditor countries and the multilateral official institutions. In this regard, the effort should focus on making existing institutions and structures work better rather than seeking to create new institutions and structures. Indeed, seeking to create new institutions and structures will only take time — something that is already in short supply.

While the above suggestions are ten in number, they are not intended to take on commandment–like qualities. But, if we are really serious about efforts to reduce the frequency and severity of sovereign financial crises, we must move to meet these needs on an accelerated basis.

Reducing the incidence and severity of sovereign financial crises will go some distance in reducing sources of severe financial market volatility more generally, but those more general problems will not go away quickly or easily. Indeed, periodic

bouts of severe financial market volatility are likely to be a more or less permanent feature of contemporary finance as far out as we can see, in part because many of the sources of instability are related to the wave of technologically induced changes in the business of banking and finance that are sweeping the world. Such changes cannot, of course, be reversed or suppressed. Over time, we will, of course, learn to understand and manage these changes better, but recognising that the relevant forces for change have not yet remotely run their course, efforts to cope better with volatility and periodic bouts of instability must be high on the agenda of priorities for both practitioners and policy makers.

Before closing, we want to comment briefly on two other issues of overriding importance to the international community of central bankers. The first is the question of the appropriate policy response to situations in which countries are experiencing substantial asset price inflation even though overall inflation remains under control and overall economic performance is broadly satisfactory. This, of course, is not an academic question because this phenomenon has occurred in many countries, and, in a number of situations, most notably Japan, the overhang of the asset price inflation has been long, painful and very costly.

This issue is complex in both analytical and practical terms. On the analytical side, selective asset price inflation should be viewed as a market problem best left to market solutions, especially since it will seldom be clear in advance whether selective asset price inflation will, in fact, be the source of more widespread or macroeconomics imbalances. Moreover, even if it was seen as highly likely that macro damage might follow, the central bank is left in the position of having to consider tightening monetary policy by raising interest rates when macro conditions provide little or, no obvious justification for such actions. Needless to say, making the case for a tighter monetary policy under these circumstances is not easy.

There is no easy answer to this dilemma, especially when the relationship between selective asset price inflation and macro economic conditions are so loose. Surely, old–fashioned credit controls will not work and would probably make things worse. On the other hand, it may be that there are ways in which supervisory practices might help. Regardless of how this problem is approached, it does seem to be another good reason why central banks should generally maintain a conservative tilt to monetary policy.

The other area of great uncertainty and intellectual frustration to monetary authorities relates to exchange rate policy. Whether we are looking at industrial countries, emerging market countries, or both, almost everyone agrees that the patterns of extreme volatility and over–shooting we have seen in exchange rates is very costly in economic and financial terms. That, however, is where the broad–based agreement ends and debate and disagreement begins. Much of that debate has an ironic twist. For example, many who seem to champion freely floating exchange rates also appear to applaud the EMU (European Monetary Union) which, of course, has recently fixed forever (so they say) the exchange rates of eleven, and soon to be more, European countries.

There is too much theology and not enough pragmatism associated with the debate about exchange rate policy. On a pragmatic level, we would all be well served to keep in mind the following:

— no exchange rate system is “right” for all times and for all places;

— those who advocate rigid foreign exchange rate systems often ignore the reality that if a country follows the right economic policies it will not need such a rigid system and if it fails to follow such policies, a rigid system will not work;

— despite their intuitive appeal, currency boards do not reduce the need for strict policy discipline and, in fact, such arrangements increase the need for such discipline;

— many observers tend to overstate the price elasticities associated with exchange rates relative to trade flows and to understate the income elasticities associated with trade flows; and

— any move towards target zones or more managed exchange rate systems inevitably entails the very difficult questions of: *a)* identifying the “right” initial foreign exchange rates, *b)* being prepared to answer the question of the extent to which the burden of adjustment lies with surplus versus deficit countries, and *c)* the willingness of countries to accept some compromise in policy autonomy.

All this may sound like a call for unfettered floating exchange rates. That, however, is not the case. Rather, it is a call for reason, starting with the recognition that now more than ever, greater stability in exchange rates depends on greater policy discipline with regard to policy fundamentals on the part of all. Those policy fundamentals include the fundamentals of trade policy. As an example, how can we reasonably expect greater stability in the yen–dollar exchange rate when for many years, Japan has had a massive bilateral surplus with the United States seemingly with little or no regard to prevailing exchange rates. Similarly, how, for example, can we expect stability between the US dollar and the Mexican peso when Mexico’s inflation rate is well into double digits while the US inflation rate has been two per cent or less for several years.

To place all of this in context, our thinking about exchange rate systems gravitates towards a segmented view of the world. For example, most emerging market countries have little choice but to permit their exchange rates to float. This is especially true for countries characterised by large external trade sectors relative to GDP. However, emerging market countries with especially strong policy records may be able to move towards more managed exchange rate systems that seek to keep the real exchange rate relatively stable.

Among the major industrial countries, it seems that neither the economics nor the politics are ready for a move towards a system of target zones or similar arrangements. As the EMU has forcefully illustrated, such a move presupposes a high degree of convergence in policy and performance and a political consensus to cede at least some elements of policy autonomy to a higher order. Maybe that day will come, but we are not there yet.

It should be clear that the period ahead will not be short of challenges for the community of international central bankers. They have at their disposal an array of powerful and flexible policy tools. Most have gained an appropriate degree of autonomy, if not policy independence. As a group, they are characterised by leaders having extraordinary levels of competence, commitment, and integrity. Still, they cannot walk on water! Thus, if we preserve that vital link between open and market–driven economic systems and open and more democratic political systems, while achieving the goal of broad based gains in living standards, we must see all arms of economic policy working in lockstep with central banks' policy to produce a disciplined and more stable environment for the future. Despite our problems, we are better positioned today to achieve those goals than at any time in recent memory.

International Financial Stability: The Contribution of the OECD Principles of Corporate Governance

Joanna R. Shelton

Introduction

We analyse here an important factor in the sustainability of any international financial system, namely: corporate governance, or the way corporations are run. It also offers the opportunity to review initiatives underway in Asia and elsewhere, and in international organisations such as the OECD.

Modern economies rely on corporations to create jobs, generate wealth, and increasingly to manage our savings and secure our retirement income. Amid growing reliance worldwide on the private sector, the issue of corporate governance has similarly risen in prominence on the international agenda. Last month, OECD Ministers, at their annual meeting in Paris, adopted the OECD Principles of Corporate Governance. These Principles represent the first initiative at an inter–governmental level to develop the core elements of a good corporate governance regime. From the outset, this effort received strong public support from the international community, including the G–7 and the so–called Group of 22 countries.

Why Corporate Governance Matters for Domestic and International Financial Stability

Before looking in greater detail at what contribution these OECD Principles can make to strengthening the international financial system, let us briefly consider why corporate governance matters for domestic and international financial stability.

Corporate governance involves a set of relationships between a company's management, its board of directors, shareholders and other stakeholders, through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

The financial crises in Asia and elsewhere in the last two years have made amply clear why shortcomings in corporate governance mechanisms can be so harmful to national economic performance and ultimately to global financial stability. In many of the countries affected by these crises, interest groups linked to large financial institutions or to the state ran vast conglomerates under conditions that prevented effective external scrutiny. In many cases, minority shareholders — both domestic and foreign — as well as creditors were given neither the information nor the effective right to monitor corporate operations. This lack of transparency and accountability contributed in turn to distorted incentive structures, leading to over–investment and dangerously high levels of corporate indebtedness. Poor disclosure and lack of independent and good quality auditing prevented early warning of the deteriorating financial conditions of corporations. When the imbalance became too large to be ignored, it prompted a rout in financial markets, setting back the development efforts of entire countries and regions.

To be sure, blame for the crisis lies with deficient corporate governance not just in the countries affected. Foreign financial institutions showed imprudence in lending large amounts of funds without analysing sufficiently the risks that they were taking. That is why efforts are also being made at the international level to encourage foreign lenders to take more responsibility in assessing risk before they lend, as well as to participate in financial crisis resolution.

In reaction to the emerging–markets crisis, many of the countries affected are now embarking upon ambitious reforms of their corporate governance frameworks. Korea is requiring local companies to increase the transparency and accountability of their management and boards. Korea also is strengthening the rights of minority shareholders and making changes in its financial market that will allow banks and other lenders to play a necessary role in disciplining the degree of risk that lenders and corporate borrowers may undertake. Other Asian governments also are exploring and making changes in these areas.

Here, again, the challenge is not limited exclusively to developing and emerging economies. No country can claim immunity from deficiencies in the area of corporate governance. European countries face mounting calls for better treatment of minority shareholders and greater transparency in mergers and acquisitions. In Japan, efforts to relaunch economic dynamism clearly require improvements in corporate governance, including in areas such as information disclosure and the structure of company boards. In the United States, where issues of corporate governance have been at the forefront of public attention for the longest, institutional investors in particular have expressed concern that in companies with dispersed ownership, management could be pursuing objectives that may not be in shareholders' long–term interests. Accordingly, efforts

by governments and private bodies are underway within a number of developed countries to re–evaluate their own legal frameworks and practices for corporate governance.

Clearly, in an increasingly integrated world characterised by highly mobile capital, investors' expectations for more responsive corporate governance practices are something that governments and companies can no longer afford to ignore. In their constant search for investment opportunities, investors can and do take their money around the globe. If companies are to attract long–term and patient capital from a large pool of investors, they need to establish credible and widely accepted corporate governance arrangements. A recent survey by MacKenzie Consulting Company of more than 60 major international and Wall Street investors indicates that these investors would be prepared to pay a much higher price — by more than 30 per cent — for Korea's capital assets; and that the level of foreign direct investment in Korea could more than triple, as the reform of the corporate governance regime in this country is completed. Other surveys, such as that recently conducted by the executive research firm Russell Reynolds, confirm that more and more fund managers in developed countries are taking a "corporate governance" profile into account when assessing the quality of management and making investment decisions. A similar move is emerging within international credit rating agencies. But this is not simply an issue relevant to foreign investors. Strengthening the confidence of *domestic* investors in a country's own corporations and stock markets matters greatly to the long–term competitiveness of corporations and to the overall health and vitality of national economies.

The OECD Principles of Corporate Governance

It is in this context of growing awareness of the importance of good corporate governance that the OECD was asked by Ministers one year ago to develop the OECD Principles of Corporate Governance.

These OECD Principles have now been adopted by OECD Ministers. They are the result of the work of a Task Force comprising all 29 OECD Member governments and the European Commission, private parties, the World Bank, the IMF, and other international organisations. From the start, this work benefited from a broad exposure to public commentary on successive drafts, including through the Internet. A number of important non–OECD countries participated in our consultations and provided written comments on the working drafts.

The OECD Principles are not intended to prescribe an "Anglo–Saxon model" or any other single cultural model for corporate governance. The Principles represent a collective view, from a variety of experiences and perspectives, of the fundamental elements of any good corporate governance framework. Those elements include fairness, accountability, transparency and responsible corporate behaviour. While the Principles have been drafted to be applicable in accordance with country–specific

economic, legal and cultural circumstances, this certainly does not mean that they should be viewed as being the lowest common denominator. Rather, they represent some core building blocks for corporate governance systems.

The OECD Principles cover five main areas: the rights of shareholders and their protection; the equitable treatment of all categories of shareholders, including minority and foreign shareholders; the role of employees and other stakeholders; timely disclosure and transparency of corporate structures and operations; and the responsibilities of the board towards the company and shareholders.

Transparency is perhaps one of the most critical features of any well–functioning financial and corporate governance system. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to make informed decisions. Insufficient or unclear information may hamper the ability of the markets to function, may increase the cost of capital and result in a poor allocation of resources. All of this hampers the ability of corporations to attract capital and thereby generate jobs and growth for the economy overall.

The Principles call for the disclosure of arrangements that redistribute control over the company in ways that deviate from proportionality to equity ownership. They urge that personal material interests of the board and management in matters affecting the corporation be disclosed. Under the Principles, timely and accurate information should also be disclosed on matters such as the company's financial and operating results; its objectives, major share ownership and voting rights, remuneration of key executives and board members, and material foreseeable risk factors. This information should be prepared and audited in accordance with high quality standards. In this regard, the Principles support the development of high quality, internationally recognised accounting standards.

What Difference Will the OECD Principles Really Make?

First, the principles are intended to provide assistance to *governments* in their efforts to evaluate and improve their own legal and regulatory frameworks for corporate governance. Although the Principles are non–binding, it ultimately is a matter of self–interest for countries and corporations to assess their own corporate governance regimes and to take these Principles to heart.

At their annual meeting, OECD Ministers formally undertook to encourage the implementation and use of the OECD Principles within Member countries, and the exchange of experience among them. Recent signs that our Membership is taking this commitment to heart include the proposal for new corporate governance rules by the Dutch government, the creation of an independent Committee for the Improvement of Corporate Governance in Korea, and the White Paper being developed by the Greek Capital Markets Commission. The terms of reference of all these initiatives refer to the OECD Principles.

We also have been encouraged by the positive reaction we have received on these Principles from a number of non–Member countries, including in Asia on the occasion of the conference the OECD co–sponsored in Seoul in March with the Korea Development Institute, with the support of the World Bank and the Government of Japan. Societies of accountants, auditors, chartered secretaries and administrators, and central banks and other public authorities in several non–OECD Asian economies have begun to look at their local corporate regimes in light of the OECD Principles and have shared the results of their assessments with the OECD Secretariat. Together with the Russian government authorities, the OECD and the World Bank have set up a Corporate Governance Round Table for Russia, whose primary function will be to promote good corporate governance, by using as a starting point the OECD Principles of Corporate Governance and further developing them to address specific Russian needs and concerns. Similar round tables will be arranged in other regions around the world by our two institutions.

In addition to their role in helping governments, the OECD Principles will also provide guidance and direction for stock exchanges, national securities commissions, investors, corporations and other *private parties* as they elaborate best practices, listing requirements and codes of conduct. The Principles are not intended to substitute for any private sector initiative to identify more detailed "best practices" — something which is best left to private parties and individual countries. On the contrary, the OECD looks forward to a burgeoning of private sector efforts aimed at raising corporate governance standards still further. We have received encouraging reactions from internationally recognised auditing and investment firms such as KPMG Peat Marwick and Ernst & Young, and non–governmental organisations such as the International Corporate Governance Network and Transparency International.

Finally, in response to a mandate from the OECD Council and the G–7 Ministers for further co–operation among international organisations, the OECD and the World Bank have signed an agreement to co–operate more closely to promote improved corporate governance on a global scale. For this purpose, we will set up a Global Corporate Governance Forum bringing together developing, transition and donor countries, regional development banks and international organisations, along with private sector participants. The OECD and the World Bank have agreed to use the OECD Principles as an important point of reference in this co–operation, and to develop initiatives which will promote dialogue on the Principles, such as the regional Round Tables mentioned above. A senior private sector advisory group is being set up to assist the Forum in developing this dialogue and in providing advice to private parties in their own reform efforts[1].

Concluding Remarks

Asia is beginning to rebound from the traumatic crisis that began in 1997. At the same time, as economies and global financial markets recover, it is important that the momentum for reform of corporate governance regimes not be lost; and investors should not ease off on their expectations for improved corporate transparency and accountability. In the 21st century, stability and prosperity will depend crucially on the strengthening of financial markets and the creation of strong corporate governance systems. We look forward to working with countries in Asia and around the world to assist them in their own efforts to strengthen their economies and thereby help cushion them from the effects of future shocks. The OECD Principles can make an important contribution to this process.

Note

1. The two organisations welcome suggestions on the work programme of the Forum. These can be submitted through their respective websites: www.oecd.org/daf/peru/home.htm and www.worldbank.org/html/fpd/privatesector/cg.

Part Two

Policies for Recovery and Crisis Prevention

Policies for Crisis Prevention

Helmut Reisen

The Costs of Capital–Flow Volatility

After the Asian crisis, the times are very hard for "selling" the gains from global capital mobility. While these gains do certainly exist, the quantitative evidence is surprisingly sketchy. In principle, the benefits of global capital mobility should apply particularly in the interaction between the capital–rich, moderately–growing and fast–ageing OECD economies and the capital–poor, fast–growing and slowly–ageing emerging economies. The gains would result from a better allocation of world savings to the most productive investment opportunities, and the possibility of maintaining consumption levels in the event of adverse shocks and demographic trends. Moreover, it is often held that open capital markets impose higher standards of economic policy on capital–recipient countries. Even with net capital flows between the OECD and non–OECD economies balanced, open capital markets can be presumed to offer sizeable diversification benefits and spillovers in the form of technology, managerial know–how, market access and competition dynamics. Differences between the two areas with respect to the exposure to country–specific shocks as well as the stage of economic and demographic maturity suggest that the diversification benefits of financial globalisation will not disappear quickly.

The burden of proof of the gains from free capital flows has shifted to the proponents of open capital markets who are being criticised for having offered more "banner–waving" than hard quantitative evidence on the benefits of financial globalisation (Bhagwati, 1998). A look at the numbers seems to suggest that most of the gains that developing countries could reap from financial openness were obtained by *foreign direct investment* inflows:

— First, if foreign savings permit an acceleration of investment by augmenting (rather than crowding out) domestic savings, they typically have a positive temporary GDP growth effect of half a percentage point (Reisen, 1996*a*). This assumes typical capital shares and capital output ratios as well as a net inflow of 3 to 4 per cent of GDP; furthermore, any externalities arising from openness are ignored.

— Second, foreign direct investment adds both to domestic investment and to long–term growth if the host–country is largely undistorted. Borensztein, De Gregorio and Lee (1995) find that for each percentage point increase in the FDI–GDP ratio, the rate of growth in the host economy increases by 0.8 percentage points. The contribution to long–term growth results from two effects. First, foreign direct investment adds to domestic investment, as both are complementary in production and through positive spillover effects. Second, foreign direct investment stimulates growth through the embodied transfer of technology and efficiency, provided the host country has a minimum threshold stock of human capital.

— Third, there is little evidence in the data that countries without capital controls have grown faster than countries with capital controls, after controlling for growth determinants such as income and education levels (Grilli and Milesi–Ferretti, 1995; Rodrik, 1998). These studies, however, do not allow for varying degrees of intensity of capital account restrictions, nor for the different growth impact of various capital–account items (Eichengreen, Mussa *et al.*, 1998). Except for foreign direct investment, the time series for private capital flows are not yet long enough to draw strong policy conclusions. In particular, there is no cross–country study that would investigate the impact of capital account liberalisation, while controlling for the strength of the domestic financial system. It has been noted that none of the *developed* OECD countries maintains general capital controls, even on short–term capital (Poret, 1998). This may indicate that with mature financial systems, the benefits of free capital mobility largely outweigh any costs. It may also indicate that mature OECD economies are subject to less violent shocks in investor sentiment, and hence less disruption, than are developing countries.

Indeed, the evidence on net benefits from global capital mobility to the emerging markets may be sketchy for a simple reason: the gains and the risks of an open capital account are closely intertwined. The more a country wants to enjoy the former, the more it is exposed to the latter.

All too often, the isolated focus on characteristics which have fallen victim to a currency crisis yields portrayed "causes" that are merely endogenous effects of massive net capital inflows. Current account deficits, overvalued exchange rates (in real terms), overinvestment in real estate and declining capital productivity all figure prominently in the list of culprits of Asia's crisis (see, e.g., Corsetti *et al.,* 1998). That view ignores, however, the endogeneity of such variables. Flows from capital–rich to capital–poor countries can only be effected with corresponding external deficits of the recipient countries, which are produced by a real appreciation of the exchange rate. The appreciation in turn reduces the relative incentive to invest in exportable production and tilts incentives towards non–tradeables, including real estate, whose relative price has to rise. Higher capital equipment of labour, a result of domestic investment financed by foreign savings, reduces the marginal return to capital. So it is the effect of a net capital flow that produces a rise in the indicators stressed today as warning of heightened vulnerability to speculative currency attacks (see, e.g., IMF, 1999).

The 1990s have witnessed three distinct regional currency crises: the European crisis of 1992–93, the Latin American crisis of 1994–95, and the Asian crisis of 1997–98 which in turn was followed by crises in Russia and Brazil. Obviously, a major currency crisis every 24 months is too much for policymakers' comfort. A presentation to Asian monetary authorities in the autumn of 1995, stressed four major reasons why governments and central banks should care about the sustainability of the capital flows which their economies can tap abroad (Reisen, 1996*b*):

— First, it is increasingly acknowledged that global capital markets suffer from three major distortions: the problem of asymmetric information causes herd behaviour among investors and, in good times, congestion problems; the fact that some market participants are too big to fail causes excessive risk–taking; finally, the global financial markets feature multiple equilibria, unrelated to "fundamentals". It is questionable, therefore, whether the financial markets will discipline governments into better policies; even if they were to do so, the social and economic costs may be excessive.

— Second, any shortfall in capital inflows will require immediate cutbacks in domestic absorption to restore external balance. The savings–investment balance is more likely to be achieved through cuts in investment than through higher savings in the short term, compromising future output levels. Current output levels fall to the extent that rigidities prevent resource reallocation, so that contractionary disabsorption effects outweigh expansionary substitution effects.

— Third, the expansion of domestic credit connected with unsterilised capital inflows may not be sound enough to stand the rise in domestic interest rates and the fall in domestic asset prices that go with a reversal of these inflows. The resulting breakdown of domestic financial institutions provides incentives for monetary expansion and fiscal deficits incurred by the public bailout of ailing banks.

— Fourth, temporary capital flows may lead to an unsustainable appreciation in the real exchange rate. The appreciation is in conflict with development strategies based on the expansion of exports and efficient import substitution, which centrally relies on a reliable and competitive exchange rate. Overvalued exchange rates cause sub–optimal investments which are costly to reverse, undermine active trade promotion, export diversification and productivity growth, and breed capital flight (Fischer and Reisen, 1993). Large swings in real exchange rates, often a result of temporary capital flows, have been found to depress machinery and equipment investment significantly and thus long–run growth performance (Agosin, 1994).

The five countries most damaged by the Asian crisis — Indonesia, Korea, Malaysia, the Philippines and Thailand — received net private capital inflows worth 6.6 per cent of their combined GDP over the period 1995–96. The excessive optimism among international investors at that time was reflected in very low yield spreads on their debt instruments (less than 100 basis points over Eurobond yields). In the second half of 1997, there was a sudden stop. The reversal of net flows from 1996 to 1997 constituted a swing of 11 per cent of their combined GDP. The biggest swing came

from commercial banks who had extended loans well into 1997, despite earlier warnings on overexposure from the Bank for International Settlements (BIS) and the Institute of International Finance (IIF). There was also an important reversal of net portfolio investment. The only capital account component proving its staying power — just as during Mexico's 1994–95 crisis — was foreign direct investment (Table 1).

Table 1. **Net Private Flows to Asian Countries in Crisis**[a]
$ billion

	1995	1996	1997	1998e	1999f
Private Net Flows	80.4	102.3	0.2	–27.6	0.3
Commercial banks	53.2	62.7	–29.2	–36.1	–16.0
Other debt (bonds)	12.0	21.0	17.1	–5.3	–2.3
Portfolio equity	11.0	13.9	–1.5	4.3	6.0
Direct foreign investment	4.2	4.7	5.9	9.5	12.5

e = estimate; f = forecast
a. Indonesia, Korea, Malaysia, Thailand, and the Philippines.
Source: Institute of International Finance, *Capital Flows to Emerging Market Economies*, Washington, D.C., 25 April, 1999.

