

What has been the impact of the Asian financial crisis on the Asia-Europe relationship? Is there a similar approach among Europeans, who are building a strong regional community yet are attached to global cooperation, and Asians, who have first reached across the Pacific but are now inclined to cooperate within Asia itself? A CAEC Task Force has looked at the road from the financial crisis in Asia and at the stakes of a more active European partnership. This report recommends the adoption of monetary cooperation tools in Asia and stresses that Europeans are looking forward to the emergence of another regional pole in Asia structured around economic growth.

La crise financière asiatique a-t-elle eu un impact sur les relations entre l'Europe et l'Asie ? Existe-t-il une parenté d'approche entre les Européens, forts de leur expérience communautaire mais attachés à la coopération globale, et les Asiatiques, qui ont d'abord tourné leur essor économique vers les États-Unis mais coopèrent de plus en plus entre eux ? Le groupe de travail du CAEC examine le chemin de sortie de la crise asiatique et les enjeux pour l'Asie d'un partenaire européen plus actif. Ce rapport recommande l'adoption de mesures de coopération monétaire en Asie et souligne l'intérêt européen pour l'apparition d'un pôle régional asiatique structuré autour de la croissance économique.



# les cahiers de l'ifri

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## Asia-Europe Cooperation: Beyond the Financial Crisis

La coopération Europe-Asie  
au-delà de la crise financière

Report of the Council for Asia-Europe  
Cooperation (CAEC)

Rapport du Conseil pour la Coopération  
Europe-Asie (CAEC)



institut français  
des relations  
internationales

**ASIA-EUROPE COOPERATION:  
BEYOND THE FINANCIAL CRISIS**

LA COOPÉRATION EUROPE-ASIE  
AU-DELÀ DE LA CRISE FINANCIÈRE

In response to the call for greater Asia-Europe intellectual exchange and cooperation that was made at the first ASEM summit in March 1996, twelve leading research institutes from both regions agreed to form the **Council for Asia-Europe Cooperation (CAEC)**. Launched in May 1996, the CAEC represents the culmination of a long-standing process of cooperation between Asian and European research institutes. The main purpose of the CAEC is to encourage and facilitate greater cooperation among Asian and European intellectuals and policy specialists in order to enhance discussions about the future direction of Asia-Europe relations. It is managed by an executive committee composed of representatives from the twelve major research institutes in Asia and Europe. The Asian secretariat of the CAEC is the Japan Center for International Exchange (JCIE) located in Tokyo and the European secretariat is the International Institute for Strategic Studies (IISS) located in London.

The **Institut français des relations internationales (Ifri)** is a research centre and a forum for debate on the major international political and economic issues. Headed by Thierry de Montbrial since its founding in 1979, Ifri is a non-profit organization.

The **Institute of Southeast Asian Studies (ISEAS)** was established as an autonomous organization in 1968. It is a regional research centre for scholars and other specialists concerned with modern Southeast Asia, particularly the many-faceted problems of stability and security, economic development, and political and social change.

The Institute's research programmes are the Regional Economic Studies (RES, including ASEAN and APEC), Regional Strategic and Political Studies (RSPS), and the Regional Social and Cultural Studies (RSCS).

The Institute is governed by a twenty-two-member Board of Trustees comprising nominees from the Singapore Government, the National University of Singapore, the various Chambers of Commerce, and professional and civic organizations. A ten-man Executive Committee oversees day-to-day operations; it is chaired by the Director, the Institute's chief academic and administrative officer.

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Task Force co-organized by  
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and the Institute of Southeast Asian Studies (Singapore)  
with the support of the Japan Center for International Exchange  
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# Task Force Overview Report

*François Godement*<sup>1</sup>

Euro-Asian economic and trade relationships have grown immensely in intensity and diversity over the past 15 years. The European Union's trade with Asia is now equivalent to the United States'; direct investment, although starting from a much lower threshold, is on the rise; financial relations have also deepened, in sometimes unpredictable ways that have been highlighted by the large share of European loans to East Asia at the onset of the 1997 financial crisis.

Along with these trends, a sense of balance and mutually advantageous relationships had appeared in the mid-1990s: trade balances were more and more evenly balanced, yet hugely dynamic, with imports from the newly prosperous Asian economies catching up on their exports to European consumer markets. There had been mutual misgivings expressed in the previous years – notably, the fear of a self-centered, potentially protectionist Europe on the Asian side, while Europeans sought to counter unfair trade competition and the neglect of social rights. The ASEM process of multi-level cooperation between the two regions was founded precisely on the need to dissipate these tensions by dealing with them in a voluntary, mutually equal approach, and by emphasizing areas of agreement and of possible common action.

The financial crisis of 1997 and its consequences are of course a test and a challenge to these perspectives. Certainly, events would show that the crisis was not unique or even peculiar to Asia, nor could it be confined solely to other emerging economies: in the years since 1997, imbalances in the global financial markets and funda-

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mental problems of financial architecture have come to light, requiring common work among all of the world's financially developed economies. In the short term, the global reduction in major interest rates that has been initiated in August 1998 was the deciding factor which eased the financial crisis for all emerging economies, but in particular for indebted Asian countries.

The crisis, the debates it has spawned, and the course of action undertaken by the international community and by individual countries have extraordinarily widened the scope for international financial and monetary cooperation, however.

Issues of currency linkage exchange values and currency regimes – between the dollar and the yen, between the Chinese *yuan* and the dollar, between the euro and the dollar, among Asian currencies themselves – and the respective role of regulation and markets in currency management have become immediately relevant to the economic well-being of Asia, and indirectly Europe.

Banking regulation and loan control, financial market oversight are now areas of critical importance both for creditor and debtor countries, far beyond the immediate dilemma of sharing the burden for rescheduling or canceling debts.

The role of financial international organizations –rating agencies, regional development agencies, banks and the International Monetary Fund itself – has been unavoidably called in question, as the urgency of the crisis tested previous intervention practices: never before had there been an internationally concerted financial intervention on the scale that has happened both within and towards East Asia in 1997-1999. Finally, as the exit from the crisis appears in sight, the questions pertaining to structural changes in financial ownership and management come to the fore: increased transparency of private and public financial institutions, issues of ownership transfer of firms in difficulty, resource allocation models that impact on macro-economic policies, the future of managed growth and perhaps the growth rates themselves are now paramount.

Our task force has therefore focused the written contributions of its participants, and the debates arising from their presentations, on a limited number of themes that

involve both a retrospective judgment on the financial crisis, changes that need to be put in place after this crisis, and areas of shared perceptions and possible joint action among Europeans and Asians. Changes arising from the recent introduction of the euro have also been considered, particularly as they might influence monetary cooperation with Asia or even within Asia itself.

The conclusions arising from the work of the task force therefore relate both to a diagnosis of Asia's current recovery in midstream, a prognosis of policy and structural changes undertaken by Asian firms and governments, and a discussion of issues for regional and Asia-Europe cooperation. In the short time that was available, members of the task force never attempted to reach unanimity or to formulate specific policy recommendations. The first was deemed to be an artificial goal at this point, lessons from the crisis being still widely discussed among experts. Concrete policy recommendations would need a much longer term mandate for common work, although individual ideas were shared and do come up in this report. Most importantly, there is definitely a convergence that appears in many of the contributions to the task force discussion.

## **A Diagnosis: Asia's Current Recovery in Midstream**

The region is now undergoing an economic rebound following the triple deflation (the reversal of international capital flows leading to a drop in the value of currencies and assets) in 1997-1998. This rebound cannot be explained by a single and coherent economic policy that would be pursued by economic actors. It has to do first with macroeconomic factors such as trends in global interest rates, global demand and the stabilization of the region's currencies, and a variety of actions that was likened by one participant to a process of "muddling through". This also reflects Asian pragmatism in front of theories and advice, an attitude that would never satisfy "purists" but has nonetheless achieved results. The large financial contribution by the IMF, other international agencies and the Miyazawa initiative, budgetary stimulation undertaken by most governments in the region, the conversion of much private debts into publicly held debt after restructuring, or into equity as a result of the acquisition of ailing firms, in some cases capital controls that were already in

place (China) or have been temporarily reinstated (Malaysia), are all factors in the current Asian recovery, halting the catastrophic asset crunch and starting a process of asset reflation. Further progress should now be achieved by increases in private demand and private investment, both from within and without the region.

This, however, raises the issue of trust in the solidity of the recovery, and therefore of the changes introduced in Asian economies since the crisis began. To many, the crisis may well have been a blessing in disguise, since it brought to the fore a need for strong and pervasive reform. Task force members caution, however, that the hangover from the crisis is still very large, putting a brake on any expectation of a quick and painless recovery, such as the so-called V curve that some have predicted for Asia after the crisis. The present recovery is extremely dependent on continued fast growth in the U.S., on a buoyant Wall Street, and on the high value of the yen as well, which favors other Asian economies.

Negative facts include the overcapacity of Asian industries and the need for restructuring existing plant; the limited value of increased budgetary spending, since in many cases the planned public deficits are keyed to recapitalization of indebted firms rather than to increased investment or expenditures. The most vulnerable part of the Asian economic recovery has to do with the extent of private and public debt, often underestimated by published figures. Non-performing loans are still at very high levels (50 % for Thailand, 70 % for Indonesia) and short term loans, even after rescheduling, are also important, except in Korea where they have been cut to a level under 10 % of private debts. Particularly worrying are the low or negative capital ratios of banks in several Asian economies, with state banks often topping the list. The bail-out from Asian governments has also reversed the course of several economies, leading to actual nationalization of financial institutions or even the economy as a whole. Thus, the large quantities of capital that have been expanded by international organizations and governments themselves do not necessarily translate into renewed private investment or a boost to private demand. "Postponing the inevitable", "transferring wealth from taxpayers to shareholders" are examples of behavior cited by task force participants which explain the lack of enthusiasm among individual Asian consumers and investors. In many cases, it would be preferable for public action to foreclose existing firms which have failed

to live up to their financial commitments in order to encourage the growth of new actors in a more transparent and responsible environment.

Other task force participants contrast the superior performance of the goods and services sectors of the Asian economies over the years with the issue of excessive asset inflation: after a phase of catching-up for asset prices in the 1980s, the extremely high level of asset prices now threaten trade competitiveness in other sectors and discourage foreign investment. How to calibrate asset prices relative to actual productivity gains is an important issue.

Among other issues raised, the transformation of Asian economies for the revolutionary technological changes introduced in the telecommunications and information industry sectors stands out. How fast Asia's conventional sectors migrate towards this new economy is also contingent on the expansion of tertiary education: up to now, this has been a lagging factor and therefore a bottleneck in many Asian economies.

## **A Prognosis of Policy and Structural Changes – Homework for Governments**

All participants agreed that the essential policy lesson from the crisis and its aftermath is the convergence of systems and policies towards global norms. It is hard to categorize this convergence process as a sectoral rather than overall approach. For instance, market liberalization implies financial liberalization, while financial liberalization implies major improvements in systemic management and discipline. There is no longer an Asian economic model or paradigm. Instead, the major issue today is to create a reasonable degree of global harmonization on basic business standards, instruments and ethics on the one hand, while respecting cultural divergences and preferred priorities in values on the other.

Time and the proper sequencing of internationalization and reforms processes remain an issue. There is general agreement that the two are linked, and that a major explanation for the Asian financial crisis lies in the gap between market libe-

ralization moves on the one hand, institutional and regulatory reform on the other. This does not necessarily lead to an immediate, all-out transformation. In some cases, for reasons of social or political stability, it may be necessary on the contrary to reverse the relationship – e.g. to keep the opening up and liberalization process in check while institutional reforms proceed at a cautious pace. In the case of financial liberalization, the Chinese example suggests that this is only possible with a very strong legal base, while other forms of economic liberalization can be put in place with a more rudimentary legal system.

Moreover, efforts at reform and restructuring the banking and financial sector, as have happened in several Asian countries, should be synchronized with the reform of management and financial norms for all business firms. Existing banks, however reformed and recapitalized, will either fall in the same trap of blind lending, or will fail to deliver financial credit to the private economy, if the firms themselves have not reformed. In this sense, it is illusory to open up the financial and banking sector if business practices and laws have not been overhauled throughout the economy.

Furthermore, regulatory and institutional reforms must be consistent with the financing target chosen by a government or an economic system. Several successful high-growth Asian economies in the past – from Japan to Korea and Taiwan – did not open up completely their economies and financial markets in the past, and they were vindicated by their economic success. This attitude cannot be maintained, however, if a country is at the same time seeking large quantities of financial capital from abroad, and particularly “hot money” in the form of short-term loans, forward market instruments and equity participation. Economic techniques and cultural choices must be consistent, leaving open the option to desist for some time from tapping external market financial resources. The continuing access of Asian economies to the world’s capital resources, after the departure in 1997-1998 of 120 billion dollars of private funds from the region, therefore depends on the pace of regulatory and systemic reform. Reliance on a long-term form of intervention over capital markets is doomed by economic reality: the daily volume of capital transactions is higher than IMF and country reserves. Economists know that there exists a mutually exclusive relationship between three familiar goals of economic policy-making: exchange rate stability, free movement of capital and autonomy of mone-

tary policy cannot be pursued simultaneously by any country. Participants feel that the lack of stability for exchange rates has been instrumental in starting the financial crisis. Beyond the recognition that short term emergency measures limiting capital flows can be useful in an emergency, participants have emphasized that Asia, like other regions of the world, has much more to gain than to lose from the freedom of capital movements. It is therefore the autonomy of monetary policy, a reality that is due in Asia to a traditional lack of region-wide instruments, co-ordination or even information, which should be curtailed in the future: this finding has important consequences for the future of Asian regional cooperation (see section 3).

Beyond a shorter time frame of intervention in front of a breaking panic, and leaving aside the choice that is open to some Asian economies of a slower, domestically based rate of growth, large scale reforms are now the name of the game for a true and long-lasting exit from the crisis.

The first issue for consideration is the timing of reform in various sectors. Political, social and administrative reforms must match economic and financial reforms. Conversely, macro-economic management, beyond the high standard already achieved by Asia in some areas (high savings, low public deficits, low public foreign debt), must now also include prudent management of other targets (total foreign debt, realistic exchange rates, control over credit bubbles, central reserves in match with short term borrowing). In the context of internationalization, central banks should not only follow the price of goods and services, which can be distorted by increased imports, but also asset inflation. They must be especially attentive to sudden changes in capital flows. In the area of regulating private firms, attention must be given to distortions of competitiveness, which cannot be sustained in the long run; to corporate governance including standards for transparency, accountability and a rule-based environment.

A second issue is pointed out by several participants. Half-way deregulation of capital markets is a most dangerous situation, with democratic institutions not necessarily suited to the necessary action at times of crisis. Countries that do not have as their goal a totally market oriented financial sector should desist from surrendering

control of financial institutions. This does not mean a return to the old Asian trinity of government, business and politics: on the contrary, it is imperative that governments should reduce the issue of moral hazard by enforcing bankruptcies, especially in the sector of financial intermediation. Employees and creditors should be given preference for debtors, and the recapitalization that governments undertake should be aimed at creating new actors following rules, rather than saving old firms that did not live up to them.

Finally, encouraging the inflow of foreign capital must be continued in ways that differ from the recent past. It has been noted during the Asian crisis that countries that had the lowest net FDI ratio (FDI inflow minus outflow) were also the most vulnerable to market play. Asia's marked preference for loans over equity issues (shares or bonds) has also reinforced the vulnerability of Asian firms, often isolated by their debtor status. The current swapping of debt for equity, often to foreign investors, reduces this fragility. Foreign direct investment and equity issue both speed up the transition from a relationship based economy to a more transparent and accountable model. Domestic banks should also be open to foreign participation and foreign competition. These, rather than unworkable limitations on short-term capital movements, should be encouraged.

## **Discussion of Issues for Regional and Euro-Asian Cooperation**

Throughout the task force results and debate, the issues of regional and global cooperation have been stressed by participants. Perhaps the starting point for this emphasis lies in the impossibility for individual countries or banking systems to withstand alone the consequences of large exogenous shocks. The extreme currency swings between the dollar and the yen, which are the currencies of reference for the Asian region, and the huge capital outflow of 1997 that followed years of steady inflow were two such exogenous shocks. Western banking systems would not have been able to avoid the losses coming from such shocks, had they been directed at them, and the case of the 1998 LTCM debacle and subsequent public intervention proves that even the world's largest financial market could not do without an intervention going well beyond normal regulation. It stands to reason that much

smaller banking and financial systems, if they are not left to their own means of market suspension measures, must be bolstered by outside intervention and confidence-restoring measures.

Few participants, however, equated this with the search for a lender of last resort, as it had seemed to become necessary in 1997-1998. Beyond the recent controversy on conditions for international bail-out and the confusion between the twin goals of saving Asian markets and institutions from panic and reforming them, participants noted that the inflow of capital from international financial institutions and foreign governments (IMF, World Bank, ADB and Japan's Miyazawa initiative) has grown to huge proportions.

The search for international cooperation improvements therefore focused more on the prevention of future crises, and on systemic improvements of monetary and financial relationships. Particular attention was given to two areas: the desirable expansion of Asian regional cooperation, and the new factor represented by the advent of the euro.

The task force points out that even if changes in exchange values often reflect long-term competitive pressures among differently based economies, the short term swings and unintended consequences are too large, especially for economies whose currency is tied to one, and one only, of the main currencies. Fixed or nearly fixed exchange rates are no longer feasible in the face of huge daily exchange volumes, with currency boards being an exceptional situation which could not be emulated. Indeed, formal pegs and currency boards are judged to place unrealistic strains on macro-economic management. A "crawling peg" – e.g. involving margins of fluctuation – is deemed much preferable. Certainly, the example of European monetary arrangements prior to the euro reveal that holding to these margins requires more than monetary co-ordination. In the Asian case, the reference to a basket of currencies drawn both from within and without the region would seem necessary: it should enhance stability and reduce the excessive role that the export cycle plays in many Asian economies today.



Participants note that many proposals originating in Asia since 1997 point towards this direction. Central bank cooperation, reserve mobilization at times of excessive market play, a regional reserve fund that would draw from the ample holdings of Asian central banks, are some of these proposals that have come up in the last two years. None of these holds any promise, of course, unless the region's economies improve the disclosure standards of their own monetary and financial management, introducing more mutual transparency. ASEAN has undertaken such a role with the assistance of the IMF and the ADB. Participants note positively the recent proposal to establish a Regional Stability Forum as a practical means both to enhance transparency among the region's financial and monetary systems, and to prepare the way for better monetary management at the regional level. They emphasize, however, that one goal cannot go without the other. In this sense, the problems that have surfaced with the financial crisis may ultimately lead the way to a much enhanced regional cooperation.

Finally, the role of the euro in this context was carefully evaluated. A global economy with a dual currency and reserve system – what some call a duopoly of the dollar and the euro, for instance – would involve a risk of dangerous fluctuations between the two currencies. In the words of a participant, other currencies “would be squeezed between the dollar and the euro”, and this was highly undesirable. Although the euro would naturally hold some potential as a currency of reserve for economies trading heavily with Europe, there is no indication that such a strategy is being actively pursued at the present time. The euro is relevant to Asia in two ways: first, because it points out the way to a regional currency model, even if that experience cannot be translated in direct terms. And second, because its existence may stimulate the appearance of either a third Asian-based anchor among the world's currencies, or facilitate the transition of Asia's currencies to a basket weighted valuation system, decreasing the reliance on a single currency outside or inside the region.

Whatever the solution sought by governments, a deepening of monetary and financial consultations at various levels among Asians and Europeans is called for. Although the experience from the 1997-1998 financial crisis demonstrates that the European financial system and firms have a large stake in Asian economies,

European governments have collectively shown an insufficient interest in managing this crisis. European governments have sometimes entertained the long term ambition to reform the world's financial architecture, while resignedly supporting in the short term the IMF set of policies and instruments put in place to deal with the crisis.

Indeed, a large-scale crisis was certainly not the optimal moment for a major overhaul, involving large debates, of the international financial system. The moment has come, however, when such a process should be started globally. Asians and Europeans should have a much more intense exchange of information and views on their respective financial and monetary policies, preparing the ground for a more active cooperation and helping to stabilize global financial flows.



# **The Asian Financial Crisis: Regional, Global and Systemic Lessons**

*Jesus P. Estanislao*

The 1997-1998 Asian financial crisis has highlighted two aspects of East Asia. The first is that of victim, and the second that of culprit. The contrast is a stark illustration of the contrary views sometimes held about East Asia, depending on one's persuasion or orientation.

Those who sympathize with Mahathir's views of the financial crisis are insisting – some up to today – that most East Asian economies have been victims of the inherent volatility of global financial markets. Hedge funds and other big players in financial markets have enormous amounts of funds under their control. These they can move around quickly, oftentimes insensitively, and sometimes discriminatingly. Beside such giants, with huge powers for leveraging and accessing “hot money”, are the different East Asian economies. Most of these are relative pygmies, but with hard-earned reserves built up after decades of financial restraint and economic virtue. According to this view, when giants decide to move their funds out of East Asia, for whatever reason, sinister or otherwise, there is little that most East Asian economies can do other than cope with the adverse economic and financial consequences of such herd-like, speculative moves (Radelet and Sachs, 1998).

Those views could not be left unchallenged, and indeed they have been. There is now a rather vast literature, which argues that many East Asian economies had managed to hide their deepening structural flaws behind the façade of rapid economic growth and glib propaganda about their economic miracle. The strong macro-economic fundamentals they were showing masked real weaknesses, which in the majority of cases, resulted from informal and loose practices that multiplied “moral hazard”. These practices were perpetrated over many decades during which East Asians were busy trying to prove how different and good they really are. According to this view, many East Asian economies were guilty of a multitude of

sins of commission and omission (Corsetti, Pisenti and Roubini, 1998). Their combination and toll, over many years, finally revealed the weakness of the props to many decades of high economic growth. Once such weakness was revealed, financial markets stemmed the flow of funds into East Asia and reversed their direction abruptly. Thus, the crisis occurred.

There is a kernel of truth in both views, which are diametrically opposed to each other in characterizing many East Asian economies as either victim or culprit (Moreno, Pasadilla, Remolona, 1998). Moreover, East Asian economies are so different from each other that the degree in which the elements of truth from both views can be combined varies significantly from one economy to another. Abstract and broad generalizations have a long history of grief when applied to East Asia or to Asia. If we were not in 1999, and if there were no efforts exerted over the past decade and a half to build bridges between East Asian economies, it would have been the better part of prudence to abandon any attempt at drawing any lessons from any event in Asia.

But financial markets now find some comfort and substance in bundling many East Asian economies together, and in referring to them as belonging to one region or sub-region. Indeed, the rapid spread of contagion during the financial crisis of 1997 and 1998 from one East Asian economy to another shows that financial markets regard them as inter-connected, with increasing inter-action and inter-dependence between them. Among economists and analysts, who focus their attention on comparative exchange rates, there is growing acceptance to the proposition that the eventual vulnerability of South East Asian currencies and of the South Korean won in 1997 should be put in context of the exchange rate adjustments made by China and Japan in 1994 and 1995, respectively, and of their insistence to keep a virtual peg of their currencies to the much strengthened US dollar (McKinnon and Pill, 1997).

The thesis has spawned no small or short controversy. Such controversy is a reminder that even in 1999, after some years of promoting free and open trade and investments in East Asia, statements that can be made of the sub-region can not be very strong (Estanislao, Manzano, Pasadilla, 1999). The analysis of the financial crisis in East Asia in 1997 and 1998 can only lead to tentative conclusions, with reservations

that must be made of their relative applicability to some economies in the sub-region. The lessons to be drawn from the crisis can not be very firm either.

Nevertheless, there is a soft consensus that is beginning to emerge around the core proposition that East Asia can not differentiate itself too much from other economies committed to sustained economic growth under a more open and market-competitive regime. Neither can East Asia dissociate itself from the best practices that have proven to be most effective in macro-economic risk management, in the supervision of robust banking and financial systems, and in the governance of corporate and industrial structures. Neither can East Asia pretend that its economies can continue to move in autonomous ways and in independent directions without the need for cooperation, and in some instances for coordination. This consensus has begun to emerge in the wake of the financial crisis, which adversely affected many economies in the sub-region.

## **The Eroding Difference of East Asia**

A crisis, especially a deep and particularly painful one, can make a difference. It heightens questioning, invites introspection, and forces a review of long held paradigms.

One such paradigm is the centrality of government in issuing commands, maintaining tight control so as to give a firm guide to enterprises that need nurturing, help and protection from stronger and predatory foreign competitors. This has been long held in many East Asian economies aiming to catch up within a few decades with the more developed European and North American economies.

This paradigm developed a government-enterprise relationship, which often had to give lip service to free and open market competition, but in practice in the face of foreign competitive pressure evolved into close partnership between government and big business (Krugman, 1998). The partnership entailed and frequently fostered exchange of favors, presumably to advance the national interest. Such favors often tilted the balance in the economic playing field, which had the trappings of “capitalism”. In reality, the market play was run in a manner to shorten the odds for “cronies”, whether relatives, friends, or plain business associates, preferably all three.

Under such a regime, industrial policy was practiced with a view towards directing credit, resources and special economic privileges to a few focused industrial outcomes. Industrial winners were picked. Export champions were chosen. Conglomerates were made to assume an overbearing role in the economy. The upper tiers of the public bureaucracy, which administered such “industrial policy”, equated patriotism with the vastness of the powers and administrative discretion they enjoyed. Properly connected industrial and corporate executives spent time and resources on relationships, from which their bread was buttered, at the expense of the attention they could have focused on strengthening their competitive position in the level playing field of open markets. Within a “nation incorporated”, individuals were expected to give more importance to conformity rather than to creativity, to falling in line rather than to testing the limits of flexibility.

This stylized characterization of crony capitalism, of which many East Asian economies have been standing accused, provides a simplistic and indeed an oversimplified, but well-known framework for underscoring the success behind the East Asian miracle along with the often heroic and well-meaning sacrifices that went behind it. It developed much macro-economic strength, founded on good traditional values, and leading to admirable structures, industries and enterprises, which won market shares and conquered export markets. Fiscal discipline was observed. Savings rates were pushed up. Education, with stress on rote learning, was universalized and its standards kept high. Community discipline was honored by its strict observance. But it also spawned distortions, which grew proportionately with the seriousness of deviations from market competition principles. These distortions over many years raised and heightened “moral hazard”, which gradually weakened the structure of the economy and enfeebled it at many critical joints.

Load into this enfeebled structure the heavy burden of misguided macro-economic policies during the past few years in several East Asian economies, in particular, Indonesia, Malaysia, the Philippines, South Korea and Thailand. These economies were making themselves very vulnerable to crisis, triggered by panic. Their vulnerability has been characterized by the rapid accumulation of short-term debt in their foreign debt structure (Dornbusch, 1998). This was aggravated by overvalued exchange rates, by allowing domestic credits to build up rapidly in a short period of time, par-

ticularly in a few sectors, and by allowing reserves to fall relative to the short-term commitments of the Central Bank or of the entire banking system (Athukorala and Warr, 1999). Any economy anywhere, with such vulnerability, built up over several years, would only need a disturbance, whether internally or externally sourced, to invite speculative attacks, spawn a crisis and lose over-all confidence.

The disturbance or the trigger to panic varied from one economy to another. Geography and the rising substance of regional economic interdependence, however, tarred them with the same brush and boxed them into one category, labeled as “East Asian” or “Asian”.

The combination of structural weaknesses, mistakes in operational macro-economic policies and random events provides a rich taxonomy of elements behind the East Asian financial crisis. For each economy, the relative importance of each element varies, and the extent to which the financial crisis struck also differs. From such taxonomy, however, a few lessons may be drawn, with the caveat that they can be stated only with softness and relativity, given the differences between East Asian economies.

## **Global, Regional, Other Lessons from the Financial Crisis**

The first lesson is that of convergence. As communications are facilitated, as interactions broaden, as trade volumes multiply, and as investment flows build up on a global basis, differences are muted and universal rules made to apply to all. More specifically, as markets become open and free, competition is increasingly driven by the same principles and rules. Lip service to these market principles and rules needs to be increasingly accompanied by an operative framework of laws, customs, modes of behavior and relationships that are market-consistent. East Asia for all its differences from the West can not insist on playing by different rules from those of free and open market competition. For as long as it relies on global markets, to which it must be wired to sustain its growth and facilitate its development, it must be pragmatic enough to abide by free and open market rules.



In this regard, East Asian economies must actively engage themselves in the formulation of competition principles, standards for banking supervision, and codes of corporate governance. They must also contribute their best thoughts and pragmatic suggestions to improvements in the global economic and financial architecture, based on the experience they have gone through. They must present a balanced and enlightened position during working sessions aimed at moving forward towards free and open trade and investments. Indeed, in all the international, multilateral institutions, where principles, codes of conduct and standards are being formulated and set, East Asian economies must bring their unique contributions, characterized by their peculiar strengths and distinctive culture.

Instead of hanging on to the old and tired paradigm that East Asia is different and should therefore formulate specifically East Asian approaches to problems, we should increasingly look at universal principles and standards with a view towards adopting and adapting them positively to our own circumstances. For as long as problems have been caused by our previous insistence that our peculiar circumstances could justify our taking exceptions to generally accepted principles and standards, we can only deepen those problems in our economies by our continuing to claim exceptions, selectively, for ourselves.