A sudden stop in capital inflows must be met by a reduction in aggregate demand. Indeed, if depleted foreign exchange reserves have to be rebuilt, disabsorption (the cut in consumption and investment) must even exceed the reversal in flows. Between 1996 and 1998, the required switch on the current account of the five Asian countries in crisis, i.e. the difference between aggregate demand and output, was nothing less than 14.5 per cent of their GDP. The size and rapidity of the required adjustment has triggered a major economic growth crisis in the affected countries, exacerbated by weak banking systems. Accustomed to growth rates in the 6–10 per cent range, the five Asian countries in crisis had regressed by 7 per cent in 1998 (Table 2). Official unemployment, traditionally lower than in OECD countries as safety nets (and claims) are absent, is expected to jump from low, single–digit levels to 15 per cent in Indonesia, 13 per cent in the Philippines and 9 per cent in Thailand, according to ILO estimates (ILO, 1998).

Table 2. **Current Account Balance and Real GDP**

	1995	1996	1997	1998e	1999f
Current Account (% of GDP)					
Asian Countries in Crisis[a]	–4.1	–5.1	–2.6	10.5	5.5
Emerging Market Economies[b]	–1.8	–1.8	–1.4	–0.4	–0.6
Real GDP (% change)					
Asian Countries in Crisis[a]	8.3	7.0	4.4	–7.2	1.8
Emerging Market Economies[b]	4.5	5.0	5.1	1.3	1.5

e = estimate; f = forecast
a. Indonesia, Korea, Malaysia, Thailand, and the Philippines.
b. 29 Major Emerging Market Economies.
Source: Institute of International Finance, *Capital Flows to Emerging Market Economies*, Washington, D.C., 25 April, 1999.

Not only are the loan losses in the Asian crisis countries much higher than in earlier episodes of banking and currency crises, but they also imply fiscal costs that must be met from much lower public revenue levels than ever before (Table 3). The fiscal costs stem mostly from the need for the government to take over non–performing assets by issuing a corresponding amount of new debt. In the Asian crisis countries, the interest costs alone on the new government debt represent a very large share of government revenues; further fiscal burdens arise from direct equity stakes.

Table 3. **The Fiscal Impact of Banking and Currency Crises, 1990s**

	Years	Non–performing loans percentage of total loans at peak	Fiscal and quasi–fiscal cost[a] percentage of GDP	Public revenues percentage of GDP
Finland	1991–93	9	8–10	33
Norway	1991–93	9	4	40
Sweden	1991–93	11	4–5	39
Mexico	1994–95	11	12–15	15
Indonesia	1998	70	17	11
Korea	1998	35	16	20
Malaysia	1998	35	15	23
Thailand	1998	45	18	20

a. Lower estimates include costs of funds, credit, and bonds injected directly into the banking system; higher estimates include other fiscal costs, such as exchange rate subsidies.

Sources: IMF, *World Economic Outlook 1998*; IMF, *International Financial Statistics*, various issues; Deutsche Bank Research, *Global Emerging Markets*, Vol. 1.3, October 1998.

Do Capital Account Labels Still Provide Information on Flow Characteristics?

An important prerequisite for formulating appropriate policies to prevent currency crises is the assessment of whether capital flows can be distinguished for their volatility features. If yes, a differential treatment of inflows by the recipient economies may be in order. The increased availability and variety of financial derivatives in the world financial centres facilitate the evasion of emerging–market prudential regulation and supervision as well as of taxes and capital controls; and they obscure the meaning of capital account data from standard balance of payments accounts. Using quarterly balance–of–payments flow data for changes in *net* claims (stocks) of FDI, portfolio equity, “long–term” and “short–term” flows, Claessens *et al.* (1995) find that capital account labels do not provide any information about the volatility of the flow. In particular, they argue that FDI and long–term flows are not more persistent than others. However, the primary policy concern here is with *reversals* of foreign investment on a large magnitude, a concern not addressed by Claessens and co–authors who base their analysis on quarterly time–series properties of net, rather than gross, inflows. Moreover, Sarno and Taylor (1999) reject the results obtained by Claessens *et al.*, finding that foreign direct investment flows, unlike other flows, display an important size of permanent components.

For industrialised countries, Turner (1991) examined the volatility of different capital–account items in order to arrive at a distinction between permanent versus temporary and autonomous versus accommodating flows. For the period 1975–1989, the capital flows that were most closely correlated with financing requirements were classified as the most accommodating, and the most accommodating types of capital flows closely corresponded to the most temporary flows, proxied by their standardised variability (coefficient of variation) over the period 1975–1988. Finally, Turner made a ranking of four capital–account items, ranging from the most autonomous and permanent to the most accommodating and temporary (i.e., volatile) flows: *i)* long–term bank lending; *ii)* foreign direct investment; *iii)* portfolio investment, and *iv)* short–term bank flows.

A closer inspection of different capital–account items tends to confirm Turner's results:

— Long–term bank lending includes essentially syndicated euro loans. The OECD (1995) reports the average maturity of the recorded euro credits. A striking observation is that the average maturity on these syndicated loans to borrowers from OECD countries is *shorter* than to borrowers from developing countries. During the 1990s, the average maturity for OECD borrowers has oscillated between 5 and 6 years, while borrowers from developing countries enjoyed average maturities of between 6 and 9 years. The longer maturities for developing–country borrowers are explained by the high proportion of long–term project loans in syndicated lending.

— Foreign direct investment is largely determined by non–cyclical considerations. Being rather governed by long–term profitability expectations, it is less subject to sudden shifts in investor sentiment. While on an annual basis, large fluctuations of foreign direct investment *flows* are regularly observed, foreign direct investment *stocks* are largely illiquid and irreversible. Foreign direct investment, which is little dependent on financial market sentiment, has bad–weather qualities. This observation is reinforced by Asia's experience, which showed a strong surge of net inflow of foreign direct investment after the crisis erupted.

— Portfolio investment is a mixed bag with respect to its stability. Investment by pension funds and life insurance companies can be taken as long–term investment, since these funds follow a buy–and–hold strategy rather than a trading strategy in the emerging stock markets. Unlike banks and most other investors, pension funds and life insurers benefit from regular inflows of funds on a contractual basis and from long–term liabilities (with no premature withdrawal of funds), which together imply little liquidity risk (Davis, 1995). As long as these funds are underinvested in the emerging stock markets (as measured by their percentage share in world stock market capitalisation) and as long as the emerging stock markets display a comparatively low return correlation *vis–à–vis* the OECD stock markets, developing countries can expect further equity–related capital flows

from pension funds and life insurers (Reisen, 1994*a*). In order to tap these flows, developing countries must strive for investment grading by the major credit rating agencies. Importantly, a strong sell–off on equity markets will result in a sharp decline in stock prices that fairly rapidly discourages further withdrawals.

— Equity–related investment by domestic residents with overseas holdings, by private foreign investors, and from managed funds (country funds and mutual funds) are largely governed by cyclical determinants and oriented at short–term returns. In the course of the early 1990s, the decline in returns on riskless assets in the United States and other OECD countries has led, not to an acceptance of falling returns, but to a growing tolerance of risk. Mainly via mutual funds, this has brought much speculative money to the emerging stock markets. The mutual funds have to publish regular (by now, even daily) asset prices and can suffer large redemptions at any time when there is bad news. What is more, with the need to have sufficient cash to pay off clients redeeming their holdings, a widespread crisis forces fund managers to sell in markets totally unrelated to the origin of the crisis.

— Any other portfolio investment, in particular bond–related, should be considered as volatile. Borrowing through corporate or government bonds is largely governed by interest rate differentials and thus akin to reversal. The average maturity of emerging–market bonds has fallen during the 1990s so that a substantial part of outstanding bonds can be fairly rapidly withdrawn; moreover, a concerted response in order to sustain external financing is difficult to organise as claims are dispersed among numerous bondholders (Griffith–Jones, 1994). Bail–in clauses and majority provisions in international bond contracts are currently being discussed in order to facilitate the resolution of crises.

— Short–term bank lending and borrowing facilities (such as euro medium–term notes and euro commercial paper) are particularly cyclical and volatile. Developing countries interested in sustained growth should be wary whenever firms and banks incur these borrowings.

— A growing proportion of long asset positions has become leveraged, most notably in the case of hedge funds; leverage (investing with borrowed funds worth a multiple of own funds) implies abrupt portfolio changes when the banks (who lend money to the hedge funds) make “margin calls” (call in the credits as the price of the collateral drops below a specified level). OECD–based banks not only lent to hedge funds, but engaged increasingly in proprietary trading activities directed at exploiting short–term trading opportunities in the emerging markets, shorting low–coupon currencies such as the yen and taking long positions in high–coupon emerging–market paper. The technique, dubbed the yen or dollar “carry trade”, relies on low interest rates in OECD markets and stable emerging–market currencies (for detailed description, see IMF, 1998).

It is also widely agreed that cross–border bank lending faces regulatory distortions through the 1988 Basel Accord, the capital adequacy regime which imposes different risk weights by category of bank lending. Table 4 provides a selective overview of the

current risk–weighting scheme for on–balance–sheet assets. Most importantly, short–term bank credit to non–OECD banks of up to one year carries a low 20 per cent risk weight, while long–term credit to non–OECD banks (over one year) is discouraged by a 100 per cent risk weight. A lower risk weight reduces borrowing costs, as banks have to acquire less capital relative to their risk–weighted assets. Similar distortions are created by the fact that claims on banks carry a 20 per cent risk weight, while claims on the private sector carry a 100 per cent risk weight. This encourages cross–border interbank lending, which has been described as the "Achilles' heel" of the international financial system (Greenspan, 1998). It further implies that there is a greater incentive for banks to lend to unregulated hedge funds (indirectly through interbank lending) than to even the bluest of the world's blue–chip companies. Note also that OECD–based banks and governments receive a more lenient treatment in the Basel Accord, even if they constitute sovereign risks equivalent or inferior to non–OECD emerging markets. Finally, the fixed 8 per cent minimum capital assigned to risk–weighted assets works in a pro–cyclical way: At the peak of the cycle, when asset prices are up, the capital buffer may be insufficient in light of the higher downside price risk of collateralised assets; at the trough of a cycle, by contrast, the Basel Accord may well intensify credit starvation.

Table 4. **Basel Capital Accord: Risk Weights by Selected Category of On–Balance–Sheet Assets**

Risk Weight	Category
0 per cent	. Claims on central governments and central banks denominated and funded in national currency
	. Other claims on OECD central governments and central banks
20 per cent	. Claims on multilateral development banks
	. Claims on banks incorporated in the OECD
	. Claims on banks outside the OECD with a residual maturity of up to one year
100 per cent	. Claims on banks outside the OECD with a residual maturity of over one year
	. Claims on the private sector
	. Claims on governments outside the OECD, unless denominated in national currency

Source: IMF (1998).

Will the new Basel proposals (which would make it near mandatory for banks to use the credit ratings of the big three agencies) be more helpful in dampening boom–bust cycles in emerging–market lending? A recent study (Reisen and von Maltzan, 1999) would imply that implementing the new Basel proposals might even further pronounce boom–bust cycles in international bank lending. By looking at the links between sovereign credit ratings and dollar bond yield spreads over 1989–1997 (hence going beyond the highly publicised crisis episodes in Mexico and Asia), an event study exploring the market response for 30 trading days before and after rating announcements finds a significant impact of positive outlooks and implemented downgrades for a combination of ratings by the three leading agencies. While the

event study suggests that rating agencies do have the potential to dampen booms that precede currency crises, our Granger causality test, by correcting for joint determinants of ratings and yield spreads, supports the concern that this potential has not been productively exploited by the agencies through independently **leading** the markets with timely rating changes.

Prerequisites for the Productive Use of Inflows

Nowadays, the authorities in emerging markets are confronted with a specific transfer problem: whether to accept or to resist private inflows, or how much to accept and how much to resist. Several theories and guidelines can help in that decision.

Sequencing

The first is the *sequencing literature* which recommends linking the acceptance of capital inflows to the progress in fiscal and monetary stabilisation, domestic financial liberalisation, prudential supervision and trade liberalisation (Edwards, 1990; Fischer and Reisen, 1993). Fiscal consolidation is a necessary prerequisite because it obviates the temptation to finance unsustainable budget deficits a bit longer thanks to inflows and because regular tax revenues obviate the need for governments to rely on the implicit taxation of domestic financial intermediation. Moreover, government budgets need to allow for the contingency that subsequent capital outflows will force up domestic interest rates that worsen the fiscal balance. Monetary stabilisation entails an appreciation of the real exchange rate which is likely to be reinforced by the liberalisation of the capital account as it induces a capital inflow. This will undermine the competitiveness of the tradeable goods industries, bring export–led growth to a standstill, and threaten the country with renewed financial crisis in due course. Capital which flows in before trade has been liberalised may go into the wrong industries, causing "immiserising" growth. Likewise, capital that flows in before the financial system has been liberalised may be inefficiently allocated.

The traditional sequencing literature tended to regard capital account liberalisation as an all–or–nothing condition, but one should draw distinctions between inflows and outflows and between different kinds of flows. Fischer and Reisen (1992) divide capital flows into inward and outward flows, long–term and short–term flows, and bank and non–bank flows. We recommend that capital controls on long–term inward flows and trade–related flows be liberalised immediately, because liberalisation of these flows can be helpful even in the earliest stages of development. We recommend the removal of controls on both long– and short–term outflows only after sound government finances have been established, bad–loan problems have been resolved, and controls on domestic interest rates have been eliminated so that the differential between domestic and world interest rates is brought down to a low level. After the domestic financial system has been liberalised and weaknesses in domestic banks have been resolved, we recommend

eliminating the barriers to foreign banks. Finally, we do not recommend liberalising short–term capital inflows until a sufficient level of competition is present in the banking sector and a sound system of banking regulation and supervision is in place.

Williamson and Mahar (1998) have recently surveyed to what extent countries have followed our advice when opening up the capital account. According to Fischer and Reisen (1992), the liberalisation of inward long–term investment and trade–related finance should be implemented as early as possible in the development process. Most countries in the panel at least partly liberalised controls on trade–related finance and long–term capital inflows early in the liberalisation process. Exceptions include Chile, Colombia, Korea, and the Philippines, where restrictions on long–term capital inflows or trade finance remained in place until well after economic liberalisation was under way.

Figure 1 (from Williamson and Mahar) shows how often a number of the more conventional preconditions for prudent liberalisation of short–term capital inflows were satisfied among the 29 panel countries that began with a closed capital account. These were *i)* the initiation of trade liberalisation at least two years prior to the removal of capital controls, *ii)* an average fiscal deficit of less than 5 per cent of GDP in the three years leading up to the removal of controls, *iii)* the introduction of domestic financial liberalisation at least two years prior to deregulation, *iv)* the liberalisation of entry into the banking sector (for domestic and foreign banks) at least two years prior to deregulation, *v)* the reduction of government ownership of the banking sector to less than 40 per cent at least two years prior to deregulation, and *vi)* the presence of a system of prudential regulation and supervision adjusted for a market–based financial system. Prudential 3 is defined as a situation with laws adjusted for a market–based system; Prudential 4 as a system of prudential regulation and supervision established but not implemented; Prudential 5 as strong supervision on and off–site, with BIS norms fulfilled for the capitalisation of banks.

It can be seen that most of the 29 countries that began the period with a closed capital account waited until after fiscal discipline had been restored and trade and domestic liberalisation had been initiated to relinquish controls on short–term capital inflows. However, many fewer countries introduced competition or prudential regulation of the banking sector before liberalising short–term inflows. At the time the controls were eased, 15 countries had significant restrictions on entry into the banking sector, 18 had public sector banks that accounted for at least 40 per cent of total assets in the banking sector, and 13 countries did not even meet the minimum standard of setting up a market–based system of financial regulation. Only Chile, in fact, in its second attempt at liberalisation, had a well–developed system of prudential regulation and supervision prior to the opening of the capital account for short–term inflows.

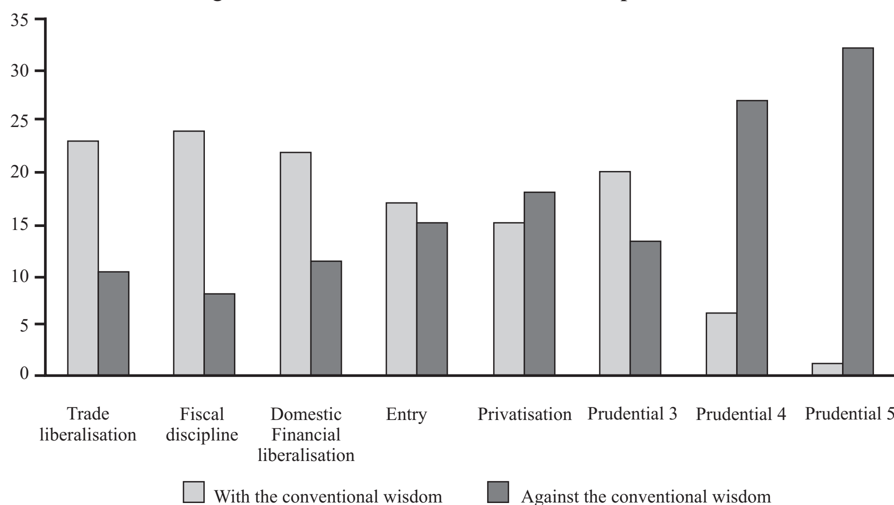


Figure 1. **Liberalisation of Short–Term Capital Inflows**

Source: Williamson and Mahar (1998).

The catalogue of prerequisites stressed by the "old" sequencing literature has recently been extended by further institutional prerequisites, focusing on better banking standards and improved corporate governance. The recommendations of the G–22 Working Groups on "Transparency and Accountability" and "Strengthening Financial Systems" provide a long list of ingredients deemed critical for lessening the probability of financial imbalances:

— good accounting standards and complete, accurate and timely information disclosure are a necessary precondition for prudential regulation and supervision. Moreover, they can stabilise market expectations by improving risk assessment during the boom and by cushioning panic during a downturn, including crisis contagion. Transparency helps to promote accountability — by creating pressure on private and public decision makers to explain their acts and to assume responsibility. Public policy can help create the appropriate environment by mandating the proper use of accounting, auditing and reporting rules. Moral hazard in the allocation of capital within countries, particularly relevant in the presence of connected and directed lending, has to be exorcised by abolishing guarantees and through forcing banks and other lenders to assume capital loss for ill–assessed credit risk;

— only with reliable accounting systems and disclosure requirements to ensure transparency will it be possible to strengthen bank and non–bank balance–sheets and to enforce prudential regulation through serious, independent supervisory arrangements. It is safe to assume that basic ingredients for effective enforcement of prudential regulation will meet resistance from affected interest groups. Nonetheless, the basic requirements are: independent internal oversight of lending decisions by a credit review committee; vesting the supervisory agency with the authority to examine bank operations and balance sheets, close banks and

establish entry criteria, define capital adequacy and exposure limits, enforce asset classification, provisioning rules and prudent collateral valuation that fully reflect the volatility of developing country asset markets;

— The Asian crises, particularly in Indonesia and Korea, have also shown the importance of sound practices in the area of corporate governance. More concerned with raising market share than with maximising profits, and reluctant to issue equity as this would dilute their management control, non–bank firms greatly contributed to overborrowing and currency mismatches by raising offshore short–term debt. This has created systemic risk to entire economies, as large–scale default resulting from currency devaluation threatens the stability of the banking system. Corporate risk management and risk control, notably the management of liquidity and foreign exchange risk, are central to avoiding financial instability arising from access to global markets. There has to be an efficient way of dealing with private sector insolvency, through credible and enforced bankruptcy laws that also allow for mass bankruptcy.

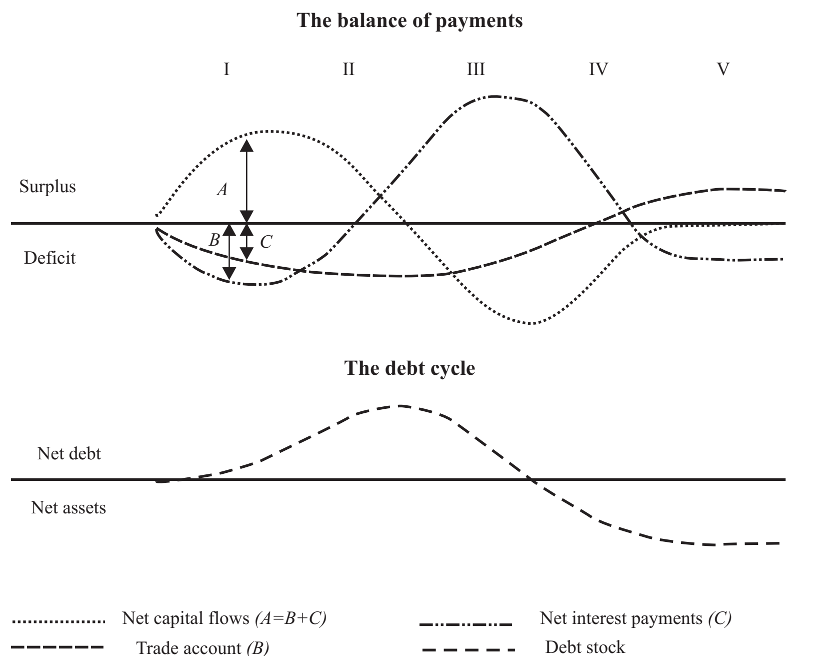
These prescriptions, while largely uncontroversial and emphasised by official thinking in both industrial and emerging countries, will take time to implement and will be hard to maintain. In fact, the Asian crisis countries had tried to strengthen the supervisory and regulatory infrastructure during the 1980s and 1990s, partly in response to costly banking crises (such as in Indonesia and Malaysia) a decade ago. What matters is the enforcement of prudential regulation.

The institutional capacity for durably strengthening balance sheets is not built overnight, however, and appropriate policies have to be formulated. Where the required manpower is in short supply, allowing free entry by foreign banks and financial service providers can speed up capacity building. Importing rather than building expertise strengthens accounting practices, disclosure standards and risk management practices as they are shaped by more demanding requirements in the foreign banks' home countries. This, however, requires an orderly exit policy for ailing domestic banks as foreign bank entry squeezes profit margins and encourages ailing domestic banks into high–risk bets for survival. It also requires free entry of financial sector experts and supervisors, as otherwise scarce supervisory personnel may be drawn to the entrant banks, as happened in Thailand.

The Mechanics of the Debt Cycle

The second body of theory on which to base the decision about whether to resist or accept inflows is derived from the mechanics of the debt cycle (Figure 2). The mobilisation of external savings has been the classic role for capital flows to developing countries, where the relative capital shortage should offer higher returns than in the developed world. According to the *debt cycle hypothesis*, rarely validated empirically, external savings raise domestic investment and growth, which in turn stimulates savings which eventually contributes to the elimination of net foreign debt. Such a virtuous circle conceals five requirements, again rarely complied with in practice (Devlin *et al.*, 1994):

Figure 2. **Balance of Payments Flows and Debt Stock During the Debt Cycle**



Stage I: Young debtor

- Trade deficit
- Net outflow of interest payments
- Net capital inflow
- Rising debt

Stage II: Mature debtor

- Decreasing trade deficit, beginning of a surplus
- Net outflow of interest payments
- Decreasing net capital inflow
- Debt rising at diminishing rate

Stage III: Debt reducer

- Rising trade surplus
- Diminishing net outflow of interest payments
- Net capital outflow
- Falling net foreign debt

Stage IV: Young creditor

- Decreasing trade surplus, then deficit
- Net outflow of interest payments, then inflow
- Outflow of capital at decreasing rate
- Net accumulation of foreign assets

Stage V: Mature creditor

- Trade deficit
- Net inflow of interest payments
- Diminishing net capital flows
- Slow–growing or constant net foreign asset position

Source: World Bank, World Development Report, 1985.

— external capital flows should consistently augment investment, rather than being diverted to consumption;

— the investment must be efficient;

— the country must invest in tradeables (or trade–related infrastructure) in order to be able to create a trade surplus to accommodate the subsequent switch in transfers required to service the debt;

— an aggressive domestic savings effort is called for, with the marginal savings rate exceeding the country's average savings rate; and

— the virtuous circle requires capital exporters willing to provide stable and predictable flows at terms in line with the recipient country's factor productivity.

In contrast to the late 19th century and to the postwar period, when capital flows to developing countries were mostly tied to particular investments and users, the recent decades have seen a disconnection between flows and investment. Such a disconnection implies the risk that inflows feed consumption rather than investment and that the recipient country's ability to earn foreign exchange through expansion of tradeable sector capacity fails to materialise. The mechanics of the debt cycle hypothesis thus provide important variables for the watch list of policy makers.

Identifying Vulnerability

The speculative currency attacks of the 1990s have challenged traditional crisis models which view them as a result of the government's inability to achieve fiscal and monetary discipline. The vulnerability to attacks was driven by private bank and non–bank borrowing, resulting in rising stock imbalances between real cash balances, short–term debt and official reserves (Calvo and Mendoza, 1996), as well as in currency and maturity mismatches. McKinnon and Pill (1998) show how reform countries get into the vulnerability zone through euphoric expectations about the permanent income level. Inefficient financial systems stimulate excessive optimism through credit growth and asset price inflation. The distortions are magnified further through net capital inflows as they stimulate bank credit growth. Once short–term foreign debt exceeds official reserves, a run on a country's liquid assets is intensified by the investor knowledge that there are not enough liquid reserves to restore confidence (Radelet and Sachs, 1998). Short–term debt poses special problems for the maintenance of financial stability, as its rapid withdrawal can trigger sovereign default, a systemic banking and payments crisis and large–scale corporate defaults (Eichengreen, Mussa *et al.,* 1998).

First, Table 5 clearly shows that currencies become vulnerable to speculative attacks because of rising imbalances between real cash balances, short–term debt and official reserves. In Asia's crisis economies, in particular during 1995 and mid–1997, lending to the private sector had clearly paced ahead of (fast) GDP growth. The two countries which experienced the highest net capital inflows — Malaysia and Thailand — also experienced the most rapid expansion in the commercial bank sectors. Abundant foreign supply of capital (offered at rapidly falling sovereign yield spreads) and the greater ability of Asian non–bank and bank borrowers to tap the international financial markets interacted to fuel a rise in non–bank and bank foreign liabilities (toward BIS–reporting banks). In terms of foreign assets, non–bank foreign liabilities exploded in Indonesia, Korea and Thailand, while bank foreign liabilities grew quickly in the Philippines and again in Thailand during 1995 and mid–1997.

Table 5. **Indicators of Financial Vulnerability**

	Indonesia	Korea	Malaysia	Philippines	Thailand
Lending to private sector, % of GDP					
end–1993	49	54	74	26	84
end–1996	55	62	90	48	
Foreign liabilities/foreign assets (towards BIS reporting banks)					
a) non–banks					
end–1994	9.9	5.9	1.9	0.9	5.3
mid–1997	14.0	8.5	2.4	1.5	6.7
b) banks					
end–1994	2.2	2.6	1.3	1.0	8.6
mid–1997	2.8	2.7	1.8	2.6	12.4
Short–term foreign debt/reserves					
mid–1994	1.7	1.6	0.3	0.4	1.0
mid–1997	1.7	2.1	0.6	0.8	1.5
M2/reserves					
end–1993	6.1	6.9	2.1	4.9	4.1
end–1996	6.5	6.5	3.3	4.5	3.9

Sources: Corsetti *et al*. (1998), Radelet and Sachs (1998).

Rapid bank and non–bank foreign borrowing finally made Asian currencies vulnerable to attack. When short–term foreign debt starts to exceed official reserves (indicated by a ratio higher than one), each creditor knows that there are not enough liquid foreign exchange reserves, so there is a race to the exit. Table 5 indicates that such a situation clearly held for Indonesia and Korea already by mid–1994, and for Thailand thereafter. While Malaysia and the Philippines displayed a short–term debt/reserves ratio lower than one, they are financially open. Openness implies that M2/reserves becomes the relevant indicator for financial vulnerability, as residents may try to obtain foreign currency for their domestic currency holdings. The M2/reserves ratio exceeded one by far in all five crisis countries, even though it had stopped growing during 1995–96 except in Indonesia and Malaysia. First then, recent crisis experiences demonstrate the importance of short–term debt containment.

Second, both the Mexican crisis of 1995 and the Asian financial crisis have demonstrated that current account deficits can pose serious problems for policy makers, even in the absence of public sector deficits. As emerging economies adopt market–oriented reforms, therefore enhancing their attractiveness as destinations for international investment, the risks of incurring excessive current account deficits from private flows may increase. Policy makers in emerging economies are thus faced with a new challenge: that of resisting or accepting the large current account deficits that may result from heavy private capital inflows. Central to their dilemma is knowing at what point deficits originating from private flows become "excessive".

Suggesting measures against which to judge whether actual current account deficits are sustainable in the long run, Reisen (1998*a*) concluded that actual deficit numbers alone cannot provide information about long–term sustainability. The size of the current account deficit does not give rise to normative judgements; a deficit worth

3 per cent of GDP may be "excessive" in one country, while a deficit worth 12 per cent of GDP may be justified for another. Any judgement needs to consider debt–GDP levels (current versus that tolerated by investors), official foreign exchange reserves (current versus targeted), the potential GDP growth rate, import growth, the Balassa–Samuelson effect, and the structure of capital inflows. Sustainability considerations do not make sense for FDI flows, as long as there is no widely held notion about the sustainability of net foreign liabilities for the stock of FDI invested in a country. As a rough guide, the current account deficit not covered by FDI should not exceed, as a percentage of GDP, half of a country's potential growth rate in the long term, provided investors are seen to accept a total foreign debt burden of 50 per cent of GDP. What distinguishes such deficits is not so much whether they are driven by public sector or private sector decisions, since there is some evidence for a Ricardian offset and since private debt is a contingent public sector liability. Rather what matters for governments is the source of the current account deficit. The intertemporal approach to the current account justifies an enlarged external deficit when the economy enjoys a country–specific, persistent rise in productivity; higher profit expectations will stimulate private investment, while higher permanent income levels should lead to lower savings. By contrast, large external deficits should be resisted when unsustainable currency appreciation, excessive risk–taking in the banking system and a sharp drop in private savings are seen to coincide.

Third, the domestic financial systems contributed heavily to weak balance sheets and financial vulnerability in Asia, not just through the excessive quantity, but also through the low quality of onlending foreign capital inflows. Table 6 represents the extent of risk exposure in the Asian bank systems at the outbreak of the crisis. Non–performing loans were the highest in 1997 in Korea (16 per cent of total assets), Thailand (15 per cent) and Indonesia (11 per cent); sharp increases could be expected during 1998. This compares to a non–performing loan ratio of 9.3 per cent in Mexico in early 1995, where the cost of rescuing banks has been estimated at some 15 per cent of GDP on a net present value basis (Caprio and Klingebeil, 1996). As the banks, with the exception of the Philippines and possibly Malaysia, were severely under–capitalised in the Asian crisis countries (with capital to asset ratios estimated at 6–10 per cent), the non– performing loans had already wiped out the total capital of banks (on average) in Korea, Thailand and Indonesia at the end of 1997.

As previously in Latin America (see Ffrench–Davis and Reisen, 1998), excessive real estate exposure has been a prominent feature of the lending and spending boom in Asia as well. Real estate exposure is estimated at 30–40 per cent of bank assets in Indonesia, Malaysia and Thailand, while it is somewhat lower in the Philippines and in Korea (where the bad loans are concentrated within the *chaebols*). The high real estate exposure of Asian banks indicates the extent to which loans were not used to finance productive investment, but speculative demand for existing assets in fixed supply. Thus, part of the foreign inflows went into feeding speculative asset price bubbles. The excessive real estate exposure was clearly related to excessive collateral valuations; the Philippines which had the lowest real estate exposure also had the

Table 6. **Bank System Risk Exposure and Financial Infrastructure**

	Indonesia	Korea	Malaysia	Philippines	Thailand
Bank system exposure to risk, % of assets end–1997					
non-performing loans	11	16	8	6	15
capital ratio	8–10	6–10	8–14	15–18	6-10
real estate exposure	25–30	15–25	30–40	15–20	30-40
collateral valuation	80–100	80–100	80–100	70–80	80-100
Regulatory features during the 1990s					
bank lending to connected firms	high	high			
government-directed bank lending	yes	yes	yes	yes	yes
bank deposit insurance	none	none	none	yes	none
importance of state-owned banks	high			high	
accounting standards	weak	weak		weak	weak
enforcement of existing regulations	weak	weak	weak	weak	weak
Incentives for capital flows					
short-term inflows	limited	limited (promoted)	limited	free	promoted
long-term inflows	limited	limited	promoted	promoted	promoted
outflows	free	limited	limited	free	limited

Sources: Folkerts-Landau and Garber (1995), Johnston *et al*. (1997), Corsetti *et al*. (1998).

lowest collateral valuation (Table 6). As the asset bubble burst, the deflating values of real estate, equities and other assets, reducing the value of loan collateral, determined the extent of the non–performing loans.

In Indonesia and Korea, as in Chile in the early 1980s, balance sheet weakness in the banking system was also related to credit exposure to borrowers connected to the lending bank (Folkerts–Landau and Garber, 1995). Although there were regulatory restrictions on bank ownership, they did not prevent banks from becoming controlled by non–bank firms. In Korea, where the use of dummy accounts was widespread, this prevented the enforcement of restrictions against concentrations of lending to the bank shareholders.

Loosening portfolio discipline and debt imbalances which were fuelled by heavy inflows can be partly traced to government intervention in bank lending and corporate finance. Folkerts–Landau and Garber (1995) point to the fact that many APEC developing countries, in fact all five crisis victims, have regulatory requirements to allocate fixed proportions of bank loan portfolios to particular sectors (see Table 6). As mandated loans carry an implicit bailout guarantee and as they are usually refinanced by the central bank at below–market interest rates, banks have little incentive to limit their credit risk.

Policies for Crisis Prevention

Beyond the prerequisites for the productive use of inflows (outlined above) — sound fiscal performance, accounting standards, information disclosure, supervision, and corporate governance — policies for crisis prevention should aim at dampening the risk of excessive short–term debt and raising the quality of inflows. These policies can be grouped under the headings of *a)* appropriate exchange rate management, *b)* debt and liquidity management, *c)* prudential and control measures to contain short–term flows into the country, and *d)* the promotion of long–term inflows, not least through orderly sequenced capital account liberalisation.

Most Asian crisis countries have effectively pegged their currency to the US dollar in the past, notwithstanding different official pronouncements about their exchange rate policies. History and economic theory, however, strongly suggest that open capital markets, monetary autonomy and pegged, but adjustable, exchange rates are incompatible and prone to speculative currency attacks. Reviewing the international currency experience of recent decades, Obstfeld (1995) sees no “comfortable middle ground” anymore with integrated capital markets between the two extremes of exchange rate regimes — either a pure float or an irrevocable currency union. The choice between these extremes should be governed by the country’s size, openness to trade, inflation history, soundness of its financial system, and the suitability of the anchor or joint currency. To the extent that Asian countries can be defined as small open economies with a good inflation record but a shaky financial system and lacking a natural anchor

currency, floating exchange rates are advised. As floating rates imply the risk of competitive devaluations in the Asian region, future solutions about exchange rate regimes may look for a jointly independent float of Asia's emerging markets.

The excessive reliance on short–term borrowing can be discouraged by flexible exchange rates. By contrast, exchange rate pegs, in combination with high interest rates, typical in developing countries for structural reasons, tend to reinforce bank lending and spending booms (Reisen, 1998*a*). They constitute an incentive for leveraged investors to exploit interest differentials as well as for offshore borrowing by creditworthy banks and non–banks to tap seemingly cheap sources of finance. Central bank intervention on the foreign exchange market to peg the currency in the face of net inflows, unless sterilised fully, is intermediated into the domestic banking system. The exchange rate peg provides the incentive to allocate those funds disregarding currency and maturity risks, as these are being implicitly transferred to the central bank (Calvo and Mendoza, 1996). Keeping nominal exchange rates flexible, even introducing "noise" through central bank intervention when it is seen to be on a too–stable, appreciating trend during inflow periods, improves the mix of inflows towards longer maturities and encourages banks and firms to hedge their foreign currency exposures.

Second, a comprehensive debt management can buffer developing countries from volatile international capital markets. Mexico's and East Asia's crises have unveiled the degree of vulnerability that emerges from large stocks of short–term debt, even if the fiscal position and total external debt are sustainable. This experience has put a premium on sound debt management, through limiting liquidity, currency and rollover risks. Argentina's recent debt management strategy provides a useful model (Kiguel, 1999). The strategy has five elements:

— the first seeks to develop a sound maturity profile of amortisation payments for long–term debt to avoid a concentration of principal repayments in a given year, thus limiting the refinancing risk;

— the second element is a deliberate limitation of short–term borrowing, in both domestic and foreign currencies or markets, as the risks of refinancing can be larger for domestic currency debt;

— the third element secures a liquidity cushion for the authorities, either at the treasury, through international reserves at the central bank, or through contingency loans with private foreign banks or international financial institutions;

— the fourth element diversifies sources of finance across currencies and across various types of investors; and

— the fifth element of the debt management strategy aims at developing a domestic treasury market, jointly accommodating the rising importance of domestic institutional investors. A cornerstone for developing domestic bond markets are sound banks which are the primary dealers, market makers and providers of liquidity to these markets.

The Argentine debt management strategy has been supported by strict prudential regulation of banks and by the refusal to convert private debt into public debt during the Tequila crisis of 1994–95.

Third, policies can operate directly at the level of capital inflows. Most mutual funds, pension funds and life insurers impose penalties for early withdrawal by investors. Chile, with its one–year unremunerated reserve requirement gradually extended to all inflows except foreign direct investment, has done likewise, as has Colombia (Ffrench–Davis and Reisen, 1998). Such capital inflow restrictions provide policy makers with a policy instrument in the policy trilemma that free capital flows, an independent monetary policy and pegged exchange rates are mutually inconsistent. They also extend the range of prudential regulation measures to limit the upwinding and unwinding of short–term foreign currency positions, which have devastated emerging–market banking systems and economies in the past, including Chile's in 1982.

It has been argued that Chile's reserve requirements amount to a distortion that does not allow capital to flow to uses that offer the highest rate of return. To the extent, however, that these flows pose an exogenous distortion to returns (e.g., when high flows with multiple leverage drive asset prices up and down) or that the structure of foreign capital supply is distorted (e.g., by the Basel adequacy regimes, discussed above) capital restrictions on short–term inflows can be seen as correcting rather than creating a distortion. Finally, when the short–term debt/reserves ratio dangerously approaches unity, avoiding a speculative attack implies the need for the central bank to put every dollar of increased debt into official reserves to prevent the vulnerability ratio from growing. For developing countries, this means borrowing at a higher rate of interest than the rate at which funds are reinvested, say, into US Treasury Bills. Such a swap clearly constitutes a negative externality to the country, hence the rationale to restrict short–term borrowing at the source.

Are caps on short–term inflows effective in improving the structure of inflows? After all, the high degree of integration in trade, production and financial services opens up many ways of circumventing controls. One reason that capital controls in most OECD countries were abolished in the 1980s was the perception that they were increasingly ineffective. Restrictions on inflows, but also prudential regulations on open foreign currency positions, are difficult to enforce as banks can use offshore subsidiaries or derivatives to evade them (Garber, 1998). Authoritative studies from Chile's Central Bank do show that Chile's measures to regulate capital flows have been effective in providing a degree of monetary autonomy and in influencing the size and mix of capital inflows (Box 1). But the impact has been weak, and regulatory measures in Chile have been supported by a culture of transparency and enforcement as well as by a set of macroeconomic policies (balanced budgets, wide target zones for exchange rates) consistent with raising the share of long–term inflows (Ffrench–Davis and Reisen, 1998). These conditions have not always been present in other emerging economies.

Box 1. **Central Bank of Chile Studies on the Effectiveness of the Country's Measures to Regulate Capital Flows**

The Chilean prudential framework, including capital inflow restrictions, has featured prominently in policy discussion on how best to deal with volatile capital inflows. Chile's authorities followed two main policy targets in view of a surge in capital inflows during the 1990s: first, to maintain a tight monetary policy without hindering export competitiveness resulting from unwarranted exchange rate appreciation; second, to control the composition of inflows by discouraging short–term capital so as to limit the short–term foreign debt and foreign currency exposure of both bank and non–bank entities. In 1991, the central bank imposed a one–year unremunerated reserve requirement (*encaje*) on foreign loans. Subsequently, the rate of the *encaje* was increased to 30 per cent and its coverage extended to cover virtually all foreign inflows except foreign direct investment. The one–year minimum holding period effectively implied a tax on inflows, inversely tied to their maturity. Prudential regulation complemented these curbs on inflows. Except for trade credits, banks cannot lend domestically in foreign currency. Moreover, maximum open foreign exchange positions are set at 20 per cent of banks' capital and reserves. As short–term flows dried up in 1998, the *encaje* was reduced to 0 per cent, but not abolished.

As it is difficult to quantify the intensity of inflow restrictions and to control for prudential regulations, macroeconomic policies and other conditions that impact on capital inflows, the effectiveness of Chile's measures is being hotly debated. The Banco Central de Chile has provided the OECD Development Centre with a set of unpublished internal studies on the impact of the *encaje*[1]. These authoritative studies do show that the *encaje* has been effective in providing some monetary autonomy and in influencing the mix of capital inflows. Eyzaguirre and Schmidt–Hebbel (1997) set up a model for analysing and estimating the dynamic effects of the *encaje* on capital inflows. The model predicts an intensification of the *encaje* to result in higher domestic interest rates, diminished net foreign debt and a depreciation of the exchange rate. These predictions are borne out by calibrating the model with monthly data for the period January 1991 to June 1996. It is also shown that the *encaje*, with a lag of one year, modifies the composition of inflows by reducing the share of short–term flows in favour of longer maturities. The paper does not explore, however, to what extent the improved mix of inflows represents relabeling in order to escape the implicit tax on short–term flows. Le Fort and Sanhueza (1998) also provide evidence for 1990–96 that Chilean capital controls have been effective in keeping domestic interest rates above international rates, and that the effectiveness has not been eroded over time. Moreover, each time the coverage of the *encaje* has been extended, the newly taxed inflows have been reduced without a full substitution towards tax–free flow items. However, while the study is empirical, it does not provide an econometric analysis of the degree of effectiveness. Soto (1997) runs a vector autoregression analysis on capital flows, interest rates and the real exchange rate for June 1991 to June 1996. He finds that capital controls have the desired effect of reducing capital inflows, maintaining higher interest rates and a lower real exchange rate, and reducing the share of short–term capital inflows. However, the magnitude of these effects is fairly small. One explanation for the small impact of the *encaje* on the dependent variable may be that the implicit tax of the inflow controls are smaller than assumed in most studies. Considering the positive option value of closing the investment position or staying invested in Chile once the investment has been done, reduces the implicit tax on a one–year investment from 2.50 to 1.25 per cent (Herrera and Valdés, 1997).

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While Chile's controls were designed to tax short–term inflows without hindering long–term portfolio and direct investment, financial opening in the worst–hit Asian economies was "disorderly" (Poret, 1998; Reisen, 1998*b*). Often the result of discretionary authorisation granted to selected sectors, the opening process implicitly encouraged short–term inflows in the pre–crisis years. While tight quantitative ceilings were maintained on non–resident purchases on the stock market and on foreign direct investment (notably in Korea), financial opening eased access to short–term foreign borrowing. Table 7 may be indicative of the lessons to be drawn: the rise in short–term debt can be contained through "orderly" liberalisation (as in Colombia and Chile); but disorderly liberalisation (as in the Asian crisis countries) encourages financial vulnerability, in particular if a strongly enforced supervisory framework is not yet in place.

Table 7. **Maturity Structure of Foreign Debt in Selected Countries**
per cent of short–term in foreign debt, end–June 1997

Country	Short–term Debt
Colombia	39.4
Chile	43.3
Malaysia	56.4
The Philippines	58.8
Indonesia	59.0
Thailand	65.7
Korea	67.9

Source: Bank for International Settlements, *The Maturity, Sectoral and Nationality Distribution of International Bank Lending,* Basel, May 1988.

These observations reinforce the need for a capacity–building sequence of liberalising capital inflows, as has indeed been advocated since the early 1990s (Fischer and Reisen, 1992). Foreign direct investment and trade–related finance, while a necessary ingredient for development even at the earliest stage, are unlikely to cause trouble for macroeconomic management and financial sector stability. They are early candidates for liberalisation, while other capital flows confront the authorities with more complicated issues. In view of the considerable time needed to establish a sound domestic financial system — accounting, auditing, disclosure, regulation and supervision — the required infrastructure should be built without delay and be enhanced by liberalising the entry of financial market expertise. This requires a clear and durable solution of prior bad loan problems in the banking sector. The next candidates for liberalisation are portfolio equity and long–term bond investments, which should be fostered in parallel with building the infrastructure for domestic stock, corporate debt and mortgage instruments. This will deepen domestic money markets, which allow authorities to smooth shocks to domestic liquidity. Deepened domestic financial markets pave the way for dismantling controls on short–term borrowing by banks and non–banks, assuming a tough supervisory regime is in place. Financial opening has the best chance to achieve its ultimate objective, to raise efficiency and growth without compromising stability, when combining a sequential opening process with building the prerequisite institutions.

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Banking Sector Reforms
Recovery Prospects and Policy Issues

Ramesh Adhikari and Soo–Nam Oh

Introduction

The importance of banks is premised on the grounds that banks are the main channels of savings and the allocators of credit in an economy. The efficiency of the banks therefore affects the financial system and the entire economy. Their failures can erode public wealth and confidence in the economy. Bank failures or systemic banking crises almost invariably are due to distorted management incentives, bad governance, weaknesses in macroeconomic policies, weak supervision, or problems in the real sector, or a combination of them.

Banking failure cuts two ways[1]. It can be the cause of macroeconomic instability, particularly when it contributes to fiscal deficits and also when it drains foreign exchange reserves. On the other hand, macroeconomic instability can cause banking failure as a result of, for example, currency devaluation, rise in interest rates, and fall in asset prices leading to corporate losses and insolvency. In addition, lack of market discipline or sufficient competition, proper regulation and oversight, and legal framework and its enforcement are other possible factors contributing to structural weaknesses in the banking system.

While there are many interpretations of the causes of the Asian financial crisis, the majority view is that it is a dual crisis — a currency crisis due to capital account imbalances combined with a banking crisis owing to structural weakness[2]. The Asian financial crisis has unveiled many intricate problems and challenges in macroeconomic management, banking and capital market management, good governance, institutional capability and human resource development for both government and private sector. More importantly, the recent developments underscore the challenges presented by a world of mobile capital — even for economies with strong institutions, and good human resources and economic fundamentals. It was also evident from the Asian financial

crisis that countries such as Hong Kong, Malaysia, Philippines and Singapore suffered less damage from the crisis than Indonesia, Republic of Korea[3], and Thailand. One major reason for this was the relative strengths and weaknesses of their banking sectors.