The second lesson is consistency. As East Asian economies move decisively forward towards opening up and liberalizing their economic and financial systems, they will have to ensure that the pacing of the corresponding reforms in their political, administrative and social systems is undertaken consistently. The timing and sequencing of the liberalization of their trade and investment regimes should be broadly in step with a similar program in their financial and monetary regimes. They should continue to struggle to maintain the high standards they have set for securing conventional macro-economic fundamentals. These include, among others, high savings, low public deficits, prudent foreign debt management of the public sector. But they should also broaden their prudence to embrace other elements that make for systemic macro-economic strength. These include a prudent profile of total foreign debt, properly valued real exchange rates, conservative growth of loanable funds, adequate reserves for the short-term commitments of the Central Bank. Indeed, on a regional or sub-regional basis, they should have a Stability Forum, where they can

exchange notes of experience and of best practices in securing systemic consistency with free and open market competition.

Indeed, the relative slowness in undertaking political reforms in some East Asian economies has made the impact on them of the financial crisis much more negative than in neighboring economies. Similarly, the relative weakness of banking and financial institutions, again in a few East Asian economies, can be traced in part to the extreme reluctance to introduce financial liberalization in step with trade liberalization. The focus on selected macro-economic fundamentals also gave many East Asian economies a false sense of security even as the toll of misguided macro-economic policies, pursued for a few years, weakened their macro-economic system and made it vulnerable to speculative attack.

A regional stability forum is called for in East Asia with an initial focus on a more comprehensive, systemic risk management of macro-economies. It can also be useful for an exchange on the common agenda many East Asian economies face in corporate and industrial restructuring as well as in banking and financial sector reforms. Over time, once the agenda can be expanded, there could be initial discussions on broader topics such as coordination on monetary and financial issues as well as the broader dimensions of liberalization and regional inter-dependence. In time, these dimensions can go beyond the purely economic and financial sphere, once sufficient mutual trust and confidence had been engendered.

The third lesson is competitiveness. In the final analysis, it is the serious, substantive homework of introducing reforms, minimizing distortions, making the domestic environment market-friendly that makes the decisive difference for the long term. The sooner reforms are put in place, the faster distortions are removed, the more supportive for a market with a level playing field the environment is made, the more competitive the economy becomes. It too becomes much less vulnerable to panic that can lead to crisis, and even should regional contagion affect it—as it is bound to in a much more integrated region—the negative impact can be cushioned. It still must find time for active participation in multilateral and broad regional efforts at improving the global economic and financial system. It should also be working intensely with its close neighbors in the region of East Asia in areas where mea-

ningful cooperation and coordination can be fostered and substantiated. But it should place the highest priority to actions that can be undertaken at home. It is at this level where its control is tightest and where the possibilities for moving at the quickest pace are highest. Indeed, any economy that does its homework in this fashion finds its voice and influence in the region and in the world stronger.

For as long as economies keep their orientation open to their immediate neighbors and to other economies, with which they have strong economic and financial links, they must endeavor to submit their operating policies and practices to the market consistency test. Markets demand transparency, accountability, respect for rules, observance of codes, professionalism and fairness in corporate and institutional conduct. Economies that endeavor to meet these demands successfully are the most likely to benefit the most from markets. Codes of governance for governments, institutions and enterprises, both public and private, need to be carefully formulated and strictly observed in any economy that aims to compete effectively in open markets.

In sum, the lessons of convergence, coherence and competitiveness, which are drawn for East Asia from the recent financial crisis it suffered, are no different from those which can be applied to any part of the world. But the ways and extent of applying them may vary from one economy to another in East Asia. After all, despite current propensity for tarring with the same brush the different East Asian economies—with increasingly good reason—they are still sufficiently autonomous and distinct from each other.

## **Concluding Comment**

The agenda for policy thought and action in East Asia is enormous. It covers a broad range, starting with micro-economic fundamentals at the institutional level of business enterprises and corporations, where corporate governance practices need to be aligned with the OECD Code. It includes the intermediate and critical area of banking supervision, independently and professionally undertaken more in line with the core principles adopted by BIS. It emphasizes care and prudence in securing a comprehensive set of macro-economic fundamentals, which go beyond the

traditional selection much preferred and highlighted, before the 1997-1998 crisis, by several East Asian economies.

In trying to cover an agenda with such a broad range, there is the danger of loading the burden and responsibility for initiative and action upon global, multilateral and regional institutions. While stressing the imperative for changes and improvements in the “global financial architecture”, East Asian economies should continue to be pragmatic enough to avoid such danger. For much of the work required by the action agenda needs to be done at home. It is within individual national economies where great impetus can be given to improved corporate governance, strengthened banking supervision, and comprehensive risk management of the macro-economy. It is on home grounds where reforms must be initiated and mostly undertaken in all these critically important areas.

But the domestic political will to get that homework done can be reinforced and helped by closer cooperation within East Asia. Indeed, East Asian economies can learn from each other. They can compare notes, exchange good policy experiences, and highlight successes within the region. In some areas, such as human resource development and training in specialized areas, they can pool resources. They can promote open networks so that the economies of the region, as they go through the process of reforms, remain open to each other. Over time, they can find common interests they can pursue together. After a few decades, they may even put up regional mechanisms and eventually regional institutions, which can contribute to regional stability and sustained progress.

Such openness should not be limited to institutions and economies only within the region. It should extend outside the region, and this is essential for East Asia’s continued solidarity with the global market system. From extra-regional sources, East Asian economies can obtain principles, codes, best practices, which are market-tested and market-consistent. Principles are generally firm and universal. But codes and best practices need to be adapted to various situations and circumstances. They evolve. It is in the continuing adaptation and evolution (indeed enrichment) of these codes and best practices that East Asia can contribute to the “global architecture” based on the variety of its experience and the richness of its culture.

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# **Corporate Restructuring and Debt Issues in East Asia: Experiences of South Korea and Other Countries**

*Choong Yong Ahn*

After decades of seemingly endless growth, some high-performing economies in East Asia came to an abrupt standstill and faced a serious crisis. What began as a sub-regional problem sparked by the massive devaluation of the Thai Baht on July 2<sup>nd</sup> 1997, quickly spread throughout East Asia to cause the most serious financial turmoil in East Asia development in recent decades. South Korea (hereafter Korea), Thailand, and Indonesia became recipients of IMF financial help subject to IMF conditionality. This represents the largest ever financial package with US \$56 billion being provided to South Korea alone.

Difficulties in both corporate and financial sectors have been at the core of East Asia's financial crisis which has been unfolding since July 1997. Given its sound macro-fundamentals, South Korea was initially thought to be free from the regional contagion effect. However, as time went by, Korea proved to be the most vulnerable among the Asian crisis countries. With its readily available foreign exchange reserves nearly exhausted by early December 1997, Korea sought emergency assistance from the IMF in order to avoid a moratorium on its foreign debt. Assistance was given on the condition that Korea would undertake far reaching structural reforms in almost every segment of its economy.

As prescribed in the IMF conditionality, the East Asian economies receiving financial help from the IMF have been forced to undertake all-court pressed restructuring of their economies. For example, the Kim Dae-Jung Administration of Korea has been overhauling simultaneously its inefficiency-ridden financial, corporate, public and labor sectors.

East Asia's economic crisis is fundamentally a corporate crisis which is in turn connected with a banking crisis. Both the breadth and depth of corporate distress in East Asia is unprecedented in recent economic history. The level and structure of corporate debt, the number of debtors and creditors involved, and the weak legal environment make corporate restructuring an enormous challenge. Although triggered by contagion and currency speculation, the Korean economic crisis is largely due to excessive debt among large conglomerates known as *chaebols*.

It is very important to understand the characteristics of the corporate debt in terms of size and the extent to which it is connected with other sectors of the economy in the crisis countries. It is also important to map out how to restructure highly-leveraged corporations in order to put them on a growth track again. In the restructuring process, what kinds of major issues are emerging? Also can a delicate balance between consistent restructuring efforts and necessary economic recovery in a mutually reinforcing manner be maintained? The purpose of this paper is to address these issues and policy implications with special emphasis on Korea as well as providing a glimpse into the experiences of some other East Asian crisis countries.

Section II presents the characteristics of the corporate debt, its size at present and its impact on other sectors of Korea's economy. Section \_ addresses the restructuring process of the corporate sector in Korea. Section \_ discusses newly conceived, forward looking loan criteria and new loss provision requirements for the banking sector. Section V discusses major issues and policy recommendations which emerge from the corporate debt restructuring.

## **Korea's Economic Crisis and Characteristics of the Corporate Debt**

The world is rapidly becoming a single global market where national boundaries mean less and the competitiveness of the individual firm matters more than ever. It becomes no longer possible to protect domestic markets and domestic firms. Only highly competitive companies can survive. Korean companies have failed thus far to take full advantage of the globalizing world market. In recent years, Korean companies have faced pressure both from the high-tech products of developed countries

and the low-priced products of developing countries, being positioned in a “nut-cracker.” For example, in 1997, profitability declined substantially; the profit/sales ratio fell to -0.3 percent and remained at a similar level while some substantially higher positive profitability levels were evident in the U.S., Japan and Taiwan during 1998 as seen in Table 1.

**Table 1**  
**Ordinary Income/Sales Ratio**

(Unit: percent)

	<b>US</b>	<b>Japan</b>	<b>Taiwan</b>	<b>Korea</b>
Ordinary income/sales	8.3	3.4	5.1	-0.3

*Note:* Statistics for 1996, except Korea which is for 1997.

*Source:* The Bank of Korea, *Analysis of Corporate Management*, 1998.

During the high growth period and especially in recent years in Korea, major corporations (*chaebols*) have undertaken ambitious expansion and diversification drives including numerous overseas investment projects. These expansion drives were funded with very aggressive borrowings often short-term from Korean commercial and merchant banks. Banks relied mainly on collateral in the allocation of credit and relatively little attention was paid to earnings performance and cash flow generation, or the corporations’ ability to repay. The *chaebols* generally supplied guarantees to their affiliates and subsidiaries to secure loans. Although most of the major subsidiaries of the *chaebols* are publicly listed, *chaebols* have traditionally raised little in new equity at Korea’s thinly capitalized stock market (Classens, et al., 1998). The government often supported this expansion and often directed *chaebols* into specific lines of business.

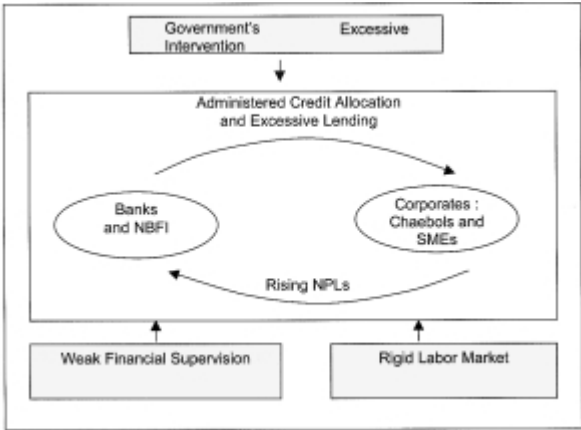
As Liberman and Mako (1998) noted, this policy of aggressive, leveraged expansion worked well as long as the economy and exports expanded vigorously and the returns on new investment exceeded the cost of capital. In recent years, however, all measures of group financial performance among the 30 largest chaebol worsened – free cash flow, return on equity, profit margin, debt coverage ratio. Meanwhile their debt/equity ratios continued to rise. Rapid wage increases, a result of a highly unio-



nized and strong labor force, often outstripped productivity growth (Ahn and Kim, 1997). Declining demand and falling prices for Korea’s major export items – particularly in semiconductors, chemicals, shipbuilding and steel markets – further weakened profitability in recent years.

Korea’s financial crisis which started in late 1997 is largely attributable to this declining competitiveness of Korean companies, and their failure to adapt themselves to a changing global economic environment. The structural weakness of Korea’s high growth model is depicted in Figure 1. A vicious chain of inefficiency between the financial sector and the corporate sector was structured and has remained so since the second stage of the heavy chemical industrial drive. The decline of both the real and financial sectors is intertwined; as corporate bankruptcies rose, financial institutions became burdened with bad debt and were no longer able to roll over their domestic or foreign liabilities. Both administered credit allocation, excessive lending without prudential rules, and *chaebols’* increasing market share and diversification policy with little attention to profitability caused an inefficiency syndrome in Korea’s economy. Korea’s restructuring needs to break away from this vicious chain of inefficiency between the financial sector and the corporate sector. While following dutifully the IMF prescriptions, the main sequence of major restructuring has involved first the financial sector and then moved to the corporate sector.

**Figure 1**  
**Structural Weakness of Korea’s High Growth Model**



A simple glimpse at current statistics demonstrates clearly the widespread insolvency problem in Korea. According to statistics released by the Bank of Korea, 17,168 firms failed in 1997. This was a 52.53% increase over 1994. From January through April of this year, an average of 3,000 firms failed each month to make annual bankruptcy cases amount to more than 20,000 (Table 2). This in turn has exerted great pressure on financial institutions, a total of 188 have been either closed down or merged on their own initiative. Corporate debt of the top 28 *chaebols* reached 247 trillion won, with the average debt-equity ratio reaching 449% per firm at the end of 1997.<sup>1</sup> Figure for non-performing loans of banks provided by the Financial Supervisory Commission (FSC) stood at 87.26 trillion won (\$63 billion) as of the end of March 1998. This accounted for 16.89% of total bank loans, or 20.72% of Korean GDP in 1997 (Table 3).<sup>2</sup> The most recent figure of the top 30 *chaebols'* debt provided by the FSC recorded 342 trillion won at the end of 1998. These figures reflect the seriousness of what is in fact a financial crisis.

**Table 2**  
**Number of Bankruptcies: 1994-1998**

No. of Firms	1994	1995	1996	1997			1998			
				Year Total	Nov.	Dec.	Jan.	Feb.	March	April
Total	11,255	13,922	11,589	17,168	1,469	3,197	3,323	3,377	2,749	2,462
Incorporated Firms (%)	4,503 (40)	6,031 (43.1)	5,157 (44.5)	8,226 (47.9)	714 (48.6)	1,559 (48.8)	1,600 (48.1)	1,499 (44.4)	1,192 (43.4)	1,079 (43.8)
Large Firms	5	5	7	58	9	6	9	6	1	3

Source: Bank of Korea.

Given the level of corporate debt, it is evident that resolving the financial crisis is directly related to industrial and corporate restructuring, success of which, in turn,

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1. *Korea Economic Daily*, 30 March 1998. Corporate debt is approximately \$177.57 billion, based on the exchange rate as of 3 June, 1998 (\$1 = 1391 won).

2. Korean GDP in 1997 was 420.986 trillion won. The proportion of bad loans in Korea is huge compared to that of the US during its Savings & Loans crisis; bad loans of FDIC member financial institutions almost reached 4% of total loans and 2.5% US GDP in 1987.

**Table 3**  
**Non-Performing Loans (ending March 1998)**

(Unit : trillion won)

	<b>Total Loans</b>	<b>Non-Performing Loans (% of total)</b>
Banks	516.6062	87.2645 (16.89)
Other Fin. Institutions	256.9355	24.7611 (9.64)
Total	773.5779	112.0256 (14.48)

Source: Financial Supervisory Commission.

hinges upon the orderly exit of ailing firms. Perfect competition would ensure that the assets of failed firms are efficiently utilized through liquidation via cash auction. However, in the real world, capital markets are often underdeveloped and usually imperfect. For example, there may not be a market for the insolvent firm's assets, or these assets maybe undervalued and the firm which is fundamentally sound but only temporarily illiquid is not saved. While liquidation of truly distressed firms releases resources for other, more productive activities, saving firms which are insolvent but fundamentally sound would increase social welfare.

One way to save such a firm is for debtors and creditors to renegotiate the terms of debt. However, private workouts (i.e., out-of-court settlements between creditors and debtors who have defaulted) are often difficult to achieve due to collective action problems on the part of creditors and the high cost of renegotiating the debt structure every time a debtor defaults. Due to problems related to private workouts, most countries have standard, legal mechanisms under which financially distressed firms are protected from their creditors and given the chance to reorganize.

To put the financial crisis in proper perspective, it is necessary to understand how and why Korean companies lost competitiveness. Even before the crisis, it had become apparent that Korean companies were over-reliant on debt and had made excessive and inefficient investments compared to their counterparts in the U.S., Japan, and Taiwan, as shown in Table 4.

**Table 4**  
**Debt/Equity Ratio in the Manufacturing Industry**

(Unit: percent)

	US <sup>1</sup>	Japan <sup>1</sup>	Taiwan <sup>2</sup>	Korea <sup>3</sup>
Debt/Equity ratio	153.5	193.2	85.7	396.3
Total borrowings and bonds payable to total assets	25.6	33.1	26.2	54.2

*Note:* 1. Figures for 1996. 2. Figures for 1995. 3. Figures for 1997.

*Source:* The Bank of Korea, *Analysis of Corporate Management*, 1998.

Throughout the decades of government-induced growth, economics had become closely entwined with politics. Company managers were more concerned with garnering outside influence than they were in making their companies profitable, and the board of directors or minority shareholders had little power to curb the managers' misbehavior. Moral hazard was prevalent, and conglomerates 'too big to fail' with guarantees from the government wielded considerable power in society.

Corporate restructuring has been a major goal of post-crisis reforms in Korea. Early last year, both the President Kim Dae-Jung Administration and business leaders agreed upon five principles of corporate restructuring as listed in Table 6. Since then, Korea's corporate sector restructuring has been carrying on with a clear timetable on the basis of these guidelines despite short-term difficulties.

**Table 5**  
**Five Major Principles of Corporate Restructuring**

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| <ol style="list-style-type: none"> <li>1. Transparency of corporate management</li> <li>2. Dismantling cross-debt guarantees</li> <li>3. Significantly improving capital structure</li> <li>4. Identifying core businesses and strengthening cooperative relationships with small and medium-sized companies</li> <li>5. Enhancing accountability of controlling shareholders and enhancing their management accountability</li> </ol> |
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Among the concrete measures adopted so far is the requirement for the top thirty *chaebols* to submit consolidated financial statements that link all affiliates from

1999. These financial statements will provide a more accurate picture of *chaebol* management by clarifying intra-*chaebol* transactions, publicizing shares held between affiliates, highlighting cross-payment guarantees and credit trading.

Since the financial crisis in late 1997, Korea has made positive inroads into reforming its weak financial sector by making purchases of non-performing assets from, and injecting funds into the severely undercapitalized banks. By the second quarter of 1999, Korea had implemented almost 80 percent of the fiscal support package, completing the first round of its financial restructuring.

In order to capture problematic loans to corporate sector, it is important to see the changes that have occurred in the size of non-performing loans (NPLs). Despite Korea's proactive restructuring effort, many critics argue that 64 trillion won of the fiscal support package is not sufficient to restore health to the financial system—at least for banks, per se. The size of non-performing loans (NPLs, hereafter) is likely to continue to rise while corporate restructuring is being undertaken. The recent dismantling of Korea's second largest *chaebol*; Daewoo, clearly indicates this consequence.

Indeed, the disposal of NPLs is at the heart of Korea's financial reform as well as corporate sector restructuring because it serves to gauge how vigorously the sector has undergone the restructuring process and how much healthier both sectors have become. Accordingly, the size of NPLs will point toward the feasibility and effectiveness of the present and future reform measures, and will predict mid-and long-term financial stability.

## **Corporate financial restructuring**

The breakup of the vicious inefficiency chain between the financial sector and corporate sector involves a simultaneous restructuring of both financial and corporate sectors. Any attempt to restructure only one of the two sectors is likely to fail. Over-extended *chaebols* need to restructure their balance sheets, increase both equity and the maturity profile of their debt to create viable corporations. Reducing

debt/equity ratios from the 400–500 level at the end of 1997 to a level of 200% by the end of 1999 was targeted. The longer-term process of real restructuring will need to include improved corporate governance, product line rationalization, increases in productivity, and a fundamental change in corporate strategies and culture, focusing on profitability and liquidity versus aggressive expansion at virtually any cost (Lieberman and Mako, 1999).

The top-5 *chaebols* are believed to have more access to external financing, particularly through capital markets, and have the ability to sell off some of their foreign assets acquired during their expansion. SMEs have been more affected by the credit crunch directly and indirectly through links with *chaebols*. Separate government programs have been adopted for these firms.

Recently, the immediate focus of restructuring efforts has been on restructuring the “non-Top 5” *chaebols*. In principle, a host of financial restructuring methods have been contemplated. In practice, market conditions and deadlines in the reform program may encourage initial emphasis on debt restructuring, including debt/equity conversions. Subsequent emphasis is likely to be on asset sales, foreign investment, and new equity infusions. Among the non-Top 5 *chaebols* in distress, some owners appear willing to give up control, and restructuring efforts have been addressing the issue of cross guarantees. The government is responding with Fair Trade Commission actions against improper intra-*chaebol* transactions, statutory reductions in cross guarantees, more careful standards for future lending, and pressuring for banks to exit from non-viable *chaebol* affiliates. This process is expected to take some more time.

The government has relied so far, on bank-led voluntary corporate debt workouts for the non-top 5 *chaebols*. Hence the re-capitalization and restructuring of banks is a central element in the strategy for corporate financial restructuring. Eight major creditor banks, identified as leading banks, are to take the responsibility for negotiating workouts with the 64 major corporate groups. Each of the banks have formed a workout unit. A series of policy measures are being implemented, which will strengthen incentives for banks and corporations to undertake debt restructuring.

The government has adopted a schedule for implementing tighter prudential limits on connected lending and exposures by banks, which will place further pressure on them to undertake corporate debt workouts. This is especially relevant for the larger *chaebols* where exposures are currently above the (future) lending limits.

Another integral element of the strategy for corporate financial restructuring has been changes in the legal and regulatory environment which remove impediments to corporate restructuring, encourage the infusion of new equity into the system and facilitate debt/equity conversions. Thus, the regulations governing foreign ownership in listed stocks has been changed to allow 100 percent foreign ownership; the M&A regime has been liberalized to allow hostile takeovers by foreigners; tax incentives, (e.g. on asset sales), have been introduced; the real estate market has been opened to foreigners; financial disclosure and reporting has been strengthened; and insolvency procedures have been improved. Changes have also been made to the labor law, which now allows layoffs and measures have been taken to improve labor market flexibility. This will facilitate the process of restructuring in the real sector, which will not only complement financial restructuring, but is needed to improve the efficiency of the corporate sector over the medium term.

The stock of corporate debt is so large that sustainable debt/equity ratios cannot be achieved over a reasonable time frame but only through the flow of new equity, asset sales and retirement of debt (Classens et al., 1998). In addition to such flows, stock adjustments in the form of conversion of debt into equity will be necessary. In the first instance, the banking laws have been changed to allow banks to hold up to 15 percent of their equity in a corporation and no more than 100 percent of their equity in total.

The FSC has developed an out-of-court framework for corporate workouts. This framework, within which the banks and non-bank financial institutions and corporations will undertake the workouts, utilizing so-called London Rules, which basically calls for extra-judicial resolution of problem debtors (Classens et al., 1998). A Corporate Restructuring Accord (CRA) has been signed by some 200 Korean banks and non-bank financial institutions, which commits them to follow the agreed workout procedures. In the event that the financial institutions cannot agree on a

workout strategy among themselves or the Lead Bank and the debtor cannot reach an agreement, an arbitration committee, the Corporate Restructuring Coordination Committee (CRCC), has been created to resolve these differences.

Development of the capital markets is an important component in the corporate restructuring strategy. Deeper capital markets will help shift corporate finances away from debt and associated risk thus far carried by the banking system. A new regulatory framework, providing greater independence to market institutions is being put in place. The FSC will accord the securities market agencies with increased authority to regulate and supervise their members. Prudential rules for securities markets activities are also being strengthened, including standards for risk management, adoption of market-to-market accounting, and use of credit rating. Improvements in financial disclosure and minority shareholder rights will also support securities market development by enhancing investor confidence.

A bridge bank has assumed distressed assets from merchant banks and Korea Asset Management Company (KAMCO) has bought non-performing loans from commercial banks. As of the end of September, 37 trillion won of such loans had been purchased by KAMCO at a cost of 17.2 trillion won. KAMCO will have to restructure these loans and has a number of tools at its disposal including : asset-backed securities; loan portfolio sale; asset sale; and M&A or direct investment. Potentially, KAMCO can be an important actor in the corporate restructuring process.

The Government has adopted a special program for SMEs caught in the wake of the financial crisis. Realizing that it could not address both the corporate restructuring needs of the large groups and assess the needs of the SMEs at the same time, the government decided to rollover the debts of the SMEs by extending working capital maturities. The scope of corporate workout programs is now also being expanded to include SMEs. Creditor banks have evaluated the financial status of approximately 22,000 SMEs with outstanding loans of 1 billion won or more, and classified about 13,000 of these as viable. These viable SMEs were selected as candidate firms for workout programs.

As part of the reform program, important changes in the corporate governance framework have been adopted. Transparency and accountability in corporate gover-



nance are being facilitated by the international standard measures: including consolidated financial statements by 1999, international accounting practices, class action suits by minority shareholders with 0.01%, removal of restrictions on institutional investors' voting rights, and outside directors in all listed companies.

The current approach to corporate restructuring in Korea can best be described as bank-led, under a "market-based" environment, which is enhanced by an out-of-court process known as (Classens et al., 1999) London rules. At the individual corporation level, the main function of creditor banks will be to drive the operational restructuring process, reduce debt to appropriate levels, and, if necessary, provide new money for working capital purposes. The government does not plan to intervene directly in the corporate sector restructuring process. All types of restructuring tools are in principle at the banks' disposal.

As of the end of September 1998, the government planned to spend a total of 64 trillion won in order to facilitate financial restructuring. Of the 64 trillion won, 32.5 trillion won is for financing the purchase of NPLs and 31.5 trillion won is for re-capitalization and deposit payments. Capital injections have been used as incentives only for merging banks, while the Korean Asset Management Corporation (KAMCO) purchased NPLs from various financial institutions. After selling NPLs to KAMCO, financial institutions were paid with bonds that were issued by the Korea Deposit Insurance Corporation (KDIC), a subsidiary institution of the Ministry of Finance and Economy (MOFE). As for capital injections, the KDIC issued and sold bonds to merging banks then, the KDIC purchased new shares in merging banks with the money in exchange for the bonds. As a result, the government holds shares in merging banks.

As of the end of June 1998, NPLs of financial institutions amounted to 63 trillion won, 40 trillion won belonging to banks while those of non-bank financial institutions amounted to 23 trillion won. The total NPLs, most of which belonged to troubled banks, were resolved by the end of September 1998. (Table 6 and 7)

The government has facilitated the disposal of NPLs for those financial institutions that planned a merger or those whose rehabilitation plans were approved by the

**Table 6**  
**Non-performing Loans (as of June 30, 1998)**

(Unit: trillion won)

	<b>Total Credit</b>	<b>Total NPLs<sup>1</sup></b>	<b>NPL Ratio</b>
Banks	471.6	40.0	8.5%
Non-banks	153.2	23.5	15.3%
<b>Total</b>	<b>624.8</b>	<b>63.5</b>	<b>10.2%</b>

*Note:* 1. Loans classified as substandard and below.

**Table 7**  
**Non-performing Loans (as of the end of March 1999)**

(Unit : trillion won, %)

	<b>Total</b>			<b>Banks</b>			<b>Non-banks</b>		
	98	99.3	Change	98	99.3	Change	98	99.3	Change
Total Loans (A)	576.5	571.6	-4.9 (-0.8)	443.4	442.3	-1.1 (-0.2)	133.1	129.3	-3.8 (-2.9)
NPLs (B)	60.2	65.4	5.2 (8.6)	33.6	37.6	4.0 (11.9)	26.6	27.8	1.2 (4.5)
Ratio (B/A)	10.4	11.4	1.0	7.6	8.5	0.9	20.0	21.5	1.5
	<b>Commercial Bank</b>	<b>Specialized Bank</b>		<b>Securities Company</b>			<b>Insurance Company</b>		<b>Merchant Bank</b>
Total Loans	299.1	143.2		7.7			42.5		22.6
NPLs	25.9	11.7		2.4			5.3		2.7
	<b>Mutual Savings and Finance Company</b>	<b>Leasing Company</b>		<b>Credit Union</b>			<b>Total</b>		
Total Loans	21.0	24.7		10.8			571.6		
NPLs	8.4	6.1		2.9			65.4		

*Source :* Financial Supervisory Commission.

FSC. All “substandard loans and below” of these financial institutions were to be purchased by KAMCO. For un-collateralized loans, 3% of book value was paid. For

collateralized loans, 45% of the appraisal value of the collateral was paid, excluding claims on wages and advanced lease payments. Long-term loans are to be purchased at a discount rate of 45%. The discount rate is to be settled by the net present value method after a court decision on the terms of repayment is made. When this purchasing process is finished, 100% of NPLs of problem banks and 50% of NPLs of sound banks will have been disposed of.

The corporate work-out, in which financial institutions determine whether or not to pursue the recovery of financially troubled companies at their own discretion, has proceeded in such a way that solving the problems has been delayed. This all indicates that the supporting function of the financial sector reform has not worked well. A major reason is that injection of public funds has not been sufficient to allow the servicing function of financial institutions to recover fully. It is, however, important to recall that one of the goals of the financial sector reform is to make financial institutions financially secure so as to be able to write-off exposures to companies whose recovery prospects are dim.

As expected in every economic restructuring, corporate restructuring under the IMF conditionality has been accompanied by a serious credit crunch. The average corporate debt equity ratios were around 400% in Korea during 1997 – 1998 period and were estimated to be almost equally high in Thailand in 1996, and were well above the international standard. Facing an aggravated asset-liability structure, corporate firms sharply cut investment and production. Reduced net worth in turn exacerbated a credit crunch problem.

The implementation of financial restructuring in conjunction with stabilization policies sharply increased overall uncertainty and corporate bankruptcies. In Korea, 3 securities companies, 4 insurance companies, 17 merchant banks and 5 out of 23 commercial banks were closed and many surviving banks were forcefully merged by the end of 1998. A tight schedule for the improvement of the BIS capital adequacy ratio has been imposed on the affected financial institutions. A similar degree of financial restructuring has taken place in Thailand. This in turn has exacerbated the degree of a credit crunch. It is hard to deny that some period of tight macroeconomic policy and financial restructuring was unavoidable to stem capital outflows

and to prevent depreciation-inflation spirals. However, the contradictory impact was greater than anyone, including the IMF imagined.

Perhaps, one of the most dramatic evidences of corporate restructuring is found in the near complete dismantle of Korea's second largest *chaebol* in terms of asset size. The Group is loaded with an excessive debt burden totaling 60 trillion won, including nearly \$10 billion in foreign debt, half of which will fall due within this year. The Daewoo story clearly shows that the traditional belief of "too big to fail" in Korea no longer holds.

Under the workout program, most of Daewoo's 25 subsidiaries will be spun off, merged or sold, with only six auto-related units rescued through debt rescheduling and debt-to-equity swaps. If Daewoo Motor is sold to GM, however, the group will be completely dismantled. The Daewoo Group and its domestic creditors in early September signed a sweeping restructuring plan for the embattled group, which will break up the nation's second largest conglomerate by the end of this year. The six surviving subsidiaries have combined assets of 56 trillion won (\$46.6 billion), a net worth of 23 trillion won, debts of 33 trillion won, and a debt-to-equity ratio of 196 percent. Creditors will closely monitor whether Daewoo will make good on the agreement. If Daewoo fails to meet the bank's designated deadlines for the sale of the units, creditors will sell off the units or subject them to a corporate rehabilitation program.

Twelve key Daewoo firms were put under the "workout" emergency rescue program. Daewoo has come to the stage of virtual dismantle because it delayed restructuring. In the process of breaking up Daewoo, Korea had to take into account the nation's international credibility, effects on the economy that has just begun to turn a corner and stability in the financial market.

Following the government's decision to place 12 Daewoo affiliates under an emergency rescue package, the conglomerates' creditors began providing \$700 million in trade financing credit to Daewoo units and cooperative firms for their export activity. The purpose of the workout is to rehabilitate the Daewoo group, by providing enough funds to help it overcome its liquidity crunch. In a related move, six credi-

tor banks of the 12 Daewoo affiliates will soon begin due diligence on assets and liabilities of the subsidiaries and send managers.

Analysts viewed the restructuring program for Daewoo as the manifestation of Kim Dae-Jung administration's resolve to reform the nation's family-controlled *chaebols* under a "convey management" practice. This follows up President Kim's August 15 Liberation Day speech on *chaebols* reform. First and foremost, the Korean government's commitment to reform – especially that for the largest conglomerates – remains very strong. Indeed, *chaebol* reform constitutes the government's top economic policy for the rest of this year. In fact rather than weakening it, the Daewoo problem has reinforced public support for strong *chaebol* reform programs. On September 8, 1999, President Kim Dae-jung also held an unprecedented meeting with the heads of the *chaebols* ranked 6<sup>th</sup> to 30<sup>th</sup> to sign up an eight-point agreement, calling for investment and technology development on core business lines, improvement in corporate governance, reducing control of the non-banking sector, restricting circular cross-subsidiary equity investment, illegal trading and unlawful wealth transfer and inheritance.<sup>3</sup>

As the domestic macroeconomic situation has greatly improved since last year with near or even greater than 8 percent growth prospects and a more than 300% rise in Korea's composite stock index compared to the level at the end of 1997, Korea's economy can provide a sufficient cushion to deal with any adverse side effects of vigorous corporate restructuring. Viewed this way, the timing of the eruption (if inevitable) of Daewoo's liquidity problems has turned out to be appropriate. Indeed, enhanced confidence of international markets asserts that Korea is an exemplary model of successful reform.

## **Forward Looking Loan Classification and Provision Requirement**

In July 1998, there was a major strengthening revision of loan classification standards and provision requirements. In accordance with international practices, loans in arrears of 3 months or more are now classified as substandard or below, and loans

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3. Korea Herald, September 9, 1999.

in arrears of 1 to 3 months as precautionary loans as shown in Table 8. As a consequence, most of the emergency loans made to technically bankrupt companies are now reclassified as substandard loans instead of precautionary loans. The reclassification of loan is causing, at present, another serious problem for re-capitalization in the banking sector.

**Table 8**  
**Changes in the Loan Classification Standards**

<b>Period of Overdue Payment</b>	<b>Old</b>	<b>New</b>
1 month to 3 months	Normal	Precautionary
3 months to 6 months	Precautionary	Substandard or Doubtful
Longer than 6 months	Substandard or Doubtful	Substandard or Doubtful

In addition, the provision requirement for precautionary loans have been raised from 1% to 2%. Provision requirements were newly introduced for commercial papers (CP), guaranteed bills, and privately placed bonds belonging to trust accounts. From the end of 1999, the asset quality classification standards based on a forward-looking approach, accounting for expected future cash flows of corporations will be introduced.

Kwon and Nam (1999) investigated the nature of loans and the impact of NPLs on corporate restructuring base on a forward-looking criteria. It explicitly considers the corporate sector’s debt levels and its debt-servicing capability while focusing on the future size of NPLs. Kwon and Nam (1999) have used the interest coverage ratio (hereafter referred to as ICR) as a scale to determine whether the loans and credits to the sample corporations will be performing or not employed by Goldman Sachs(1998), and Credit Swiss First Boston (1998) and others. They surveyed all non-financial listed companies numbering between 600 and 662 and over five thousand unlisted companies over the period 1995-1998 that are subject to external auditing. The sample companies accounted for about 79.5 percent of total corporate debt in Korea as of end-1997 which amounted 644.9 trillion won.<sup>4</sup>

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4. The Korea Development Institute (1998) estimates total debts in the corporate sector to be 810.7 trillion won.

NPLs in their study were defined as loans and credits extended to corporations with ICRs less than 100 percent. ICR is commonly defined as the ratio of earnings before interest and taxes (EBIT) to interest expense. It is a standard way of assessing the debt-servicing capability of a corporate borrower. When a corporate borrower is incapable of generating enough earnings to cover interest expense, loans and credits extended to the borrowers are regarded as 'problematic'. These problematic loans can be classified as NPLs when they are broadly defined.

The broadly defined NPL appears to be a precise indicator of the trend in asset quality and the regulatory framework. The newly defined NPLs would lead to a realistic assessment of the NPL size, especially under the persisting crisis circumstances.

In fact, the FSC has been enforcing the classification of loans extended by Korean commercial banks since July 1, 1998. Based on the International Monetary Fund (IMF) policy recommendation the forward-looking criteria for NPLs is due to go into effect at the start of the year 2000.

As Tables 9 and 10 show, NPLs as newly defined sharply increased for two consecutive years during 1995-1997 prior to the financial crisis. The NPLs held by listed companies amount to 32.1 percent of their total debts. If we solely account for borrowings, then the ratio would yield 39.1 percent. Further, the number of companies, whose ICR does not reach 100 percent, accounts for 37.5 percent of the total number of listed companies. Given this evidence, the NPL ratio of unlisted companies appears higher than that of listed companies. Moreover, the unlisted companies' NPL ratio had exceeded the 30 percent level already in 1996 and substantially increased again in the following year to face the economy-wide crisis. This finding convinces again that the financial crisis was mainly attributable to the mounting debts and low profits in the corporate sector.

The breakdown of sample based on scale shows more dramatic results for the second-tier *chaebols* and small and medium-sized enterprises (SMEs, hereafter), classifying sample companies into four groups; top five *chaebols*, second-tier *chaebols* (ranking 6<sup>th</sup> to 30<sup>th</sup>), third-tier *chaebols* (ranking 31<sup>st</sup> to 64<sup>th</sup>), and small-and medium-sized enterprises (SMEs). The NPL ratios of unlisted companies consist

**Table 9**  
**NPLs held by listed companies**

Year	Total # of Comp.	Total debt	# of Comp. Whose ICR <100%		NPL	
				Ratio (%)		Ratio (%)
1995	662 (199.8)	244,593	109 (17.5)	16.5	29,692	12.1
1996	654 (161.3)	291,058	158 (-6.9)	24.2	58,314	20.0
1997	641 (131.0)	392,980	226 (-56.0)	35.3	122,627	31.2
1998	660 (107.5)	393,426	225 (-151.9)	37.5	139,618	32.1

Source: Kwon and Nam (1999).

**Table 10**  
**NPLs held by unlisted companies**

Year	Total # of Comp.	Total debt	# of Comp. Whose ICR <100%		NPL	
				Ratio (%)		Ratio (%)
1995	4,623 (192)	159,697	1,301 (-88)	28.1	44,776	28.0
1996	4,722 (180)	202,274	1,463 (-87)	31.0	59,655	29.5
1997	5,173 (140)	251,897	1,956 (-117)	37.8	94,691	37.6

Source: Kwon and Nam (1999).

tently ascends in the order of second-tier *chaebols*, SMEs, third-tier *chaebols* and then top five *chaebols*. In the case of unlisted companies, the order is slightly changed in that the ratio of third-tier *chaebols* precedes that of SMEs. However, the order in 1998 resembles that of unlisted companies.



The result suggests that *chaebols* in the second tier and SMEs have had relatively more severe problems than others since the financial crisis. SMEs have been suffering under tight liquidity conditions. Furthermore, many of the second-tier *chaebols* have undergone the so-called ‘workout process’ led by commercial banks.

Based on a broad definition which takes into consideration the borrowers’ debt-servicing capability, the total distressed debts of the entire corporate sector would easily reach approximately 260 trillion won. This is equivalent to 32.1 percent of the 820 trillion won worth total credit extended to the corporate sector. When the same ratio is applied to the household sector, the size of NPLs in the banking sector surpasses 200 trillion won.<sup>5</sup> Given that the speculated NPL size is much higher than the government’s current estimation of 118 trillion won, Kwon and Nam’s estimation results suggest that there should be some fundamental changes in the Korean government’s policies for the financial restructuring program.

Given the sharply rising NPLs once we introduce a forward looking criteria, the questions arises as to how we can maintain the capital adequacy ratio of the banking sector. Among the many reasons for the rise of NPLs in Korea may be the down-sliding of corporate profitability, high interest rates, high tax rate, and high inflation rates.<sup>6</sup> One can estimate to what extent the NPL size could be by changing these policy parameters.

The rate of return is the most important factor in assessing the debt-servicing capability of a corporate borrower. Based on the increases of 1, 3, and 5 percentage points in the listed companies’ return on the invested capital (ROIC)<sup>7</sup> in 1998, the rates of reduction for NPLs would be 3.9, 12.2, and 13.3 percentage points, respectively as given in Table 11. In the case of unlisted companies, the reduction effect of

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5. The banking sector includes specialized banks as well as commercial banks. As of end-September, 1998, the total assets size is estimated at KRW 640 trillion, which is the sum of loans and guarantees (KRW 462 trillion) and securities holding (KRW 178 trillion).

6. The Bank of Korea’s study demonstrates that there exists very high correlation between corporate debt ratio and their variables plus the level of autonomous management of the banking sector stage of capital market.

7. Rate on the Invested Capital (ROIC) = (EBIT / Total Capital Employed)×100.

NPLs, caused by an increase in the rate of return, was relatively small, compared with that of the listed companies.

**Table 11**  
**NPL size and changes in ROIC**

ROIC Increase	Listed companies		Unlisted companies	
	# of comp.	NPL/ratio	# of comp.	NPL
Base	207 (-131.6)	121,435 35.7%	1,623 (-75)	77,073 39.8%
1%	197 (-130.2)	108,044 31.8%	1,496 (-70)	71,288 36.8%
3%	177 (-130.6)	86,035 23.5%	1,256 (-61)	59,102 30.5%
5%	155 (-138.4)	76,222 22.4%	1,029 (-57)	49,673 25.7%

*Note:* Numbers in parentheses indicate the average of interest coverage.

*Source:* Kwon and Nam (1999).

Interest rates are another crucial variable to determine the debt-servicing capability of over-leveraged domestic companies. Kwon and Nam's study suggests that the decline in interest rates by 3 and 5 percentage points will lead to the reduction of NPL volume by 11.1 and 13.9 percentage points, respectively. Moreover, according to the 1997 figures, it is estimated that a 3 percentage point decrease in interest rates would cause a 16.4 percentage point reduction of NPLs. (-131.6) 121,435A sharp decrease in domestic interest rates has certainly given a break for corporate borrowers, who have been suffering from excessive debts and weak domestic demand for their products. However, this alone does not warrant any visible improvement in the corporate sector's debt servicing capability. Given the still-high level of risk premium involved in Korean corporate sector, particularly by foreign creditors and local bank's reluctance to cut their lending rates aggressively, funding costs in the corporate sector may be reduced only to a limited extent. Reduction of the labor costs may be a reliable policy option to reduce NPLs. According to the 1997 figures, it can be seen that a 20 percentage point decrease in labor costs would reduce NPLs

**Table 12**  
**NPL size and changes in borrowing costs**

<b>Borrowing Costs Decline</b>	<b>Listed companies</b>		<b>Unlisted companies</b>	
	<b># of comp.</b>	<b>NPL/ratio</b>	<b># of comp.</b>	<b>NPL</b>
Base	207 (-131.6)	121,435 35.7%	1,623 (-75)	77,073 39.8%
1%	199 (-145.1)	98,065 28.8%	1,512 (-88)	72,177 37.3%
2%	189 (-164.8)	93,065 28.8%	1,388 (-106)	62,738 32.4%
3%	176 (-196.0)	83,734 24.6%	1,254 (-133)	57,908 29.9%
4%	164 (-238.9)	76,603 22.5%	1,127 (-173)	52,667 27.2%
5%	154 (-316.5)	74,243 21.8%	1,020 (-236)	45,232 23.4%

*Note:* Numbers in parentheses indicate the average of interest coverage.

*Source:* Kwon and Nam (1999).

by 4.3 percentage points and a 30 percentage point decrease in labor costs would reduce NPLs by 8.6 percentage points.

A drastic change in the ICR can be made through asset sales or debt restructuring by creditor financial institutions. Debt restructuring includes a variety of options, such as debt-equity swap, debt forgiveness, debt relief, and others. The choice and related prices are, of course, negotiable between debtor and creditor. Debt-equity swap and debt reduction will alleviate the debt burden of corporate borrowers, thereby improving their ICRs.

## **Emerging Issues and Policy Implications**

After paying enormous economic and social costs with an all time high unemployment rate of 8% in 1998 during the restructuring process, the real wages have been

substantially reduced, interest rates have gone down below the pre-crisis level, currency overvaluation has been corrected perhaps somewhat excessively, and rental costs have plummeted in Korea. This development now provides a much more favorable business environment for those economies that had been suffering for a while from the weakening competitiveness of their exports and inefficiencies due to the rigidity in the labor and financial markets.

However, the most crucial issue appears to be how to maintain a delicate balance between the reform inertia and economic recovery efforts to mitigate all time high unemployment and the worst economic setback in recent history. Nevertheless, there still remain formidable constraints to recovery. Among other things, there still exists a persistent credit crunch due to the incomplete financial restructuring, weakness in the corporate financial structure and over-capacity, and lack of foreign capital inflow. These constraints, in connection with review and comparison of the adjustment experiences of other economies lead to the following policy implications.

### *Low Interest Rate Policy*

First, accommodative macroeconomic policies need to continue for a while, perhaps until a clear sign of inflationary pressure develops, to prevent weakening of the corporate financial structure. Since the recovery path is still fragile and the corporate sector of crisis economies, particularly in Korea and Thailand, is highly leveraged, a tight monetary policy would accelerate corporate bankruptcies and asset deflation. This would then impose a heavier burden on efforts aimed at resolving financial instability. Both stabilization and lowering interest rate will play a crucial role in this regard. The maintenance of a careful balance between the conflicting goals of stabilizing the exchange rate and preventing massive bankruptcies and rapid aggravation of financial instability is essential to avoid severe economic contraction and resulting social problems. If the stabilization policy overshoots its original goals of strengthening the foreign debt service capacity, the policy will prove to be counter-productive.

In the early stages of economic reform, too tight macroeconomic policies could jeopardize the sustainability of reform as the economy the risk of increasing NPLs. Therefore, a modest amount of macroeconomic stimulus is needed to secure the sustainability of financial restructuring (Cho and Lee, 1999). Since the domestic demand is unlikely to pick up speed rapidly while a higher level of unemployment rate is expected after a rigorous corporate restructuring, a strong recovery in exports would be the key to improving cash flows for the Korean corporations.

In order to encourage future profitability in its corporate sector, the Korean government must maintain a low interest rate policy in order to ensure necessary restructuring of the corporate sector, to stimulate capital markets and to foster increases in exports, thereby speeding up a return to the positive economic growth

However, an optimum combination of accommodative macroeconomic policies and driving timely financial and corporate sector reforms will not be an easy task in the East Asian economies. Too relaxed and dragging, the accommodative macroeconomic policies can give signals to corporate firms to be complacent and procrastinate in reducing their over-capacity. From the experience of Indonesia, it became clear that expansionary monetary policy without necessary financial and corporate sector reforms is ineffective in bringing about recovery while causing hyper-inflation. From the experience of the Philippines, we can glance the importance of the quality and sustainability of recovery (Cho and Lee, 1999). What shielded the Philippines from the full brunt of the regional crisis was its structural reform, particularly the financial sector reform, which had been steadily pursued from the early 1990s. As the root cause for the financial instability in this region was the structural weaknesses of the corporate and financial sectors, full recovery of these economies will be realized only after these problems have been properly resolved<sup>8</sup>.

### *Proper Sequence of Policy Implementation such as Forward Looking Criteria*

The government should present a clear sequence on how to deal with the debt. So far, the government has succeeded in stimulating the economy by lowering interest

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8. See Cho, Yoon Je (1999).

rates. Also, screening of non-viable firms should be accelerated to restore more confidence in the market. The Corporate Reorganization Law, the Composition Law and the Bankruptcy laws were amended in 1998, but change in the procedures alone does not help improve the situation. Especially, the prolonged proceedings tend to distort the stockholder's interests. For instance, while allowing opportunistic behavior of the debtors, the long proceedings create a moratorium for creditors and only makes it difficult for to meet the capital requirement.

During the first half of 1999, most Korean banks, after restructuring with an injection of public funds equivalent to more than 50 trillion won, obtained the BIS capital adequacy status. However, stricter capital adequacy standards and additional loan, loss provisions due to the forward looking criteria will sharply affect the profitability of banks which have already been exposed to Daewoo's huge debts amounting to 23 trillion won.

Application of forward looking criteria (FLC) to the fullest extent that has been proposed by the Bank for International Settlements and OECD needs to be adjusted in terms of degree and timing. The strict and immediate application of the FLC to the already shaky corporations and banks in uncertain financial positions needs to be carefully considered. Its application needs to be tuned to a speed suitable for economic recovery and restructuring progress in the banking sector.

### *Capital Market Development*

A resumption of capital inflow, even after introducing a capital control albeit temporarily, will be a key factor for the fast recovery of these economies. Malaysia adopted a less tight monetary policy than Korea did in the first half of 1998, but her economic contraction was at least as severe as Korea's and her exchange market remained more unstable. If Malaysia had been able to receive external financial assistance organized by the IMF program or another institution, it could have avoided such a severe economic contraction. Judging from this experience, the right mix for the economies in this region may have been a less strict stabilization policy package but a larger amount of financial assistance that is heavily front-loaded. Since

it would be hard to expect a quick resumption of private capital inflows to a crisis-hit country, there is an urgent need to expand the available financial resources through multilateral and regional financial institutions.

In this regard, it is encouraging to see recent discussions on the expansion and establishment of emergency financing facilities such as the contingent financing facility under the IMF and the enhancement of its role as an effective lender of last resort in the international capital market.

One of the key factors to achieving successful corporate restructuring which will facilitate full economic recovery, particularly in Korea and Thailand, is to reduce the corporate leverage ratio. Substantial inflow of foreign capital, particularly foreign direct investment, will be necessary to this end, especially when the prospect of new domestic funding is poor such as it is now.

However, given the huge size of the overall debt of corporate firms in these economies, this ultimately will have to be achieved by a substantial conversion of debt to equity, a change in the domestic financial market and a shift in the patterns of financial savings of households. Improvements have to be made in the corporate financial market structure. Therefore, serious efforts have to be made to expand the equity market in these economies by encouraging collective investment vehicles, including mutual funds and investment and trust business. Further stabilization of domestic interest rates will play a crucial role for this purpose.

Although the reduced interest rates and the rebounding economy in Korea helps the corporate debt problem to a certain extent, a significant proportion of the Korean corporate sector is still subject to various risks, such as commercial and market risks and external shocks.

Many Korean corporations appear not to be able to generate positive cash flows, despite the sharp falls in interest rates and cost-saving efforts. The present high debt-equity ratio suggests that corporations are significantly exposed to shocks, wherever they originate from.

A large portion of the non-financial firms still cannot generate profits to cover their interest expenses even under the improved economic environment. Thus, in addi-

tion to the deflationary policy measures, improving the capital structure of the corporate sector would require development of the capital market, through which corporations could directly raise their funds.

### *Additional Public Resources*

A sizable amount of public resource has been already mobilized and injected to recapitalize financial institutions in congruence with measures to dispose of NPLs in Korea. Moreover, sharp declines in interest rates have had a favorable effect on the NPL formation, and improvement in the macroeconomic environment will improve the liquidity conditions of the corporate sector and bank balance sheets.

Up to date, eighty corporations including those from fifteen *chaebols* have undergone the corporate workout process. Their aggregate debts at the end of March 1999 exceeded 30 trillion won, the bulk of which had already been classified as either 'precautionary' or 'non-performing.' Furthermore the forward-looking loan criteria will make a substantial part of the precautionary category of loans as non-performing.

### *Inducement of Foreign Capital and Skills*

Given the limited local capital resources, Korean corporations must invite foreign capital participation, thereby strengthening and solidifying their capital positions and improving their capital structures. Further, to ensure that corporations are fully operational, the Korean government must place an attentive and greater policy emphasis on the development of market principles and sound management.

Toward this end, strengthening of corporate governance, capital market development, and more deregulations must be vigorously followed. Nevertheless, because any direct measures implemented for these purposes would not produce immediate results, increased attraction of foreign capital and the adoption of foreign management skills would better serve to improve local knowledge and practices.



The desirability of large-scale foreign investment to help restructure Korea's industries, as well as to upgrade managerial skills and technological standards to world-class levels, is now indisputable. It is now well established in relevant literature that a low level of net FDI (FDI inflow minus outflow) has a close correlation with the incidence of the Asian financial crisis.

Similarly, one can argue that in a currency crisis, countries (such as Malaysia) where multinational firms have a dominant presence in the domestic economy may endure or overcome the crisis without being forced to resort to IMF assistance (Ahn, 1999). Thanks to their parent firms, subsidiaries of multinational firms in crisis-ridden countries do not suffer lowered credit ratings or such difficulties in importing raw materials or in trade financing as do other domestic firms. As a latecomer in an increasingly globalized world economy, it will take time and considerable effort for Korea to overcome its negative international image as a destination for foreign capital.<sup>9</sup>

The crucial problem for the *chaebols* is the problem based on the "too-big-to-fail" principle. There needs to be clear and smooth handling to let mismanaged *chaebols* exit from the market through the practitioner's approach, not the bureaucratic approach. The government should recognize that adjustment policies need to be more motivation based and speedy so as to satisfy the short-tempered market. The "Big Deal" policy should be first treated as the problem of large firms instead of an industry problem.

### *Establishment of New Governance Structure*

The establishment of a new governance structure for *Chaebols* is another urgent task. The market-enhancing government should have a concrete vision on what

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9. In the past, Korea relied little on foreign investment due to its indigenous growth strategy and high saving rate. This resulted in a weak foreign presence and made Korea one of Asia's most difficult markets; according to managers participating in the International Institute for Management Development, Korea ranked among the least attractive sites for FDI in 1996. For example, Dow Chemical recently cancelled a multi-billion dollar project which had already been approved by the central government and moved to Malaysia because of conflicts over local zoning and other regulations. The government has introduced legislation to address this problem by setting up a "one-stop" FDI government office.

kind of governance is now desirable for Korea. As we saw, the post war Japanese government had clear ideas on governance and prepared a framework with more labor participation while restricting equity-holders' rights intentionally. In Korea, introducing equity-holders dominant governance may not be effective at all, because owners' family members are themselves the majority shareholders, and they have already attempted to defend management control through cross-share holding. If the independent equity-holders are too small to balance the internal ownership, the right of minority equity holders may only create confusion reflecting the anti-*chaebol* sentiment. The growing use of institutional investors including foreigners may be the first step, but this is already faced with the dilemma that; if banks are opened to *chaebols* this step may become difficult.

The new governance proposal mandates that one half of the corporate board be represented by outside directors. It is important to determine the number of board members and its exact role in enhancing the transparency as well as its effectiveness in routine corporate management.

### *Development of New Tools such as Corporate Restructuring Vehicles (CRVs) and Debt/Equity Swap*

While simultaneous restructuring of both corporate and banking sectors has been underway in Korea and other East Asian countries, debt/equity swap proves to be one of the most effective methods to restructure highly leveraged corporations and creditor banks. As debt/equity swap is employed as a method of corporate restructuring, the government controls companies via the state-run banks. As a result, the overall economy might be influenced by government policy, not by market principles. In practice, debt/equity swap is frequently used in Korea to resolve potential bad loans and lift capital adequacy ratios. In order to prevent moral hazard like this, it is necessary to build a responsible management system in the financial institutions which lead corporate restructuring. A variant on the Asset Management companies has also emerged as Corporate Restructuring Vehicles (CRVs). The goal of the CRV would be to manage the equity interests acquired from banks in a more efficient and effective manner than the banks by using specialists and investment techniques. Major differences are in the ownership and funding structure. Many of the

issues faced by CRVs are similar to AMCs. They involve assets, ownership, funding, consideration, and management expertise.

Some benefits of a CRV are a) to facilitate disposal of assets by creditor banks, b) to facilitate effective management and governance on companies undertaking a workout process, c) encourage foreign capital investment, and d) stimulate capital markets. In other countries, asset management companies (AMCs) have played the role of absorbing from banks' distressed assets and restructuring financially troubled enterprises.

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# Reserve Currencies and the Role of the Euro

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Europe's new currency, euro plays an important part in the ongoing discussion on the 'new financial architecture'. There are as many reasons for this as there are known functions for money; medium of exchange, store of value and unit of account. In addition, money functions as an instrument of foreign exchange intervention. In each of these functions, the US dollar has been dominant throughout the post-war years. The assignment given to this paper is to discuss the role of the euro from an Asian perspective, in the context of the post-Asian-crisis world.

The paper is constructed as follows. First, as a background, we discuss what can and cannot be done to avoid another financial crisis. Discussing the role of the euro in post-crisis Asia will be meaningful only after the options are clearly defined. We argue that convergence of standards in financial intermediation<sup>1</sup> to those that ensure transparency is the way to minimise the frequency and magnitude of a financial crisis. Next, we look at the performance of the euro since its advent, and its implications. We conclude by pointing out that euro's strength may bring an unexpected benefit for Asia, in the form of a counterweight against dominance of extremely market-oriented ideas.

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1. We use 'standards in financial intermediation' to indicate economic, legal and social norms of financial intermediation, which affect transparency and stability of an economy's financial sector. These include the relationship between lenders and borrowers, the relationship between private sector and authorities, commercial customs, corporate governance, written or unwritten rules on supervision, disclosure, risk management, accounting etc. When different, these are seen by foreigners as 'structural impediments' to entry. More recently, some of them have been collectively called 'crony capitalism' and regarded as the source of a country's economic demise.

## **The Two Basic Ingredients of a Financial Crisis**

Among the many factors have been pointed out, two stand out as the basic ingredients of a financial crisis. They are (a) the intrinsic volatility of exchange rates, and (b) the peculiarities of financial markets. Other factors such as macroeconomic performance, ratio of foreign exchange reserves to short-term external borrowing, productivity, deregulation, liberalisation, human capital, technology etc. are all relevant. But they are relevant only to the extent they can become the country-specific reasons why financial crises are triggered, and the country-specific degrees to which the economy is devastated as a result.

### *Intrinsic Volatility of Exchange Rates*

An exchange rate is the relative price of two monies. This price is determined just like any other price, where demand meets supply. But because an exchange rate is a relative price, its level is determined where relative demands are equal to relative supplies of the two currencies in question. In other words, people who demand and supply currencies are always comparing the different currencies, i.e. looking at the value of a currency relative to other currencies.

Consequently, an exchange rate changes when people find a reason to favour one money over the other. If one currency is just as good as the other, there is no reason to sell one to buy the other, and there is no reason for the exchange rate to change. In contrast, if the effects of an event on the two currencies are asymmetric (i.e. different in magnitude and/or direction), one currency is no longer as good as the other. The “better” currency is bought and the “worse” one is sold, changing their relative demands and supplies. As a result the exchange rate changes.