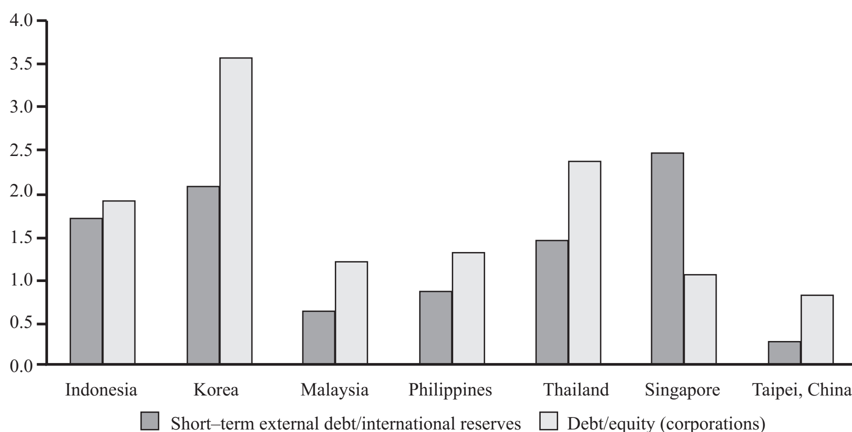
This chapter is concerned with the banking sector reforms in the crisis–hit economies of Asia, namely, Indonesia, Korea, Malaysia, Philippines, and Thailand. We first present a brief account of the evolution of the crisis from the perspective of banking sector reform. Second, we provide highlights of the banking sector reform measures taken under the framework of the International Monetary Fund and the assistance provided by the Asian Development Bank (ADB). Finally, we outline recovery prospects and key policy issues.

Asian Financial Crisis and the Banking Sector

The Asian financial crisis has revealed the difficulties in managing large short–term capital flows after financial sector and capital account liberalisation with relatively underdeveloped institutional capability and regulatory framework in the banking and capital market areas. It also highlighted the fact that globalisation of the financial markets, deregulation in domestic financial and corporate sectors, and capital account liberalisation encourage both short–term capital inflows and corporate debt, and increase the vulnerability of the banking sector. In Indonesia, Korea, and Thailand, short–term external debt exceeded international reserves in pre–crisis years and corporate debt–equity ratios were also high (Figure 1).

The crisis has also revealed that the key problems in the banking sector were: *i)* high exposure to large–scale infrastructure and real estate projects with long gestation periods and large conglomerates; *ii)* large exposure to foreign currency–denominated loans; *iii)* structural rigidities and liquidity crisis facing the export sector, and *iv)* deteriorating financial conditions of large conglomerates and manufacturing firms. The crisis showed that bank credits tend to expand during the upswing of the business cycle accompanied by large capital inflows, which were absorbed by non–traded sectors or over–investment in other sectors such as heavy industries. The tendency is more pronounced after financial sector liberalisation as the banks can then access offshore borrowing and lend wherever they wish. This may lead to many possible problems, for example, maturity mismatches — short–term funds in long–term investments, and little provision for currency and interest risks. Owing to limited experience and undeveloped risk management, motivated by immediate rewards implicit in the imperfect incentive systems, and inadequate supervision and guidance of central banks and monetary authorities, banks tend to lend too recklessly. These contribute to increasing non–performing loans (NPLs). In countries where not only the financial sector, but also the whole process of economic reform is less than complete, the banking sector bears a huge financial burden. Although the definition of NPLs vary from country to country, the NPLs at the peak of the crisis were estimated to be 30 per cent, and that they have increased further (Table 1)[4].

Figure 1. **Debt–Reserve and Debt–Equity Ratios**



Sources: Short-term debt:Bank for International Settlements; reserves: IMF (1998a); debt/equity (based on 5,550 samples); Claessens, Djankov, and Lang (1998).

Table 1. **NPLs of the Five Affected Countries**
(per cent)

	Indonesia	Korea		Malaysia		Philippines	Thailand
Category	Commercial banks	Bank and NBFIs		Banking system		Banking system	Banking system
Definition (period of overdue payment)	3 months	3 months		3 months		3 months	3 months
Date	January 1998	June 1998		June 1998		June 1998	June 1998
NPLs/Total Loans	7.9	21.8		12.6		9.7	35.7
Peak							
S & P	40+	20-30		20		n.a.	35-40
J. P. Morgan	30-25	25-30		15-25		8-10	25-30
Official NPL ratio (Category)		Commercial banks		Commercial, and merchant banks, and finance companies		Commercial, thrift, and rural banks	Commercial, and state-owned banks, and financial companies
(period of overdue payment)		3 months	6 months	3 months	6 months	3 months	3 months
Dec 1996			3.9	–	–	3.5	–
Dec 1997			5.8	–	5.9	5.4	21.7
June 1998			8.6	12.6	–	9.7	35.7
Dec 1998		7.4	–	18.7	12.6	11.0	49.5

Source: Various sources, and IMF (1998*b*).

The experience of Thailand shows a policy mismatch coupled with structural weaknesses. It shows that an open capital account with a fixed exchange rate system will be a lethal policy combination, which can damage the economy. In addition, there was no matching institutional capability and oversight mechanism to handle the rapid capital inflows and banking sector activities. When there was heavy pressure on the exchange rate,greater reliance was placed on government intervention than on market forces. This approach could not last long as the international reserve position worsened and eventually the currency (baht*)* was floated, leading to a massive devaluation at the outset and considerable cost to the government treasury. The impact of such devaluation further deteriorated the already precarious health of the banking sector.

The experience of Korea is somewhat different. It appears to be a case of selective economic liberalisation with significant government involvement. Although the weight of such a policy regime accumulated over decades and the economy was under tremendous pressure, the contagion effect of baht devaluation triggered the crisis. In Korea, while the financial sector had the nominal freedom to become market–based, the interlocking relationships between the government and the financial institutions meant that they were still subject to pervasive government controls, thus constraining market orientation. There was no independent regulatory oversight. Government provided implicit guarantees, sometimes, and financial assistance to financial institutions that faced difficulties, particularly those arising from resource misallocation influenced by government decisions. The system worked well during the high growth period but it could not last. The policy environment was worsened by the closeness of the government and the enterprise sector, which grew very fast into gigantic conglomerates; they in turn started implicitly influencing government decision making. At the same time, overvaluation of the national currency was maintained. Export deceleration continued due mainly to the loss of export competitiveness resulting from the overvalued exchange rate and enterprise–level inefficiencies. The system of heavy reliance on second–best options, in which the government involvement predominated over market forces in promoting businesse, thus resulted in a banking crisis, leading to currency instability and spillover effects on trading partners.

While Indonesia was liberal in the area of capital account and exchange rate regime, its banking sector had serious structural problems. The contagion effect, coupled with the impact of natural disasters and political uncertainties, led to a loss of investors' confidence and macroeconomic instabilities. This resulted in massive devaluation of ruppiah and further worsening of the already fragile banking sector. The crisis also revealed weaknesses in corporate governance. The case of Malaysia and the Philippines was different, although they were also hit by the contagion effect of the Thai, Indonesian and Korean currency crises. This was largely because of the their relatively robust banking sector.

It should also be noted that the external environment contributed to some extent to the emergence of the Asian financial crisis. For example, the East and Southeast Asian countries were experiencing export deceleration particularly since 1996. Because of the prolonged sluggish growth in demand and considerable increase in competition in the US and European markets, and in traditional trading zones, the export dependence

of these countries on regional markets had grown more than before. The second largest market in the world and the largest in the region, Japan, was going through a period of recession and financial sector problems. The yen had been under pressure. The Japanese yen always exerted pressure on regional currencies because of the regional linkages owing to trade and investment flows. The movements in the value of yen in relation to the dollar are still largely influential to the regional currencies, including the won, ruppiah, baht, peso and ringgit.

Despite increasing fragility of the banking sector and a sluggish real sector, the relatively underdeveloped institutional capability and supervisory framework in the financial sector did not provide early warning signals or take any measures to prevent the crisis. The crisis has revealed many problems in the banking sector, including problems in asset and liability management, ownership, governance, competition and institutions (Box 1). Figure 2 and Figure 3 show developments in the pre–crisis stock market, and property markets.

Box 1. **Key Characteristics of Banking Sector Problems**

The crisis was preceded by an extraordinary expansion in bank credit in all these economies. During 1990–97, bank credits to the private sector increased by 18 per cent in Indonesia, the Philippines, and Thailand; 16 per cent in Malaysia; and 12 per cent in Korea.

The mismatch between maturity of assets and liabilities of commercial banks increased dramatically during the 1990s as banks, making use of the greater access to global financial markets, borrowed short–term capital in foreign markets and lent to long–term infrastructure projects and the real estate sector in the domestic economy.

In many cases the banks also suffered from a currency mismatches of their assets and liabilities. The assets were domestic currency denominated while the liabilities were accumulated in foreign currency to take advantage of the lower interest rates in foreign markets with the assumption that the exchange rate would remain unchanged.

In other cases, the banks tried to hedge against the exchange rate risk by lending to borrowers in foreign currency and passing on the exchange risk to the borrower. However, when the currency depreciated sharply, these borrowers' incomes were in domestic currency, and the exchange risk became a credit risk.

Commercial banks were highly exposed to the real estate sector. Banks use property values as collateral for their loans. These values rise rapidly during boom periods and encourage banks to underestimate credit risks inherent in lending to this sector. When the bubble bursts and asset prices crash, banks suffer the consequences.

In a number of cases the banks were part of larger conglomerates with diversified interests. The conglomerates used the banks to finance aggressive market grabbing and expanding capacity on thin margins. This variant of connected lending resulted in increasing magnitudes of non–performing loans.

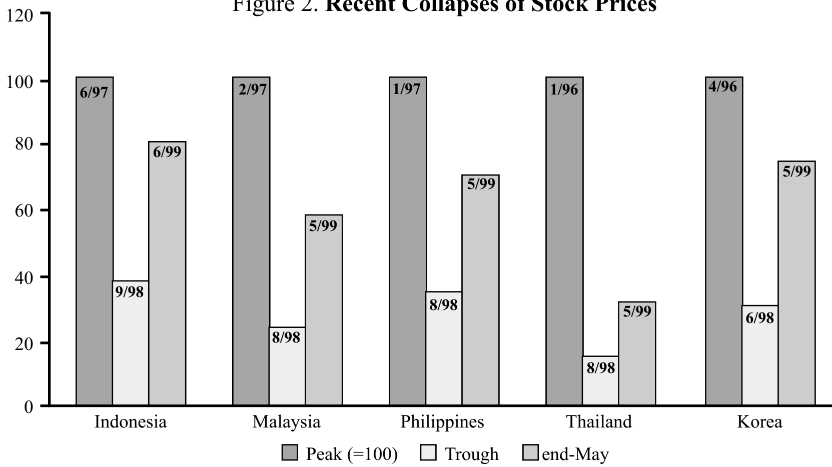
Commercial banks also suffered from the consequences of government–directed lending for financing large infrastructure projects.

The deregulation of the financial sector resulted in excessive entry and fragmentation of the banking sector in crisis–hit economies.

Prudential regulation and supervision, institutional capabilities and governance were weak.

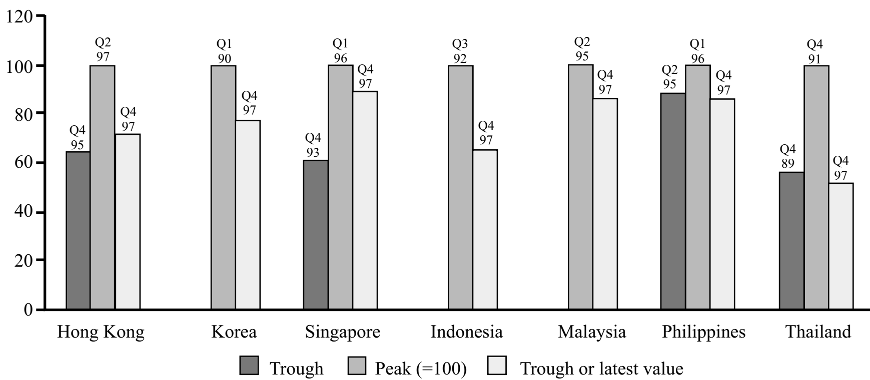
Source: Lee (1998).

Figure 2. **Recent Collapses of Stock Prices**



Source: Bloomberg.

Figure 3. **Recent Collapses of Commercial Property Prices**



Notes: Based on prices (in local currency) in inflation-adjusted terms.
Source: Colliers Jardine, Sydney, Jones Lang Wootton and national date, cited in BIS 68th Annual Report (1998), p. 140.

Review of Banking Sector Reform Measures

A quick review of the reform measures undertaken by the crisis–hit Asian economies indicates that the key reform measures were based on the following strategic considerations: *i)* stopping panic, *ii)* achieving short–term macroeconomic stability, *iii)* removing structural and institutional weaknesses in the banking and corporate sectors and ensuring long–term fundamentals, and *iv)* achieving a robust and sustainable banking system. Following these, the guiding principles for banking sector reform were: *i)* resolving unviable banks (closure, merger, nationalisation), *ii)* recapitalising viable banks (capital injection), *iii)* resolving NPLs (restructuring, rescheduling, sale and swap), *iv)* revamping regulatory framework (regulation, supervision, re–organisation), *v)* strengthening bank management and credit culture (no political interference, governance, foreign participation), and *vi)* strengthening borrower repayment culture (exit laws, repayment of directed credits, reform of corporate sector).

A full recovery from the crisis will require regaining investors' confidence by properly addressing these structural problems. However, short–term macroeconomic stabilisation measures are needed to stabilise the economy and stop investor panic. Table 2 gives the estimated cost of bank restructuring. The short–term macroeconomic measures in the crisis–hit Asian economies included a tightening of monetary policy (raising of interest rates) and the maintenance of a sound fiscal policy. Restoring fiscal discipline and monetary stability in the economy was considered to be important in restoring investor confidence and reversing capital flows. The short–term stabilisation measures were introduced together with a massive international financial rescue package to improve the current account balance and replenish international reserves.

Table 2. **Cost of Bank Restructuring in Crisis-hit Asian Economies**

	Debt issues		Interest payments	
Economy	$ billion[a]	Percentage of GDP	$ billion[a]	Percentage of GDP
Indonesia	40	29	5.4	3.5
Korea	60	17.5	6.4	2.0
Thailand	43	32	4.0	3.0
Malaysia	13	18	0.9	1.3
Philippines	3	4	0.3	0.5

a. At the exchange rate of 30 November 1998.
Source: IMF (1998*a*).

To strengthen supply response, ensure long–term macroeconomic stability and achieve a robust banking system, a supplementary set of structural reforms measures were required. They were essentially aimed at achieving relative price alignments and institutional reforms in various sectors. The reforms were intended to make the economy more efficient and more flexible and thereby to engineer sustainable long–term growth by improving allocative efficiency so that resources go only to most productive uses. In the crisis–hit economies, it was therefore necessary to restructure the banking sector by removing inherent structural and institutional weaknesses. In addition, concomitant measures were considered to address the social impact of the financial crisis. Banking sector reform is therefore a

comprehensive adjustment process entailing a package of macroeconomic adjustments, structural reforms, institutional and regulatory measures to restore a problem–ridden banking sector to solvency and sound financial health, and mitigating possible social costs.

The chief responsibility for dealing with the Asian crisis at an international level was assumed by the IMF, the institution in charge of safeguarding the stability of the international financial system. Box 2 provides a summary of the reform measures under the IMF–led framework in the crisis–hit Asian economies. The IMF's goal was to restore confidence quickly in the three hardest hit Asian economies — Indonesia, Korea and Thailand — through a combination of tough economic conditionalities and substantial financial support[5]. In 1997, the IMF approved $35 billion of loans for these countries and, in addition, mobilised commitments worth $77 billion from the ADB, the World Bank and bilateral sources. In 1998 the IMF arranged further loans worth $6.3 billion for Indonesia.

Following broadly the IMF–led framework, the ADB's response has been focused mainly on four key areas: *i)* banking sector reform and capital market development, *ii)* promotion of good governance and corporate management, *iii)* mitigation of social costs of structural reforms, and *iv)* provision for stimulating growth in the real sector. In Thailand, the ADB has provided a $300 million loan for a financial sector reform programme. The ADB has also made $500 million social sector programme loan to Thailand to help to provide support for laid–off workers and the unemployed, improve efficiency in the provision of social services, and help overcome skill shortages and other weaknesses in the educational system which constrain Thai industrial competitiveness. The ADB also arranged a $1 billion loan package with international commercial banks to help Thai exporters. As credit to the export sector was quite constrained, the loan was intended to inject liquidity by funding exports and export–related imports. In addition, there is a programme loan for agriculture sector reform.

In Korea, the ADB has provided a $4 billion loan for a financial sector reform programme aimed at making the sector more reliant on market forces and more subject to independent regulatory oversight. The programme covers banks and other financial institutions, financial markets, and corporate accounting and disclosure standards. In addition, there was a $15 million technical assistance loan for institutional strengthening of the financial sector.

In Indonesia, the ADB has prepared a $1.5 billion programme aimed at reform of financial governance. This sector development programme is expected to assist in financial sector restructuring, and strengthening of the legal and regulatory framework. It also supports the standby arrangement agreed with the IMF, by helping in the reform of private banks and development banks, the development of capital markets, and the management of public sector resources. To address social dislocations, including unemployment and poverty, arising from the financial crisis and a prolonged drought, the ADB is supporting labour–intensive income–generating activities and the provision of social safety nets. To this end, a $300 million social sector development loan has been approved. Further, a trade and industrial sector programme loan with a provision of assistance to small and medium–sized enterprises is being considered.

Box 2. **Summary of Reform Measures in the Crisis–hit Asian Economies**

Financial and Corporate Sector Reforms

- Closing of insolvent financial institutions, with their assets transferred to a resolution or restructuring agency (Indonesia, Republic of Korea and Thailand), together with recapitalisation and mergers of others (all countries); the reform programmes in Malaysia and Thailand place particular importance on the finance company sector.
- Announcement of limited use of public funds for bank restructuring; actual funds used to be made explicit in the budget (all countries).
- Measures to significantly strengthen prudential regulations, including loan classification and provisioning requirements, and capital adequacy standards (all countries).
- Liberalisation of foreign investment in domestic banks (Indonesia, Republic of Korea, and Thailand).
- Strengthening of prudential regulations on loan exposure (all countries).
- Introduction of funded deposit insurance schemes (planned in Indonesia and Thailand; under consideration in Malaysia; already in place in the Republic of Korea and the Philippines).
- Restructuring of domestic and external corporate debt (Indonesia, Republic of Korea and Thailand) and closure of non–viable firms (Republic of Korea).

Competition and Governance Policies

- Liberalisation of restrictive marketing arrangements for a variety of key commodities (Indonesia).
- Establishment of competitive procedures for privatisation of government assets and for procurement (Indonesia, planned in Malaysia and Thailand).
- Announcement of bans on or limits to the use of public funds to bail out private corporations (Indonesia, Republic of Korea, Malaysia, and Thailand).
- Introduction or strengthening of bankruptcy laws and exit policies (Indonesia, Republic of Korea, and Thailand).
- Acceleration of privatisation or closure of non–viable public enterprises (Indonesia).
- Strengthening of corporate disclosure standards (Republic of Korea).
- Liberalisation of foreign investment in ownership and management in sectors other than the financial sector (Indonesia, Republic of Korea, Malaysia and Thailand).

Trade Policy Reforms

- Reduction of import tariffs and export taxes (Indonesia).
- Easing of quantitative import or export restrictions or both (Indonesia and Republic of Korea).

Social Policies

- Labour–intensive public works programmes (Indonesia and Thailand) and expansion of unemployment insurance system (Republic of Korea).
- Protection of low–income groups from increases in prices of food and other essentials (Indonesia, Malaysia, Philippines and Thailand).
- Provision of higher spending for health and education (Indonesia) and reallocation of budgetary expenditures to health programmes for the poor (Thailand).
- Expansion of scholarship and loan programmes to minimise number of student dropouts (Malaysia and Thailand).
- Provision of subsidised credit for small and medium–sized enterprises (Indonesia and Malaysia).

Source: International Monetary Fund (1998*a*).

Furthermore, the ADB has actively participated in the New Miyazawa Initiative (NMI), led by Japan, and the Asian Growth and Recovery Initiative (AGRI), led by the United States and Japan[6]. The NMI is cofinancing many ADB sector policy reform packages. To compliment this, the ADB will administer the Asian Currency Crisis Support Facility (ACCSF), a yen facility equivalent to $3 billion. It will leverage, through guarantees, more funding from international financial markets for restructuring.

Progress in implementing reform in the banking sector varies amongst the crisis–hit Asian economies. Most have introduced legislation to strengthen prudential regulation and improve banking supervision. Throughout the region, disclosure requirements, auditing standards, loan classification, and provisioning rules are being improved. The crisis–hit Asian economies have created financial sector restructuring agencies (e.g., the Thai Financial Sector Restructuring Authority, the Indonesian Bank Restructuring Authority, and Korea's Financial Supervisory Commission). They have provided substantial public money for bank recapitalisation and NPL resolution, and all have closed down or merged some insolvent financial institutions. Of the crisis–hit economies, Thailand has achieved much by way of genuine reform, that is, by relying more on market–based bank and debt restructuring approaches than straight bailouts. Nonetheless, they still have to go a long way before their banking sectors are fully restructured[7].

There has been good progress has been made in the Philippines and Korea, fair progress in Thailand and Malaysia but more needed, and only limited progress in Indonesia. In almost all crisis–hit Asian economies, good progress has also been made in resolving unviable banks. Reasonable progress has been made in recapitalising viable problem banks, and resolving NPLs in all the countries, except in Indonesia where progress has been limited but efforts are in place. The trend is reported to be similar in other areas such as revamping the bank regulatory framework, and strengthening bank management and credit culture. In the Philippines, which had a relatively robust banking sector before the Asian financial crisis because of bank restructuring in the mid–1980s, several banks have merged and take–overs of some are being considered, and tough regulations on bad loans have been legislated. Appendix 1 provides a summary of comparative details on major banking sector regulations in crisis–hit Asian economies as of the end of March 1999.

On the corporate restructuring front, progress has been much slower than in the banking sector. There is a strong linkage between the banking sector and the corporate sector in the region. The latter is heavily indebted to both domestic and foreign banks. In particular, the corporate foreign debt is huge and many corporates have overdue debt servicing obligations. Insolvency is pervasive. This situation is slowing down production and investment and obstructing financial restructuring. Furthermore, there

Box 3. **A Summary of Progress in Bank Restructuring in Selected Countries**

Key Principles	Korea	Malaysia	Thailand	Indonesia
Level of fragility in 1997 pre–crisis (worst = 24)	*Highly fragile: fragility score of 22 (1999: 11)*	*Some fragility: fragility score of 15 (1999: 11)*	*Highly fragile: fragility score of 22 (1999: 13)*	*Highly fragile: fragility score of 20 (1999: 18)*
1. Resolve unviable banks	Good progress, 36 NBFIs removed, 4 banks nationalised, exit for 5 of 26 banks.	Fair progress but more needed. 2 of 35 banks absorbed, 16 of 39 fincos merged into parent banks.	Good progress. 55 of 91 fincos and 1 bank shut, *1999*2 of 25 banks nationalised, 2 banks and 16 fincos absorbed.	Fair progress: 26 of 237 banks including 2 of Big 5 taken over by IBRA; 4 of 7 state banks to merge.
2. Recapitalise remaining banks	Good progress. Gov't. injected W18tn equity into 10+ banks, foreign buyer found for 1, sought for another; more gov't–led recaps expected.	Good progress. Danamodal set up, RM 4.55 billion equity placed into 9 FIs, RM 16 billion in additional recaps of more FIs planned by mid–1999.	Fair. Capital support programme in place. 2 sold to foreign banks, 2 for sale, 6 raised equity. But many banks still under–capitalised, holding out.	Limited progress. Gov't looking at Rp 257 trillion recap of some 55 banks. Preliminary talks with foreign buyers.
3. Resolve NPLs	Fair. Gov't forcing reforms on Big 5. Workouts for SMEs, other chaebol. KAMCO actively buying NPLs (7 per cent of all NPLs at present). Closure usually avoided.	Good pace. Danaharta has agreed to buy RM 22 billion (5.2 per cent of all loans), may buy up to 50 per cent of NPLs, can rapidly foreclose, will restructure loans, even underlying assets.	Fair. Gov't banks committed to NPL restructuring; guidelines and incentives in place. But no system carve–out of NPLs despite high NPL levels.	Limited progress. Foreclosure law needed; banks need recaps before NPLs can be restructured. No resolution for closed banks' NPLs.
4. Revamp bank regulatory framework	Good progress. Prudential norms now at global standards. Better supervision with set–up of FSC.	Good norms, supervision pre–crisis, helped by Danaharta, Danamodal. Reversion to 6–month NPL definition an issue.	Fair progress. Prudential norms to global standards by 2000; forbearance still an issue. BoT reorganisation by 3Q 1998.	Limited progress, still in damage assessment. Weak enforcement, high related–party lending.
5. Strengthen bank managements, credit culture	Fair progress but more needed since pre–crisis credit culture very weak. Need foreign bank buy–ins.	Rapid NPL sales at >50 per cent discounts exacts pain, but await details of bank/ management reforms as part of recap.	Good progress. 2 foreign bank buy–ins, more for sale. No gov't bailout promotes discipline.	Limited progress. Survival, trying to get recapitalised still the singular priority.
6. Strengthen borrower repayment culture	Good progress. Gov't imposing restrictions on chaebol leverage, cross–guarantees; focusing on core competencies, downsizing.	Good pre–crisis. Good bankruptcy framework enhanced by Danaharta Act. But holding company leverage, "rescues" must be curbed.	Committed but modest progress. Bankruptcy law set up, no bailout of borrowers but need promised foreclosure law and credit bureau.	Some progress. New bankruptcy framework put in place; gov't after repayment of related–party loans, but much more needs to be done.

Source: Goldman Sachs (1999).

are capability limitations. Even though the crisis–hit countries have revamped their bankruptcy laws, they do not have enough trained people to implement them. Moreover, handling the restructuring of hundreds of firms is certainly formidable. In Thailand, the government has initiated legal and regulatory reforms and the privatisation of state–owned enterprises (e.g., Bankruptcy Law, implementation of foreclosures, and Alien Business Law)[8]. Government authorities recognise that privatising state enterprises is necessary for economic recovery as a way to attract new local and foreign investment.

In Korea, the dominance of the *chaebols* is increasing instead of shrinking; in Indonesia, corporates are still not solvent and debtors have just started to negotiate workouts[9]. Furthermore, in Korea, some meaningful progress has been made with smaller *chaebols,* including the sale of assets and business, a decline in cross–debt guarantees, and ongoing loan workouts. On the restructuring of the larger *chaebols*, the task is more daunting. The government has issued guidelines requiring the larger *chaebols* to reduce their debt–equity ratio from 500 per cent at the end of 1997 to about 200 per cent by the end of 1999[10]. To achieve this the corporate sector will have to raise a substantial amount of resources through assets sales and new issues of equity. Success will depend on government–developed mechanisms to facilitate this debt–equity conversion. The other problem in corporate restructuring is possible resistance from labour because restructuring might involve retrenchment.

A Goldman Sachs[11] study indicates that while macroeconomic volatility is stabilising in the crisis–hit Asian economies, there is still sluggish progress in removing structural weaknesses in the banking and corporate sectors (see Box 3 for further details). Foreign exchange liabilities are high and there are still some government–directed credits. On the regulatory front, both regulation and supervision compliance are improving. Overall, it is reported that Indonesian economy is still relatively more fragile and the Philippine economy is fairly solid. In non–crisis countries in the region, such as Singapore and Hong Kong, which experienced some macroeconomic volatility during the peak of the Asian financial crisis, the overall recovery is reported to be solid.

Recovery Prospects and Policy Issues for Building a Robust Banking Sector

There are signs of recovery from the financial crisis and economies are stabilising. Exchange rates and stock prices are responding positively. However, this process of recovery needs to be solidified and sustained by completing effective implementation of the reform agenda in both the banking and corporate sectors. This is because of the fact that the onset of the Asian financial crisis involved structural weaknesses, and it was not just a sharp and temporary economic slowdown. Leaving these unresolved will impede recovery prospects and may lead to future crises. Recovery prospects are therefore dependent upon continued government commitments in resolving structural weaknesses in their respective economies. The economic situations in larger economies in the region such as the PRC and Japan, and elsewhere, like Brazil, may also influence the pace of the recovery.

While there are many policy issues in building a robust and sustainable banking sector in the crisis–hit Asian economies, the most important ones are: *i)* co–ordination between macroeconomic and banking sector policies, *ii)* reorientation of the development role of the banks towards commercialisation, *iii)* improving corporate governance, *iv)* de–nationalisation and privatisation, *v)* financial restructuring, including resolution of NPLs, *vi)* corporate sector restructuring, *vii)* improving bank regulation and supervision, *viii)* strengthening infrastructure, *ix)* liquidity problems and the need for real sector stimulation,), and *x)* sequencing of reform actions. These were also underscored by the findings of an ADB study[12] of financial markets in nine countries in the region. These warrant full attention by governments and donors.

Co–ordination Between Macroeconomic and Banking Sector Policies

Governments must maintain appropriate co–ordination between macroeconomic and structural policies. Reduction of macroeconomic instability or uncertainty is the most urgent concern for both domestic economic agents and foreign investors. However, achieving this is not easy. The best practice is to start with stabilising macroeconomic variables, such as exchange rate, inflation rate, interest rate, and prices of assets including stock and property. However, care should be taken in sequencing macroeconomic policy reforms. For example, a market–based exchange rate system is considered to be superior to a government administered exchange rate system; benefits of capital account liberalisation outweigh its cost, but exchange rate liberalisation should precede capital account liberalisation.

Reorientation of the Development Role of the Banks Towards Commercialisation

In many of the Asian countries banks were historically assigned a developmental role, and they were used to channel directed credit to priority sectors at interest rates fixed by the government. The system allowed very close linkages between the government, banks, and the corporate sector, and the risk of moral hazard increased. It is therefore essential to strike a balance between the developmental role of banks and their commercial orientation.

Improving Corporate Governance

Poor governance leads to resource misallocation, inefficiencies or losses, all contributing to banking failures rather than helping in avoiding them. There are many reasons for poor governance, however, the most important one relates to the ownership structure of banks. Governance problems are prevalent in both state–owned banks as well as banks owned by family–based conglomerates[13]. There are two possible options to improve bank governance: selling state–owned banks to the general public, and enhancing competition in the banking sector. To achieve this, bank privatisation should

be implemented, entry barriers must be eliminated or reduced, and foreign participation should be encouraged. The role of foreign participation is especially important, because it would not only encourage competition in the banking sector, it also would enhance overall efficiency by introducing good governance and advanced financial technology.

De–nationalisation and Privatisation

The problems relating to nationalisation and state ownership of banks are a potential source of systemic vulnerability in the banking sector. The Asian financial crisis has led to nationalisation of banks in several cases in which the crisis–hit countries relied on government intervention (e.g., bailing out, nationalisation), but one worrying factor is that there does not seem to be any explicit time–bound programme for their de–nationalisation.

It is commonly argued that bank privatisation *i)* reduces expectations that the banks will be bailed out in the future, *ii)* limits the scope for intervention by government in credit allocation, *iii)* creates incentives for restructuring, *iv)* fosters competition and improves productivity. In many Asian countries there is considerable state ownership of banks. Where privatisation has been introduced, it has not quite led to full commercialisation and higher efficiency because of the problems related to ownership structure or market structure.

Financial Restructuring, including Resolution of NPLs

The first task in financial restructuring is the estimation of NPLs and the identification of best possible ways for their resolution. While NPLs are a useful indicator of bank performance, their true meaning depends on the method of their estimation. In a crisis, NPLs exist on a large scale, which is why restructuring requires considerable financial assistance. Furthermore, the accumulation of NPLs deteriorates profitability of financial institutions and makes them more cautious in providing liquidity due to a lowered capital adequacy ratio.

There are two main approaches to financial restructuring: one is government intervention (e.g. nationalisation, liquidation with deposit insurance, etc.*)* using public money; and the other is through market–based mechanisms (e.g. shareholder capital injection, sale or merger, privatisation, liquidation without deposit insurance*)* using private sector and foreign participation. In the crisis–hit countries both approaches have been tried. However, the use of public money is the most frequently used approach, despite the fact that it could be costlier to the national economy and may not be sustainable.

The speed and success of the NPL resolution will depend on several factors. For example, for unviable banks a legal framework for easy foreclosures is required. Asset management companies of government agencies, which will require government financial support, can purchase some NPLs. In addition, creation of secondary markets can help dispose of NPLs to institutional investors as well as the general public through auction or issuing of mortgage–backed securities.

When there is a high possibility of bank runs and systemic collapse of the financial system, closing or nationalising unviable banks is one possible option for the government. In some cases, the government can request individual institutions to provide a rehabilitation plan and, based on it, further measures can be taken such as closure, merger and acquisition, or financial support for a viable institution. However, the restructuring process must be transparent and implemented consistently. In particular, financial support should be conditional on fair cost sharing among stakeholders, i.e., shareholders, management, creditors, and depositors. This will also help in mitigating potential moral hazard problems in financial intermediation where asymmetric information is generic. However, some reliance on foreign participation is desirable, since in most cases there is the lack of liquidity in the domestic financial markets, and there is a large demand for financial support for social protection and economic revival.

Corporate Sector Restructuring

The goals of corporate restructuring should include: enhancing transparency and eliminating insider trading, improving the financial structure, establishing core competencies, and strengthening accountability of major shareholders and management. The government should play the role of a facilitator by providing guidelines and legal/ institutional framework, and financial institutions have to be allowed to lead corporate sector restructuring as creditors.

However, it is often argued that banking sector reforms made ahead of corporate sector reforms could lead to subsequent reversals as recapitalised banks continue to give credits to loss–making enterprises (Sheng, 1996). Since the banking sector and the corporate sector are mutually dependent, to achieve a successful banking sector reform, corporate sector restructuring should be implemented simultaneously.

Improving Bank Regulation and Supervision

To maintain a sound and stable banking system, prudential regulation should be enhanced and bank supervision strengthened. Core Principles for Effective Banking Supervision provide minimum requirements. Measures to strengthen prudential regulations in the banking sector include making the definition of NPLs stricter, raising loan–loss provisions, raising capital adequacy ratios, limiting bank exposure to the property sector, and strengthening lending guidelines.

Moreover, a balance needs to be struck between traditional supervisory–based regulation and market–based regulation. Market–based processes can instil the discipline required for prudent behaviour without it being imposed by supervisory authorities. Transparency in the financial system is important for market–based processes to work. Poor and inadequate bank supervision was a major reason for the lack of incentives for bank owners and managers to behave in a prudent manner. The attempts to strengthen bank supervision prior to the crisis were inadequate, delayed, and in some countries, not effectively implemented. The focus of supervision in the globalised environment should give greater emphasis to bank risk management. A strong and independent bank supervisory function is necessary to achieve a sound banking system.

Supervisory authority should develop a CAMEL system[14] not only to evaluate safety and soundness of the bank but also to categorise banks with deficiencies in particular component areas. The CAMEL rating needs to be extended by adding sensitivity to market risk. In addition to the on– and off–site examinations, prompt corrective action (PCA*)* is an important vehicle for effective supervision.

Strengthening Infrastructure

A well–designed and operated financial infrastructure can lead to higher efficiency in financial intermediation. It essentially enables financial institutions to provide better services at a lower cost, while customers enjoy a higher return at a lower risk. The key components of financial sector infrastructure are: a legal system for supervision, bankruptcy, foreclosure, the monetary policy of the central bank, and bank secrecy; accounting and disclosure standards; data collection and dissemination; payments system; deposit insurance (to a certain extent); asset management companies; and human resource development. In particular, the setting up of bankruptcy and foreclosure laws was also required to encourage financial and corporate sector restructuring. In additon, the crisis revealed the necessity of explicit deposit insurance to prevent bank runs and an asset management company to enable financial institutions to concentrate on the banking businesses[15]. Improvement of human capital, in particular for better investment decisions and risk management of the banking institutions, has become an urgent task.

Liquidity Problems and the Need for Real Sector Stimulation

In the aftermath of the financial crisis, financial institutions have become extremely conservative in their lending policies. Asian economies are either growing sluggishly, or at or near recession levels. Under such circumstances, the perceived risk of loan default is high. Furthermore, financial restructuring itself subjects banks to increased stress, as insolvent banks are closed down and stricter loan–loss provisioning and bad debt classification standards are imposed.

One of the most daunting challenges facing the countries affected by the crisis is the prevention of a vicious circle of credit crunches and a slowdown of the real economy affected by capital outflows while financial sector restructuring is in progress. The credit crunch raises interest rates and induces a further contraction in the real economy. As the real economy slows down, NPLs rise and the credit crunch is exacerbated by the increased conservatism of banks in their lending. This feeds back to the real economy and induces greater slack. Efforts to distribute limited liquidity to viable but marginal corporations, in particular small and medium–sized ones, are most urgent.

Sequencing of Banking Sector Reforms

The sequencing problem must be dealt with. Different weights may be placed on each of the problems based on the urgency for implementation. For example, the mitigation of liquidity problems may come first, as it is the most urgent issue, followed by other policy issues, including the resolution of NPLs and consolidation of the banking industry. Afterwards, the role of banking institutions and strengthening of the industry infrastructure may follow as medium– and long–term issues. Furthermore, a gradual approach may be undertaken to reflect country–specific situations in the design and implementation of specific policy measures. For example, two separate sets of policy recommendations might be necessary: e.g. one for the crisis–affected economies, and the other for vulnerable economies.

While dealing with banking sector reforms, focusing on the short–term issues alone can be costly because banking policy makers may miss the broad picture of financial sector reforms. The trade–off between the efficiency of financial intermediation and financial stability should be considered in policy design. The resolution of NPLs should be speeded up. A flexible rather than rigid application of prudential regulation and supervision may be considered for times of crisis.

Notes

1. See Sheng (1996) for further details.
2. See Krugman (1998, 1999), ADB (1999*a*), Yoshitomi and Ohno (1999), and Ito (1999).
3. Henceforth Korea.
4. This estimation is rather conservative. Deutsche Bank (1999) estimated NPL ratios of five countries as 82, 30, 30, 20, and 67 per cent for Indonesia, Korea, Malaysia, Philippines, and Thailand, respectively.
5. This approach was initially criticised as an old prescription for new disease since the Asian crisis was different to that which occurred in Latin America in the 1980s and 1990s.
6. Chino (1999).
7. Asian Development Bank, 1999*a*, p. 34.
8. Asian Development Bank, 1999*a*, pp.118–19.
9. *Business Week,* 23 November 1998.
10. Asian Development Bank, 1999*a*, p 57.
11. Goldman Sachs (1999).
12. ADB (1999*b*). Countries included in the study were Thailand, Korea, Indonesia, Philippines, Malaysia, India, Pakistan, People's Republic of China, and Viet Nam.
13. Khan (1999).
14. CAMEL (Capital, Asset quality, Management, Earnings, and Liquidity) rating is a system that assigns a numerical ratings to a bank based on an examiner's judgement regarding the bank's financial condition and operations on five key components. This rating utilises a more comprehensive set of information than the Prompt Corrective Action (PCA) criteria.
15. These may be particularly useful as short–term measures during crisis management. However, they may be criticised as an extension of government intervention and a potential source of moral hazard.

Appendix 1. **Comparison of Major Banking Sector Regulations**

Country	Regulations
1. Loan Classification and Provisions	
Indonesia	Current (0.5%), special mentioned (1.25% gross of collateral), substandard (3.75% net of collateral), doubtful (50% net of collateral), and bad debt (100% net of collateral)
Korea	Normal (0.5%), precautionary (2%), substandard (20%), doubtful (75%), estimated loss (100%)
Malaysia	Substandard (20%), doubtful (50%), and bad (100%)
Philippines	Unclassified (0%), loans specially mentioned (5%), substandard (25%), doubtful (50%), loss (100%)
Thailand	Pass (1%), special mention (2%), substandard (20%), doubtful (50%), doubtful of loss and loss (100%)
2. Single Customer Limit	
Indonesia	20% of equity capital (10% for related party)
Korea	loans: 15% of the equity capital; guarantees: 30%
Malaysia	25% of a bank's shareholders' funds
Philippines	25% of unimpaired capital
Thailand	25% of Tier 1 capital
3. Group Limit	
Indonesia	50% of equity capital
Korea	current–45% of bank's equity capital; June 1999–50%; and end of 1999–25%
Malaysia	50% of total credit facilities
Philippines	30% of unimpaired capital
Thailand	Incorporated with the single customer limit
4. Credits for Small and Medium Enterprises	
Indonesia	20% of credit to small businesses. Or 25% of loan growth from small business credit.
Korea	45% of an increase of total loans (regional banks–60%, foreign banks–35%)
Malaysia	During April 1998-March 2000, as group; commercial banks–RM 1 billion, financial companies–RM 240 million
Philippines	Out of total loans; small enterprises–6%, medium–sized industries–2%
Thailand	No regulation (In process of classifying SME as a priority sectors)
5. Lending to the Property Sector	
Indonesia	No new loans for land purchase or property development, except in the case of low-cost housing.
Korea	None
Malaysia	Exposure to the broad property sector limited to 20% of outstanding loans; no bridging finance for the development of properties exceeding RM 250 000
Philippines	20% of total loan portfolio
Thailand	Lending growth is monitored by the central bank (Low-cost housing is classified as a priority sector; land accumulation, condominium, and golf courses are classified as a non-priority sector)
6. Lending to Stock and Share Purchases	
Indonesia	prohibited from underwriting CPs
Korea	No lending for speculation purpose
Malaysia	No lending based on collateral of its own stocks or in excess of 20% of the issued stocks of any other corporation.
Philippines	Out of total outstanding loans: commercial banks and finance companies–20%, merchant banks–30%
Thailand	For finance and securities companies, margin loan is classified as a non-priority sector
7. Capital Adequacy Ratio Target	
Indonesia	4%; end of 2001–8%
Korea	March 1999–6%; March 2000–8%; end of 2000–10% (For the banks not doing international businesses, apply lower ratios by 2%.)
Malaysia	8%
Philippines	8% (BIS standard), 10% of total risk assets
Thailand	Commercial banks: 8.5% (4.25% for Tier 1 capital); Finance companies: 8% (4% for Tier 1 capital)

Appendix 1 (continued and end)

Country	General Ownership	Bank-Ownership	Remarks
8. Opening the Financial Market to Foreign Participants			
Indonesia	. Restrictions sharply reduced, except a few	. 99%	. World's 200 biggest banks above the rating A are allowed to open branches in Jakarta
Korea	. No general restriction (30% for 39 public interest corporations)	. 10% by reporting (domestic investors are allowed only up to 4%) . Over 10%, 25-33%, and over are allowed with permission	. No difference in business between domestic and foreign banks
Malaysia	. 30% (49% for telecoms)	. 30%	. No new license issued since 1983 (both domestic and foreign banks) . Foreign banks are allowed to extend financing to non-resident controlled companies (NRCCs) up to maximum of 40 percent of total financing requirement of the NRCCs . Restriction on opening of new branches, including off-branch ATMs, for foreign banks
Philippines	. Various (40% for mining and telecoms)	. 30% (40% on approval)	. Foreign banks may acquire, purchase or own up to 60% of the voting stock. . Foreign banks may set up branches with full banking authority. . No difference in business between domestic and foreign banks
Thailand	. 100% for 10 years	. 100% for 10 years	. No difference in business between domestic and foreign banks

Country	Regulations
9. Other Regulations	
Indonesia	. Net open position: 25% of bank capital for the weekly average net position of both on and off balance sheet positions . Loan deposit ratio: maximum 110%
Korea	. Loans exceeding 15% of capital: 500% of total capital (Loans exceeding 10% of capital: 500% of total capital by March 2000) . Chaebol: debt/equity ratio should be lowered to 200% by end-1999; no new cross-debt guarantees are allowed and existing ones should be resolved by March 2000.
Malaysia	. Loans to Bumiputra Community: 30% of total loans, each for commercial banks and finance companies as a group
Philippines	. 30% liquid cover on all foreign exchange liabilities . Ceilings on equity investment varying across types of banks . Limits on aggregate insider loans: 15% of total loans or 100% of net worth
Thailand	. Net open foreign exchange position: the higher of 15% of Tier 1 or $5 million

Source: ADB 1999*b*.

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Post–Crisis Issues in Asian Capital Markets

Arvind Mathur, S. Ghon Rhee and Christine Wallich

Introduction — Challenges for Post Crisis Area

One of the many lessons of the Asian crisis is that in spite of a large domestic savings rate, countries were still vulnerable to macroeconomic instability and volatile international capital flows. Another surprising fact is that while many Asian countries had created apparently robust financial and capital markets and had working institutions such as pension funds, banks and non–bank financial institutions, as well as regulatory bodies, they proved to be less than fully effective. What went wrong? It is now clear that the builders of these institutions were handicapped because intangibles such as good governance, transparency and good forward–looking professional management and skills were either absent or in short supply.

The inference is that unless institution building and legal reforms are accompanied by parallel investments in good governance systems, good management development programmes and transparency–enhancing measures, the benefits of reform cannot be sustained. In other words, capital markets cannot develop in isolation from the standards that are, or are not, applied economy–wide and from the level of advancement of society as a whole. The worst consequences of the absence of these intangibles are those of a higher cost of capital, its misallocation and its flight over sustained periods causing serious macroeconomic instability and social stress.

East Asia, in particular those economies that were most severely affected by the financial crisis, had a commendable and consistent record of rapid economic growth, which in turn led to significant social advancement. While the rapid growth performance, in combination with relative openness of the economies, attracted significant capital inflows, which fuelled further growth, these economies also had access to a large–pool of domestic resources supported by savings rates in the range of 35–40 per cent of gross domestic product (GDP). However, by highlighting a number of financial and real sector weaknesses, the crisis has demonstrated that these capital flows were not managed properly in the affected economies.

To meet the challenges facing post–crisis Asia, countries in the region will have to take steps in a wide range of areas, including maintaining macro–stability, restoring health in the banking and corporate sectors, and allowing capital markets to play an appropriate role in the overall financial system. In particular, to develop capital markets, countries will need to: develop their long–term bond markets; improve their corporate governance practices, reinforce regulatory and supervisory arrangements, and expand the investor base by giving fuller support to institutional investors.

This is not an exhaustive recipe even for capital market development. Rather, it represents a list of some of the vital intangibles that are indispensable for the sustained development of capital markets.

The greatest challenge going forward will be to ensure quality governance in the public sector, as well as in private companies. Being an intangible, it will be a slow process. The winners in Asia in the future may well be those who successfully take on the corporate governance challenge. Their rewards may well be a lower cost of capital. The responsibility for good governance will not only be that of companies but institutional investors will need to stand for their rights and adopt an activist stance. Another risk is that legal impediments may be removed only slowly. The net result for policy makers is that they will have a rich agenda for reform in the new millenium.