For instance, when domestic and foreign monetary policies are changed in an asymmetric manner, the exchange rate is affected. As a simplified example, assume that the policy authority in the foreign country decreases money supply while the authority in the domestic country does not. Market participants may judge this as a prelude to higher interest rates abroad (with unchanged interest rates at home), as well as a depreciation of the domestic currency against the foreign currency. In a rush to

make (or avoid losing) money, they sell the domestic currency to buy the foreign currency. The exchange rate changes as a result. If in contrast the monetary policies are changed in exactly the same, symmetric fashion, there is no reason to exchange the two currencies. *Ceteris paribus*, the exchange rate does not change. Monetary policy shifts are not the only source of potential asymmetry between two countries. Other asymmetric changes, such as changes in fiscal policies, strikes, elections, natural disasters, need for a currency as medium of exchange etc. can also affect the exchange rate. And even if the events themselves are symmetric, if responses by market participants are asymmetric, exchange rates change<sup>2</sup>.

In the world we live in, there are almost constant exogenous changes. Most of the time there is asymmetry (in the changes themselves as well as in their effects) between two countries. This means that authorities must intervene almost constantly if the exchange rate is to be kept stable. Intervention can be done by one of the two countries, or by both. Either way, if the intervention is to be effective, the relative money supplies must change in a way that offsets the effect of the asymmetry that changed the exchange rate in the first place<sup>3</sup>.

However, foreign exchange intervention can easily become impossible for two reasons. One is that foreign exchange reserves are not infinite. This applies to the case of intervention to support a domestic currency under attack. If devaluation or depreciation is to be stopped, the authorities must sell the foreign currency and buy the domestic currency. But no country has foreign exchange reserves enough to sustain a continuous sale of the foreign currency, in the face of a continuous purchase by the majority of participants in the global market. The amount of money changing

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2. This is shown in the appendix using the reduced-form for the exchange rate derived from a simple two-country model.

3. This statement and the explanations in the text that follow require a qualification. Sometimes, intervention can be effective even if relative money supplies do not change to create an asymmetry that offsets the original asymmetry. This is when relative expectations change instead, and offset the original asymmetry. If intervention succeeds in changing expectations in just such a way, it would succeed in keeping the exchange rate constant. This type of intervention can take the form of a mere announcement (with little or no actual buying and selling by authorities), or of a sterilised intervention. To be effective, such intervention must be infrequent, short and unexpected, however.



hands in the world foreign exchange market each day is estimated to exceed the foreign exchange reserves of all IMF member countries combined.

The other reason why intervention becomes unsustainable is related to Timbergen's theorem. This theorem says that the number of independent policy tools must be at least as great as the number of independent policy goals, for the goals to be attained. In the present context, the tool is monetary policy. The goals are exchange rate stability and domestic economic stability. The two goals cannot, in general, be achieved by the one policy tool. For example if intervention requires the money supply to change in one direction, while the health of the domestic economy requires the money supply to change in the other, at least one of the goals must be abandoned.

Another way to explain this is by using the 'inconsistent triangle', which shows the relationship between a country's exchange rate, capital flows and monetary policy. In general, out of the three goals of (i) exchange rate stability, (ii) monetary policy autonomy and (iii) free movement of capital, only two can be attained at the same time. For instance, when a country chooses to remove capital controls but still wants to maintain exchange rate stability, it gives up its monetary policy autonomy<sup>4</sup>.

There can be special cases in which some of the three goals are not independent from each other. In such a case this triangle deteriorates into a line or a point. An example is when the monetary policy that is good for the domestic economy also happens to be consistent with a stable exchange rate under free capital mobility. But in general the three goals are independent from each other, and this leaves us with a dilemma. Monetary policy affects both the exchange rate and the domestic economy. If monetary policy must be changed to stabilise the domestic economy, the exchange rate will change, unless capital controls can stop that. In other words, as Timbergen's theorem tells us, two policy-goals cannot be reached at the same time with one policy-tool.

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4. This is just another way of stating the famous Mundell-Fleming results under fixed exchange rates, perfect capital substitutability and static expectations regarding exchange rate changes.

To sum up this sub-section, it is natural for exchange rates to change. To keep them constant, the authorities must intervene. But they face a dilemma. Should the authorities put priority on stability of the exchange rate, or the domestic economy? In general, a country must be ready to give up either monetary policy autonomy or free movement of capital to maintain a fixed exchange rate. And even then, lack of foreign exchange reserves may make the task impossible. Exchange rates simply cannot be kept fixed for an extended period of time<sup>5</sup>.

### *Peculiarities of Financial Markets*

Since exchange rates are prices in financial markets, their nature is closely related to the fundamental features of financial markets. Financial markets are different from markets for other goods and services in the following ways.

1. The cost of transactions is lower, or the speed of adjustment is higher, in financial markets than in other markets. As a result, massive amounts of funds can flow from one place to another in a short period of time.
2. Market expectations, rumours and credibility of authorities are important in the determination of prices in financial markets. As a result of this and point 1 above, prices in financial markets (including exchange rates) are volatile by nature.
3. Information asymmetry is prevalent. The borrower has more information than the lender on the likelihood of repaying his debts. This leads to adverse selection, a situation in which economically unviable projects are financed (and/or viable projects are not financed). It also leads to panic, once uninformed market participants are surprised by some unforeseen event. In a broader context, there is also asymmetry in information held by those who engage in financial transactions and those who try to supervise them. The reason is because financial transactions are much less visible and much less costly than transactions in goods and services.

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5. The only certain way to obliterate the problem of exchange rate volatility is to obliterate exchange rates themselves, i.e. to introduce a single currency. This of course requires complete loss of monetary policy autonomy, in the form of a hand-over of monetary policy decision-making to an internationally established central bank.

4. Moral hazard is stronger than in other markets. Those engaged in financial intermediation know that their survival is vital to the economy. The knowledge that policy authorities will have no choice but to save them can easily lead to irresponsible business decisions. Effectively, this means shifting the burden of risk management to some other party, which is possible because information is asymmetric. And even if financial institutions do not actually expect bankruptcy and a bailout, the knowledge that authorities will always protect them is enough to make them complacent. Protection creates a stable environment, which leads both lenders and borrowers to manage risk poorly<sup>6</sup>.

5. Money does not have a substitute. Unlike other goods and services, if money is needed, one cannot exit the market for funds and go to the market for something else that serves the same purpose. In other words, only financial intermediation (direct or indirect) can provide finance. This gives rise to an element of monopoly on the part of the lenders, in so far as funds are indispensable for the survival and/or growth of the borrowers.

All these characteristics are particular to financial markets, and the first three become stronger with global financial integration. Alone or together, they compose an important ingredient of a financial crisis. Financial markets are by nature prone to instability, and all that is needed is some economic or political difficulty to trigger a crisis. In fact, characteristics 1 to 5 are enough to cause a financial crisis domestically, even if cross-border capital flows are strictly controlled and no exchange rates are involved.

But the crisis becomes more serious when international capital flows and exchange rates enter the scene. There are several reasons for this. One apparent reason is the amount of capital involved. This will almost surely be larger when international lending is allowed. Furthermore, if panic sets in and funds are withdrawn, foreign funds are more likely to be withdrawn abroad than domestic funds. The problem of information asymmetry is also worse when funds move internationally. International lending and borrowing are more likely than domestic lending and

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6. There is debate about the importance of moral hazard in financial crises. This point is discussed in detail in Kaji (1999c).

borrowing to be between two economic agents that do not have a similar background. The authorities also have more difficulty acquiring information on foreign financial firms, especially on those established in tax havens. In addition, the monetary authority has less control over monetary affairs if the currency has convertibility. And last but not least, if a financial crisis occurs in the international arena, an international monetary authority with the same mandate, or political, legal and institutional backup (and in some cases funds) as its domestic counterpart does not exist. For all of these reasons, international capital flows tend to magnify the basic volatility of financial markets.

In the previous sub-section, we discussed why exchange rates are difficult to stabilise. Both exchange rate volatility and the peculiarities of financial markets arise from economic logic, and not unique to any particular region of the world. They are always there, and if conditions are met, together they can cause serious harm to an open economy.

## **Measures and Implications**

Of the two basic ingredients of financial crises, there is not much that can be changed by policy. Exchange rates are by nature volatile, and intervention can easily become unsustainable. Of the five characteristics particular to financial markets, 1, 2 and 5 cannot be changed by policy. The best we can do is to take measures that minimise 3 and 4, moral hazard and information asymmetry<sup>7</sup>.

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7. Since the Asian crisis, there has been much discussion on the desirability of capital controls. But how to weigh the cost and benefit of capital liberalisation is not a question that can be answered at an abstract, general level. This is because once intervention in the workings of the market is recommended, the discussion enters the realm of what economists call the 'second-best' (compared to the optimal with no intervention at all). Economics does not answer the question of whether one 'second-best' situation is better than another. There is no general theorem that answers the question of whether capital controls are good for the economy. Such answers must be figured out on a case-by-case basis. In any event, capital controls cannot be kept forever, if a country wishes to benefit from the efficient allocation of world savings. If and when the controls are to be removed, the country will once again have all the basic ingredients for a financial crisis. We are back with the question of what to do about the two elements of these basic ingredients which we can hope to change by policy.

## *Benefits of Foreign Competition*

Moral hazard can be reduced if market participants can be convinced that there is no lender of last resort. For this to happen, lenders of last resort must actually become non-existent. Many would agree that this is not a realistic option. A less radical approach is to expose domestic financial institutions to foreign competition.

It is one thing to achieve capital account liberalisation, quite another to allow foreign competitors to enter the financial sector. In other words, regulating the flow of capital is not the same as shutting out foreigners from the domestic financial sector<sup>8</sup>. This point has profound implications to our question of how to minimise the frequency and magnitude of a financial crisis. Keeping out foreign competitors from the domestic financial sector is dangerous because it leads to standards in financial intermediation that are unique to that country. By being exclusive of foreigners, such standards in financial intermediation promote information asymmetry and moral hazard. These two are dangerous, because they easily lead to financial crises. The East Asian countries, as well as Japan are among the recent examples. If countries wish to lower the risk of such crises, one way to do so is to open the domestic financial sector to foreign competition<sup>9</sup>. First of all, interaction with foreign agents demands more transparency, in the form of rules and standards more comprehensive to new-comers. Second, to compete and win, one must be efficient and effective, not just in production of services but also in risk management. Three,

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8. Malaysia after the recent crisis is an example of a country that imposes regulations of both types, although IMF (1999a, p. 2) reports that this has not stopped the country from pushing ahead 'a well-designed and effectively implemented strategy for financial sector restructuring'. Chile is an example where capital flows were controlled (until the temporary halt recently) while some competition with foreign financial institutions in the domestic markets were allowed. Thailand, Indonesia, South Korea and Japan are examples of the other extreme. In these Asian countries, capital controls were removed, but there was virtually no competition with foreign financial firms.

9. This involves foreign direct investment in the financial sector. Eichengreen et. al. (1999, p.8) recommends this on two grounds. One, it can bring transfers of technology and more efficient business practices. Two, foreign direct investment flows do not flow out as quickly as bank loans and debt financing. Such views are heard also from within East Asia. The Assistant Governor of the Bank of Thailand, Mr. Kiattisak Meecharoen anticipates foreign banks operating in Thailand to have increasingly important roles in the next two years, and hopes their management skills will have good influences on local banks (Nihon Keizai Shimbun, 23rd August, 1999). In addition to all this, from the point of view of domestic depositors, there will be the benefit of being able to diversify risk if both domestic and foreign banks operate in their country.

domestic financial institutions can learn from their foreign counterparts. Four, domestic policy authorities will be forced to abandon special treatment of domestic firms and to make their own actions more transparent. And five, authorities will also see the acute need for legal frameworks (such as bankruptcy laws) that maintain stability in the more competitive environment.

As the last point suggests, and since the financial sector is by nature prone to instability, too much competition can be destabilising. This defeats the whole purpose of introducing competition, which was to achieve stability by minimising information asymmetry and moral hazard. Evidently, introducing competition in the domestic financial sector is a much more delicate task than introducing competition in other sectors.

Monetary authorities face a trade-off. Too much competition in the financial sector can hinder economic stability and/or development. This is why some regulation and fixed exchange rates are often recommended to a country in its earlier stages of development. However, too much protection of the financial sector invites moral hazard, and standards in financial intermediation lacking in transparency.

Therefore, monetary authorities must find an optimal balance between competition and protection. This balance is not constant through time, but changes with the surrounding environment. The authorities themselves cannot become complacent, or influenced by vested interests. They need to introduce measures that encourage or even enforce transparency and disclosure. This should also help reducing the asymmetry in information between the authorities and the private sector.

Because international lending and borrowing are involved, the degree to which transparency and disclosure are enforced would need to be uniform in all relevant countries. This requires convergence of the relevant rules.

### *Convergence*

Financial business on a global scale would be facilitated if rules regarding financial intermediation were the same everywhere. In this respect, it is obvious that conver-

gence of standards is beneficial. What makes this so contentious is the question of whose rule everyone should adopt. Politically weaker countries object to the real or perceived imposition of rules by politically stronger countries. However, in the context of minimising the risk of financial crises, there are at least two additional benefits to convergence.

One is exchange rate stability, and the other is reduced information asymmetry and moral hazard (given the right kind of convergence). Exchange rates change due to asymmetry. By definition, convergence means less asymmetry. In this sense, convergence on its own is already desirable, leaving aside the question of what kind of rules the convergence is made towards.

In addition, if convergence is towards rules that ensure transparency and disclosure, it is even more beneficial. Rules regarding financial transactions should converge to the standard that keeps contracts and conducts clear to everyone on the globe, which could be called the 'global standard'<sup>10</sup>.

Convergence towards such a standard will not eliminate financial crises. But without it, the possibility of another crisis is higher. It is dangerous for Asia to have a standard of financial intermediation unique to Asia. It took a serious crisis for Thailand, South Korea and Indonesia to see this. The East Asian countries should welcome competition from foreign financial concerns, all the while introducing regulations to ensure transparency (and even temporary capital controls, if need be). As for Japan, the crisis was milder in comparison, which explains the lack of urgency. But after ten years of recession, rising unemployment and the 1997 to 98

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10. The 'global standard' should be defined as the standard that maximises stability in a global environment. In Asia the word is often viewed with suspicion, as synonymous to the 'US standard'. This is not always appropriate, but it is at times correct, because the domestic environment in the USA most closely resembles the global environment. More than in any other country, in the USA business is done between agents that do not share the same background in terms of race, origin, religion, gender, culture etc. Through the workings of the freer market, there are constant entries and exits. By necessity, rules in the USA tend to emphasise transparency and disclosure to enable smooth transactions between people who have no established relationships. The demise of Long Term Capital Management in 1998 made it clear that disclosure and transparency can be insufficient at the heart of Anglo-American capitalism. But the circumstance was exceptional, if only in terms of the reputation and connections of the financiers involved. And the incidence only reinforces the argument here that transparency and disclosure are essential to financial stability.

financial crisis, foreign firms are finally being introduced in the Japanese financial sector<sup>11</sup>.

Standards of financial intermediation in other parts of the world are not perfect. But there are those that are better at maintaining stability. As far as the standards on financial transactions are concerned, the Asians need to conform to the standards being established in the USA and other Western countries whose financial sectors are successful.

Because money has no substitute (the fifth characteristic of financial markets), standards accepted in the financial sector is likely to spread to other sectors of the economy. Borrowers in need of funds cannot refuse to accept standards set by the sources of funds (including the stock market). This is already happening in Japan, for instance, as traditional ties between industry and main banks break down.

This process meets resistance. However, the 'global standard' does not have to remain unchanged. In fact, in order to remain conducive to stability, it must keep up with the rapid pace of innovations in global finance. It would also be influenced by the relative dominance of the currencies and financial sectors of the world's major regions. This is where the successful start and continuation of stage III can have profound implications.

## **What the New Currency Means for Asia**

If the euro and European financial institutions come to play a role that is as dominant as their counterparts in the USA, that would change the balance of power in the international arena. Given that Europe, and especially Continental Europe shares with the Asians the suspicion towards unbridled working of market forces, this is important for Asia. As has been expected as one of the benefits of the single currency, European businesses, including the financial institutions are going through an unprecedented process of restructuring and consolidation. As for the

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11. Further details can be found in Kaji (1998), (1999a,b).



euro itself, some have almost triumphantly reported the slide of the euro against the dollar and the yen, as the year 1999 wore on. Behind this is a classic misunderstanding of the exchange rate as the reflection of national strength. An exchange rate is a double-edged sword and neither a depreciation nor an appreciation is necessarily good. The euro's slide has certainly helped economic recovery in Germany and Italy among others who needed it.

### *The Importance of Bonds Denominated in Euros*

More importantly, behind the so-called decline of the euro, an important phenomenon was taking place, reflecting the benefits that the single currency brings to Europe. This is the expansion in the euro bond market (Table 1).

During the first six months of 1999, the amount of euro-denominated bonds issued was 325.3 billion euros. Compared to the same period an year ago, this amount is 3.5 times the amount of euro-denominated bonds, and twice the amount of Euroland currency denominated bonds issued. It is also higher than the 324.9 billion euros worth of dollar denominated bonds issued in the first half of 1999. Funds have not stopped flowing in from the USA as well as Asia, despite the foreign exchange loss suffered since the beginning of the year. Needless to say, Euroland governments are issuing bonds in euros. But importantly, the mega-M&A activities, unprecedented in Europe, is also behind this. A total of 169 companies issued bonds in euros amounting to 69.5 billion euros, or 21.4% of total issuance. Daimler-Chrysler, Mannesman, Endesa all issued bonds worth one billion euros. Olivetti

**Table 1**  
**International Bond and Note Issuance**

(US\$ billion, %)

	1995	1996	1997	1998	1999Q1	1999Q2
US\$	180.4	391.2	515.1	587.8	197.5	193.5
(% North American borrowers)	38	38	39	53	61	62
Euroland currencies	143	211.9	218.6	319.5	147.2	176.6
(% Euroland borrowers)	58	57	56	63	67	71
Yen	126.2	135.1	129.5	72.8	17.7	24.6
(% Japanese borrowers)	30	32	34	44	52	38

Source: BIS International Banking and Financial Market Developments: Second Quarter 1999, p. 22.

could not have raised the funds needed to take over Italian Telecom, a company twelve times larger, in Italian lira. As it turns out, Olivetti launched the largest corporate bond in history in June, in a 9.4 billion euro offering. A total of 1.6 billion euros were raised to finance part of the 31.3 billion euro take-over. The euro has started an irreversible process of restructuring and consolidation in European business, as had been expected. This process seems to entail a shift from the more traditional indirect financing to direct financing, which may be pointing to the future of finance.

Outside of Europe, euro-bonds have been popular in the emerging markets, 3.5 billion US dollars worth of euro denominated bonds have been issued during the first six months of 1999. This compares to 1.8 billion US dollars worth of dollar denominated bonds during the same period<sup>12</sup>. Chile Telecom and Argentine Telecom have issued euro-denominated bonds worth 200 million euros. Petroleos Mexicanos raised about 300 million euros. Governments of Brazil, Mexico, Kazakhstan have raised money in euros, and electricity authorities of South Korea and Estonia plan to do so. This is not just a question of interest rate differentials. For a currency to be attractive as store of value, its market must be liquid and deep. An example that proves this point is the Swiss franc, long known for its strength and stability, yet never a serious rival to the US dollar. The same can be said about the Dutch guilder.

Which brings us to a phenomenon that bodes well for the euro, the disappearance of budget deficits in the USA and the UK. On 4<sup>th</sup> August 1999, the US government announced its plan to reduce government bonds (including bonds issued by government agencies, amounting to 3,600 billion dollars) by 1,700 billion dollars in the next decade. The reduction planned for 1999 is 87 billion dollars, and by 2015 the plan expects to reduce bonds held by the public to zero. This will be done by repurchasing government bonds with longer maturities and higher interest rates, and replacing them with short-term bonds. The funding source of this operation is the budget surplus of 1,000 billion dollars expected in the next fifteen years.

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12. The effective Brady-bond default, the first of its kind, by Ecuador was received in the markets as shift in US and IMF policy towards 'bailing-in'. As a result, the average cost of borrowing for emerging markets, which was four percentage points above rates on US Treasury bills in early 1999 has now risen to seven percentage points above. If this continues, borrowing by emerging markets from the markets, in whatever currency, is likely to be subdued for the foreseeable future.

Of course, huge budget deficits are a sign of weakness in a currency on the one hand. This idea comes from the inability to pay back debt, especially of the foreign kind. But on the other hand, a huge budget deficit financed by issuing bonds necessarily leads to liquid, deep markets for bonds denominated in that currency.

If the US continues to run current account deficits at today's levels (expected to be above 300 billion dollars in 1999), and at the same time US government bonds become scarce, foreigners will have no choice but to hold assets in other forms such as corporate bonds. However established a corporation can be, its bonds are riskier than government bonds. With the US stock market boom, many executives have chosen to repurchase stocks and replace them with bonds<sup>13</sup>. This means that there are corporate bonds to replace government bonds are plentiful but riskier. If all goes well, Americans will continue on their spending binge, which will keep their current account in deficit and capital account in surplus, money will keep flowing in, not to the government but to the private sector, further fuelling production, wages and consumption. But if something goes astray, the entire cycle could come down in a crash.

Government bonds are also in short supply in the UK. The total amount of gilts (government bonds) issued by the treasury in the 1997-98 financial year was £8.1 billion, down from £39 billion in the 1996-97 financial year. According to the Financial Times (20<sup>th</sup> August 1999), this amount is expected to be much lower this year, and pension funds and life insurers are unable to satisfy their demand, especially in 25 to 30-year gilts. The shortage is especially hard because these institutional investors are obliged under the government's minimum funding requirement, to hold a fixed percentage of their assets in securities such as gilts. Institutional investors are substituting with long-term bonds issued in the private sector. The same FT article quotes a financial information provider (Capital Dataware) that some '31% of sterling bond offerings by UK companies between January 1998 and July 1999 were of a maturity in excess of 15 years, ... nearly half ... in more than 25 years'. UK

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13. The Economist, July 17<sup>th</sup> 1999, 'Buy now, while stocks last'. The article reports that 'American companies are now buying back as much as 2% of their outstanding equity every year.' If this rate continues, America should be financed almost entirely by debt' in one hundred years.

investors could substitute with Continental government bonds, and the risk of exchange loss will disappear should they join the single currency.

As this argument shows, lower budget deficits and scarcer supply of government bonds in the USA and the UK are good news for the euro as the only alternative for risk-averse investors<sup>14</sup>.

### *The Euro and Asian Central Banks*

Given that monetary authorities are risk-averse investors, this points to an increase in demand for euro as a reserve currency, in Asia and elsewhere. At this stage, it is still early to see much evidence. For one thing, central banks are not known for disclosing currency compositions of their foreign exchange reserves, with the exception of the Honk Kong Monetary Authority. As a consequence, the discussion of reserves inevitably involves anecdotal evidence and guesswork.

The HKMA (1999) reports that as at 31 December 1998, the Exchange Fund's assets (including forward transactions) comprised the following ratios of the following currencies. 61.8% for the US dollar, 23.9% for the HK dollar, 11.3% for European currencies and 2.6% for the yen. As for the Land Fund's net assets<sup>15</sup>, as at 31<sup>st</sup> October 1998, the respective figures were 64.0% for the US dollar, 29.5% for the HK dollar, 5.9% for European currencies and 0.0% for the yen.

On 9<sup>th</sup> March 1999, the Nihon Keizai Shimbun reported that the HKSAR had announced the change in the mix of currencies in its Exchange Fund. The ratio of US dollars was increased from 70% to 80%, while those of the yen and European currencies were cut down by 5 percentage points to 5% and 15% respectively.

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14. New financial instruments do exist that can separate and sell the risk attached to corporate bonds to risk-loving investors. This would make the remainder almost as riskless as government bonds. But the transferred risk is still held by some parties in the market, and if they become numerous enough, their demise could have serious consequences to the global financial markets. Hence, there is no fail-proof way of getting around the shortage of dollar and pound denominated government securities.

15. The Land Fund was established by the Chinese and British authorities to transfer the revenue from official land sales to the HKSAR (Hong Kong Special Administrative Region). Part of the fund is managed in foreign currencies, and is therefore counted as part of Hong Kong's foreign exchange reserves.

Given the particular nature of the exchange rate arrangements, i.e. a currency board with the US dollar, Hong Kong does not provide a typical example from Asia.

For the other nations, the ratios of different currencies in foreign exchange reserves is not public information. We can, however, discuss the relative importance of currencies in terms of their roles as medium of exchange and repayment of overseas loans. Looking at the three Asian countries most affected by the recent crisis, Thailand's settlement of trade in goods and services in 1999 were 80-85% in US dollars, 6-8% in yen, 1-2% in Deutsche marks and 0.5% in British pounds<sup>16</sup>. The ratios seem to be similar for Indonesia in 1998, although the Deutsche marks and British pounds have higher rates of around 6% and 1.5% respectively. South Korea shows a slightly different picture. In October of 1999, the Bank of Korea reported a 26.6% increase in yen-denomination of their imports and exports during the first seven months of the year. 53.7% of Korean exports were denominated in yen, up 5.9% from an year ago. The equivalent number for imports was 62.9%, up 5.5% per annum.

As for foreign borrowing, total Thai foreign debt stood at \$ 86 billion at the end of 1998, 67% in US dollars, 33% in Yen and 0.7% in Deutsche marks. In Indonesia, throughout the 1990s, debts held by government and state enterprises were about 40 to 45% in US dollars, 30% in Japanese yen and 5% in Deutsche marks.

The Bank for International Settlements (1999) reports the situation from the lenders' side. At end-December 1998, banks reporting to the BIS had claims of nearly 40 billion US dollars on Thailand, 65 billion US dollars on South Korea and 45 billion US dollars on Indonesia. Table 2 shows the relative importance of the major lenders. Needless to say, nationalities of lending banks are not always the same as the nationalities of currencies used in lending. However, these figures do show the relative importance of financial sectors (if not the currencies) in the different nations. This point becomes relevant below.

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16. Unless otherwise noted, data for Thailand are provided by the Royal Thai Embassy in Tokyo. Those for Indonesia are from their Central Bank's website. The Bank of Korea's announcement was reported in the Nihon Keizai Shimbun.

**Table 2**  
**Consolidated International Claims of BIS Reporting Banks**  
**end-December 1998**

(%)

	<b>France</b>	<b>Germany</b>	<b>Japan</b>	<b>Netherlands</b>	<b>UK</b>	<b>USA</b>
Indonesia	8.6	12.6	36.6	7.4	8.5	7.9
South Korea	11.4	12.6	25.9	3.9	8.5	9.6
Thailand	8.7	11.5	55.0	3.9	4.3	3.3

*Source:* Table 2, BIS Consolidated international banking statistics for end-1998, 31 March 1999, p. 9.

We close this section by touching upon the responses of China and Japan. China's initial response to the euro was cool. The Financial Times of 13th October 1997 reported that the State Administration of Foreign Exchange 'said it expected the euro to be a "soft and unstable currency in its early years"... and would keep most of its foreign exchange reserves in dollars until the European single currency had "matured"'.<sup>17</sup> By May of 1998, the official government-owned Economic Daily was reporting that China 'in accordance with the stability of the currency, needs to increase our euro reserves appropriately and the weighting of our foreign debt' (Financial Times, 6<sup>th</sup> May, 1998). The same article quotes the Economic Daily and reports the mix of China's foreign exchange reserves as about 60% in US dollars and 15% in yen and Deutsche marks. As the yen lost value in the same year, in August it became clear that the State Administration of Foreign Exchange had cut its yen holdings 'from just less than a third of the portfolio to below a quarter ... to around 24-25%' (Financial Times, 11<sup>th</sup> August 1999). By October, the Nihon Keizai Shimbun (31<sup>st</sup> October, 1998) quoted a Chinese economist at the National Development Planning Committee as saying the mix should be 40% in US dollars,

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17. Mr Zheng Wufu, an economist in the international department of the People's Bank of China wrote the FT in response to this article. In his letter, carried in the letters section on 3<sup>rd</sup> November 1997, Mr Zheng states that '(t)he governor of the People's Bank of China, China's central bank, has signalled that he is giving consideration to actively holding the euro, while officials from the State Administration of Foreign Exchange have made clear that China's holding of the euro would increase in line with the European single market'. He concludes by adding that '(t)his is not to say that China will hold euros immediately after January 1 1999.'

40% in euros and 20% in yen. At the same time, the Financial Times reported Mr Chen Yuan of the State Development Bank showing enthusiasm in issuing bonds in euros because they wished to 'keep the balance between the US and Europe' (16<sup>th</sup> October, 1998).

For Japan, the euro has already played an important role in foreign exchange market intervention. On 18<sup>th</sup> June 1999, at the request of the Bank of Japan, the European Central Bank sold yen in exchange for euros in European markets. This was the first major intervention initiated by the BOJ involving a European currency, whose amount is estimated in the markets to be in the order of one billion euros. Perhaps because it was unexpected, the yen responded immediately and dropped to 125 yen to the euro, and 120 yen to the US dollar. The slide of the euro against the yen had been hurting Japanese institutional investors who, at the end of 1998, had stacked up over 10 thousand billion yen worth of Deutsche mark denominated bonds, up 42.1% from the year before<sup>18</sup>.

At the time this paper is being written (mid-October 1999), the euro is about 1.08 US dollars and 115 yen. If the euro should have a problem rivalling the US dollar, one obvious reason is the lack of serious control on remarks regarding this currency<sup>19</sup>. In the USA, only two people are allowed to comment publicly on their currency, the chairman of the Federal Reserve and the Treasury Secretary. In contrast, not only the European Central Bank have several different voices regarding the euro, member central banks chime in as well. In fact, the August 17<sup>th</sup> Financial Times reports that research released by the economic consultancy 4Cast finds 'an inverse relationship between the number of official statements on the euro and the performance of the currency'.

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18. Assuming Japanese investors had held on to this amount of Deutsche mark bonds until July, the estimated foreign exchange loss would have been about 850 billion yen.

19. A recent example is Bundesbank president Welteke's remarks on 7<sup>th</sup> September endorsing the value of US\$1.05 to the euro, which had to be retracted. The same criticism applies of course to the yen, in its bid to become at least one of the major international currencies.

## Concluding Remarks

The euro may become a reliable alternative to the US dollar to the Asians and others all around the world. It is still too early to judge if this is certain to happen. However, the potential benefits of the single currency is not confined to expansion of choices. The political importance of Europe will be enhanced with the euro's importance as an international currency. This will provide a welcome counter-balance against the convergence towards extremely market-oriented standards in financial transactions.

Convergence of standards in financial transactions is inevitable, if not desirable. For those Asian countries who have chosen to remain a part of the global integration of financial markets, the best that can be done is to minimise the frequency and magnitude of financial crises.

To enhance stability, convergence must be towards a standard that enforces disclosure and transparency in the financial sector. The goal is to diminish the problems of exchange rate volatility and information asymmetry. Such a standard should be the 'global standard', a standard that minimises the risk of a financial crisis in a globalised environment. When transactions take place between people who do not share religious, ethnic, cultural and historic backgrounds, capital account liberalisation without transparency is a fertile ground for financial disasters.

Once the financial sector decides to do business according to the 'global standard' thus defined, the rest of the economy will follow. The financial sector sets many of the standards in the rest of the economy and society. The reason is because borrowers do not have any choice but to meet standards set by lenders. Thus he who rules the financial world rules the world. Inevitably, financial integration pushes forward the global integration of other aspects of the economy and society. For open systems that vigorously interact, the long-run tendency is convergence.

But the 'global standard' itself will be influenced by the advent of the new European single currency. In order to remain conducive to stability, the global standard on financial transactions must adjust to the constant and rapid changes. It is



likely to be determined by the region of the world with a dominant currency and a dominant financial sector. This is why the success of the euro and European financial institutions are important for Asia.

Euro may become a key currency and increase the importance of the European economies. Emu gives rise to as many opportunities as challenges. Europe must dismantle its structural rigidities and become more flexible. And disclosure and transparency must be sufficient to maintain stability. But if that is ensured, the standard in other aspects of the economy and society may remain less free-market-oriented. Europe will then be a welcome influence and important model to the rest of the world.

## Appendix: The Reduced Form for the Exchange Rate

In this appendix, a reduced form for the exchange rate is derived to support the statement in the text that an exchange rate changes due to asymmetry between the two countries. The asymmetry could be in the changes in exogenous variables such as money supplies and exogenous shocks. It could also be in the partial derivatives (i.e. the response by the private sector to changes in economic variables). Both types of asymmetry could simultaneously exist, in differing degrees, but for clarity we consider some extreme cases.

We use a simple two-country model found in chapter 11 of Dornbusch (1980). The statement ‘the exchange rate changes due to asymmetry’ is a mere reflection of the fundamental fact that the exchange rate is a relative price of two monies. Complicating the model is not advantageous when the goal is to see this basic fact.

The notation is as follows;

h: nominal money stock

e: nominal exchange rate

(value of 1 foreign currency in terms of the domestic currency)

y: national income

p: price of the product

r: rate of interest

g: government spending

An asterisk denotes variables for the foreign country.

The model is as follows;

$$(1) y = g + d(e + p^* - p) - sr + fy^*$$

$$(2) h - p = -lr + fy$$

$$(3) r = r^*$$

$$(4) y^* = g^* - d^* (e + p^* - p) - s^*r^* + f^*y$$

$$(5) h^* - p^* = -l^*r^* + f^*y^*$$

The endogenous variables are  $y, r, y^*, r^*, e$ .

The exogenous variables are  $g, h, h^*, p, p^*$ .

The reduced form for the exchange rate turns out to be

$$\begin{aligned}
e = (p - p^*) &- \frac{l + fb}{af(l^* + f^*b^*) + a^*f^*(l + fb)} (h^* - p^*) \\
&+ \frac{l^* + f^*b^*}{af(l^* + f^*b^*) + a^*f^*(l + fb)} (h - p) \\
&- k \frac{ff(l^* + f^*b^*) - f^*(l + fb)}{af(l^* + f^*b^*) + a^*f^*(l + fb)} g^* \\
&+ k \frac{f^*f^*(l + fb) - f(l^* + f^*b^*)}{af(l^* + f^*b^*) + a^*f^*(l + fb)} g \quad (6)
\end{aligned}$$

where

$$\begin{aligned}
a = \frac{d - fd^*}{1 - ff^*}, \quad b = \frac{s + f s^*}{1 - ff^*}, \quad k = \frac{1}{1 - ff^*} \\
a^* = \frac{d^* - f^*d}{1 - ff^*}, \quad b^* = \frac{s^* + f^*s}{1 - ff^*}
\end{aligned}$$

$a, b, a^*, b^*, k$  are all positive, as are all the partial derivatives.

If all partial derivatives are respectively the same for the two countries (i.e. the model is symmetric),

$$de = (dp - dp^*)$$

$$\begin{aligned}
&- \frac{l + fb}{af(l^* + f^*b^*) + a^*f^*(l + fb)} [d(h^* - p^*) - d(h - p)] \\
&+ k \frac{ff(l^* + f^*b^*) - f^*(l + fb)}{af(l^* + f^*b^*) + a^*f^*(l + fb)} - [dg^* - dg] \quad (7)
\end{aligned}$$

and we can see that in this case, the exchange rate changes when there is asymmetry in the changes in each pair of exogenous variables. In other words, the exchange rate does not change even when exogenous variables change, if the changes are symmetric between the two nations.

If on the other hand the exogenous variable pairs change symmetrically but there is asymmetry in the partial derivatives,

$$\begin{aligned}
 de = & \left[ - \frac{1 + fb}{af(l^* + f^*b^*) + a^*f^*(1+fb)} \right. \\
 & + \left. \frac{l^* + f^*b^*}{af(l^* + f^*b^*) + a^*f^*(1+fb)} \right] d(h - p) \\
 & + k \left[ - \frac{ff(l^* + f^*b^*) - f^*(1+fb)}{af(l^* + f^*b^*) + a^*f^*(1+fb)} \right. \\
 & + \left. \frac{f^*f^*(1+fb) - f(l^* + f^*b^*)}{af(l^* + f^*b^*) + a^*f^*(1+fb)} \right] dg^* \quad (8)
 \end{aligned}$$

with  $dp = dp^*$ ,  $d(h^* - p^*) = d(h - p)$  and  $dg^* = dg$ .

Equation (8) shows that with symmetry in the changes in exogenous variables, it is the asymmetry in the responses of the private sectors that lead to exchange rate movements.

This simple model's exogenous variables are the money supply, government spending and the fixed level of product price. But government spending in this model can be interpreted as a type of demand shock. Using a model of the Canzoneri and Henderson type, it is easy to derive the reduced form for the exchange rate as a function of differences in changes in money supplies and demand and supply shocks, as well as expectations of these variables.

*Ceteris paribus*, the smaller the asymmetry in the pairs of changes in exogenous variables or pairs of partial derivatives, the smaller the exchange rate change. But symmetry is sufficient, not necessary for a constant exchange rate. In the event the asymmetry in the changes in one pair of exogenous variables is exactly offset by the asymmetry in changes in another pair of exogenous variables, the exchange rate does not change. The same is true when asymmetry in one pair of partial derivatives (times the exogenous change) is offset by the asymmetry in another pair (times the

exogenous change). The same is true also when asymmetry in partial derivatives is cancelled out within the coefficient on each exogenous change.

In fact, the goal of a foreign exchange market intervention is to create an asymmetry that exactly offsets whatever asymmetry that initially induced the exchange rate movement. It follows that if the intervention is sterilised in a way that relative money supply levels are unchanged, it is not successful. This would be the case if both countries intervene and completely sterilise. On the other hand, intervention is effective even when sterilised if it nevertheless succeeds in creating the required asymmetry. An example would be when only one country intervenes and sterilises, and the other country does not react to the change in its money supply thus created. Another example is when sterilised intervention changes expectations asymmetrically.

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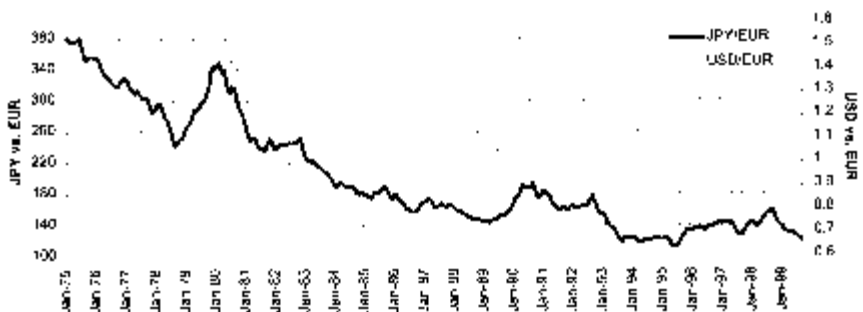
# The Euro as an International Currency

*Stefan Collignon and Susanne Mundschenk<sup>1</sup>*

With the start of European Monetary Union (EMU), the euro has become the world's second currency, after the dollar and before the yen. EMU countries account for 14 per cent of world GDP and 17 per cent of world trade. In economic size and power the euro area is comparable with the United States, which represents 19 per cent of world GDP and 14 per cent of world trade. If the UK and the three other EU countries outside EMU were to join, the euro-15 share in GDP would rise by a quarter to 18 per cent of the world total, almost the same as the US. However, the pace of development of the euro as an international currency remains somewhat unpredictable, and will vary between different uses.

Since its launch the euro has fallen against the dollar by 10% before appreciating again. This is not in itself a sign of instability, even though it was unanticipated.

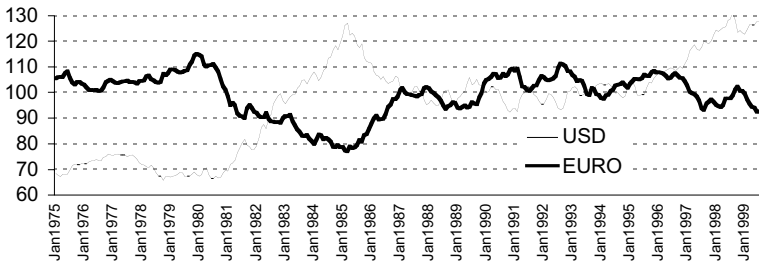
**Figure 1**  
**Monthly Nominal Exchange Rate JPY and USD vs.**  
**EURO**



1. The authors work in the German Ministry of Finance (Berlin) and the Association for the Monetary Union of Europe (Paris) respectively. They do not necessarily express the views of these institutions.



**Figure 2**  
**Monthly Nominal Effective Exchange Rate**  
 EURO and USD vs. Ind. Countries (1987 = 100)



Judged against the background of other currencies, it is as much a rise in the dollar as a fall in the euro. The trade-weighted exchange rate of the euro has fallen by only 4% (see figure 1 and 2).

With the arrival of the euro, the international monetary landscape has changed for other countries as well (see table 3). Central and Eastern European Countries and African countries who actively trade with the euro area might now have an incentive to integrate further around the euro. As the euro emerges on international markets, it is also becoming attractive for Asia as an alternative to the dollar - for private investors and exporters or as a reserve currency for monetary authorities. Asian countries will now have to decide whether to integrate around a regional anchor or what other strategy to choose with respect to the two main international key currencies.

The reasons for the Asian crisis are well known. The subject of this paper is to discuss future options for Asian monetary and exchange rate regimes on the background of the lessons from the past. During the crisis, Asian countries had to abandon their exchange rate policy. On their way to recovery, the question now arises if an active exchange rate policy is needed at all. Those who claimed domestic factors as responsible for the Asian crisis are also proponents of flexible exchange rates as they would isolate Asian countries from domestic shocks. However, in the presence of highly dynamic financial markets, flexible exchange rates make small countries more vulnerable to world-wide events which lead international investors to restructure their portfolios and to withdraw their currency positions. Therefore, the costs

of having flexible exchange rates can be high and the benefits are becoming less clear in the presence of international financial markets since spill-over effects are not avoidable.

The European experience has shown that stabilising intra-regional exchange rates is possible and can be beneficial when the elimination of exchange rate uncertainty enhances investment and intra-regional trade. Given Asia's diversified trade and investment structure with respect to the three key currencies – dollar, euro and yen – large and persistent fluctuations between key currencies would also affect growth potentials and competitiveness of Asian countries. This is because the exchange rate risk cannot be fully hedged away.

This paper suggests to rethink monetary exchange rate regimes for Asian countries in the presence of three important key currencies. After a short outline of the future international role of the euro, the importance of the international monetary system will be highlighted for future exchange rate policies in Asia.

## The Euro's Internationalisation

There is widespread disagreement on two major issues. How quickly will the euro take over some of the dollar's share as an international currency? How volatile will the dollar-euro exchange rate be? Both issues matter, and they are linked. This depends on how central banks and the private sector will adjust their currency portfolios and how these portfolio adjustments effect the euro exchange rate.

As an international currency, the euro would have to fulfil the three classical functions of store of value, unit of account and means of payment. They take slightly dif-

**Table 1**  
**Dimensions of an International Currency**

<b>Function</b>	<b>Private Sector</b>	<b>Public Sector</b>
means of payment	vehicle	intervention
unit of account	denomination	anchor currency
store of value	portfolio	official reserves

Source: Krugman (1991).

ferent forms in the private and public sector. The attractiveness of the euro depends largely on the size of its domestic markets, its substitutability (liquidity) and its general acceptability with potential non-resident holders.

Probably the most important is the financial role of the euro as a store of value and its use to denominate financial liabilities. The euro is already quite important in this regard. In the first two quarters of 1999 net issues of pure international debt securities in euro exceeded those in US dollars (although the total amount including domestic issuers in dollars is still slightly more important than the euro).

For the private sector, the store of money function will further expand rather rapidly as domestic financial markets develop further. In large financial markets, where euro-denominated assets are traded actively and domestic and foreign borrowers could raise sizeable volumes of funds at low costs, the euro's attractiveness as an international currency is greatly enhanced.

Private and public functions of a currency can experience different developments. A currency might be chosen as a vehicle currency without being used as an inter-

**Table 2**  
**Financial Market Indicators**

	EU11/euro	EU15/euro	US/\$	Japan/Y
GDP 1997	4800	6050	6300	2350
<i>% of world total</i>	<i>14</i>	<i>18</i>	<i>19</i>	<i>7</i>
World trade share % 1997	17	22	14	4
Forex reserves by currency 1997 ( <i>% of total</i> )	19.6%		57.1%	4.9%
Debt securities, in euro bn:				
Amount outstanding Jun. 1999	563	766	1379	418
<i>% of total amount outstanding</i>	<i>20%</i>	<i>27%</i>	<i>66%</i>	<i>15%</i>
International Issues (incl. Domestic), <i>first two quarters 1999</i>	263	318	314	-7
<i>% of total</i>	<i>41%</i>	<i>50%</i>	<i>49%</i>	<i>-2,8%</i>
International Issues (excl. Domestic), <i>first two quarters 1999</i>	100	121	87	-13
<i>% of total</i>	<i>48%</i>	<i>58%</i>	<i>42%</i>	<i>-6%</i>
Foreign exchange market daily turnover Apr. 1998 euro bn	710	890	1470	350
<i>% of total world forex market turnover</i>	<i>25%</i>	<i>30%</i>	<i>47%</i>	<i>11%</i>

Source: BIS, ECB Monthly Bulletin, August 1999.

vention instrument. Trade might be denominated in euro although monetary authorities have not pegged their currency to it. Finally, official reserves will be denominated in euro only if the monetary authorities want to stabilise the exchange rate against the euro whatever the composition of private portfolios might be.

### *The Official Use of the Euro*

According to the IMF, the share of the dollar in official reserves has been falling over the last twenty years from 76.1% in 1973 to 58.9% at the end of 1996. Over the same period the share of the main European currencies grew from less than 15% to 25%. At the end of 1997, the former euro area national currencies accounted for 19.6%, the dollar for 57.1% and the Japanese yen for 4.9%. Such figures, however, are likely to underestimate the effective share of these reserve currencies since the currency breakdown of individual countries' official reserves is in most cases confidential.

With the introduction of the euro, the share of euro area currencies in the foreign reserve assets of central banks declined as a result of two technical adjustments: First, on 31 December 1998 the Eurosystem unwound into gold and US dollars the official ECUs that were issued to EU central banks through revolving swaps against the contribution of 20% of their gross gold holdings and US dollar reserves, for a total amount of ECU 60.9 billion. Second, with effect from 1 January 1999 the Eurosystem's reserves previously denominated in former euro area national currencies became domestic assets, which brought about a decrease in the Eurosystem's foreign exchange reserves.

These developments, which are related to technical implications of the changeover to the euro, resulted in a contraction of the share of the euro in official reserves. However, although no updated information is currently available, the euro is likely to remain the second international reserve currency as a legacy of the former euro area national currencies.

Where, then, is the euro as a reserve currency going to develop from here? This largely depends on the synergies with other key currency functions:

- Countries who decide to peg to the euro will necessarily need to hold official reserves and to intervene in the euro in order to defend the peg.

- As transaction costs are low, monetary authorities are likely to hold assets denominated in euro, provided it is expected to be a stable store of value. Therefore price stability and exchange rate volatility (stability of internal and external purchasing power) are crucial elements for the future development of the euro as an international currency.

The use of the euro as an *intervention currency* is mainly related to its function as a pegging currency. In addition, countries with currencies which are not directly pegged to the euro can also use it for intervention purposes to pursue more informal exchange rate objectives. No quantitative data are available on this function since, with a few exceptions, most central banks do not release figures on their intervention operations. However, it has been known that the European Central Bank has been intervening on behalf of the Bank of Japan in the summer of 1999, in order to dampen the rapid appreciation of the Japanese yen.

With regard to the use of the euro as a *pegging currency*, there are a number of arrangements ranging from the introduction of the euro as their own currency by a few countries (e.g. Montenegro) to the adoption of exchange rate regimes involving the use of the euro.

The implications of the use of the euro as a pegging currency are twofold:

- First, if the euro is used as a nominal anchor, the incentive to use it for trade invoicing and debt denomination will increase for those countries, thereby reinforcing the international role of the euro. Private sector traders might increasingly denominate transactions in euro, a practice that would lead them to hold working balances in euros, and ultimately reinforce the tendency for investments to shift to the euro.
- Second, the use of the euro as an anchor currency could push the international monetary system towards a bipolar framework, which in turn also has consequences for the variability of the dollar-euro exchange rate. In a world with two major currency blocs, the exchange rate between the two anchor currencies could be more volatile, as this is the only exchange rate to adjust for fundamental disequilibria between the currency blocs. Such a development could be of utmost importance to the future growth of Asian economies.

In the following chapter we will explain the concept of bloc floating and the consequences for exchange rate variability and world-wide growth and investment.

**Table 3**  
**Exchange Rate Regimes Involving the Euro**

Country	Exchange rate regime	Peg against
Bosnia-Herzegovina	Currency board	EUR/DEM
Bulgaria	Currency board	EUR/DEM
Croatia	Managed floating (EUR/DEM used informally as reference currency)	
Czech Republic	Managed floating (EUR/DEM used informally as reference currency)	
Cyprus	Peg	EUR
Denmark	Peg within co-operative arrangement	EUR
Estonia	Currency board	EUR/DEM
Greece	Peg within co-operative arrangement	EUR
Hungary	Crawling fluctuation band	Basket: EUR (70%) USD (30%)
Iceland	Peg	Trade-weighted basket incl. the euro
Latvia	Peg	SDR
Macedonia	De facto peg	EUR/DEM
Malta	Peg	Currency basket: EUR (56.8%) USD (21.6%) GBP (21.6%)
Poland	Crawling Fluctuation band	Currency basket: USD (45%) EUR (55%)
Slovak Republic	Managed floating	euro used informally as reference cur.
Slovenia	Managed floating	euro used informally as reference cur.
Turkey	Managed floating with de facto crawling peg	Currency basket Including USD and EUR/DEM
14 African countries of which the CFA franc is the legal tender	Peg	EUR
Bahrain	Peg	SDR
Bangladesh	Peg	Basket of trading partners' currencies, including the euro
Botswana	Peg	SDR and basket of trading partners' currencies, including the euro
Burundi	Peg	Basket of currencies of its major trading partners, including the euro
Cape Verde	Peg	EUR
Chile	Crawling fluctuation band	Basket USD, EUR/DEM, JPY
Comoros	Peg	EUR
Israel	Crawling Fluctuation band	Basket (in terms of units of each currency in the basket): USD (0.6741) EUR (0.2282) GBP (0.0589) JPY (6.5437)
Jordan	Peg	De jure peg to the SDR
Libyan Arab Jamahiriya	Peg	SDR
Morocco	Peg	Undisclosed basket
Myanmar	Peg	SDR
Qatar	Peg	SDR
Saudi Arabia	Peg	SDR
United Arab Emirates	Peg	SDR
Vanuatu	Peg	Undisclosed transactions-weighted currency basket

Source: ECB Monthly Bulletin, August 1999.

## **The Emergence of Currency Blocs**

The breakdown of Bretton Woods was accompanied by the hope that flexible exchange rates would isolate country-specific shocks and prevent crises to spill-over to other countries. This belief was founded on the assumption that the exchange rate will stabilise around its long term value in accordance with the country's economic fundamentals. Unfortunately, reality turned out to be different. In the presence of highly efficient financial markets, economic fundamentals seem to have no systematic impact on flexible exchange rates at least over the medium term. Additionally, factors driven by market psychology also influence and sometimes may even dominate foreign exchange markets.

The resulting exchange rate fluctuations in the post-Bretton Woods world created uncertainty for investment and trade decisions. As a consequence, the required future profits and interest rates had to account for a risk premium due to exchange rate volatility. Trade and investment decisions became rather expensive. Therefore, growth opportunities remained unexploited. This was of particular relevance for Europe, where the degree of openness was very high (over 2/3 in some smaller countries). As a consequence, devaluations undermined price stability, and the subsequent tight monetary policies led to low investment rates, low growth and high unemployment. The need to return to a stable and competitive environment for business investments was the reason for the creation of the European Monetary System in 1979. Other countries stayed with the US-dollar. As a consequence, two large currency blocs emerged around key currencies – the dollar and the D-Mark. Most small regional currencies did join a currency bloc in order to achieve monetary stability at home and to reduce exchange rate uncertainty in the international arena. Hence a system of regional currency blocs has emerged where key currencies float against each other while at the same time significant exchange rate stability was maintained within the currency blocs.

Empirical evidence for the emergence of monetary blocs has been provided by Frankel and Wei (1992) and Bénassy-Quéré (1995, 1997, 1999). A country is defined as belonging to a currency bloc when the relative exchange rate variability is signi-

ificantly lower within a group of countries than across groups.<sup>2</sup> This definition permits some flexibility in the pegging rule but emphasises the reduction in exchange rate volatility.

After abandoning their link to the US dollar in the 70s, an increasing number of countries have pegged their exchange rates to regional anchor currencies. In 1992, only 26 currencies out of 178 followed a fixed exchange rate to the dollar. However, more important than the number of currencies belonging to a currency bloc is its economic size. The size of a currency bloc can be measured by the share of foreign trade between countries belonging to the bloc compared to total world trade. It appears that the dominant characteristic of the last 20 years was the emergence of the DM-bloc, while Asia, with the exception of Japan, belonged to the dollar zone.

Yet, the size of a currency bloc is not to be explained solely in terms of the stabilisation of the major trade relationships. While the D-mark served as anchor currency only for those economies in which trade with the European Union (EU) accounted for over 50% of their exports, the U.S.A. did not necessarily have to be the major trading partner to induce a country to link its currency to the dollar. The reason for this was the dominant international role fulfilled exclusively by the dollar since the second World War. In that sense it is to be expected that the arrival of the euro as an international currency will also have a profound impact on world relations.

Two features are important in this respect. First, the euro has created a new “country”, Euroland, in terms of currency. It is not the same as a currency-bloc, because monetary policy is unified by the European Central Bank. Interest rates are the same over the whole area and only one external exchange rate exists for Euroland. Therefore adjustment in case of imbalances takes the whole area into consideration and not just one country as in the case of a currency bloc. Because Euroland is a big country with a relatively low degree of openness, the equilibrium exchange rate will respond less to current account imbalances and more to cyclical divergences. This provides an opportunity for more exchange stability, provided the EU and the US

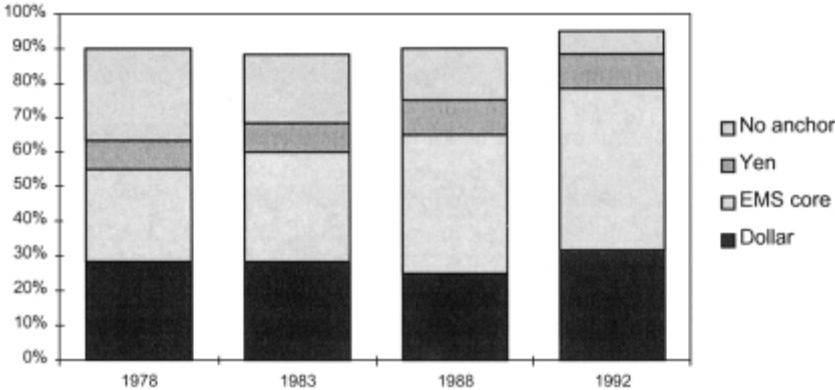
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2. For Bénassy-Quéré (1999) the criterion is a quarter of the volatility compared to the other two world currencies.



are willing to improve the co-ordination of their policies. However, if this does not happen and a new currency bloc develops around the euro (see table 3), the risks of instability are even greater.

**Figure 3**  
**Importance of Currency Blocs**  
**Share in World Exports**



Source: Bénassy-Quéré in CEPII n° 63.

Why does bloc-floating affect exchange rate volatility? There are numerous treatises in the literature explaining exchange rate volatility. The *overshooting effect* of the nominal exchange rate as a deviation from long-term equilibrium as shown by Dornbusch (1976) results from the differing price elasticities of capital and product markets. The *magnification effect* (Bilson, 1979) of a nominal exchange rate over-reaction is based on differing monetary policy expectations by market participants. But bloc floating gives rise to an additional *enlargement effect* differing from the two previously mentioned in that the equilibrium rate of exchange is in itself instable and volatile. Thus, in the absence of any orientation for financial market operators, exchange rate movements are left to chance (*random walk*).<sup>3</sup>

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3. Formal derivation see Collignon (1997, 1999).

## *Internal Versus External Stability - The Bloc-floating Experience*

How is the “enlargement effect” of bloc floating explained? Countries peg their currency to an anchor in order to create stability within the region and to promote investment. Hence, given the existence of a currency bloc, the external exchange rate between the blocs is the only instrument to adjust fundamental imbalances between the blocs. The larger the currency zone, the greater is the need for adjustment of the flexible exchange rate between the anchor currencies for a given imbalance.

Consequently, there is a trade-off between intra-bloc stabilisation and inter-bloc volatility through exchange rate pegging. As a result the equilibrium exchange rate between the anchor currencies becomes volatile and can no longer serve financial market operators as an orientation for exchange rate expectations. For when a large proportion of trade is conducted within one currency bloc, the adjustment of fundamental imbalances can take effect only in relation to the remaining flexible exchange rates.

In 1992, for instance, the dollar bloc provided 45% of U.S. imports. An improvement of the American current account deficit could therefore only be achieved by a devaluation against the free-floating currencies, representing 55% of US trade. Hence, assuming similar trade elasticities, the necessary devaluation of the dollar against the free floating yen and the D-mark had to be more than twice as high in order to achieve the same current account improvement as under fully flexible exchange rates. The more currencies are pegged to the dollar, the greater the devaluation in relation to the flexible exchange rates (DM, yen) had to be in order to achieve the desired current account response. In other words, the larger the currency zone, the less efficient is the exchange rate as an adjustment tool and the greater is the required adjustment of the inter-bloc equilibrium rate.

Exchange rate uncertainty does affect investment activity and growth prospects in the tradable sector of an economy. Reducing exchange rate uncertainty within the currency bloc eliminates the risk premium for trade and investment within the bloc and therefore maximises the profitability of investment for risk-averse investors in the tradable sector. An economy will benefit from greater exchange rate stability

within the currency bloc but will at the same time be exposed to increased exchange uncertainty between the currency blocs: if the fundamental equilibrium rate of exchange between currency blocs is volatile, international investors will demand risk premiums to offset volatile equilibrium rates. Hence investment will shift to the less-risky short-term sector. The larger the currency bloc, the greater the risk premium that may be expected. Thus bloc floating triggers a negative feedback effect on reserve currencies. This in turn exerts a negative, unintended effect on investment and growth.