Developing Local Bond Markets[1]

Compared to the banking markets, the region's bond markets are underdeveloped. Most lending to the private sector in the region has continued to take the form of shorter–term bank credit, while only piecemeal efforts have been made to develop long–term bond markets. At the end of 1997, in the nine Asian economies covered by this study, bank loans amounted to approximately 79 per cent of their combined GDPs, while capital market borrowing using long–term corporate bonds amounted to a mere 9.82 per cent (see Appendix 1). In the PRC, for example, Lardy (1998) reports that banks accounted for between 75–90 per cent of all financial intermediation between savers and investors during the 10–year period, 1987–1996. Shin (1998*b*) reports that Korea's manufacturing sector financed only 18 per cent of its outstanding debt by issuing bonds and the remaining 82 per cent by bank financing in 1997.

Although the Asian financial crisis was caused largely by structural factors, macroeconomic policies adopted by the Asian economies were also unhelpful for the development of domestic fixed–income securities markets[2]. Between 1993 and 1996, the Asian economies sterilised large capital inflows and built up foreign exchange reserves. This sterilisation raised domestic interest rates, increasing spreads between domestic and international interest rates and encouraging overseas borrowing (Stiglitz, 1998). At the same time, the Asian economies' pegged exchange rates, put severe strains on their export competitiveness as real exchange rates appreciated in tandem with the US dollar beginning in 1995[3] . Pegged exchange rates also fostered the illusion

that currency risk was not a significant concern in offshore borrowing decisions. Thus, domestic corporations borrowed heavily on offshore markets to take advantage of interest rate differentials and pegged exchange rates.

When long–term bond markets remain underdeveloped, any economy pays a high price in the form of foregone benefits. At least four types of lost benefits may be cited. First, long–term contractual savings institutions (pension and provident funds, insurance companies, and open– and closed–end investment companies) cannot function well in the absence of well–functioning long–term bond markets to supplement banking institutions in savings mobilisation. The role of contractual savings institutions is critically important when the banking sector reveals its own structural weaknesses. Second, banks in financial distress can improve their capital adequacy and liquidity ratios by selling their assets, both performing and non–performing, through asset securitisation. Especially for those economies in the Asian region affected by the on–going financial crisis, asset securitisation represents a critically important process in restructuring bank assets. Without a well–functioning bond market, asset securitisation cannot be employed.

A third foregone benefit is the valuable monitoring function of corporate debt over managers who might waste free cash flow. Jensen (1986) recognised this unique role of corporate debt in proposing the "debt–monitoring" hypothesis. He states that "conflicts of interest between shareholders and managers become severe when the corporation generates substantial free cash flow. The problem is how to motivate managers to disgorge the cash rather than investing it at below the cost of capital. The creation of debt enables the managers to bond their promise to pay out future cash flows."[4] Thus, an adequate level of corporate leverage, limited to prudent levels by bond covenants disciplines management, allowing shareholders to gain positive benefits of prudent leverage. With a grossly inadequate corporate governance system, a fully–developed debt market could have been useful in monitoring management activities when excess liquidity was wasted on projects that did not warrant investment.

The fourth foregone benefit is that the absence of a long–term bond market — particularly a mortgage–backed securities market — limits the supply of long–term funds required for housing finance. This also partly explains the low level of housing loans in a number of Asian economies (see Appendix 2).

In retrospect, underdeveloped capital markets, and especially the absence of long–term bond markets, played a large role in the Asian financial crisis because many local corporations chose to rely on offshore sources of funds. At the same time, the sudden reversals and flight of international capital and massive foreign exchange losses exacerbated a corporate liquidity crisis of systemic proportions. Structural weaknesses, characterised by lax supervision, non–autonomous management, and poor corporate governance, limited the banking sector's ability to channel prudently large savings amounting to 30 to 40 per cent of GDPs to long–term productive investments. Clearly, one important lesson from this crisis is that the existence of alternative domestic sources of long–term capital would have been desirable to minimise reliance on short–term foreign capital.

Four factors impede the development of long–term bond markets in the region: *i)* the lack of benchmark yield curves, *ii)* restricted supply of quality bond instruments, *iii)* limited demand, and *iv)* inadequate market infrastructure.

The Lack of Benchmark Yield Curves

The importance of an appropriate and reliable benchmark yield curve cannot be overemphasised for the development of domestic bond markets, particularly for the development of markets for corporate bonds. A lack of benchmark interest rates has sometimes been attributed to fiscal surpluses enjoyed by the majority of Asian economies. Some governments did not borrow, therefore a government benchmark never had the chance to develop. Thus, even where countries have had financeable deficits, such benchmarks were slow to do so. Deficits have typically been financed on a non–market basis. For example, bonds are placed on a non–market basis with banks as well as with captive pension or provident funds. Thus, market benchmark rates have not been developed.

Some Government authorities in the region have been making special efforts to create a benchmark yield curve as they recognise its importance in pricing long–term corporate bond issues. The most remarkable success case is the Hong Kong Monetary Authority's (HKMA's) Exchange Fund Note (EFN) programme that began in 1993. EFNs initially started with relatively short–term maturities of two and three years, but the longer maturities of seven and ten years were introduced later. The success of the EFN programme may be attributed to three reasons: *i)* the HKMA provides a central bank discount window for EFNs, *ii)* the HKMA uses EFNs as a monetary policy instrument to adjust interbank liquidity, and *iii)* the issue cycle is regularly scheduled. In other Asian economies, the government's effort in creating a benchmark yield curve has been mixed, for reasons such as the dominance of the banking market or the "crowding out" of private–sector issuers by government pre–emption.

Restricted Supply of Quality Bond Issues

In the absence of a government bond "benchmark", strong, high–quality corporate borrowers could also serve as benchmarks. In fact there is a very restricted supply of quality debt securities, representing another challenge in developing the fixed–income securities markets. Four underlying reasons can be identified for the limited supply of viable debt instruments: *i)* poor credit standing of issuing corporations, *ii)* statutory restrictions on the issuance of fixed–income instruments, *iii)* repressive regulatory processes, and *iv)* availability of lower–cost bank financing.

Poor Credit Standing of Issuing Corporations

The credit standing of corporations in Asia has generally been weakened since the onset of the crisis. The factors responsible are: *i)* lower revenues from depressed domestic and intra–regional aggregate demand; *ii)* high foreign exchange losses on foreign–currency borrowings due to massive currency devaluations, *iii)* magnification of losses due to high pre–crisis financial leverage, *iv)* pro–cyclical effects of high interest rates associated with tight monetary policies, and *v)* non–availability of credit due to a post–crisis "credit crunch" associated with the systemic banking crisis in Asia.

PEFINDO — the rating agency in Indonesia, for example, reports that fewer than one–third of bond issues were above investment–grade rating prior to the financial crisis, while no publicly rated entity had received PEFINDO's highest rating[5, 6]. In Korea, as of June 1997, the interest coverage ratio of the Korean non–financial corporations was 1.36, which means that operating income (or earnings before interest and taxes) was 1.36 times greater than interest expenses. This ratio compares with 3.00 – 5.00 in a sample of the OECD Members. According to International Monetary Fund's rough estimates, a five percentage point increase in interest rates will lower this coverage ratio to around 0.86. Korean interest rates were raised by 5.5 percentage points under the IMF programme from the pre–crisis average of 12.5 per cent to the post–crisis average of 18 per cent, which should be indicative of the financial health of Korean corporations.

Stock exchange–listed companies of Thailand also showed extremely high financial leverage. At the end of 1997, the average debt–to–equity ratio was 450 per cent, which compares with 194 per cent (Japan), 160 per cent (Malaysia), 90 per cent (Taipei, China), and 106 per cent (United States). The probability of bankruptcy estimated for Thai corporations was on average 40 per cent[7, 8]. State–owned enterprises (SOEs) in China are also highly leveraged. The average debt–to–equity ratio of all SOEs climbed to 566 per cent in 1995 from 300 per cent in 1994. Unfortunately, more up–to–date information is unavailable, but given the recent non–performing loan ratios of 25 per cent in 1997 and 22 per cent in 1995 of the PRC's four largest state–owned banks, the debt–equity ratio of SOEs must have deteriorated[9].

Statutory Restrictions and Regulation of the Issuance of Bond Instruments.

Statutory restrictions and financial regulations also account for the limited supply of credit worthy fixed–income securities. In some Asian economies, the company law or commercial code stipulates how much corporate debt can be raised based on a company's net worth. In some economies, the minimum size of new debt issues is also stipulated, which effectively keeps small–size corporate borrowers out of the corporate

bond markets. In capital markets, the financial leverage decision should be that of individual corporate issuers, underwriters, lenders and investors in debt instruments. The leverage ratio should not be a subject of government regulation, although its disclosure in line with accounting standards is regulated. The government, however, should improve the legal framework to define the priority of different types of creditors and quicken the litigation process related to corporate bankruptcies.

Repressive Regulatory Processes

Repressive regulatory processes are yet another reason for discouraging the supply of fixed–income securities. In Malaysia, the Banking and Financial Institutions Act defines the issuance of bonds as a deposit–taking activity and, hence, prohibits the issuance of bonds without prior approval of the central bank. Therefore, all new issues of debt instruments must receive central bank approval and then apply for approval from the Securities Commission (SC), the capital market regulator. This dual process of approval frequently may cause long delays, in turn discouraging local corporations from using bond market financing. Countries in the Asian region need to adopt a more "disclosure–oriented" regulatory approach, as against a "merit–type" approach under which regulators approve or disapprove bond offerings.

Availability of Lower–Cost Bank Financing.

Bank financing has been a dominant form of financing in most countries of the region. Moreover, it was relatively cheap financing as bank management faced few pressures to generate adequate returns for bank shareholders. Bank financing was also generally easier to secure and cheaper than capital market financing due to other market imperfections. As a result, high quality credits, particularly large companies, rely on bank financing, or offshore capital market financing, as was observed in Indonesia, Korea, and Thailand, and there was little demand from corporate borrowers.

Limited Demand for Bonds: Financial Repression and Underdeveloped Processes

The limited demand for fixed–income securities in Asian economies may be attributed, among other, to the captive nature of the primary markets, given controlled or administered interest rates; and the underdeveloped insurance and pension fund institutions, which are the natural repositories of bonds. Although interest rates have been deregulated, financial repression means that a substantial gap typically still exists between the primary market yield and the secondary market yield for government–issued securities. As noted earlier, some Asian governments continue to rely on bank and non–bank financial institutions (especially pension/provident funds) as captive holders of government bonds in the primary markets. Korea presents itself as a good

case in point. Korean government bonds are issued using a "competitive" bidding method that awards the bids in the order of the lowest to the highest yields. However, the highest yields must be lower than the rate set by the Korean government. If the total award is lower than the total planned issue, then the syndicate is obliged to buy the rest at an annual yield which is 0.1 per cent lower than the average yield of successful bids. As the pre–set rate is lower than the market interest rate, the primary market yield fails to reflect the conditions in the credit market[10] .

In the People's Republic of China, placement of government debt obligations with SOE employees, public officials and pensioners is mandatory. In Korea, individuals are also forced to purchase government–issued bonds at low yields. When they register their newly purchased homes and cars, they are obligated to buy national housing bonds and subway bonds. As a result, a bewildering array of more than a dozen government–issued bonds exists as the government allows a number of special accounts and funds to issue bonds for the convenience of compulsory subscriptions. The size of some bond issues is too small to maintain liquidity. The issuance cycle is irregular, but is clustered near the end of the year. Also, maturity and yields are not carefully planned to pave the way for the creation of a benchmark yield curve.

Inadequate Bond Market Infrastructure

Further development and expansion of bond markets in the region will also require substantial improvements in their infrastructure, with special focus on: *i)* a competitive auction system, *ii)* secondary market trading system with capability of disseminating real–time price and volume information, *iii)* clearing and settlement system for bond instruments, *iv)* reinforcing the role of credit rating agencies, and *v)* increasing the supply of hedging instruments for long– and short–term interest rate risk. These elements are all essential for supporting capital market development.

Improving Corporate Governance Practices

A major factor inhibiting the sound development of capital markets in Asia is the poor, or ineffective standards of corporate governance. According to Scott (1999) "high bank–debt–to–equity ratios and low ratios of external to inside equity, suggest corporate governance inadequacies." This factor has been overlooked until recently. Corporate governance weaknesses in Asia spring from a wide range of factors such as: *i)* the excessive influence of the government on corporate decision making, *ii)* the absence of contestable capital markets, characterised by ownership concentration, without adequate (or with ineffective) legal safeguards for the enforcement of shareholder and bondholder rights, and *iii)* poor governance practices in the banking sector, which may have encouraged and condoned corporate indiscipline and inefficiency.

The Role of the Government

Heavy–handed government presence in the capital market should be eliminated. Governments must be limited to policy making and neutral rule making to foster a better system of corporate governance. Government interference in business has manifested itself in three ways. Firstly, it is directly involved in the management of certain businesses. Secondly, it gives directions to private enterprises as to the choice of corporate strategies, as in the case of the Korean *chaebols*. Finally, it directs bank credit to favoured industries or enterprises, with or without explicit or implicit government guarantees.

For example, the Korean Government was instrumental in shaping *chaebols*, a Korean version of conglomerates. The Korean authorities decided to pursue an export–oriented growth policy using large–sized industrial firms. The Korean Government regulated interest rates, controlled credit allocation, and provided easy access to bank financing. Two major problems may be identified as the consequences of the Korean *chaebol* system. The first is that excessive diversification caused over–investing and over–leveraging among corporations under the *chaebols*. Claessens *et al.* (1998*a*) reported that extensive diversification was associated with misallocation of capital investment towards less profitable and more risky business segments. They further found that the misallocation was more pronounced in Korea and Malaysia. A heavy government presence in capital markets is not conducive to the development of good corporate governance practices. The main creditors of *chaebols*, commercial banks and other non–bank financial institutions, were not able to exercise effective discipline and monitoring activities, unlike their counterparts, for example, in Germany. The reason was that Korean financial institutions did not institute an acceptable level of corporate governance. Thus, Webb (1998) argued that ownership concentration represented typically both a symptom and a cause of weak corporate governance in the Asian region.

Governments have been slow to privatise in the region. State ownership of corporations and interference in bank lending has also contributed to the uncertain quality of corporate governance. Privatisation has accelerated since the early 1990s, partly to help develop equity markets. However, it was not always accompanied by enhanced standards of corporate governance. Although a privatised company may be owned partially by dispersed shareholders, in some cases, the majority of shares can still be controlled by the government. The government and government–controlled institutions send directors and management executives to the privatised company. As a result, key directors and management executives of the privatised company are mostly existing and retired government officials. Given their inability to compete due to lack of experience in dealing with the competitive pressures of the marketplace, they have not adequately enhanced the efficiency of the privatised companies.

Prowse (1998) argues that the heavy hand of the government is a guarantee for poor governance and an uncompetitive capital market. Implicit or explicit government credit guarantees should be avoided to prevent moral hazard. Privatisation of

government–owned enterprises and financial institutions needs to be accelerated. To protect the interest of the general public, regulators should require government–controlled institutions to comply with strict standards of transparency, adherence to international accounting standards, adequate disclosure and a requirement of high corporate governance standards, since their funds belong to the general public. The government should be minimalist and transparent.

Contestable Capital Markets

Prowse (1998) suggests that "the major challenge in East Asia's corporate governance is not how outside shareholders can control the actions of the managers, but how outside shareholders can exert control over big insider shareholders. "Contestable capital markets" mean the existence of forces that can effectively counterbalance the entrenched management associated with ownership concentration, in order to maximise shareholder value. Such counterbalancing can come from the existence of effective shareholder rights, the presence of independent directors, simplicity in the merger and acquisition process, an imposition of an express fiduciary responsibility on directors, the mandatory disclosure of conflicts of interest, the ability to sue directors and the adoption of best practises in board conduct.

The absence of such a contestable capital market means that the "insider's risk tolerance will determine the firm's investment policy. The result may be to lead the owner to diversify within the firm, whether economically efficient or not. The public investors cannot in practise use voting power to discipline the controlling shareholder. That opens the door to a higher level of managerial rent–taking. The price at which shares are purchased or trade (if they are listed) will be discounted to reflect their vulnerability, resulting in a higher cost of capital to the firm." (Scott, 1999).

Legal Protection for Investors (Creditors and Shareholders)[11]

Legal and regulatory protection for outside investors (creditors and shareholders) needs to be improved. For example, although creditors' rights are fairly well–defined in a number of Asian economies, strict enforcement is problematic because courts generally do not have the requisite expertise and practical knowledge. Bankruptcy proceedings are protracted, taking at least two years or even longer to complete after initial application (Korea, Thailand, and Indonesia). Some form of basic ownership right must be protected so that the right to claim collateral, and the right to monitor management can be properly exercised (Korea). A rehabilitation framework of troubled companies must be better defined to make operational procedures speedier and more effective (People's Republic of China, Malaysia and Indonesia). In the PRC, foreign creditors are concerned about the lack of transparency in handling the Guangdong International Trust and Investment Corporation's (GITIC's) liquidation process which was initiated in October 1998. For example, they learned that GITIC transferred one of its main assets to another provincial government–owned firm without disclosing the fact to its creditors.

In Thailand, one of the most important obstacles to the restructuring of financially troubled companies is Article 94(2) of the 1940 Bankruptcy Act. Under this Act, a creditor who extends unsecured credit to an insolvent debtor is not allowed to a claim for payment of that debt in a subsequent bankruptcy proceeding. This effectively limits creditors' willingness to provide unsecured financial assistance to debtors that are experiencing temporary liquidity problems[12]. According to an informal tally, the Thai corporate sector has a total debt of $68 billion outstanding and as much as one–third of this amount is considered "strategic" debt, which means that borrowers deliberately refuse to pay, hiding behind legal manoeuvres.

Thailand's Parliament passed a streamlined foreclosure law in early February 1999 but strong opposition was expected in the Senate. Critics call one stipulation in this bill that holds future court–imposed foreclosure rulings final unconstitutional, leaving no legal recourse for debtors to appeal against the rulings. They claim that this bill is biased in favour of creditors. Under the old legislation, foreclosure proceedings could start only when a debt remained unpaid for five years and then it would take two years to process through the courts[13]. This weak legal framework has kept the pace of corporate restructuring slow, and created a new class of solvent debtors who have simply ceased loan payments to save money. Revision and new laws passed in March 1999 in Thailand allow swift execution of foreclosed assets of debtors in default and establish a bankruptcy court to address only bankruptcy and foreclosure laws.

In the absence of effective bankruptcy procedures, debtors are not willing to come to the negotiating table (Indonesia). Although creditors vote on the reorganisation plan, they have almost no voice in its design and have limited access to information (Korea). Controlling inside shareholders often attempt to maximise their wealth through business deals between family–controlled unlisted companies and listed companies, i.e., the sale of unlisted companies in share swaps, sale of properties, favoured sale and purchase of goods and services to/from unlisted companies, and payment guarantees by listed companies for family–owned companies.

In all Asian economies covered by this study, both internal and external monitoring of management decisions is either lacking or weak. Internal monitoring has not been effective because ownership and management are not fully separated. One way to enhance external monitoring is through mergers and acquisitions (M&As). Although the necessary laws and regulations are in place in many countries, M&As have never been popular in Asia.

As many listed companies in Asia are family–controlled, family members hold management positions and board memberships. These families, who are majority owners, disclose as little information as possible, to protect their interests. Moreover, there is no internal and external monitoring of management decisions. To protect outside investors (creditors and shareholders) against major inside shareholders pursuing their own self–interests, the power of inside major shareholders should be reduced, by clearly defining the rights of outside minority investors.

Legal and regulatory protection for outside investors must be strictly enforced. Within a corporation, a number of areas may be improved to achieve this goal: *i)* eliminate cross–shareholding; *ii)* a board of directors should have an adequate number

of outside independent directors, *iii)* minority shareholders' rights and responsibilities must be clearly spelled out, *iv)* compensation and incentives for the directors and managers should be based on performance, *v)* independent auditors and audit committees should be introduced, *vi)* bankruptcy and corporate laws to protect creditor rights have to be revised and reinforced, *vii)* the M&A markets must begin to function, to pressure major inside shareholders and restrictions on foreign participation in domestic M&As should be relaxed, and *viii)* substantial shareholding by outsiders such as institutional investors needs to be encouraged.

Better–Defined and Enhanced Role of Outside Shareholders.

The role of outside shareholders as a guardian of minority shareholders, and as a monitor of corporate decision making is not well defined in Asia and their role–playing was not encouraged. Unlike in the United States and United Kingdom, institutional investors are not dominant forces in Asia. Provident and pension funds invest mostly in government securities and other fixed income instruments. Some mutual funds have emerged since the mid–1990s, but they are more interested, for the time being, in short–term capital gains. Their monitoring role has yet to develop to exert their influence over corporate decision making. The Indian market regulators may consider giving institutional investors voting rights that are currently prohibited at present. Until September 1998, Korean institutional investors such as ITCs were prohibited from exercising their voting rights. They were allowed to do so through shadow voting. Minority shareholders' rights were not protected such that they could not sue directors for violations of fiduciary duty and auditors for negligence. In the region, the legal framework for class action law suits is also either missing or inadequate.

Corporate Governance in the Banking System

Ineffective regulatory and supervisory frameworks and inadequate human resources to conduct proper risk assessments led to excessive lending, resulting in over–capacity in real estate and other over–leveraged corporate sectors. The weaknesses in the pricing of risk and risk management were aggravated by the implicit understanding that the government would support any financial institutions or large corporations in difficulty. These domestic institutional inadequacies in the crisis–affected economies played a major role in the transformation of what started as currency depreciation into a deeper financial crisis. A number of tools can be used for encouraging good governance in banks. Wallich (1999) suggests six measures:

First, in certain countries, governments have established schemes to assist banks to recapitalise either by injecting equity capital or by purchasing bad loans. Any such assistance should be conditional on corporate governance reforms in the affected banks;

Second, institutional investors and international financial institutions should factor in the quality of corporate governance in their decisions to do business with banks. As providers of substantial capital, institutional investors and other lenders can influence

the quality of corporate governance in banks. As a responsible lender to the public sector and as an investor in the private sector, the Asian Development Bank for example puts great weight on this, in making investments in all sectors;

Third, legal regimes must codify the fiduciary responsibilities of bank board members. They should have a fiduciary responsibility to act in the best interest of shareholders and to exercise the duty of care. Bank supervisors should have the authority to require notification of changes in directors and to prevent appointments that are deemed to be detrimental to the interests of depositors;

Fourth, training of board members in the art of board membership needs much greater attention. Thus, greater attention to establishing institutes of directors is necessary;

Fifth, legal regimes must permit the takeover of banks, bankruptcy or official intervention. The threat of losing capital or forfeiting control of their bank should compel most owners to exert good internal governance; and

Finally, rating agencies should also throw the spotlight on the quality of governance as one of the factors in their overall evaluation of the integrity and soundness of banks. It is not adequate to evaluate only the quality of management. The quality of the board should also be critically evaluated.

Reinforcing Regulatory and Supervisory Arrangements

Governments have had a key role in the development of capital markets, as in any other sphere. As such, the slow progress or weaknesses, both on the operational and regulatory fronts, in some countries may be attributed to slow progress on the part of governments in promoting capital markets *vis–à–vis* the banking sector. With the exception of Viet Nam, and to some extent the PRC, where the key regulatory policies governing the capital markets remain to be formulated, all the other countries already have most of the essential ingredients of a regulatory framework in place. However, enforcement problems and rising monitoring costs beset regulatory and supervisory arrangements in this region. Among the most serious of these are: *i)* over–emphasis on merit–based regulatory philosophy and *ii)* under–utilisation of self–regulatory organisations (SROs).

Over–emphasis on Merit–based Regulation[14]

The underlying philosophy of the merit–based regulatory approach is that the market regulator has better information than investors and is in a better position to decide on the merits of transactions for investors. However, the capital market is notorious for the problems of moral hazard and adverse selection caused by information asymmetry, even worse than what borrowers and lenders face in the banking sector (Mishkin, 1996; Wyplosz, 1998). Therefore, regulatory games begin between the

regulator and the regulated. Market participants are always reluctant partners in this regulatory game, disclosing as little as possible. The market regulator tries to collect as much as possible and to obtain assurance of the quality of information from the regulated at the expense of increased monitoring and compliance costs Faced with the responsibility of judging the merits of transactions, the market regulator tends to delay decisions in an effort to gather more quality information, which may cause undue delays, loss of operating efficiency, corruption, and missed opportunities.

Merit review has unfortunate adverse effects on the attitude of market participants. First, they will lose the incentive to improve compliance since they feel they have passed the government requirements. Second, market participants become heavily dependent on the market regulator for the disclosure standards and quality of information, which should be determined by investors or market participants themselves rather than the market regulator. This implies higher a enforcement cost[15].

An alternative to the merit–based approach is the disclosure–based approach which was first introduced in the United States in 1933. Its underlying philosophy is that the market rather than the regulator is better able to decide on the merits of a transaction, provided there is full and continuous disclosure of all information and risks that affect the value or price of a security. Investors must take responsibility for their own investment decisions and they are not protected against making poor judgements. Responsibility for compliance would be left with market participants, especially securities market institutions. The market regulator would not be trapped in a never–ending cat–and–mouse game for additional information for a better merit assessment. The merits of transactions are subject to market discipline as better–informed investors exercise greater vigilance. The US Securities and Equities Commission, for example, does not rule on the quality of a share issue, but reviews initial public offering (IPO) prospectuses and proxy statements unlike some of the Asian market regulators and stock exchanges charged with IPO evaluation.

The success of the disclosure–based system from an investor's point of view is dependent upon factors such as genuine and instantaneous transparency of corporates, the existence of timely and widely available research, the existence of professionally managed transparent mutual funds, effective legal enforcement rights to serve as checks and balances in the capital markets, presence of independent directors and high–quality corporate governance.

Under–utilisation of Self–regulatory Organisations (SROs)

According to Greenspan (1997), no market is truly unregulated, in that the self–interest of participants generates private market regulation. He further suggests that private regulatory forces should gradually displace many cumbersome, increasingly ineffective formal regulatory structures. Although the regulation by SROs and market–based self–regulation are not the same, his suggestion is consistent with a market–based approach towards regulation. Many advanced economies have shifted towards

market–based self–regulation, with the utilisation of SROs as a means of complementing traditional, top–down regulatory regimes. Dickie and Bond (1997) cite New Zealand's banking regulation as a role model of a market–based approach in which banks are encouraged to provide full disclosure of their performance data and credit rating to the public.

This type of disclosure system strengthens the incentives for banks and their managers to identify, monitor, and manage risks and places market pressure on banks to behave prudently. Under the market–based approach, banks supervise and regulate themselves. Hence, the concept of SROs and full disclosure is the cornerstone of this new approach. The underlying philosophy is the same for the market–based banking regulation and the disclosure–based capital market approach. Two of IOSCO's 30 principles of securities market regulation relate to SROs: *i)* The regulatory regime make use of SROs to the extent appropriate to the size and complexity of the market, and *ii)* SROs should be subject to the oversight of the regulator and should observe standard of fairness and confidentiality. However, SROs have not been utilised much in Asia.

Expansion of the Investor Base and Market

Life Insurance, Pension Funds and Contractual Savings

Stimulating market activity on the demand side of the capital markets should be an important goal of governments in promoting capital markets, once a well–functioning legal and regulatory framework and adequate market infrastructure are ensured. Appropriate government policies and incentives should be in place to ensure that a viable and effective institutional investor community exists to promote and deepen capital markets, in particular long–term debt markets.

The life insurance sector and pension systems can contribute in a significant manner to the development of capital markets. At present, the region's economies do not optimally utilise these sources of funds, given the small reach and limited coverage of pension systems. In general, it is imperative that governments provide a facilitating environment to promote the growth of all types of contractual savings institutions, including contributory pension, trust, and mutual funds.

Recent efforts of some of the Asian economies to strengthen their pension systems by enhancing their long–run fiscal sustainability have not succeeded due to many factors, including the current dependence on pay–as–you–go defined benefit (DB) schemes, absence of a sound regulatory and legal framework which would ensure that the savings of workers in any funded defined contribution scheme will be invested to yield adequate returns, and less developed annuities markets. While any reforms to strengthen pension systems would promote capital markets, such reforms in fact have been frustrated in many economies by the government direction of the pension fund assets.

In order to catalyse the contribution that the insurance sector can make to capital–market development, it is essential to review government policies with regard to the portfolio composition of insurance firms. Another limitation is the absence of adequately qualified fund managers in developing countries, which restricts the ability of insurance companies to invest in risky non–government guaranteed securities. Clearly laws that require that the bulk of eligible investments are government securities, do not foster the development of capital markets. In many countries, development of the insurance industry has been blocked by an overly restrictive licensing policy. India a clear example of this has only one life insurance company, owned by the state.

In the People's Republic of China (PRC), the policy issue is one of lack of freedom for insurance firms in investment decisions as well as a restrictive licensing policy. The Philippines has been relatively open in allowing the entry of well–capitalised international life insurance companies. In Malaysia, institutional investors, including insurance companies, have to comply with the same statutory requirements as are applicable to commercial banks, and invest in eligible securities (mostly government and CAGAMAS bonds).

Refinement of Contractual Savings Regulations

A wide variety of pension arrangements can be found across the region's economies, including pay–as–you–go and a mixture of defined benefit and defined contribution schemes. India, Malaysia and Pakistan have had provident fund systems in place for a significant length of time, which have catalysed the growth of capital markets. On the institutional front, pension systems should be reformed in general, to introduce, over time, sizeable funded components. However, a sound legal and regulatory framework is an essential prerequisite to ensure that the accumulated funds can be prudently invested. Governments can also remove distortions in the taxation of pension funds and their contractual savings institutions that invest in the domestic capital markets; where incentives one given, care must be taken that these do not become distortionary themselves.

Promotion of Mutual Funds

Collective investment vehicles such as mutual funds can make a significant contribution to the development of domestic capital markets, by allowing small investors to purchase shares in a relatively low risk and diversified fund. They play an important role by reducing the impediments faced by individuals or retail investors in participating in capital markets. However, in general, it can be stated that in many economies in which bank–dominated financial systems exist, mutual funds have been slow to grow because of: *i)* poor governance and government interference in fund management, *ii)* poor risk management, and *iii)* the perceived threat that they pose to banking sector deposits.

The development of the capital market and the mutual fund industry in India has been distorted by the non–transparent and subsidisation policies of the government. This was manifested in the scare, when it was revealed that for many years the Unit Trust of India (UTI) was subsidising mutual fund investors by redeeming shares of its UNIT 64 scheme at prices substantially above net asset values. The non–transparent approach has been questioned. Similar problems of implicit guarantees to unit holders or mutual fund holders have been experienced in other countries in Asia as well, Korea being a prominent example. Thus, by distorting the risk–reward relationship, these policies have severely undermined not only the development of mutual fund industries but also the capital markets, since mutual funds play a major role. India, which has had a fairly long history with mutual funds, since 1964, needs to provide improved governance, reduce government intervention in UTI, create incentives and institute a level–playing field.

Korea introduced the mutual fund industry in 1998. So far, only closed–end funds have been allowed. Korea's collective investment funds may be grouped into three types: *i)* those managed by currently existing investment trust companies (ITCs); *ii)* those managed by the newly defined investment trust management companies (ITMCs); and *iii)* those managed by securities investment companies known as mutual funds in Korea. In the Philippines, mutual funds have targeted primarily the less well–off sources of capital, as against the high–net–worth individuals who are attracted by the high deposit rates offered under the common trust fund (CTF) schemes run by banks. In Thailand, the regulatory framework is being reinforced to promote transparency, disclosure and investor protection. A strict monitoring and enforcement system is being implemented. For example, mutual fund management companies are required to have compliance officers as an internal check and balance mechanism.

Notes

1. Discussion materials in this section are drawn from Rhee (1998).
2. A useful exposition of various causes of the Asian financial crisis along with relevant references can be found in Radelet and Sachs (1998*a*, 1998*b*) and Boorman (1998).
3. See Asian Development Bank (1998*a*), pp. 19–37.
4. Free cash flow is cash flow in excess of that required to fund all projects with positive net present values.
5. See Harianto (1998).
6. The Capital Market Supervisory Agency (BAPEPAM) points out the ready access to bank financing as one reason why corporations with higher credit rating did not issue debt in the local market.
7. The probability of default is defined as Prob[(Earnings before interest and taxes + Depreciation + Amortisation) < Interest Expenses].
8. See IMF *Fourth Review under the Stand-By Arrangement (Thailand)* (August 1998).
9. According to Lardy (1998), approximately 85 per cent of the total liabilities of SOEs are loans from the banking sector.
10. At present, the pre-set rate reflects the market condition.
11. This section is drawn from a number of IMF reports: *Selected Issues Papers on Malaysia* (May 22, 1998), Thailand (May 27, 1998), and Korea (May 14, 1998). For Indonesia, IMF, *Second Review under the Stand-By Arrangement* (July 1, 1998) is the source.
12. The IMF recommended that Article 94(2) be repealed or modified.
13. "Thai Senate Approves Bankruptcy Bills", *International Herald Tribune,* 31 March,1999
14. Discussions in this section are drawn from Monetary Authority of Singapore (1998).
15. Asymmetric information is not the only source of moral hazard and adverse selection problems. Moral hazard can occur if high enforcement costs are involved (Mishkin, 1996).

Appendix 1. **Bank Loans, Corporate Bonds and Equities in Selected Asian Countries**

(December 1997)

	Outstanding Bank Loans	Outstanding Corporate Bonds	Equity Market Capitalisation
PRC	965.19	n.a.	206.37
	(105.0)		(22.46)
India	80.4	30.98	128.47
	(23.5)	(9.1)	(37.6)
Indonesia	80.82	2.01	29.11
	(60.2)	(1.5)	(21.68)
Korea	118.17	53.16	41.88
	(47.6)	(21.4)	(16.86)
Malaysia	117.27	11.96	93.61
	(165.8)	(16.9)	(132.3)
Pakistan	15.46	0.62	10.97
	(27.2)	(1.1)	(19.3)
Philippines	43.83	7.60	31.36
	(72.3)	(12.5)	(51.73)
Thailand	128.26	3.86	23.54
	(125.5)	(3.8)	(23.04)
Viet Nam	5.6	n.a.	n.a.
	(21.2)		
Total	1 555.0	107.76	565.31
	(79.34)	(9.82)	(29.24)

Notes: Figures in parentheses represent % of GDP.
n.a. denotes "not available".

Sources: ADB (1998*b*).
ADB (1998), Mortgage–Backed Securities Markets in Selected Developing Member Countries (Unpublished).
ADB (1998), Financial Markets in Selected Member Countries (Unpublished).
Member Government Authorities.

Appendix 2. **Outstanding Housing Loans in Selected Countries**

Country	Housing Loans	% of GDP
PRC	22.18[1]	2.41
Korea	31.85	12.83
India	2.74[2]	0.80
Indonesia	3.52[1]	2.62
Malaysia	8.48[2]	11.99
Pakistan	0.60[3]	1.05
Philippines	3.98[4]	6.57
Thailand	16.78	16.43
Viet Nam	n.a.	n.a.

1. As of end–1996.
2. As of March 1997.
3. As of June 1997.
4. The figure is for real estate loans which may be greater than housing loans.

Sources: ADB (1998), "Mortgage–Backed Securities in Selected Developing Member Countries" (Unpublished)
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Corporate Governance and Restructuring in East Asia: An OECD Perspective[1,2]

Richard Frederick, Mats Isaksson and Stilpon Nestor

Introduction and Summary

Corporate governance has gained increased visibility among policy makers during the last few years. Close to 50 codes of best practice have been adopted and a vast number of legislative reforms have been undertaken since 1997. This has been the result of a number of different factors. The increasing globalisation of the capital markets has made it necessary for different systems of corporate decision making and control to become broadly compatible with each other — at least in terms of transparency — in order to be able to attract investors from other countries. Hence, a trend towards global convergence of corporate governance norms can be discerned. In addition to the globalisation of markets, some other factors are also contributing to convergence: a more propitious environment for international co–operation and policy debate after the end of the cold war encouraged by the on–going communications revolution; and a clear convergence of legislative and regulatory trends especially in the commercial law area.

The importance of the overall openness of the economy to competitive pressure in the product and factor markets should not be underestimated. Corporate governance improvements will produce their full benefits only if markets are allowed to function properly and transmit their signals to foreign and domestic investors, customers, competitors, creditors and employees. Monitoring and accountability will not be effective if the information generated by markets is not adequate.

The East Asian financial crisis has played the role of a catalyst in the corporate governance debate in the 1990s, much as corporate governance scandals did in the later part of the 1980s. One of the fundamental causes of the crisis is the lack of effective corporate governance mechanisms. On the one hand, there is weak outside monitoring by stakeholders in firms, capital markets and credit institutions. On the other, there is a concentration of control in small groups of interests that are very

often closely connected to the state and the financial sector. The lack of transparency of these arrangements, combined with the increasing, direct or indirect, corporate exposure to international capital markets created vulnerabilities that led to the crisis.

Corporate East Asia has been plagued by over–investment, excessive conglomeration and over–indebtedness. These conditions have, to a large extent, been the result of poor corporate governance mechanisms. Major shareholder in corporate groups, very often their "founding fathers", sought to retain control and appropriate most of the returns, while diminishing their risk participation. This resulted in unbalanced risk/return conditions and a perverse incentive structure, which encouraged all of the above tendencies.

To be sure, the fault does not lie only within the countries affected by the crisis. Many Western investors were imprudent to provide large amounts of financing, in spite of the opacity of corporate governance arrangements and the precious little information on the activities and levels of liabilities of the companies or banks.

The East Asian experience is a good illustration of how important credible corporate governance practices have become in open market economies. If companies are to benefit fully from the opportunities that follow from access to international capital markets, they need to exhibit a corporate governance framework that — both on paper and in practice — meets the requirements of an increasingly mobile investment community operating under intense competition. The presence of such a framework is essential at all stages of the investment process and corporate life. At a first stage, credible and enforceable provisions for property protection, secure methods of ownership registration and the opportunity to obtain effective legal redress are governance requisites that will facilitate the *mobilisation* of capital. At a second stage, reliable and transparent corporate accounts are essential if investors are to make informed decisions about the *allocation* of financial resources among alternative uses. At the third stage, proper procedures for internal corporate decision making, the distribution of authority among company organs, operational incentive schemes and established lines of accountability are important for executing effective *monitoring* of those immediately responsible for managing the company's assets.

Tackling shortcomings in corporate governance is therefore an important step in the process of regaining investor confidence in the East Asian region, of re–establishing access to global capital markets and thereby improving the private sector's ability to contribute to stable economic growth. Many East Asian countries have made considerable progress during the last two years and the return of investors to East Asian markets can testify to that effect. However, improving corporate governance should be seen as an ongoing structural reform commitment that will produce long–term benefits.

Efforts in this area will benefit greatly from an international exchange of experiences that takes differences in cultural, social and economic circumstances into account. This is also the perspective of the OECD Principles of Corporate Governance, which can serve as a useful benchmark when addressing specific aspect of the East Asian governance structures in more detail (OECD, 1999).

The Role of Corporate Governance in the East Asian Crisis

Allowing for a certain degree of generalisation, the widely acknowledged governance problems in East Asia originated from a growing "mismatch" between corporate governance practices and successively changing conditions in the capital markets. On the one hand, capital markets were liberalised and companies opened themselves up to outside investors, in search of funds to finance growth. On the other, the corporate governance practices essentially maintained their "relational" nature, characterised by insufficient monitoring by lending institutions, a direct or indirect capture of the banking sector by corporate interests, intricate control structures and weak enforcement of property rights protection[3].

The inevitable point of departure for any discussion about the shortcomings of the East Asian corporate governance system must be the functioning of the financial sector. With the notable exceptions of Hong Kong, Singapore and, partly, Chinese Taipei, the lack of developed capital markets in East Asia has typically been compensated by a banking system dominated by interlocking networks of dominant families, government and industrial corporations.

As the financial institutions often served the interests of corporate groups and industrial policy, credit was not allocated on market terms. This was particularly evident in Korea where the government during the drive for the development of the heavy and chemicals industries in the 1970s directed banks and non–banking financial institutions to supply more than 50 per cent of total domestic credit as subsidised policy loans (Nam, Kang and Kim,1999*b*). While most Korean banks were privatised in the early 1980s, state influence over the banking sector has remained substantial until recently (OECD, 1998).

Table 1 shows the total debt/equity ratio for a number of countries. While the absolute degree of leverage varies substantially between the East Asian countries, with Thailand, Korea and Indonesia on top, there is a fairly consistent pattern of increased corporate leverage during the 1990s. This is most marked in Thailand where the debt/equity ratio increased from 71 per cent in 1992 to 155 per cent at the end of 1996. Substantial increases can also be noted for Indonesia and Malaysia. During the same period, the debt/equity ratio decreased in both the United States and France.

To be sure, the optimal degree of leverage is a much–discussed issue in applied corporate finance (see Vanderbilt University Roundtable, 1998). In a well functioning capital market the appropriate level is assumed to be settled according to corporate specific needs and the combined cost of different sources of finance. What is important in the East Asian context, however, is that the increased debt was provided by lending institutions that basically neglected their monitoring responsibilities and who themselves operated under insufficient or lax financial supervision. Given the implicit state guarantees on bank lending and insufficient regulations, banks had little incentive to make prudent assessments of alternative investment opportunities or to scrutinise if corporations actually used the available funds in accordance with commercially rational strategies.

Table 1. **Total Debt/Equity Ratio in Selected Countries, 1992 and 1996 (end year)**

Hong Kong	26	39
Indonesia	59	92
Korea	123	132*
Malaysia	31	62
Philippines	81	69
Singapore	37	58
Chinese Taipei	71	65
Thailand	71	155
Latin America	31	31
France	141	111
Germany	61	58
Japan	136	138
United States	106	90

* 1995.
Source: Pomerleano (1998).

The rush of Thai financial institutions, most of them controlled by the borrowers themselves, to finance real estate development is an example. In sharp contrast to the received wisdom that bank lending has a significant disciplining function on companies, managers and controlling shareholders could, without sanction, use credit to undertake risky investments in projects that would otherwise be intolerable from the creditor's perspective.

The practical consequence of increased leverage coupled with weak oversight by creditors, was that a large and growing portion of the capital that companies had at their disposal for investment became detached from proper price signals and monitoring safeguards. In other words, the actual cost of capital for many companies was far below the true cost of funding, which in turn encouraged heavy corporate reliance on debt in relation to equity. The lack of capital market scrutiny often induced unconstrained investment in fixed assets, which in turn put strain on already scarce managerial resources and limited distribution and marketing channels. As the consequences of this rapid capacity expansion often had a negative effect on cash flows, it created a vicious borrowing cycle. The fact that many companies financed long–term investment with short–term credits made the situation even more precarious.

As companies were confronted with increasing international product market competition and new demands from a globalised capital market, the negative consequences of the lax corporate governance system finally became apparent. It became more and more evident that the system was neither capable of allocating financial resources efficiently, nor monitoring the final use of the capital it provided; i.e. two of the most basic governance functions that the capital market is supposed to carry out. The cumulative effects of these shortcomings made an increasing number of East Asian companies extremely vulnerable to external shocks and finally resulted in an avalanche of insolvency throughout the economy.

Table 2. **Control of Publicly Traded Companies in East Asia**
(Weighted by Market Capitalisation)

Country	Number of corporations	Widely held	Family	State	Widely held financial	Widely held corporation
Hong Kong	330	7.0	71.5	4.8	5.9	10.8
Indonesia	178	6.6	67.3	15.2	2.5	8.4
Japan	1 240	85.5	4.1	7.3	1.5	1.6
Korea	345	51.1	24.6	19.9	0.2	4.3
Malaysia	238	16.2	42.6	34.8	1.1	5.3
Philippines	120	28.5	46.4	3.2	8.4	13.7
Singapore	221	7.6	44.8	40.1	2.7	4.8
Taiwan	141	28.0	45.5	3.3	5.4	17.8
Thailand	167	8.2	51.9	24.1	6.3	9.5

Source: Claessens *et al.* (1998).

A second distinguishing feature of the East Asian corporate governance landscape has been the concentrated and often opaque structures of ownership and control. This is true even for the largest companies. In the Philippines and Indonesia for example, a single family controls almost 20 per cent of the total market capitalisation. Table 2 represents an attempt to classify the control structure in publicly traded companies in East Asia. The most striking feature is probably the high degree of family control in most countries, with a large majority of listed companies in Hong Kong and Indonesia being family controlled.

A second observation is the relatively high percentage of widely held companies in Japan and Korea. However, as firms that are not controlled by families are actually quite rare in Korea (with the exception of state or foreign owned companies) this figure might be due to a rather narrow definition of control. The founding families and their allies usually exercise control over an extensive network of listed and non–listed companies. They are often shielded from risk by directly holding only a limited number of shares. Most of the remaining shares are held by other corporations in the group or other "friendly" agents. Often, a minority is floated on the local exchange. The families that control the Korean *chaebols* own an average of less than 15 per cent in group companies, the rest of the controlling blocks being held by affiliates in a complex web of cross shareholdings. As for Japan, a close network of cross shareholdings provides for a stable core of ownership that lies at the centre of *keiretsu* structures (Kanda, 1998).

A common characteristic of such control systems is that the concept of limited liability, i.e. the separation between the shareholders and the corporation (which has its own decision–making mechanism and assets/liabilities) is weak. In Korea, one of the most important hidden liabilities within *chaebols* is the cross–guarantees of bank loans between *chaebol* affiliates. As regards governance, decisions on the strategy of different affiliates are made by a small group of family–related individuals in an informal way — i.e. outside the governing instances of the corporations (board and

general meetings). Reliance on debt for corporate expansion was also reinforced by the desire of the "founding fathers" of corporate groups to keep close control even after their public floatation.

While large and often controlling shareholders are not necessarily a governance problem, combined with weak minority protection or opaque control structures, large shareholders can act to the detriment of minority shareholders. One prominent example of this is cross–shareholdings used by management or significant shareholders within corporate groups to attain corporate autonomy and diminish the influence of non–controlling investors. Another example is complex corporate group ownership structures that allow an owner to maintain control while providing only a small portion of the actual capital at risk. These complex structures facilitate the generation and appropriation by blockholders of free cash flow within the firm

Opaque control arrangements have generally discouraged broad public ownership and created concerns among investors. Over time, an adverse selection problem emerges both among investors and issuers. The prevalence of "bad" companies in the market and the absence of effective good corporate governance rules penalises any issuer with better corporate governance, as the issuer has to pay a higher cost of capital due to the bad reputation of the market as a whole. The "good issuer" will end up seeking listing elsewhere and thus perpetuate the home market's bad reputation (Black, 1999).

Corporate governance practices in many East Asian countries left minority investors in a state of genuine uncertainty. Their most natural response was to rely on an investment strategy that allowed for easy and rapid exit, rather than active participation in long–term corporate affairs. This experience suggests, that countries with weak corporate governance institutions either have to accept the risk of financial fragility or improve their governance provisions in a way that make them compatible with the expectations of globally mobile investors, be they domestic or foreign.

Another interesting piece of the East Asia puzzle is a large state sector[4]. This can be seen both as a result and a cause of the rise of family–based conglomeration: on the one hand, the state has to be able to counter the concentrated power of these Shumpeterian giants. On the other hand, family–based businesses feel that they have to acquire political weight against such an overwhelming state presence by branching out in as many sectors as possible. There is a premium for sheer size, employment capacity and political voice. Size becomes another element of moral hazard, as governments are sensitive to social problems in case of corporate failures of large groups.