For the country of the anchor currency the logic of bloc floating implies benefits by reducing the exchange rate risk within the bloc without constraining domestic policy objectives. But for the pegging countries the situation is more ambivalent. While diminished exchange rate volatility within the bloc will stimulate trade and investment, the pursuit of a restrictive monetary policy in the anchor economy would generate deflationary pressures. This exerts a counterproductive effect on economic growth in peripheral countries, since higher growth would require interest and exchange rates to be lower than is possible in a bloc floating regime.<sup>4</sup> This leads to irregular adjustment crises in currency blocs, as witnessed in Europe in 1992/3 and in Asia in 1997.

### *Currency Blocs - The Asian Experience*

Although nobody could foresee the dramatic consequences of the Asian crisis which broke out in 1997, it had already become apparent for some time that the successful development of South-East Asian economies had come to an impasse. Their rapid integration into the world market had been dependent on the monetary stability of their dollar peg. This provided a stable environment for investment and trade and kept the cost of capital comparatively low. However, once the penetration of the dollar area by cheap Asian exports had reached a significant degree, the dollar-oriented strategy yielded diminishing returns and further advances were difficult. Japan and Europe became attractive alternative markets to the US in the early 1990 when both regions' exchange rates were overvalued in relation to the US dollar.

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4. See Collignon, 1999, Chapter 4.

**Table 4**  
**Exchange Rate Management and Trade Orientation of Asian countries 1991**

Country	Nominal anchor	Main trading partners: (20 to 50% of total trade)	
		Import	Export
India	None	EU	EU
Indonesia	Dollar	Japan	Japan
Pakistan	Dollar	EU	EU
China	Dollar	Japan	USA
Malaysia, Philippines, Thailand	Dollar	Japan	EU/Japan/USA
Korea, Singapore	Dollar	Japan	USA

*Source:* Comptes Harmonisés sur les Echanges et L'Economie Mondiale (CHELEM) and Agnes Bénassy-Quéré (1997).

After the EMS crisis of September 1992 economic growth in Continental Europe slowed down and the bursting of the speculative bubble in Japan reduced the demand for imports from the East-Asian countries significantly. As a result, East Asian exports were constrained (except to the US), while booming domestic demand stimulated imports primarily from EU and Japan. Their current account deficits worsened markedly after 1993/94. These deficits were funded mainly with unhedged short term dollar credits from Japanese and European banks.

When the dollar began to appreciate from early 1995 onwards, export earnings from Europe and Japan were insufficient for the liquidity needed to service dollar-denominated foreign debt. By mid 1997, the dollar exchange rate had risen from 1.40 D-Mark to 1.80 D-Mark and from 85 Yen to 115 Yen.

Although Asian debtor countries were poorly regulated, their deposits were more or less insured by their national governments. Asian banks were therefore tempted to overborrow by accepting foreign exchange liabilities without covering the exchange rate risk. Short term bank loans into the five affected economies - Indonesia, Korea, Malaysia, Philippines and Thailand - peaked in 1996 at \$40.6 billion and then reverted to \$32.3 billion in 1997.

With the progressive abolition of capital controls, managing national monetary policy with the aim to sustain the exchange peg meant that short-term interest rates had to be flexible and increasing. This in turn required that the term structure of finance within each Asian country be lengthened. If business finance were short term, changes in short term rates imposed undue strain on commercial banks and enterprises and were therefore also harmful for growth.

The difficulties in servicing the short-term debt then shattered the confidence of the lending banks and induced them to withdraw their capital abruptly. It forced the borrowing countries to make much higher reductions in imports and production than would have been necessary had the financial debts been restructured in a co-ordinated way. As a consequence, the dollar peg of many Asian countries became unsustainable.

After the crisis, Asian countries have to choose a new exchange regime: a new peg – and which currency? – or free floating?

### *Future Options for Exchange Rate Policy in Asia*

The pre-crisis exchange rate regimes of the Asian countries had three features in common:

1. Dominance of the dollar for the majority of countries in the region despite the comparatively minor role of trade relations with the U.S.A.
2. Rigidity of the exchange rate regime despite increasing liberalisation of capital movements.
3. Underdeveloped monetary policy co-operation within the region despite the proliferation of trade and direct investment links.

Hence pegging to the dollar was not an optimal solution for the Asian region in the long term, although it allowed the increasing integration of the emerging economies into the world market. In many ways the 1997 shock and its consequences in Asia resembles the European experience after the end of the Bretton Woods System and

the first oil shock in 1973 with volatile exchange rates, rising inflation and low growth. It remains to be asked, therefore, what an optimum exchange rate policy for the Asian region could look like in future.

Because countries gave up the dollar peg, intra-Asian exchange rates became volatile. This has already acted as a brake on intra-regional trade and investment. Against a background of increasing intraregional trade links (Table 5), volatile exchange rate trends are detrimental for the entire Asian region. More than 40% of South East Asia's imports and nearly half its exports are with Asia, while trade weights with the US and Europe are similar, although America dominates as a supplier and the EU as a market.

Flexible exchange rates and volatility between dollar and euro are therefore counterproductive in the medium to longer term if the region aims to pursue a sustainable growth path. Under these circumstances, exchange rate stabilisation with respect to one of the key currencies of the major trading zones is not recommendable. In a bloc-floating world with a highly volatile dollar/euro exchange rate, trade and external debt strategies will be constantly disrupted given the importance of these two reserve currencies. An unstable or highly volatile transatlantic exchange rate would be a permanent source of instability for Asia. Therefore, the region must have a prime interest in the exchange rate management by EU and US authorities.

Alternatively, given the continuously increasing regional trade, intra-Asian exchange rate arrangements seem to be a preferable option. For example, Dornbusch and Park (1999) and Williamson (1999), have proposed a "BBC" exchange rate regime (band-basket crawl). Yet, mainly for political and cultural reasons, Asia has not been able to achieve close regional co-operation comparable to Europe after the war, although intra-regional trade in South-East Asia has become substantial. Willingness to co-operate may improve as a result of the crisis. Ideas of regional monetary funds and mutual credit lines have been explored. In this respect, Europe's experience in the European Monetary System might prove to be of interest for Asia. In the medium to long term, the essential question will be whether Asian countries should integrate around the Japanese yen, which is already an important currency in international capital markets or around a regional anchor such as the Chinese yuan. However, such choice is not independent of regional trade.

**Table 5**  
**Import and Export Shares 1995 (as% of total)**

<b>IMPORT SHARES</b>							
	Destination:				1996		
Country of origin	World	USA	EU15	Japan	<i>SE Asia</i> <sup>1</sup>	<i>China</i>	Central Europe
World	100	15.18	38.70	6.37	<i>13.86</i>	<i>3.48</i>	1.93
USA	100	0.00	20.99	11.91	<i>16.39</i>	<i>8.66</i>	0.34
EU15	100	6.71	61.36	2.30	<i>5.75</i>	<i>1.57</i>	2.90
JAPAN	100	27.67	15.11	0	<i>35.58</i>	<i>8.76</i>	0.17
SE Asia <sup>1</sup>	100	20.70	15.15	13.91	<i>27.80</i>		0.50
<i>China</i>	<i>100</i>	<i>13.48</i>	<i>14.05</i>	<i>25.67</i>			
Central Europe	100	4.25	52.90	3.32	<i>7.22</i>		11.52
<b>EXPORT SHARES</b>							
	Destination:				1996		
Country of origin	World	USA	EU15	Japan	<i>SE Asia</i> <sup>1</sup>	<i>China</i>	Central Europe
World	100	11.29	41.23	9.21	<i>12.39</i>	<i>2.70</i>	3.23
USA	100	0.00	18.24	16.80	<i>16.90</i>	<i>2.40</i>	0.90
EU15	100	6.13	65.37	3.60	<i>4.85</i>	<i>0.98</i>	4.42
JAPAN	100	21.11	14.90	0	<i>27.05</i>	<i>10.89</i>	1.69
SE Asia <sup>1</sup>	100	13.36	17.12	23.66	<i>24.85</i>		1.68
<i>China</i>	<i>100</i>	<i>28.09</i>	<i>18.60</i>	<i>23.17</i>			
Central Europe	100	2.01	61.96	0.81	<i>3.21</i>		19.32

1. Indonesia, India, Korea, Hong Kong, Singapore, Taiwan, Malaysia, Philippines, Thailand, Asia NDA.  
Source: CHELEM.

The trade structure of Asian countries is diverse and their main trading partners are the USA, Europe, Japan and intra-regional countries. None of these countries could claim a dominant position in Asia. This mismatch raises the question of the optimal pegging strategy given that the reduction of exchange rate uncertainty improves

investment: A new regime could therefore be based on a trade-weighted basket of currencies. Such a basket could link a regional currency system, perhaps centred around the yen, with a global currency system based on the dollar and the euro. Basket pegs are second best with respect to exchange rate uncertainty (see Collignon, 1999).

Could the yen emerge as a regional anchor currency? Given the current state of the economy in Japan and its long-term prospects, this still appears to be uncertain. To date, the yen has not served as an anchor for any currency.<sup>5</sup> Since the seventies it has displayed a continuing trend towards overvaluation against the dollar<sup>6</sup>, resulting in permanent pressure on Japanese production costs and the shifting of investment abroad. To maintain the real rate of exchange and hence the ability to compete at international level, the constant nominal appreciation of the yen set off a deflationary spiral. Consequently, there is no scope for monetary policy action in Japan, while fiscal policy lacks the necessary credibility of a resolute government. The period of the ever-rising yen that has lasted for almost thirty years has to be brought to an end if Japan's domestic economy is to be strengthened. The development of the yen into a regional anchor currency, could be an important step toward containing this historic strength. The lessons from Europe are clear in this respect: by overcoming the exchange chaos of the 1970s and the creation of a DM-bloc through the European Monetary System<sup>7</sup>, Europe has returned to macroeconomic stability and the deflationary bias in Germany has been less than in Japan.

Against the background of Japan's weakness and the East Asian crisis, the People's Republic of China has played an unexpected role in the past few years, with the yuan increasingly assuming the status of a regional transaction currency in cross-border trade. The official stock of currency reserves is put at \$ 200 billion. However, China's ability to compete is undermined by regional devaluations, so that the fixed linkage to the dollar cannot be taken as certain in the medium term. However, given the large share of semi-finished goods in China's exports, a devaluation of the yuan

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5. For a possible explanation of this phenomenon, see Bayoumi and Eichengreen (1998).

6. Over the period from 1970 to 1994 the yen appreciated by 250% against the dollar, twice as much as the corresponding cumulative D-mark appreciation. For an explanation of the phenomenon of the "ever rising yen", see McKinnon and Ohno (1997).

7. For a description see Collignon (1994).



could have a negative effect on China's growth and development at least in the short run, as was already the case in other Asian economies. Moreover, the reforms of the administrative system have generated tensions which the government has hitherto held in check with high growth rates. Further extensive reforms are still needed, not least to ensure the convertibility of capital accounts. These developments would not yet favour the yuan as a regional anchor.

## **Conclusions**

High exchange rate volatility and possible misalignments between the dollar and the euro could become a permanent source of uncertainty for emerging countries and especially for Asia. Hence, it would be natural for the yen to fulfil a greater regional role. Yet, a lack of stability and policy co-ordination between the USA, Europe and Japan could hamper economic and monetary integration in Asia in the long run. As Prime Minister Mahathir of Malaysia pointed out: "When elephants fight, it is the grass that gets trampled."

However, if the relation between the three key currencies could be stabilised, this would also stabilise currency relations inside Asia and between Asia and the rest of the world. Some form of Asian monetary system could emerge where Japan would play a natural role. In the medium to long run, this might prove to be indispensable for the sustainability of growth and prosperity in Asia.

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# Capital Flows and Exchange Rate Regimes in East Asia: Lessons from the Crisis

*Françoise Nicolas*<sup>1</sup>

The worldwide liberalization of financial markets in the 80s led to a sharp rise in the movements of funds across country borders. Newly Industrialized Economies (NIEs) and Southeast Asian (SEA) economies were major beneficiaries of this move which allowed them to get access to a larger pool of resources, to invest more and grow faster. A virtuous circle of capital flows and economic growth can thus be said to be an important part of the Asian miracle (Ito 1999).

Yet an increased reliance on private capital (in particular short-term) inflows may also render emerging markets more susceptible to volatility, including large reversals in those flows. Moreover, managing surges in capital inflows is by definition a tricky task. In a context of rising financial globalization, emerging economies are faced with the need to avert overheating resulting from large surges of capital inflows. While the most direct means is to reduce or control the net inflows of foreign exchange, other measures may aim at reducing the impact of reserve accumulation on monetary aggregates or reducing the impact of inflows on aggregate demand. In addition, policies may also help limit vulnerability through the development of better-functioning financial systems in particular. Until recently, most Asian economies were praised for their responses to surges in capital inflows; these typically involved a combination of sterilized intervention, capital controls and fiscal tightening. There was however a recent shift from a virtuous circle of capital inflows and economic growth to a vicious circle of capital inflows and financial problems.

The concerns associated with the potential risks of financial globalization have recently materialized with a succession of financial crises in a number of emerging

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1. I would like to thank Stefano Manzocchi for helpful comments on an earlier version of this paper.

economies. To be sure, the Asian financial crisis was in large part the result of the twin liberalizations (a deregulation of the domestic financial system and an opening of the capital account). As a result, in the aftermath of the Mexican and Asian crises, capital market opening has come into question (Dornbusch 1998). Actually, because most countries were also committed to a fixed exchange rate; they were necessarily heading for trouble. This is another illustration of the so-called inconsistent trinity hypothesis according to which exchange rate stability, monetary autonomy and full capital mobility cannot be attained simultaneously. Yet this analysis cannot account for the shift from a collapse of the exchange rate peg to a full-fledged banking and financial meltdown, nor for the speed and magnitude of the contagion to the rest of the region. The paper aims precisely at shedding some light on the mechanisms which turned the Thai exchange rate crisis into a systemic financial crisis.

Financial globalization may be potentially both positive and risky. Yet, in fairness, what matters more is both the composition of the capital inflows, as well as the conditions under which they take place. The benefits of financial integration clearly depends on the policy environment and in particular on the quality of the financial system. In the case of Asia, the crisis clearly resulted from an inconsistency between the speed of the financial liberalization move and the maturity and resilience of domestic financial systems. As a result, the priority should be placed in those countries on improving the health of their financial systems. Because this is no doubt a daunting task, there is also scope for complementary policies, and in particular for exchange rate policy. This paper argues that exchange rate policy is an important determinant in the potential risk associated with financial openness; such is the case because it may affect the type of flows a country is able to attract as well as the resilience of the financial system. In the case of Asia, the stability in the exchange rate was considered to be important for nurturing exporting industries and inviting capital inflows, yet it also contributed to weakening the banking sector by lulling economic agents into complacency about credit and currency risk.

The purpose of the paper is first to examine the role played by exchange rate policy in the expansion of capital inflows and in the build-up to the crisis in East Asia, and second to suggest means for emerging economies to better manage their integration

into global finance in the future, next to the necessary reforms of their domestic financial systems. Because exchange rate policy can be shown to have driven capital inflows in the past, it will be given a special emphasis in the analysis.

## **Pre-crisis Exchange Rate Policies and Capital Flows**

### *Pre-crisis Exchange Rate Policies*

In a majority of cases, immediately before the crisis, the currencies were officially pegged to a basket of currencies.<sup>2</sup> Yet, as rightly pointed out by Jomo (1998), despite “official fictions of exchange rates moving with the basket of currencies of major foreign trading partners”, in reality SEA currencies were pegged to the dollar. The effective weight of the dollar in the basket was so high that exchange rate policies can be characterized as an implicit peg to the dollar. This is confirmed by a number of authors who show that the weight of the dollar in the reference basket was much higher than what would have been implied by trade flows (Goldberg and Klein 1997; Frankel and Wei 1994, Kwan 1995).<sup>3</sup>

As a result of these policies, most East Asian currencies proved extremely stable vis-à-vis the dollar in nominal terms for most of the period 1985 through August

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2. The basket was either used as an official anchor (Thailand) or as a benchmark for managed floating (other major ASEAN economies). All countries did not belong to the same IMF category, however. According to this classification, most countries were following a flexible exchange rate regime, with the exception of Thailand, whose currency was considered pegged to a trade-weighted basket of currencies. ‘Flexible’ regimes consist of exchange rate arrangements in which the exchange rate follows a managed float or is independently floating. For some countries the exchange rate may be classified as managed floating or independently floating but in fact is informally pegged (IMF 1997). The Philippines was the only country in the region to be considered as purely floating (IMF Exchange Rate Arrangements). As for Korea, it dropped an official peg to the US dollar in 1980 and moved to a managed floating exchange rate system. In reality, the Korean government can be said to have followed a strong won policy since the late 1980s, with the exchange rate allowed to move within a narrow daily fluctuation band.

3. Some other econometric estimates point in the opposite direction however. By looking at how SEA currencies moved when the yen appreciated sharply against the US dollar during the period 1980-95, Takagi (1996) shows that the weight of the yen appears larger than most of the econometric estimates would suggest. In particular, his findings suggest that Thailand strictly adhered to a basket peg.

1997 (see graphs). By contrast, they depreciated vis-à-vis the yen and most European currencies over the period 1985-95, and appreciated in the last two years before the crisis. The major turnaround in the summer of 1995 came about when the dollar started strengthening with the US economy. It appreciated versus the yen (rising from 80 Yens to the dollar in mid-1995 to 130 Yens to the dollar in 1997) and most European currencies (with the exception of the pound). Southeast Asian countries by contrast resisted similar downward adjustments of their currencies. As a result, all SEA currencies reversed their course vis-à-vis the Yen, and appreciated in the wake of the dollar.

This exchange rate policy served most countries in the region rather well for some time but it became increasingly rigid and monetary authorities proved unable to adapt to changing circumstances. Such was the case because of the pressures exerted by various groups with vested interests in the preservation of the peg.

### *The Impact of the Peg on FDI and Exports*

Exchange rate fixity vis-à-vis the dollar can be seen as a way of enhancing export competitiveness for products to be sold in the US but also in other countries the currencies of which were strong relative to the dollar. Because a large weight was given to export promotion in the objective function of the authorities, they were reluctant to tie their currency too closely with the appreciating yen to the extent that nominal currency appreciation may have contributed to reduce the growth of exports in the short run. By contrast, if price stability had been deemed important an objective, the authorities may have been less willing to accept a nominal depreciation of their currency in the wake of the dollar because of the likely impact on domestic inflation.<sup>4</sup>

Preventing the exchange rate from appreciating vis-à-vis the dollar was certainly instrumental in maintaining export competitiveness in East Asian economies when

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4. This consideration is particularly relevant given the significant share of Japanese goods in total imports in all SEA economies. By contrast to other ASEAN countries, Singapore chose to let its currency appreciate vis-à-vis the dollar. This is because price stability was more important an objective than export promotion in the case of Singapore (Takagi 1996).

the dollar was weak relative to both the Yen and most European currencies, namely during the decade following the Plaza agreement. The yen appreciation turned out to be positive for those economies which pegged their currencies to the dollar because it made their products more price-competitive vis-à-vis competing Japanese products. This latter explanation fits the Korean case particularly well, because Korean products such as ships, steel and semi-conductors are in direct competition with Japanese products in the world markets, if not in the same quality category, at least in the same good category (Ito 1999).

Pegging (like fixing) the exchange rate also reflects the search for more stability, a factor deemed fundamental to attract foreign investors. This objective appeared of the utmost importance for SEA countries whose major objective was to boost FDI-related exports. The *de facto* dollar peg strongly influenced trends in FDI in the four major ASEAN countries (Indonesia, Malaysia, Philippines and Thailand).<sup>5</sup> Goldberg and Klein (1997) underline the importance of pegging to the dollar for the expansion of trade and FDI linkages within the region, which is one feature of the so-called Asian miracle.<sup>6</sup> As a result, of the currency realignments decided among the G7 finance ministers under the Plaza agreement, the value of the yen vis-à-vis the world's major currencies was boosted, making SEA countries attractive locations for Japanese investors. This can be seen very clearly in the following graph plotting the evolution of the dollar/yen exchange rate and of Japanese direct investment in the four major ASEAN economies.<sup>7</sup>

Starting in April 1995, the dollar appreciated vis-à-vis the Yen, drawing all SEA currencies in its wake, leading to a loss of competitiveness. To be sure, other factors were certainly at play<sup>8</sup>, yet within the context of large current account deficits, and given

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5. For more details, see OECD (1999).

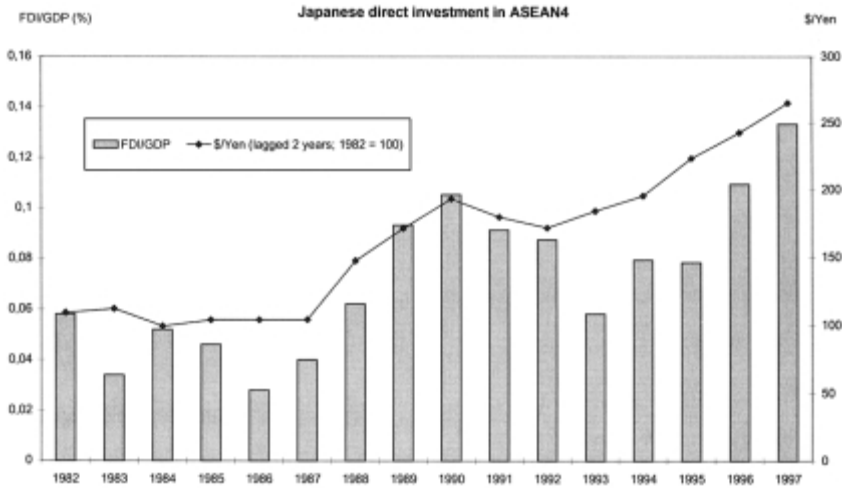
6. The tight interdependence which had developed between the economies of the region has now turned out to be a liability because these links provided a channel for the contagion to spread throughout the whole of East Asia, making the recovery process more problematic.

7. In a regression of the aggregate FDI flows from Japan to 8 Asian countries on the Yen/dollar exchange rate lagged one period, Ito (1999) shows more formally that FDI from Japan tends to increase as the Yen appreciates.

8. According to Montes and Popov (1999), this is a major difference with the financial crisis in transition economies. In the latter case, the overvaluation-induced loss of competitiveness was an important explanation of the crisis.



Figure 1



Source: Ministry of Finance, Japan.

the sharp reversal in the trend, the real appreciation certainly contributed to the loss in competitiveness and constituted a factor of increased vulnerability (Rajan 1998).

### *Pegging as an Incentive for Over-borrowing*

An excessively rigid exchange rate policy may also entail a number of perverse, more pervasive, effects in the banking sector. In the case of East Asia, these effects paved the way to the currency crisis of the summer 1997. While it must be admitted that these effects were only allowed to play because of the lack of banking supervision and the existence of long-standing weaknesses in the financial sector (Goldstein 1998), they also contributed to aggravate the situation. The rigidity of the exchange rate policy played a role both in abetting the rapid buildup of private external debt by encouraging borrowing in foreign currency, and in weakening the domestic financial system by enhancing excessive risk-taking. It can thus be held responsible for part of the difficulties experienced by East Asian economies since the summer 1997.<sup>9</sup>

9. Because Thailand pegged its currency most rigidly to the dollar, it was also the country which accumulated the most serious imbalances. The following remarks are particularly relevant to the Thai case.

The increasingly rigid exchange rate policy increased the dependence by firms and governments on global capital markets for financing their needs and above all encouraged borrowing in bad conditions<sup>10</sup>: First because it acted as an incentive for local banks and firms to borrow abroad in foreign currency and second because it was a disincentive to engage into hedging operations in the process. The combination of these two factors led to currency mismatches that proved lethal once the initially favorable dollar/yen exchange rate relation was modified. Because the balance sheets of the indebted firms and financial intermediaries were made highly vulnerable to sharp exchange rate variations, insolvency eventually resulted from unforeseen and significant depreciations. The emergence of insolvencies can be traced to financial liberalization, the shortening of the foreign debt structure, and the currency denomination of assets vs. liabilities.

Although with hindsight it may appear extremely perilous not to have hedged for currency exposure, there were good reasons not to hedge *ex ante*. First because the authorities had managed to keep a high degree of stability over a reasonably long period of time and because they might have expected, if anything, the exchange rate to appreciate over time, which would have reduced the cost of their overseas borrowing (Grenville 1998). Moreover, the rapid growth in foreign exchange earnings through exports provided an implicit hedge against foreign exchange risk for export-oriented firms which may have been indebted in foreign currency. Given their brilliant track record, these firms were lulled into the conviction that such increases could be perpetuated for ever and that little of the currency risk needed to be hedged. All this means that although it would certainly not have been unwise for them to hedge, it is perfectly understandable that they chose not to. Moreover it must be remembered that hedging would have eliminated the interest rate advantage of borrowing in foreign currency. Finally, firms and banks also probably expected to be bailed out if things went wrong (such had been the case in the past in Thailand for instance).

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10. The composition of external borrowing is probably more important than the overall external debt burden. This explains why SEA economies seemed to fare relatively well when judged on the basis of standard macroeconomic indicators such as external debt ratios which were not particularly alarming, except may be for Indonesia.

The rigidity of the exchange rate policy undoubtedly encouraged foreign capital inflows<sup>11</sup> and helped financing the countries' current accounts deficits. By giving foreign investors a false sense of security, the stability of the exchange rate helped inviting in foreign capital, and not only in the form of FDI. Total capital flows to the 5 ailing Asian economies increased markedly in the 1990s, rising from 1.1 per cent of GDP in 1983-89 to 4.8 per cent of GDP in 1990-95, while inflows into the rest of Asia were little changed at about 1 per cent of GDP in both periods (Mussa and Richards 1999). As pointed out by Montes and Popov (1999), the strong currency pegs in Southeast Asia sent a signal to international lenders that these economies were not subject to the risk of the devaluation of the currency. Foreign lending to Southeast Asia was premised on the assumption that the exchange rate would hold; if the SEA currencies fell, the advantages might be wiped out as repayment would increase in domestic currency and foreign lenders faced higher risks of non-repayment. It was indeed reasonable to assume that the exchange rate would hold because domestic inflation was somewhat higher than in both Japan and the US (leading to some real appreciation), while the productivity growth was also higher. In parallel, there was no credit risk perceived because of high rates of economic growth.

An additional factor was the slump in the Japanese economy. Japanese interest rates were much lower than those in the US and those in SEA economies, inducing outflows of hot money from Japan to Asian debtors and fuelling over-borrowing in those countries. By driving a wedge between domestic and international interest rates, sterilization policy also made external financing more attractive.<sup>12</sup> As long as the interest received on the placement is higher than the interest paid on the funding, it is an attractive transaction; the investor enjoys a positive carry. Such was the

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11. In the case of Thailand, these flows were further encouraged by the establishment of the so-called Bangkok International Banking Facilities (BIBF). The BIBF is an offshore banking market established in March 1993. Although the original objective was to develop it into a regional financial center, it appears that it was primarily used right from the outset to facilitate steady inflows of foreign money into Thailand (Kobayashi 1997).

12. The persistence of interest rate differentials is somewhat puzzling: if financial markets are working as in textbooks and given that inflation rates in SEA have been rather low, that government deficits were low and declining and that sovereign premia were declining, the strict currency pegs should have led to a reduction in interest differentials; yet such was not the case and this is what provided the strong pull factor for private borrowing from abroad. This was probably due to domestic market imperfections and oligopolistic structures (Reisen 1998).

case in particular with Japan, where funds could be borrowed at low interest rates and used for lending to the SEA economies which offered higher rates.

The combination of favorable interest rate differentials and expectations of low exchange rate risk fuelled large short-term capital inflows, primarily in the form of bank lending.<sup>13</sup> The appreciation of the dollar (and with it of the East Asian currencies) relative to the yen as of April 1995 further boosted capital inflows. Yet, as a result of their weak health, Japanese banks reduced their loans, leading to a drop in their share in total foreign bank lending to the 5 ailing Asian economies between 1993 and 1997.

### *Weakening Risk Assessment*

Further mechanisms were also at work, making the situation even more perilous. Not only did the exchange rate peg encourage indebtedness in foreign currency and discourage hedging; it created opportunities for wrong investment decisions and gave no incentive to improve risk assessment and banking supervision.<sup>14</sup> Indeed, the flows of borrowed money had a self-reinforcing effect on confidence, investment and economic growth, leading eventually to complacency and overconfidence. To the extent that exchange rate pegging contributed to the development of over-optimistic beliefs in future growth prospects of emerging markets, it can be held partly responsible for excessive external debt accumulation and for increasing the vulnerability to unforeseen changes in market sentiments. This mechanism is described by Bird (1998) as an excess credibility effect: chances of devaluation are underestimated, leading to further inflows, to more destabilization, thus strengthening the need for a devaluation. In other words, large capital inflows proved to be too much of a good thing. The ease with which external funding could be obtained undoubtedly encouraged mal-investment.<sup>15</sup> Because of the stability of the system,

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13. The boom in private banking in SEA also contributed to fuel the spiral of competitive lending from abroad. These loans are usually short term but based on the implicit assumption of indefinite rolling over (Ito 1999).

14. These two features were shown by Mishkin (1997) to be lethal for developing countries.

15. In some countries, investment concentrated in real estate and property (Thailand and Malaysia), while in others it was directed to sectors with already excess capacity (Korea) or unclear profitability (Indonesia).

banking prudence was overlooked and there was no perceived need to improve financial supervision or control bank asset quality (Wade 1998). The perceived absence of currency risk (or of worries about currency fluctuations) in terms of dollar also encouraged extremely rudimentary corporate risk management strategies by firms (Rajan 1998).

The exchange rate peg provides the incentive to allocate foreign funds disregarding currency and maturity risks, as these are being implicitly transferred to the central bank (Calvo and Mendoza 1996). Moreover in the case of Asia, such incentives for currency and maturity mismatches were clearly reinforced by its experience of sustained and stable growth (Reisen 1998). Partly as a result of the pegging policy, banks tended to disregard (or at least underestimate) risks on both sides of their balance sheets. As shown by McKinnon and Pill (1998), over-borrowing arising from currency risk was much larger in SEA than in Mexico. This was due to the failure of regulators to limit the foreign exchange exposure of Asian banks. As a result this magnified the impact of poorly controlled domestic credit expansion.

### *A Depreciation-led Banking Collapse*

The perverse effects discussed above took their toll once the dollar started to appreciate against the Yen. The perils of pegging too closely to an appreciating currency are underscored in the Thai case. With a slowdown in exports and economic growth, the peg appeared less and less sustainable and even more so because of financial excesses that gave rise to major frailties in the banking sector. In particular, the extreme rigidity with which the baht was pegged to the dollar against the backdrop of increasingly apparent financial sector weaknesses and macroeconomic imbalances made it a particularly tempting target for speculators (Rajan 1998). The collapse of the peg occurred because stabilizing banks and keeping the exchange rate target became mutually incompatible objectives (Chang and Velasco 1998). The high interest rates needed to defend the peg (against short sellers) were bound to create problems for weak financial sectors faced with a sluggish economy, as a result the defense of the peg was made increasingly costly. And the costs of holding on to the peg were soon found to exceed the cost of giving it up and losing credibility (Goldstein 1998). Thai authorities initially used their first line of defense, entering

into a forward contract to act as the counter-party to the short-sellers of the baht, to no avail.

Thailand ended up being trapped in a vicious circle: because Thai corporations were heavily indebted in dollars, it was perilous for the authorities to devalue and hurt corporations with large dollar liabilities. Heavy reliance on foreign currency denominated debt created the conditions for the emergence of speculative attacks because of the existence of currency mismatches (which were made worse because they were accompanied by asset-liability mismatch or maturity mismatch). At the same time it made it harder to get out of the crisis once it had broken out because the borrowing country could not reduce the real value of its liabilities through devaluation. The rigidity of the exchange rate policy motivated speculative attacks, magnified the consequences of subsequent exchange rate changes, and finally limited the authorities' room for maneuver in crisis management (Goldstein 1998).

The mechanism, which led the Thai economy and currency into a tailspin, is as follows: Once the crisis broke out, the losses resulting from firms and banks' unhedged positions deepened the existing financial crisis. The devaluation exacerbated the cause of the crisis, namely the fragility of the domestic financial sector. Dollar liabilities were revalued in domestic currency terms, thus creating an additional burden on domestic firms and on an already weakened financial system. Moreover, as assets are typically denominated in domestic currency, there was no simultaneous increase in the value of firms' assets, which led to a deterioration in their balance sheets and increased the risks for lenders. Firms with potentially solvent projects facing acute liquidity problems ended up being technically insolvent because of currency devaluations affecting unhedged liabilities and/or deep recessionary conditions leading to market share losses (Rajan 1998). The deterioration of non-financial balance sheets automatically led to a deterioration in bank balance sheets, and triggered a large-scale banking crisis. This is because banks' balance sheets were squeezed on both sides: on the liability side because they were heavily exposed in foreign currency, and on the asset side because firms were having problems paying off their debts. Such mechanisms together with the sharp curtailment of credit, led to situations of insolvency, increasing the panic and the magnitude of capital outflows, thus validating further the expected weakening of the currency (Corsetti et al. 1998).

The crises in SEA have been exacerbated by the unhedged foreign exchange positions of Asian banks and firms encouraged by the pegging policy. These open currency positions not only magnified the scale of over-borrowing during the cycle's initial boom phase and raised the chance of speculative attacks, they also imposed significant additional losses on the banks following the devaluation. The failure to limit the exposure of banks to foreign exchange risk therefore increased both the boom and the bust phases of the over-borrowing cycle (McKinnon and Pill 1998). Denominating debt in foreign currencies not only makes a developing country's financial system more prone to financial crisis, it also intensifies the negative consequences of such a crisis. If a financial crisis does occur, a developing country with a lot of its debt denominated in foreign currency also has limited policy options for extricating itself out of the crisis.

Exchange rate policy played a role in the accumulation of unhedged debt in foreign currency (because of the implicit guarantee of a fixed exchange rate), and in weakening the financial sector (because of the induced lack of banking prudence). The depreciation of the currency led to a financial collapse because of the ensuing rise in the value of liabilities resulting from massive unhedged borrowings in foreign currency, and thus in the size of the required bailouts for the financial system (Corbett and Vines 1999).

### *Assessing Pre-crisis Exchange Rate Policies*

Rather than the peg itself, it is the increasing rigidity of the exchange rate policy that is to blame. In the case of SEA, this rigidity can be attributed to a number of factors which changed over time: export fetishism is certainly one and explains the initial choice (see above). In addition, a stable currency was crucial in order to attract the long-term investment needed to finance the countries' current account deficits. Exchange rate instability in emerging countries can indeed be shown to have a negative and long-lasting impact on the availability of external finance, first because it leads to a loss in economic policy credibility and secondly because the need to compensate for an increased exchange rate risk implies hefty risk premia.

Once the dollar started appreciating, pulling the SEA currencies along in its wake, the resistance to a devaluation<sup>16</sup> was probably due to the existence of strong vested interests lobbying against a more flexible exchange rate régime. In the case of Thailand, among the large corporations and conglomerates with high unhedged external indebtedness, one finds very influential giants such as Thai Petrochemical Industry and Siam cement Company (which belong to the Crown property Bureau, i.e. the Royal Family) (Lauridsen 1998).<sup>17</sup> Some authors also argue that the policy had definite advantages for the US, which is why it was not abandoned (Jomo 1998).

Moreover, an important real-world characteristic of pegged rates is that they are notoriously sticky. As rightly explained by Tobin (1999), the decision to devalue is always a tricky political step: 'A discrete change in an official parity is ... traumatic. It is a loss of face and a blow to pride. It is an administrative decision, that is to say, a decision of policy and politics. It necessarily requires responsible officials – finance ministers, chancellors, central bank chairmen – to go back on their solemn word. Moreover, they or their successors have the unenviable task of choosing a new rate in a climate poisoned by distrust, clouded by uncertainties about the fundamentals, and dominated by unpredictable psychology. It's easy to get the choice wrong, prolonging and aggravating the crisis. For all these reasons, there is great temptation to stick with an overvalued parity too long'.<sup>18</sup>

## **Making the Best of Financial Integration**

There is now a wide consensus that weak domestic financial systems in emerging economies were the major cause of the excesses that led to the currency and financial crash in East Asia. As a result, in order to avoid the recurrence of such crises and reap the full benefit of global financial integration emerging economies should focus on strengthening their financial systems so that capital flows are intermediated and allocated more efficiently. Yet, because these recommendations will no

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16. The Bank of Thailand merely chose to adjust the weight of the dollar in the reference basket as an alternative to the expected negative consequences of a devaluation.

17. These firms were found to be among the big losers of the baht's depreciation.

18. In very much the same vein, Walters (1998) explains the reluctance to devalue, a step considered as a great failure, as the reflection of macho attitudes towards the exchange rate.



doubt be hard to implement, it will be some time before well-functioning financial markets can be put in place in emerging economies; enhancing supervision of the financial system, and prudential regulations may prove elusive for some time. As a result, complementary measures need to be taken to reduce the risk of renewed turbulence and the degree of vulnerability. Because other policies can be shown to have contributed to the weakening of the financial sector and thus to the build up of imbalances through excessively risky behaviors, they should also be considered as additional means of preventing a rerun of the 1997-98 meltdown and of reducing the severity of crises, should these still occur. In particular, as exchange rate policies played a key role in the build up to the crisis, the choice of exchange rate policy is of the utmost importance.

### *The Need to Raise the Quality of Capital Inflows*

From a record capital inflow of US\$ 93 billion to the 5 ailing East Asian economies in 1996, there was a net outflow of US\$ 12 billion in 1997. This sharp reversal, which is equivalent to 11 per cent of the combined GDP of these economies, was made possible because a large share of the previous flows was short-term. A major lesson of the recent East Asian crisis is that the nature of capital inflows has a direct impact on the stability of the growth path. Macroeconomic challenges are made more pressing when the composition of capital inflows is unbalanced in favor of short-term capital. In the case of Asia, short-term capital inflows did play a negative role and increased the vulnerability of these economies to international turbulence and to intrinsically unstable international financial markets. As a result, improving the quality of capital inflows is an important concern for LDCs or emerging economies.

In the 5 ailing East Asian economies, in particular in Thailand, over the 1990s there was a clear shift away from FDI towards more and more portfolio inflows and bank loans (see table 1). The return of international bank-lending (to both banks and firms), which had virtually disappeared in the wake of the Latin American debt crisis in the early 1980s, was also associated with a dramatic rise in the share of short-term borrowing (see tables 2 and 3). As a result the way of financing the current account deficit and of bridging the gap between savings and investment was increasingly unstable and vulnerable to changes in investors' sentiments and external shocks.

**Table 1**  
**Private Capital Flows to the 5 Ailing Asian Economies, 1989-96**  
(in per cent of GDP)

Country	1989-95	1991	1992	1993	1994	1995	1996
<b>Indonesia</b>							
Net direct investment	1.3	1.2	1.2	1.2	1.4	2.3	2.8
Net portfolio investment	0.4	0.0	0.0	1.1	0.6	0.7	0.8
Other net private investment	2.6	3.5	1.4	0.7	1.9	3.1	2.7
Net official flows	0.8	1.1	1.1	0.9	0.1	-0.2	-0.7
<b>Malaysia</b>							
Net direct investment	6.5	8.3	8.9	7.8	5.7	4.8	5.1
Net portfolio investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other net private investment	2.3	2.9	6.2	9.7	-4.2	4.1	4.5
Net official flows	0.0	0.4	-0.1	-0.6	0.2	-0.1	-0.1
<b>Philippines</b>							
Net direct investment	1.6	2.0	1.3	1.6	2.0	1.8	1.6
Net portfolio investment	0.2	0.3	0.1	-0.1	0.4	0.3	-0.2
Other net private investment	0.9	0.2	0.6	1.1	2.5	2.4	8.5
Net official flows	2.0	3.3	1.9	2.3	0.8	1.4	0.2
<b>Thailand</b>							
Net direct investment	1.5	1.5	1.4	1.1	0.7	0.7	0.9
Net portfolio investment	1.3	0.0	0.5	3.2	0.9	1.9	0.6
Other net private investment	7.4	9.2	6.8	4.1	7.0	10.0	7.7
Net official flows	0.0	1.1	0.1	0.2	0.1	0.7	0.7
<b>Korea</b>							
Net direct investment	-0.1	-0.1	-0.2	-0.2	-0.3	-0.4	-0.4
Net portfolio investment	1.4	1.1	1.9	3.2	1.8	1.9	2.3
Other net private investment	0.8	1.3	0.7	-1.5	1.7	2.5	3.0
Net official flows	-0.3	0.1	-0.2	-0.6	-0.1	-0.1	-0.1

Source: IMF, *World Economic Outlook - Interim Assessment*, December 1997.

**Table 2**  
**Cross-Border Bank Lending (1993-1997)**

	Total Liability/GDP		Short Liability/Foreign Reserve	
	1993	1997	1993	1997
Indonesia	0.192	0.265	1.622	1.629
Malaysia	0.166	0.293	0.210	0.609
Philippines	0.108	0.162	0.499	0.726
Thailand	0.207	0.381	0.733	1.411
Korea	0.119	0.213	1.397	2.106

Source: Bank for International Settlements, *The Maturity, Sectoral and Nationality Distribution of International Bank Lending*, Basle, January 1998.

**Table 3**  
**Maturity Structure of Foreign Debt in the 5 Ailing Asian Economies**  
(per cent of short-term in foreign debt)

Country	Short-Term Debt	
	End-June 1997	End-December 1998
Indonesia	59.0	52.7
Malaysia	56.4	44.5
Philippines	58.8	53.7
Thailand	65.7	58.1
Korea	67.9	45.3

*Source:* Bank for International Settlements, *The Maturity, Sectoral and Nationality Distribution of International Bank Lending*, Basle, May 1998.

The potentially high reversibility of short-term capital inflows is often perceived as the major source of risk associated with such flows. Empirical evidence, however, is rather mixed on the correlation between short-term flows and increased vulnerability and volatility (World Bank 1997). Yet volatility is not the only problem. First substantial empirical evidence shows that, unlike FDI flows, both portfolio flows and commercial loans are more sensitive to external factors (so-called push factors) than to domestic factors (or pull factors), making them much more difficult to monitor by recipient countries.

Second, short-term capital flows exhibit other characteristics which make them risky for emerging economies. Capital inflows other than FDI exert more pressure on the exchange rate: when capital inflows are primarily in the form of FDI in export-oriented activities, they usually involve large imports, thus dampening the appreciation pressure. Overall, short-term inflows are also more tricky to manage. Misallocation of these funds was a major source of concern in East Asia. The lending boom and the deterioration of bank and non bank entities' balance sheets were the result of large short-term capital inflows. Everything should thus be done so as to tip the balance in the composition of investment in emerging markets in favor of longer-term equity flows.

Reisen (1998) argues that FDI flows meet all the demanding requirements which may launch a virtuous circle leading to higher investment and higher growth as a

result of a more intensive use of external savings. A first uncontroversial point is that FDI responds to long-term profitability expectations and constitutes a stable form of development finance.<sup>19</sup> In contrast to portfolio investors, foreign direct investors cannot pack up their factories and go home overnight should things turn sour. Moreover, because FDI is directly tied to real investment in plant, equipment and infrastructure, it can legitimately be expected to augment investment and not consumption, thus raising the host country's productive capacity, and the export earnings necessary to service the debt in the future. In addition, it is likely to enhance efficient investment. Empirical evidence indeed suggests that FDI is particularly beneficial in addition to being a more stable source of external finance. First, FDI and domestic investment are complements rather than substitutes. A dollar of FDI was shown to raise the sum of domestic and foreign investment by more than a dollar, making this type of capital flows an efficient engine of growth (Borenstein et al. 1995). Moreover, foreign investment was empirically found to be more efficient than domestic investment, provided it is not of the tariff-jumping kind, as a result growth may benefit through higher quality. This result is fairly uncontroversial. Finally, FDI may play a positive role through technological spillovers in particular. On the latter point, empirical evidence is both more scant and more shaky. In particular, the positive impact of Japanese FDI flows on ASEAN economies in terms of technological spillovers is highly controversial. Some authors even contend that such flows increased the technological dependence of ASEAN economies. Although FDI may be no panacea, it can certainly contribute positively to economic development.

Empirical evidence shows that high levels of FDI flows relative to total debt are negatively correlated with the occurrence of currency crashes (Frankel and Rose 1996), thus suggesting that promoting FDI may be a way of limiting the risk of speculative attacks.<sup>20</sup> Expanding on this work, Kim and Hwang (1998) show that higher levels of FDI also lower the odds of IMF rescue packages. Even in a currency crisis,

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19. Following the late-1994 peso crisis, FDI held up much better than other forms of capital flows in both the short and medium term. By the same token, FDI in Asia has so far held up very well, in spite of the crisis, while other capital flows have reversed themselves (OECD 1999).

20. Park and Rhee (1998) show that in the case of Korea, a low level of net FDI correlates closely with the incidence of a currency crisis.

countries where MNEs have a dominant presence in the domestic economy may endure or overcome the crisis without being forced to resort to IMF bail-out loans, because thanks to their parent firms, subsidiaries of MNEs in crisis-ridden countries do not suffer lowered credit ratings or such difficulties in importing raw materials or in trade financing as do other domestic firms.

Because of the destabilizing potential of short-term flows and of the potentially beneficial impact of FDI on economic growth, there is a strong need to improve the composition and quality of capital inflows and in particular to tip the balance in favor of long-term capital inflows (Reisen 1999).

The next question that needs to be addressed is how to affect the composition of capital flows into emerging economies. There are basically two types of policies that may help contain the risk from excessive short-term debt by raising the quality of capital inflows. A first set of measures consist in direct pro-active interventions in favor of certain types of capital flows and/or at the expense of other types of flows. Capital controls belong to this first category. A second set of policies which have the potential to indirectly affect the composition of capital inflows constitute a second category which includes exchange rate policy. These two types of policies will be examined in turn.

### *Monitoring Capital Flows*

The most straightforward way of enhancing the share of FDI in total capital inflows is to liberalize FDI policy. In the pre-crisis period, the major reason why short-term debt-creating flows dominated total foreign investment in Korea was the highly restrictive policy vis-à-vis foreign direct investors together with an acceleration in financial liberalization. As rightly pointed out by Reisen (1998), in Korea the 1994-97 surge in short-term inflows can be attributed to acceleration in financial liberalization by allowing domestic financial institutions greater freedom in asset and liability management, in particular in borrowing from international financial markets. Meanwhile, restrictions on long-term inflows were left in place, further inducing short-term inflows. Traditionally, foreign borrowing has always been favored over FDI by Korean authorities because this form of finance could fit better in the

Korean system of industrial targeting. The liberalization of FDI regulations in the wake of the recent crisis is a step in the right direction.<sup>21</sup>

Korea was an exception in East Asia, and most other countries were definitely much more open to FDI. In spite of a generally favorable stance towards FDI, the four major ASEAN economies (with the exception of Singapore) proved highly selective, however. They can be said to have adopted a dualist policy of aggressively promoting export-oriented FDI, while protecting the local economy from market-seeking inward investment. This was reflected in particular through the imposition of numerous restrictions on foreign investors' activities, in the form of ownership limitations, outright prohibition in some sectors, performance requirements, etc. The perceived threat of investment diversion away from ASEAN and towards China had begun to push ASEAN policies towards FDI in a more liberal direction even before the crisis, but the crisis has definitely given a new impetus to the liberalization. In the wake of the financial crisis, all East Asian countries eased further the access of their markets to foreign investors. As a result, the number of sectors still restricted or closed to foreign investors has been reduced to a minimum, while the conditions for entry (in the form of foreign equity limits in particular) have been drastically relaxed in most cases.<sup>22</sup>

In parallel to promoting directly FDI inflows, it is common to try to check the rise in short-term (and supposedly volatile) capital flows through the imposition of controls on capital flows. Capital controls are defined by Fane (quoted in Rajan 1998) as "measures which impose quantitative restrictions, or explicitly or implicitly tax broad categories of capital movements and which apply to all firms and households". Yet controls on capital flows may also take the form of exchange controls, which impose restrictions on foreign exchange transactions.

While the effectiveness of capital controls in reducing aggregate capital inflows is still a matter of controversy, there seems to be a general consensus that they are ins-

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21. For an analysis of Korea's direct investment policies before and after the financial crisis, see Nicolas (2000).

22. See the case studies in OECD (1999) for more details on FDI policies in the four major ASEAN countries before and since the crisis.

trumental in affecting the mix between short-term and long-term flows. In the Chilean case<sup>23</sup>, for instance it is widely recognized that they have helped lengthen the average maturity of capital inflows, with FDI playing much more of a role than in neighboring Latin American economies (Rajan 1998). The share of short-term loans as a percentage of total capital inflows to Chile dropped from 96.3 per cent in 1988 to 28 per cent in 1992 (the year after the controls were put in place), and to 3.2 per cent in 1996 (Edwards 1999). To the extent that longer-term capital inflows such as FDI exert less pressure on the exchange rate, there is a presumption that capital controls constitute an effective way of avoiding exchange rate appreciation, yet there is non conclusive evidence from past experience on this point.

In addition to their controversial, and altogether limited, efficiency, capital controls are also likely to give rise to major costs, including the usual rent-seeking and other unproductive activities (bribery, corruption, etc.) associated with any dirigiste policy (Rajan 1998). Costs may also come under the form of a loss of credibility, in particular when the controls are imposed *ex post*. In the case of Malaysia for instance, because the capital controls imposed in September 1998 may be interpreted as departures from the usual rules of the game, there is a real risk that investors' confidence may be durably damaged and that the future access of Malaysia to the international inter-bank market may be compromised. In this respect, controls on capital outflows are certainly more costly and risky than controls on capital inflows.

Another reason why controls on capital outflows may not be advisable is that while they are supposed to buy an economy time to restructure its financial sector in an orderly fashion, on the basis of Latin American countries' experience, there is very little evidence that such has ever been the case (Edwards 1999). In the case of Malaysia, a major concern is precisely that there is so far little evidence that the breathing space is being used to that purpose. Finally, empirical studies suggest that capital controls have been more effective at preventing excessive capital build-up than at stemming capital flight (Rajan 1998).

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23. In 1991, Chile imposed controls in the form of minimum stay requirements for FDI flows and of non-remunerated reserve requirements on other forms of capital inflows.

More generally, a major problem with capital controls is that they tend to focus on the symptoms of financial fragility rather than on its very source. In this respect exchange rate policy may be a more promising avenue for helping enhance the resilience of the financial sector.

### *Which Direction for Exchange Rate Policy in East Asia?*

Flexible exchange rates have the obvious advantage that movements in the exchange rate are much less non-linear than in a pegged exchange rate régime. Moreover, the depreciation or appreciation of the currency in a flexible régime may also provide an early warning that policies need to be adjusted in order to limit the potential for a crisis (Mishkin 1997). As far as capital flows are concerned, some flexibility in exchange rates will no doubt discourage excessive reliance on short-term borrowing. In a context of floating exchange rates, more responsibility is carried by international investors so that more attention will be paid to exchange rate risk. A somewhat flexible exchange rate policy may also help designing a transparent, properly regulated banking system. It may be instrumental in creating the conditions for a sounder management of capital flows. These various features of flexible exchange rates advocate at least for some flexibility.

By contrast, the classic argument in favor of floating rates, according to which a flexible exchange rate allows a country more autonomy with regard to its macroeconomic policy should not be exaggerated, in particular for developing countries. Such a country may have trouble gaining credibility in international financial markets, moreover, and more importantly, governments may be tempted to make use of their discretion to pursue imprudent policies. As a result, developing countries with floating exchange rates often have to keep interest rates high to maintain investor's confidence (ADB 1999).

There are a number of additional reasons to argue that freely floating exchange rates could be more costly than beneficial. First of all, such an option is unlikely to be favored by export-oriented SEA economies because of the high degree of uncertainty this would involve. Export competitiveness was shown to rank high in the objective function of these countries in the past.



It must also be recognized that in a world of high capital mobility, asset markets are mostly driven by herd behavior, thus leading to wild gyrations in exchange rates. It cannot be denied that in the recent episode devaluations were excessive because of excessively violent reactions on the part of the markets. In particular, by contrast to what was expected from the shift to floating exchange rates after the breakdown of the Bretton-Woods system, speculation has been found to be destabilizing rather than stabilizing. While this may be due to the absence of rational expectations, a more convincing argument is that rational speculation is necessarily destabilizing in the context of a speculative bubble, because in such a case the only way not to lose money is to go along with the trend, thus amplifying the deviations from the initial level. Indeed, numerous empirical studies suggest that there is no stabilizing speculation in reality.

As explained above, some flexibility is clearly warranted. In particular, although it may not have prevented the crisis altogether, it would have probably contributed to reduce the magnitude of financial excesses (and thus the severity of the crisis) by encouraging more careful attitudes by investors. At the same time, the need to provide more predictability to the exchange rate system is generally recognized, as exchange rate uncertainty can be shown to have pervasive negative impacts on the real economy. As a result, the challenge facing policy-makers is how to strike the right balance between exchange rate stability and flexibility, or in other words to obtain flexibility with some predictability. To be sure, trying to reach these two objectives simultaneously is not easy because one seeks in a way to get the best of both worlds but we will suggest possible ways of overcoming these difficulties.

Since exchange rates are influenced by expectations, a key point lies in stabilizing expectations. Resorting to some form of target zone system, or peg with a band, could provide a way of stabilizing expectations together with a fair amount of flexibility. The major difference with floating and the key reason for preferring a band system over pure floating is that the former helps focus market expectations on where the long-run equilibrium rate lies. This objective implies that the band should not be too wide. Because a movement of the spot rate within the band is normally accompanied by a smaller movement in the forward rate, while such is usually not the case with flexible exchange rates, this suggests that a band system has a stabilizing effect (Williamson 1998).

While this option may help gain both predictability and flexibility, it involves a number of practical difficulties.<sup>24</sup> First is the problem of what the central rate should be. Second is the question of the conditions and frequency with which the central rate may have to be changed. Third, and most important, is the issue of the conditions under which the currency should be defended. The last two questions are tightly connected. Because the increasing stickiness of the peg was shown to be a major source of difficulty in the past, spelling out the conditions under which the monetary authority should step in to defend the exchange rate is key to ensure the sustainability and efficiency of the mechanism.

In this regard, an attractive solution is the so-called monitoring band described by Williamson (1998). The main feature of this scheme is that by contrast to standard target zone schemes it should not provide a target for speculative attacks. Under this scheme there is no obligation to defend the edge of the band; there is a presumption that the authorities will normally intervene to discourage the rate straying too far from the band but they are free to decide whether and how to do it. In particular they can choose to let the rate go outside the band if they deem market pressure to be overwhelming. The existence of such an option is a way of taking some wind out of the sails of speculative attacks.

In the case of standard target zones, as the exchange rate is getting close to the edge of the band, there is increasing resistance on the part of monetary authorities which may induce speculators to try to test their commitment to defend the currency. These active interventions in defense of the exchange rate are necessarily followed by a switch to non resistance as soon as the exchange rate goes over the edge, with an unlimited depreciation of the currency as a possible result.<sup>25</sup> By contrast, within a monitoring band scheme, the exchange rate may be allowed to go temporarily outside the band if necessary, but there is a steadily growing resistance to a further fall once the currency has gone over the edge. The point of such a policy is to allow the exchange rate to fluctuate within a potentially wide band over short horizons

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24. Further problems such as the definition of the parity, or the width of the band are not addressed here.

25. Such was the case with the Indonesian Rupiah; when it was allowed to float in mid-August 1997, it dropped rapidly from Rp 2300 to the dollar to Rp 3500 in October to reach Rp 16000 at the height of the crisis.

while keeping it on average within a narrow band over longer horizons. There is thus no commitment to keep the exchange rate within narrow margins at all times. The flexibility in exchange rate management provided by the use of soft margins is thought to help eliminate one-way bets and discourage arbitrage flows.<sup>26</sup> Moreover the imposition of soft margins implies that the stance of the exchange rate policy can be adapted to changing circumstances, which is highly desirable in an environment where the challenges facing countries keep changing over time.

Because interventions may not suffice to defend a band against strong market pressures, other tools may have to be used, such as limiting the magnitude of capital inflows through some form of capital controls, subject to all the caveats mentioned earlier. Temporary capital controls should not be excluded altogether in the market-friendly form of obligatory reserve requirements against short-term foreign loans (Williamson 1998). In such a case, however, controls should be of the *ex ante* type and not of the *ex post* type. Moreover, restrictions to capital mobility are only possible as temporary solutions or should be extremely selective as financial isolationism could very well be more harmful than beneficial.

## **Concluding Remarks**

Despite the recurrence of financial crises in emerging economies faced with the challenges of financial globalization, the benefits of free capital mobility are still believed to be significant. Large scale capital inflows were instrumental in fuelling economic growth in high performing East Asian economies. In the form of export-oriented FDI flows, they helped these economies to take part into the international division of labor, while they complemented domestic savings in the form of portfolio flows or bank loans. This virtuous circle was turned into a vicious circle partly because of an excessively rigid pegging policy which led to the erosion of export

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26. Empirical evidence indeed suggests that soft target zones proved considerably more resilient to speculative attacks than hard target zones. Bartolini and Prati (1998) argue for instance that the sharp abatement of speculative pressure in Europe can be traced at least in part to European central banks' soft approach to exchange rate intervention.

competitiveness as well as to excessive risk-taking and to rising vulnerabilities in the domestic financial system. The major lesson from the recent financial crisis that shattered most East Asian economies is that a wide array of policies is necessary to help these countries make the best of financial globalization. While a complete overhaul of domestic banking and financial systems should definitely be a priority, other policies should also be envisaged. Moreover, while emerging economies should not be asked to bear all the brunt of the adjustment and while international measures should also help, one cannot reasonably bank on a concerted stabilization of the three major currencies of the Triad in the near future. As a result, self-help by emerging economies is probably the only realistic solution.

Because the pre-crisis rigid exchange rate policy fuelled the capital and credit boom, raised the chance of a crash and magnified the bust, the choice of an appropriate exchange rate policy is of the utmost importance. Flexible exchange rate management in the form of a monitoring band may be a promising strategy that combines flexibility with some predictability. Exchange rate policy can help improve the resilience to future shocks or mitigate the severity of future (inevitable) crises. It has an important role to play in helping to monitor capital flows and financial globalization. Yet an active management of external liabilities may also prove necessary and should thus not be excluded altogether, at least in the form of temporary measures. Finally, a more open and balanced regulatory framework towards FDI should also be part of the overall strategy of taking part in financial globalization.