East Asian Corporate Restructuring after the Crisis

The 1997–98 crisis left a large number of East Asian corporations in a very bad condition. Radical restructuring was needed if economies were to rebound in a relatively short period of time. Some of the countries worst hit by the crisis grasped this

opportunity and addressed restructuring head on (albeit not always effectively). Others have been bogged down with broader political problems and have not made much headway. Finally, in other cases where the financial crisis was less acute, governments have avoided dealing with the underlying longer–term problems.

It was recognised at the outset that the heart of the problem was the weakness of the financial sector. Thus, financial sector reform became the priority in the wake of the crisis. In Thailand, 56 financial companies were closed and their assets sold while four large commercial banks were taken over by the government and are now waiting to be privatised; two other banks were sold to foreign investors (Nikomborirak and Tangkitvanchi, 1999). In Korea, the authorities have committed significant budgetary resources to the rehabilitation effort. By mid–1999, expenditure for the purchase of impaired assets, re–capitalisation of financial institutions and reimbursement of depositors amounted to some 41 trillion won (about 15 per cent of GDP). The state took over two of the largest banks which are now being sold to foreign investors, pushed a number of weaker banks to merge and closed down half (16) of the merchant banks. In both countries, radical measures were taken to tighten financial supervision. In Indonesia the banking sector was devastated. The state ultimately acquired 55 banks and is still struggling with the consequences.

But tightening the financial screws was not enough. Most countries faced an urgent need to address over–capacity. Mergers and acquisitions activity was facilitated and, most importantly, access to foreign investors became easier. In Korea, domestic mergers and acquisition activity increased by more than 17 per cent in 1998. Foreign acquisitions increased by more than six times in both Korea and Thailand. Both of these countries significantly changed their legislative framework for foreign investment in 1998. Singapore is also envisaging a more open foreign direct investment regime in some of its protected sectors.

Exit mechanisms were deficient in most East Asian economies. This lowered the flexibility of the system and considerably complicated the ability of corporations to deal with over–capacity. From another perspective, it impaired the access of creditors to insolvent company assets and thus lowered the creditworthiness of companies. In most cases, corporate failure in the wake of the crisis had a systemic aspect. Hence Korea, Indonesia and Thailand adopted informal, out–of–court work–out frameworks that enabled technically solvent companies that nevertheless faced liquidity problems to restructure rapidly. While these agreements seem to have worked in some cases, their uncertain legal nature has caused problems; in Indonesia a confused judiciary reversed some of the major work–out agreements.

While work–out agreements might address some of the fire–fighting, anti–crisis concerns, a more efficient general insolvency framework has become a priority for restoring the longer–term financial discipline and creditworthiness of East Asian economies. Both Korea and Thailand have embarked on insolvency reforms. In the former, the fruits of the first wave of reforms in late 1997 were evident by the end of

1998, with the number of insolvency procedures closed by the courts jumping almost threefold. Thailand introduced a new law in 1998 and, most importantly, a new commercial court to implement it. Indonesia also adopted a new law whose implementation still seems to be bogged down with implementation problems.

The role of the state has been very important in shaping corporate practices in East Asia before the crisis. It is therefore normal that government has driven much of the restructuring effort since then. In Korea the government imposed specific targets for lowering the debt equity ratios of the top five *chaebols*, and had them agree on a series of asset swaps and specialisation agreements, the so–called "big deals". From an expediency perspective, such heavy–handedness by the government might create an impetus for reform and downsizing, but it perpetuates a paradigm of industrial policy over market mechanisms and might produce further distortions down the road.

Corporate Governance in East Asia and the OECD Principles

In May 1999 the OECD Council reviewed and endorsed the OECD Principles of Corporate Governance. The Principles are intended to serve as a benchmark for evaluating corporate governance and assist governments in their efforts to improve the legal, institutional and regulatory frameworks in their countries. They can also provide useful guidance for stock exchanges, investors, companies and other parties that play a role in governance and can be used as a benchmark against which to evaluate and gauge corporate governance progress in Asia.

The Principles were developed both in response to the growing recognition of the importance of governance to enterprise performance and to the recent financial crisis in Asia. They express a particular concern for the relation between corporate governance and increasing international investment. Adherence to good governance practices should also improve the confidence of domestic investors, reduce the cost of capital, and ultimately induce more stable sources of financing.

The Principles contain basic concepts that OECD Member countries consider essential for good governance. Detailed recommendations on legislation, regulation and codes of best practices need to be established at the national level and reflect local conditions. The Principles can be viewed as providing a framework for a more detailed elaboration of such national practice, an agenda for reform.

The Principles are organised under five headings, each of which is considered a fundamental contributor to good governance. They deal with: *i)* the rights of shareholders, *ii)* the equitable treatment of shareholders, *iii)* the role of stakeholders, *iv)* disclosure and transparency, and *v)* the responsibilities of the board. Alone, none of these individual elements can ensure good corporate governance. Taken together, however, and with proper enforcement, they should help to create a strong governance regime.

The Rights of Shareholders

The first chapter of the OECD Principles concerns the protection of shareholders' rights and the ability of shareholders to influence the behaviour of corporations. The Principles list some basic rights including those to: obtain relevant information, share in residual profits, participate in basic decisions, fair and transparent treatment during changes of control, and fair use of voting rights.

Many Asian countries have rights that compare favourably or exceed those of OECD countries. Hong Kong and Singapore have capital markets with sophisticated shareholder rights. Indonesia, Korea, Malaysia, Philippines and Thailand all have mandatory shareholder approval of major transactions and significant related–party transactions. In each of these countries shareholders have the right to call emergency shareholder meetings. Korea and Malaysia both require one–share, one–vote rules for their public companies — typically considered best practice by institutional investors.

However, extensive rights are not equivalent to good governance. In practice, the ability of shareholders to influence companies in Asia may be quite limited. Ownership structures in East Asia often allow for levels of control out of proportion to ownership. In some countries pyramid structures and cross shareholdings by affiliated firms enable the largest shareholders to exercise disproportionate control, sometimes at the expense of outside shareholders. Even where controlling shareholders do not directly hold a majority of shares, their representatives may effectively retain control through linkages to senior executives or the board of directors.

Effective control and direction of an enterprise is, of course, desirable and the Principles show no preference regarding what ownership structures might best serve to achieve this goal. Ownership and control structures should, however, under all circumstances be transparent. Control structures, in particular where controlling or other shareholders exercise a degree of control out of proportion to their equity ownership, should be disclosed so that investors can properly assess how the enterprise is directed. In this respect, recent efforts to introduce transparent holding companies in Korea could help. They might make the current opaque ownership structure of Korean groups more transparent to outside investors and encourage an arm's length relationship in companies where there is no preponderant ownership control.

The Principles also recognise the role of outside capital providers in external monitoring. In this respect, voting by financial institutions has been restricted in Asia. Until recently institutional investors were barred from using their voting rights as they deemed proper in Korea, in compliance with the so–called "shadow voting" rules. These regulations and practices prevent investors from exercising basic ownership rights and deny them the opportunity to engage in governance. Other limitations might take more subtle forms. A practice of holding annual general meeting of shareholders of major corporations on the same day is a good example of practices that need to be addressed.

The Principles recommend that markets for corporate control should be allowed to function in an efficient and transparent manner. Regulations for takeovers generally aim at ensuring equal treatment of shareholders. Takeovers via the stock market do not appear to be common in Asia and contested takeovers are even less prevalent. To date, there has not been sufficient experience to determine how effective these regulations might be. Markets for ownership have become possible with the easing of previously restrictive anti–takeover rules.

The Equitable Treatment of Shareholders

The second chapter of the Principles emphasises that all shareholders, including foreign shareholders, should be treated equitably by controlling shareholders, boards and management. Insider trading and abusive self–dealing should be prohibited. The Principles call for transparency with respect to distribution of voting rights and the ways voting rights are exercised. Finally, the Principles call for disclosure of any material interests that managers and directors have in transactions or matters affecting the corporation.

In Asian countries controlling shareholders have commonly undertaken transactions that are to the clear detriment of minority shareholders. Cases of abusive self–dealing, where resources of the companies are used to benefit controlling shareholders, were widespread. Groups have often engaged in extensive cross subsidisation, to the detriment of minority shareholders in individual companies. There are, however, differences within the region. High levels of self–dealing occurred in Korea, Thailand and Indonesia but not in Hong Kong (Nam, Kang *et al.,*1999). Not all related–party transactions are by definition to the detriment of the company and its shareholders. The problem may be in subjecting such transactions to appropriate scrutiny and identifying what is "abusive".

While regulation should protect investors from expropriation, such transactions will inevitably occur. For this reason, the Principles call for providing shareholders with the opportunity to obtain effective redress for violation of their rights. In some of the Asian countries, the ability to obtain effective redress appears to be limited by law and in practice. In Korea, for example, the effectiveness of redress was weak with few cases being brought for the breach of minority shareholder rights. However, changes in the legal framework in 1998 have considerably improved the possibility of redress. Two well–publicised derivative suits resulted in the award of several billion Won of damages to shareholders by directors. Class action suits are, however, still not possible.

The Role of Stakeholders

The third chapter of the OECD Principles deals with the role of stakeholders in governance. The stakeholder chapter asserts that the competitiveness of a company is the result of contributions by a range of different resource providers. It encourages

active co–operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises. In addition, the Principles encourage performance–enhancing mechanisms for stakeholder participation in governance. Where stakeholders have governance rights, they should have access to adequate information in order to participate in the governance process. Stakeholders, like shareholders, should have the opportunity to obtain redress. The OECD Principles do not list nor propose specific stakeholder rights. They support the protection of rights where they exist.

The role of stakeholders in the governance of Asian companies has not figured prominently in the discussion of governance failures. Nevertheless, unemployment, the negative results frequently associated with the restructuring of enterprises, environmental impact and risks, etc., are key concerns. It is likely that proper consideration of stakeholder concerns at board levels will yield more balanced decision making and will ultimately improve company performance. Restructuring efforts might meet with more success if employees are consulted regularly and, where appropriate, are given a direct stake in the process.

On the other hand, management can blame poor financial performance on its stakeholder policies and shield itself from accountability to shareholders. This is a particular concern in the Asian context where accountability to shareholders, and transparency in decision making have been low. It is important that stakeholders not be used as an argument to shield management from accountability.

Disclosure and Transparency[5]

The fourth chapter of the Principles calls for timely and accurate disclosure on all material matters regarding the corporation. High quality standards of accounting, disclosure and audit should be followed and there is support for the development of internationally recognised accounting standards. An annual independent audit is required. The rules by which the company is governed should be intelligible and the business of the company should be conducted in an open way. Finally, practical issues of access to information are addressed.

A strong disclosure regime is indispensable for the effective governance of enterprises. It is generally accepted that good disclosure can be a powerful tool for influencing companies and for protecting investors. An improvement in disclosure would also improve the environment for domestic and foreign investment, and provide greater credibility and confidence in the capital markets. Ultimately a strong disclosure regime should help companies by lowering their cost of capital.

Good disclosure is of particular importance in the Asian context where companies have been operating in a weak reporting and regulatory framework. During the financial crisis investors panicked as a result of unexpected or unquantifiable bad news. While disclosure was not responsible for triggering the crisis, markets and regulators did not receive the early warning that would have signalled the deteriorating financial condition

of banks and companies. Better information should have allowed companies and policy makers to recognise underlying problems and react accordingly. Without proper warning, poor disclosure contributed to the depth and breadth of the crisis.

Accounting standards are a central concern. Accounting disclosures of most banks and corporations in the region do not comply with international accounting standards. In addition, there was considerable latitude given to management in interpreting accounting standards. Deficiencies in reporting were recognised by investors who contributed large amounts of foreign capital despite the absence of reliable information.

Some of the fundamental accounting problems were: the hiding of large enterprise debts by related–party transactions and off–balance sheet financing, such as cross–guarantees within corporate groups; high levels of foreign exchange risk disguised as short–term borrowing in foreign currency; the absence of segment information that would have revealed the risks related to specific sectors such as real estate; the absence of reporting of contingent liabilities, particularly loan guarantees taken by related or unrelated parties, and; inappropriate loan–loss provisions by banks. The introduction of consolidated accounts for corporate groups in Korea is an important step to improve transparency. Other Asian countries are further behind in this respect.

Particular attention needs to be paid to the role of the auditor. Regardless of the standards that are applied in compiling information, the reliability of information depends on the independent audit. When auditors give an opinion on financial statements, they provide investors with a level of comfort regarding the quality of the audit and the reliability of information. Local members of the five largest audit firms were involved in auditing most of the large corporations and banks in Asia. Auditors in Asia — even when they were international accounting firms — followed local auditing standards and practices. Many Asian firms that received unqualified audit opinions from their auditors were not going concerns within a few months of the completion of their audit. Had auditors adhered to international practices and standards of audit, financial reports would have revealed the precarious situation of many of the companies and banks that later collapsed.

Most Asian countries have professional and quasi–governmental bodies that review accounting and audit standard setting. Disclosure rules themselves are typically set by a combination of securities and exchange commissions and stock exchanges. In many cases countries appear to apply some form of international accounting standards. Malaysia had officially adopted IAS before the crisis. Other countries prepared their national standards in line with international standards. Policy makers have recognised the importance of disclosure in developing credible capital markets and are taking steps to improve it. However, the degree of compliance needs to be improved since there are significant discrepancies between regulation, standards and actual practice. Even if countries comply with IAS, without monitoring, standards may not be implemented by enterprises.

The Responsibilities of the Board

The final chapter of the Principles calls for a corporate governance framework that ensures the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. Accordingly, board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interests of the company and shareholders. They should also take into account the interests of other stakeholders. Other responsibilities of board members are listed including: reviewing strategy and planning; managing potential conflicts of interest, and; assuring the integrity of the company's accounting, reporting and communications. The Board should be able to exercise objective judgement, independent of management. The OECD Principles state that any majority–controlled company could benefit from independent directors. It is expected that inclusion of directors that are independent from both management and controlling shareholders would provide higher levels of assurance to minority investors that their interests are protected.

While the need for independence in broadly held companies is widely understood, the issue of independence in listed companies controlled by a major shareholder is more complex. Asian economies tend to have greater concentrations of ownership in companies. The so–called "agency" problem between managers and shareholders may, consequently, be less acute. In contrast, problems arise when the majority has the potential to take advantage of minority shareholders. While a board structure is mandated for every company in all corporate laws of the region, boards were often a formality. In Korea, the "Chairman's Office", an unofficial team of executives headed by the "founding father" was the institution responsible for taking decisions for the group, irrespective of the existence of minority shareholders in individual listed companies.

The appointment of independent directors in listed companies is now mandatory in Hong Kong, Korea and Thailand. While this is an important first step in changing the role of the board of directors, the independence and the effective function of the board is, of course, a much more complex issue that implies changes to profoundly embedded business culture and traditions. Concerns remain regarding whether directors are truly independent. There are also doubts concerning the director nomination process itself. Finally, the use of cumulative voting for the election of directors might be a useful tool for increasing the influence of minority shareholders in the election of the board.

Board members will likely require time to assimilate the new responsibilities that are required of them in the changed business environment. In this respect it is important to intensify efforts to train directors and to make their duties and responsibilities clear in the law and corporate practice. Most importantly, the corporate sector needs to be convinced that independent boards enhance the value of the corporation and make it more attractive to investors.

Conclusions

Changes in the Asian corporate governance landscape have been slower to emerge than changes in the financial sector. This is not surprising: while corporate governance failures where one of the root causes of the crisis, reform in this area cannot be used as an anti–crisis remedy. Reforms are more about creating a longer–term legislative, institutional environment that will promote a shift in the behaviour of corporations from over–investment and relentless expansion to producing more shareholder value. While the results of corporate governance reforms should not be expected to emerge overnight, their consistent pursuit should be a high priority of policy makers and regulators.

Corporate governance changes are part of a broader set of changes that aim at making economic agents more transparent and institutions more accountable. Improving governance in corporations can only go hand in hand with the fight against corruption and cronyism in the state apparatus. It is part and parcel of a process of decentralisation of economic decision making and of the effort to increase competition.

The adoption of corporate governance rules in itself might not be enough for substantially improving the performance of the corporations in the region. There is a great need to improve the infrastructure which ensures an effective implementation of these rules. There are several areas that need to be addressed: improved capacity for the judiciary and for regulatory authorities in the capital markets, the emergence of a set of intermediary market institutions that will keep shareholders informed and assist them in the exercise of their control rights, and the continuing education of corporate directors who can be expected to lead the behavioural change at the corporate level. Without these reforms may never become effective.

While there is no single model of corporate governance that will fit all companies through all stages of development there is a clear need for a common language between international investors and corporations. The OECD undertook a first multilateral attempt at a global “grammar” of corporate governance in 1998. The OECD Principles of Corporate governance have put together a number of core elements that might help countries, companies and investors get closer in their respective understanding of what is needed for the effective linkage between globally available financial resources and domestic corporate needs. The wide variety of experiences among OECD countries underlies the universal applicability of these Principles and is at the same time a testament to their respect of national diversity.

Notes

1. This paper was prepared by Richard Frederick, Mats Isaksson and Stilpon Nestor at the Corporate Affairs Unit, OECD. The term East Asia is used in a generic, geographical sense and does not distinguish between OECD Member and non-member states.

2. This paper benefits from contributions presented at a 1999 senior experts meeting on "Corporate Governance in Asia" organised by the OECD, particularly Nam, Kang and Kim (1999*a* and *b*) and Nestor and Thompson (1999).

3. Although many East Asian countries exhibit satisfactory formal corporate governance regulations, a deeper inquiry concerning the effectiveness and practical application of these provisions reveals a mixed picture. Important factors that may impact compliance include the effectiveness of remedial measures available to minority shareholders, the efficiency and presence of enforcement mechanisms and the use of effective sanctions in case of violation. For an overview of some key corporate governance provisions in selected countries, see Appendix 1.

4. In Singapore, Malaysia and Korea, governments control 40, 35 and 20 per cent respectively of total market capitalisation.

5. This section draws extensively on the article "The Role of Accounting Disclosure in the East Asian Financial Crisis: Lessons Learned", prepared by Zubaidur Rahman for the United Nations Conference on Trade and Development.

Appendix 1. **Selected Corporate Governance Provisions in East Asia and Other Emerging Economies**

Variables	Description/Effect	Korea	Indonesia	Malaysia	Philippines	Thailand	Mexico	India
Right to call emergency shareholder meeting(per cent shareholder meetings)	Facilitates shareholders control	yes 3	yes 10	yes 10	yes 10	yes 20	yes 33	yes 10
Right to make proposals at shareholder meeting	Facilitates shareholders control; increased opportunity to prevent biased decisions by insiders	yes	yes	yes		yes	n.a.	n.a.
Mandatory shareholder approval of interested transactions	Protects against abuse and squandering of company assets by insiders	yes	yes	yes	yes	yes	n.a.	n.a.
Pre–emptive rights on new stock issues	Protects against dilution of minority shareholders; prevents insiders altering ownership structure	yes	yes		yes	yes	n.a.	n.a.
Proxy voting	Facilitates shareholders control	yes	no	yes	yes	yes	no	yes
Penalties for insider trading	Protects against use of undisclosed information at the expense of current and potential shareholders	yes	yes	yes	yes	yes		
Provisions on takeovers legislation	Protects against violation of minority shareholders' rights	yes		yes	yes	yes		
Mandatory disclosure of non–financial information	Both financial and non–financial information data are important to assess a company's prospects	yes	yes	yes		yes		
Mandatory disclosure of connected interests	To protect against abuse by insiders	yes			yes	yes		
Mandatory shareholder approval of major transactions	Protects against abuse by insiders. Protection can be enhanced through supra–majority voting	yes	yes	yes	yes	yes	yes	
One share–one vote	Basic right; some shareholders may waive their voting rights for other benefits such as higher dividends	yes	no	yes	no	no	yes	no
Allow proxy by mail	Facilitates shareholders control	yes	no	no	no	no	no	no

Source: World Bank, *The Road to Recovery: East Asia after the Crisis,* Washington, D.C., 1998.

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Fifth International Forum on Asian Perspectives

PROGRAMME

Co–chairs of the Forum	Tadao Chino, President, Asian Development Bank
	Ulrich Hiemenz, Director, OECD Development Centre
Co–chairs of the Seminar	Jungsoo Lee, Chief Economist, Asian Development Bank
	Ulrich Hiemenz, Director, OECD Development Centre

Experts' Seminar

Monday, 28th June 1999

Session I: Policies for Crisis Prevention

Presentation:	*Policies for Crisis Prevention*
Helmut Reisen	Head of Research Division, OECD Development Centre
Discussant:	Yung Chul Park, Professor, Economics Department, Korea University, and Chairman, Korean Exchange Bank

Session II: Banking Sector Reforms

Presentation:	*Banking Sector Reforms, Recovery Prospects and Policy Issues*
Ramesh Adhikari	Senior Economist
Soo–Nam Oh	Economist, Asian Development Bank
Discussant:	Éric Girardin, Professor, CEDERS – Université de la Méditerranée, Aix–en–Provence, France

Session III: Capital Market Development

Presentation:	*Post–Crisis Issues in Asian Capital Markets*
Christine Wallich	Director, Infrastructure, Energy and Financial Sectors Department–West, and Head, Private Sector Group, Asian Development Bank
	Co–authors: Arvind Mathur, Senior Investment Officer, Private Sector Group and S. Ghon Rhee, Research Scholar, Economics & Development Research Centre, Asian Development Bank
Discussant:	John Hawkins, Senior Economist, Emerging Markets Department, Bank for International Settlements, Basel

Session IV: Corporate Governance and Restructuring

Presentation: Corporate Governance and Restructuring in East–Asia: An OECD Perspective

Stilpon Nestor	Head of the Corporate Affairs Unit, Directorate for Financial, Fiscal and Enterprise Affairs, OECD
Co–authors:	Richard Frederick, and Mats Isaksson of the Corporate Affairs Unit, Directorate for Financial, Fiscal and Enterprise Affairs, OECD
Discussant:	Christine Wallich, Director, Infrastructure West and Private Sector Group, Asian Development Bank

Conclusion

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Ulrich Hiemenz	Director, OECD Development Centre

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Public Conference

Tuesday, 29th June 1999

Inauguration — Philippe de Fontaine Vive, Deputy Assistant Secretary for Debt, Development and Emerging Markets, Direction of the Treasury, Ministry of Economy, Finance and Industry, France

Ulrich Hiemenz, Director, OECD Development Centre

Keynote Address — Tadao Chino, President, Asian Development Bank

Session I: Panel Followed by Open Discussion

Chair: Ulrich Hiemenz — Yung Chul Park, Professor, Economics Department, Korea University, and Chairman, Korean Exchange Bank

Andrew Crockett, General Manager, Bank for International Settlements, and Chairman of the Financial Stability Forum

Farid Harianto, Deputy Chairman for Bank Restructuring, Indonesian Bank Restructuring Agency (IBRA)

Mats Karlsson, Secretary of State for Development, Ministry of Foreign Affairs, Sweden

Session II: Panel Followed by Open Discussion

Chair: Jungsoo Lee

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Jean–Jacques Rey, Executive Director, National Bank of Belgium

Philippe de Fontaine Vive, Deputy Assistant Secretary for Debt, Development and Emerging Markets, Direction of the Treasury, Ministry of Economy, Finance and Industry, France

Roberto De Ocampo, Former Finance Secretary, Government of the Philippines

Joanna Shelton, Deputy Secretary–General, OECD

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