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## **Are Banks in Asia “Rotten”?**

*Heiner Flassbeck*

For many observers the financial crisis which hit many countries in Asia in the course of 1997 and 1998 is mainly a crisis of the banking system in these countries. Even today, after the turnaround of growth rates and signs of an overall improvement in the economic situation, it is a widely perceived view that the banking system in Asia has to be restructured fundamentally. According to this view Asia as a whole can only return to the growth path experienced in the last decades if this restructuring has been completed. But such a view raises many questions. How has it been possible that countries with a “rotten” banking system had been extremely successful in terms of catching up with the western world. No region of the world, outside the part we call today the “western industrialized countries”, has ever accomplished such a long and stable phase of high growth rates as the Asian “Tigers” in the 80s and the 90s. The most remarkable one is the performance of Japan after the Second World War. But even this country could not avoid a deep “structural” crisis if the mainstream analysis is right.

The Japanese slump leads to the most important question: Why is it that very different countries had been subject of a banking crisis? On the one hand we have seen the failure of countries with current account deficits and competitive weaknesses, like Thailand and Korea. On the other hand, and this is a neglected fact of the events which are called “Asian Crisis”, with Japan a country got into trouble with a still very high current account surplus and without fundamental competitive problems. The gulf which separates Japan from the others can be easily identified. The remedy for the acute crisis in the “weak” countries had been a devaluation of their currency vis-à-vis the rest of the world which tended to overshoot and had to be fought by buying domestic currency with US- Dollars. In Japan it was just the other way round. The Yen was strong most of the time and this year Japan faces a revaluation which tends to overshoot and has to be fought by the central bank by buying foreign currency with Yen.

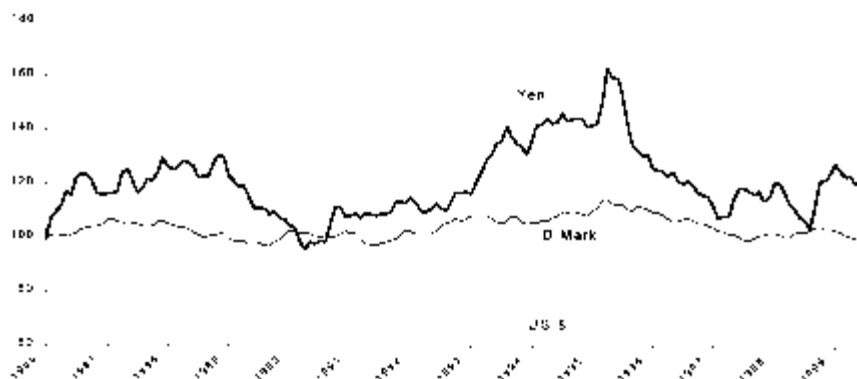
Paradoxically, this constellation is sometimes taken as a proof that something fundamentally has gone wrong in Asia as countries with weak as well as with strong currencies are hit by the same virus. But if a country has a weak currency because it has a “rotten” banking system, how can a country like Japan have a very strong currency although it seems to have the same weaknesses of the banking system? Thus, the conjecture of a “fundamental rottenness of the banking system in Asia” is – for *a priori* reasons – not a convincing hypothesis. There must be other factors which explain the problems of the banking system beyond “rottenness”? I will look at the two different groups of countries in Asia, namely Japan and Non-Japan, and try to find similarities which do not have common roots in the banking system as such but, nevertheless, may explain the problems in that sector of the economy which have been coming up during the Asian financial crisis.

## **The Japanese Slump**

Japan’s economy is in a deep crisis for the fourth consecutive year. Although there are first signs now that it has gone through the trough the overall situation and the outlook remain rather bleak. In the last years a lot of ideas have been launched to explain the persistent slump of an economy which, for decades, had been the role model for many „sclerotic” economies in the Western World. Most explanations of the Japanese crisis focus on factors like a long isolated and inflexible banking system, the low profit margins of Japanese companies or the kind of cooperatism between the government and the private sector which indeed had characterized the Japanese „model”.

The role of one factor, however, seems to be systematically underestimated even in those analyses which do not only stress the importance of „structural” causes of the crisis: The exchange rate of the Yen. The Yen had wildly fluctuated in the last 20 years. But erratic fluctuations are not adequate to describe what has happened in the beginning of that period. After the bubble in the stock and real estate market in the first years of the 90s had burst in response to a late but effective tightening of monetary policy, the exchange market entered the stage in an unprecedented and unpredicted manner. The nominal exchange rate of the Yen had already been over-

**Figure 1**  
**Real Exchange Rate of D-Mark, US-\$ and Yen**



shooting the inflation and unit labor cost differentials with the rest of the world throughout the whole of the 70s and the 80s. The resulting real appreciation already falsified the traditionally held theory that the real rate cannot have a trend. But after the sharp recession in the first two years of the 90s things got even worse.

Between 1992 and 1995 the real rate of the Yen appreciated, according to different calculation methods, in a range of 50 to 100 %!<sup>1</sup> Not one of the larger economies in the world has ever suffered from such an appreciation shock on top of a long phase of overvaluation. Germany, for example had a real revaluation of around 15% at the same time and was hardly hit by the consequent fall in export volumes, the loss of market shares and a rise in unemployment. A shock like in Japan, five to eight times that large would have led to a big crisis. But, and this is the surprising fact for western observers, in Japan, despite the extraordinary dimension of the shock, neither a sharp drop in market shares nor a rise in unemployment can be observed. The growth rates of exports slowed down, but, according to OECD data, not even touched an absolute reduction. The unemployment rate in Japan rose slightly, employment stagnated but didn't fall.

1. The data in the graph are from the OECD and are based on consumer prices.

A huge external shock like the one Japan has experienced after the real appreciation of the Yen would have brought about huge repercussions for the government sector under the institutional arrangements given in Western industrialized economies. Companies would have adjusted their labor force downwards, unemployment would have risen sharply, government deficits would have mushroomed. In Japan, in the first round at least, not much of that happened. As unemployment did hardly rise, the deficit in the public budgets increased slightly up to 1995, not even as much as in one of the major recessions in western countries. Clearly visible is the shock, however, in non-residential fixed capital formation.

There is in my opinion only one explanation for such an outcome. Obviously, in the Japanese system, companies, for a remarkably long time, stabilized the system by bearing most of the unavoidable burden of the huge shock. Keeping the labor force, with the growth rates of total compensation per employee only coming down in small steps, means that the shock had to be absorbed to the largest part by a profit squeeze. Such a profit squeeze would have led, again, under the auspices of a western system, to a sharp reduction of bank lending to companies due to much higher risk of default. In Japan, however, bank lending only stagnated at a rather late stage of the process. Close institutional relations of the banking system with the company sector and an insufficient supervision of banking activities have definitively played a role if we want to explain this kind of burden sharing. Only after the danger of major bank defaults the government had to step in and to consolidate the banking system thereby accepting mushrooming public budget deficits.

The conclusion of this analysis is not as simple as the one which is based on „structural” explanations of the Japanese crisis. Japanese or Asian institutional arrangements, i.e., the relationship between government, companies and banks, are not *per se* inferior to western ones. Given the size of the shock that the Japanese society had to absorb in one way or the other, any western economy would have tumbled too. In western societies the government would only step in at an earlier stage and the private sector would have to shoulder the burden to a much larger extent from the beginning. In Germany, for example, the small, 15% real appreciation induced a persistent debate about a fundamental loss of competitiveness and a lack of flexibility in the German society. With an appreciation of the Japanese size most of the existing German institutional arrangements and achievements would have been put in question.

Thus, if adequate room in the analysis of the Japanese crisis is given to the external shock the Japanese economy faced in the first half of the 90s the simple messages loose their persuasive power. Those who explain the visible weaknesses of institutions without taking into account the strain posed upon these institutions by external and, to a certain extent, exogenous shocks, tend to overemphasize „structural factors” as well as „structural remedies”. This may lead quickly to an „overshooting effect” concerning the steps recommended to reform institutions. Given many differences in the traditional values of our societies on the one hand and the Asian economies on the other hand, western advisors should be very careful by recommending to superimpose our institutions over an Asian society.

## **The Non - Japanese Slump**

The story of the slump in Asia outside Japan is a bit more complicated and needs a bit more theoretical elaboration. The Asian countries had been under pressure from the West during the 80s to liberalize their markets and thus to open their economies for goods as well as for capital. In consequence these countries had to decide about adequate exchange rate regimes under open market conditions. In the light of the experiences of some smaller countries in Europe and a number of newly industrializing countries with a successful stabilization of the price level in the short term, many international observers and advisers recommended in recent years that emerging countries including the Asian “Tigers” should employ a fixed exchange rate vis-à-vis Western countries. In these regimes the nominal exchange rate acts as the nominal anchor, giving incentives to all sectors of the economy to adjust their nominal claims to the conditions prevailing in the Western world. Even for large transition economies like Russia, Ukraine, and Kazakhstan this was considered by the IMF and others to be a reasonable strategy<sup>2</sup>. This strategy, the proponents argued,

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2. In accordance with concepts promulgated by the IMF, controlling the national money supply was in the first phase of transition seen as the best way to achieve this objective and to accomplish the necessary consolidation of public budgets. However, it soon became clear that this was not a feasible way to fight inflation. In particular, this was true for small open economies which experienced huge exchange rate fluctuations and an unstable money demand.

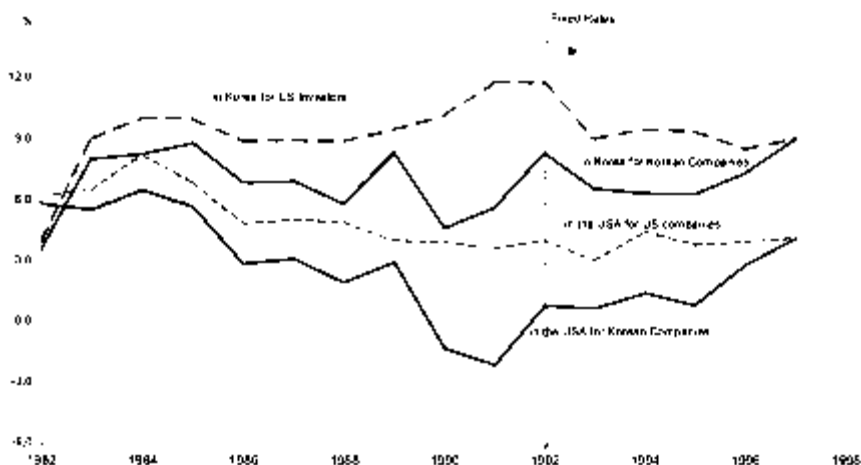
should render the steering of monetary policy and the stabilization of inflation rates easier in countries where the credibility of the central bank is not sufficient to keep a check on inflation in the short term. In the extreme case of the so-called currency board, monetary policy is deprived of any scope for autonomous action.

The strategy of anchoring a national currency by fixing its nominal rate vis-à-vis a big and stable country has found many supporters in Asia too because it seemed to offer another major advantage compared to domestic solutions. Investment, according to the basic tenet of the school of thought which dominates the IMF and the mainstream of economics today, depends on the prior accumulation of savings. These, however, due to relatively low levels of income are too small in emerging economies, if they exist at all. In Asia the ratio of investment was high but there seemed to be a scarcity of capital which could be removed by opening the borders. It was, according to this view, just necessary to meet certain institutional and procedural requirements in order to get the “necessary” inflow of foreign capital. Anchoring the exchange rate would create stable monetary conditions for foreign as well as for domestic investors. More and more countries therefore turned to the strategy of pegging their exchange rate to some lead currency, just as Austria, for instance, had successfully linked the Schilling to the German Mark for several years.

If such a strategy of pegging the exchange rate is adopted, the nominal interest rate of the anchoring country is fixed at roughly the nominal interest rate of the anchor country, after adjusting for any differences in the rates of inflation. Thus, real interest rates, being the crucial quantity for fixed investment, are, in the eyes of potential investors, in the anchoring country approximately as high as in the anchor country. Additionally, these arrangements do not bestow any special advantage on the financing of long-term fixed investment in the anchoring emerging country. If there the expected return on investment is higher (due to the enhanced productivity of capital), the process of catching up becomes possible. But, exactly at this stage of affairs, the monetary conditions, the combination of interest rates and exchange rates is in disequilibrium.

Let us look at Korea, one of the countries in which there had been a successful catching-up for decades and which collapsed suddenly in the new environment of open

**Figure 2**  
**Real Interest Rates in the USA and Korea**



markets and fixed exchange rates. The relevant data are in the graph below: Korea started fixing the nominal rate more or less in 1992. At that time the real interest rate for a Korean company searching for a loan in the United States was very low, namely close to zero. For US investors at the same time the interest rate offered in Korea was close to 10 % and thus much higher than in the States.

Proponents of the “nominal anchor approach” usually overlook the fact that in this situation foreign investors can take advantage of *de facto* short-term arbitrage opportunities. The numerical example in Table 1 demonstrates the point: Even though the differential between nominal interest rates corresponds to the one between inflation rates, given the anchor approach, there is no risk that the anchoring country’s currency will depreciate in the short run. The inflation rate in the anchoring country is of no concern to the foreign investor, as he usually calculates with his domestic inflation rate. For him it is important that the real rate of return he can earn with financial assets in the anchoring country exceeds the one he could earn at home.

In the numerical example the real rate difference is equal to the differential between the rates of inflation. Conversely, it is attractive for debtors in the emerging



**Table 1**  
**Real Interest Rates for Investors / Debtors in the U.S.A.**  
**and Asia When Nominal Exchange Rates Are Fixed**

(as %)

	1	2	3	4	5	6	7
	Inflation rate	Nominal interest rate	Real interest rate (2)-(1)	Real interest rate for investors / debtors in USA	Real interest rate for investors / debtors in Asia	Changes in nominal exchange rate	Changes in real exchange rate (appreciation: +)
In the U.S.A.	2	6	4	4	6-14=-8	0	-12
In Asia	14	18	4	18-2=16	4		+12

country to borrow in the anchor country, because they can take advantage of lower nominal interest rates without having to accept any exchange-rate risk. Both effects generate a permanent flow of foreign capital to the anchoring (emerging) country. Since wages, unit labor costs and prices rise faster in the newly industrializing country than in the hard-currency country, the currency of the anchoring country appreciates in real terms, the country loses competitiveness. As a result, the inflow of capital will be mirrored by corresponding deficits in the current account. As a rule, capital inflows will mainly consist of short-term funds, because short-term opportunity for quasi - arbitrage will be a more attractive option than the considerable risks involved in making profitable fixed investments in the anchoring country.

Thus, nominal exchange-rate stabilization destabilizes short-term international capital flows and directly undermines sound banking principles. Exchange-rate stabilization can only be implemented if, during the period of disinflation, the anchoring country offers consistently higher interest rates than hard-currency countries if negative real interest rates are to be avoided. The inflation-rate differentials between transforming and hard-currency countries are matched by corresponding interest-rate differentials. But, unlike the conditions normally prevailing in the global market for capital, the inflation differentials are not matched by a corresponding risk of depreciation of the anchoring country's currency.

Using the exchange rate as a nominal anchor will inevitably break the link between inflation differentials and the risk of depreciation. If a country chooses to adopt this

strategy, its assets become extremely attractive during the period of disinflation, because international investors base their decisions solely on nominal interest rates and the risk of depreciation but not on inflation differentials *per se*. As a result, speculative capital starts to flow into the country and domestic banks and companies borrow much more abroad than they would if the risk of a depreciation would not have been eliminated *de facto*. At the same time, as in any period of disinflation the conditions for domestic investment deteriorate. Real interest rates deflated by the actual inflation rate may not be extraordinarily high but if the real rate is calculated by using the medium-term inflation target it is usually very high.

Thus, international investors may earn very high rates of return in countries where real income and domestic profits may be falling. Moreover, the transforming country is unable to cut interest rates because this would endanger the credibility of monetary policy at home. In the short term, at least, the political will to achieve economic stability is reflected in the decision to keep nominal interest rates high. Real-world examples of this constellation were provided by the Baltic republics in 1992 and 1993, Mexico in 1994, and Russia, Ukraine and Kazakhstan in 1995 and by Asia quite recently<sup>3</sup>.

How long an external economic imbalance following the exchange rate peg can be sustained is an open question. With growing visible imbalances the markets willingness to believe in the emerging country's exchange-rate policy will fade. As soon as investors are convinced that the anchoring country will not manage to slow down the growth of its external debt within an adequate period of time, confidence in the exchange-rate's stability deteriorates. Fearing the ultimately inevitable devaluation of the currency, foreign investors withdraw their short-term funds and domestic companies stop borrowing abroad. This will cause liquidity shortages in the anchoring country. At the same time, increasing amounts of this country's currency are

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3. Given the very often unreliable data a simple but straightforward rule to identify a coming exchange rate crisis or a collapse of the real economy in an "emerging market" is the following: If nominal short-term interest rates in a developing or transition economy are higher than in industrialized countries and the nominal exchange rate of the former does not fall at a (annual) rate that equals the difference in (annual) interest rates the constellation of data is not sustainable as either the interest rates or the exchange rate are too high in the "emerging market".

offered for sale in foreign-exchange markets which forces policy makers to restrict liquidity even more. Sooner or later, policymakers have to abandon the exchange-rate peg, which is usually followed by a currency crisis. Enormous dislocations in all sectors of the economy are the result. The problem may be aggravated by close ties and cross-holdings between banks and non-financial business, the government's too hesitant withdrawal from the financial sector, insider lending, adverse selection and moral hazard, but the core of the problem has been the anchor strategy.

The economic situation in Non-Japan Asia was not as extraordinary as many observers believed in the first round. Given the heavy exposure of domestic companies in foreign markets the sharp depreciation of the exchange rates would under any "structural" conditions have led to enormous problems with the bank's balance sheets. That in Europe similar problems could have been avoided in the past has two reasons. Firstly, there was usually a "safety net" for devaluation as most of the devaluations had taken place with members of certain currency systems, like the EMS. Secondly, an expectation about a certain "necessary" amount of depreciation of the weak currencies had always been in the markets as the differences in nominal exchange rates between countries in a similar stage of development could not be interpreted as a good bargain but as an early warning of a coming depreciation. Nevertheless, even in Europe there had been big devaluations accompanied by banking problems. Sweden in the 90s offers an example. But there is virtually no case where, after a rather long period of exchange rate stability, a currency lost half or more of its value within a short period of time.

In the long run, emerging economies can avoid such an outcome only if they succeed in the control of inflation without letting high real interest rates stifle growth. This means that they have to implement wage and income policies comparable to those in the country whose currency they prefer to pick as an anchor. Since it is very hard and time-consuming to pursue such wage policies in emerging countries, it is imperative that any solutions implemented during the period of adjustment shield these countries from cumulative bouts of devaluation. According to textbook economics, this can be accomplished by announcing in advance a crawling peg aimed at keeping the emerging country's exchange rate constant in real terms.

The rationale behind such a crawling peg is illustrated in Table 2. The interest rate differential as well as the inflation differential reflect the announced depreciation of the high-inflation-country. In theoretical terms: The exchange rate doesn't follow the interest rate parity but the purchasing power parity even in the short run. Real world examples are most of the Eastern European countries which are in a stage of transformation still. The best example seems to be Hungary. The country has achieved to stabilize the real rate of the Forint over a couple of years now without being subject to speculative attacks from the markets.

Such a policy will, however, not induce immense capital inflows from abroad. At the very least, controls on the flow of capital must be imposed in order to safeguard the policy. Even though this involves problems of its own, it does not preclude the implementation of a successful strategy of development. As I will argue below, dynamic investment activity does not depend on the existence of accumulated savings at home and abroad. Investment in all of the successful cases had been financed through bigger profits and higher levels of employment. In this way, investment generates higher incomes and automatically encourages bigger savings. Thus, the process of development depends less on prior financing through existing savings or capital imports than on a favorable monetary environment for investment in the emerging country itself.

**Table 2**  
**Real Interest Rates for Investors / Debtors in the U.S.A. and Asia**  
**When Exchange Rates Change in Accordance**  
**with the Theory of Purchasing Power Parity**

(as %)

	1	2	3	4	5	6	7
	Inflation rate	Nominal interest rate	Real interest rate (2)-(1)	Real interest rate for investors / debtors in USA	Real interest rate for investors / debtors in Asia	Changes in nominal exchange rate	Changes in real exchange rate
In the U.S.A.	2	6	4	4	$6 - 14 + 12 = 4$	12	0
In Asia	14	18	4	$18 - 2 - 12 = 4$	4		0

These considerations are not at all new. Already in the 1950s and 1960s, the same dilemma was the subject of a debate concerning England.<sup>4</sup> When capital is free to flow between countries, a system of floating or flexible exchange rates will ultimately also be unable effectively to reduce the need for adjustment. It may even be the other way round: With flexible exchange rates in the short term an investment in a developing country may be more attractive as a nominal appreciation adds to the attractive interest rate. This is definitively true for all periods in which the purchasing power theory does not hold and interest rate parity dominates. Developments following this pattern can be observed in many Eastern European countries in the first phase of their transformation.

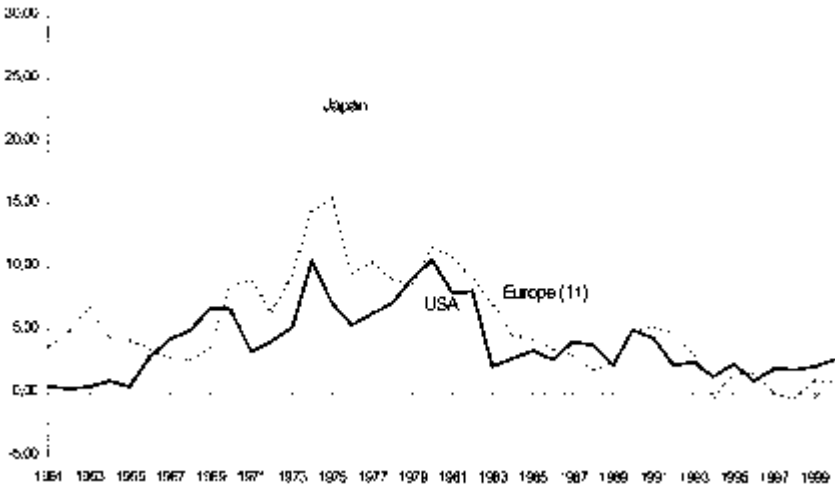
It is the international division of labor which creates the need to adjust with regard to productivity gains and the rise of money wages not an inadequate exchange rate regime. For a while, flexible or adjustable exchange rates may eclipse the necessity of adjustment, but no monetary system can completely eliminate this predicament. Countries which are candidates for a devaluation of their currency, that is, countries with deficits in their balance of payments, or countries with chronically high inflation rates will have to adjust sooner or later. Otherwise they will get caught in a spiral of devaluation and inflation again and again. They can only avoid this if they finally manage to create the kind of domestic conditions that would also be required by a system of absolutely fixed exchange rates or a currency union. In other words, the free flow of capital can only be guaranteed if unit labor costs and prices do not rise faster at home than abroad. Otherwise, various types of currency crisis, or restraints on the free flow of capital, will prove to be inevitable.

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4. J.R. Hicks wrote in 1968: "To adjust the value of money as a once-for-all measure to meet a single identifiable change (such as that caused by a world war) seems to me to be one thing, a continuing failure of competitive power, to be quite another. If currency depreciation is adopted as a regular policy people must come to foresee it. If they do so, they will decline to hold the depreciating currency; for it is more profitable to hold a stable money than one which is depreciating. Even though the 'soft' currency is fortified by exchange restrictions, the objection is not wholly met; for it is doubtful if any practicable exchange restrictions will suffice to protect a currency, depreciation of which has become a habit. In our own case, in view of the advantages which we gain from the use of sterling as an international medium, this argument is particularly powerful. We may be put to great strains in order to maintain the exchange value of sterling (at least to the outsider), but I doubt if we have any alternative but to bear our cross." Hicks (1968), p. 453.

But nominal convergence is only the necessary not the sufficient condition for a stable international monetary environment. The degree of convergence within the group of large industrialized economies, for example, is impressive.

**Figure 3**  
**Nominal Unit Labor Costs in National Currency**  
 (annual increase in %)



Nevertheless, the degree of exchange rate stability is much less impressive. Although Japan has achieved absolute stability of the domestic monetary conditions since a very long time, its currency is time and again the subject of speculative attacks in both directions. To avoid huge fluctuations in the external value of money and to allow at the same time a very high degree of capital mobility a close cooperation of the big player’s central banks and/or a formal exchange rate regime are the only way out. Europe has reached with the introduction of the monetary union the corner solution of absolute fixed exchange rates. This solution requires a high and permanent convergence of the monetary conditions, i.e., mainly unit labor costs and prices. But for countries which are not yet able to guarantee this level of nominal convergence there must be solutions between the “corners” of fully flexible or fully fixed rates.

## Wages Versus the Exchange Rate as a Nominal Anchor<sup>5</sup>

Most developing countries suffer from rather high and sticky inflation rates. It is this “inertial inflation”, as opposed to virtually “no inflation” in the industrialized countries, which makes it so hard to liberalize capital flows and stabilize prices at the same time. In a vertically fully integrated economy labor is the only non-produced input in the production process. As a consequence the price of labor together with the efficiency by which labor is used in the production process determine the price of all goods. Thus, sticky inflation or inertia are usually closely linked to sticky or rigid wages or better, unit labor costs.

A formula used by Dornbusch and Fischer (1993) with a slight modification (substituting real wages by unit labor costs) reveals the logic of inertial inflation:

$$p = p_{-1} + \alpha(w - \mu) + (1 - \alpha)(e - p_{-1}) + y,$$

where  $p$  is the inflation rate,  $p_{-1}$  is past price inflation,  $\alpha(w - \mu)$  is the change in unit labor costs plus a lag,  $e$  is the rate of depreciation of the nominal exchange rate  $(1 - \alpha)(e - p_{-1})$  represents the lag in the change of the real exchange rate, and  $y$  is a term for supply shocks. It follows, as Dornbusch and Fischer put it, that “*Inflation today will be equal to inflation yesterday except for any combination of the following: (i) Wage inflation falls below past price inflation. This requires a break with any implicit or explicit backward-looking indexation. The suspension of indexation, or introduction of an incomes policy, could accomplish this. (ii) Exchange depreciation falls below the rate of past inflation. (iii) Favorable supply shocks lead to disinflation without the need for the exchange rate or wages to take the lead.*”<sup>6</sup>

Thus, the chances of breaking inertial inflation would seem to be equally good, no matter whether the wage regime or the exchange-rate regime is changed. Closer analysis casts doubt on this view, however. The wage regime and the exchange-rate regime cannot be chosen independently of each other. Exchange-rate stabilization, for instance, makes sense only if the aim is to force greater price and cost discipline

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5. This chapter is based on Flassbeck/Hoffmann/Lindlar (1997).

6. Dornbusch/Fischer (1993), p. 11.

on the domestic economy via the competitive pressure of imports. If the exchange rate is to be stabilized successfully, unit labor costs in the transforming country must be pegged to those in industrialized countries in a credible way. This must be attainable within a limited period of time. As in the case of a strict monetary regime at home, a fall in the growth rate of unit labor costs can be accomplished only through an adequate incomes policy or by pressure of high unemployment. Deindexation, a break with backward-looking indexation, must be achieved if exchange-rate stabilization is to be successful. Thus, exchange-rate stabilization and a break with backward-looking indexation are not substitutes. Rather, they complement each other.

Seen from another perspective, exchange-rate stabilization looks more ambitious and expensive than direct wage stabilization. The stabilization of the exchange rate can be successful in countries emerging from a period of relatively high inflation only if the domestic currency is devalued substantially at the start of the stabilization phase, in other words, if the currency is undervalued in the first round. As a result, an additional negative supply-side shock, the result of higher import prices, must be overcome at the beginning of the disinflation period. It has to be absorbed in the form of a decline in real wages. Subsequently, unit labor costs have to adjust to the prevailing trends in hard-currency countries in a disinflation process. Wage policy faces an especially difficult task, because a disinflation path, once chosen, can only be abandoned at the cost of a substantial loss of credibility in the capital markets. The entire adjustment process, the success of each and every step along the way, and thus each failure with regard to adjustment, are subject to daily evaluation by the capital markets. It will be difficult to explain to investors any reverses in the fight against inflation, even those induced by negative supply-side shocks that might, for example, have been caused by bad harvests or hikes in import prices.

There is, in addition to the economic problems mentioned above, a political problem which tends to pose a major threat to any kind of exchange rate anchor strategy. Economic policy makers choose the anchor approach because they want to fight domestic inflation by the means of cheap imports. If this strategy is successful after a period of painful adjustment by the whole society the final achievement is fundamentally endangered. At the very moment in which the harvest of the political rigor reaches the barn the whole concept is put in question by the unsustainable



overvaluation which has been accumulated during the phase of transition from high to low inflation rates. Low inflation is directly endangered as devaluation means higher import prices. In a society which just got rid of the virus of inflation the danger of a new infection is obviously big. Politicians usually hesitate because they fear to lose all their political credit if they quickly agree to a devaluation. But there is no way out. A devaluation is unavoidable. The only alternative to regain competitiveness without nominal devaluation would be wage and price deflation. But a deflation is even more dangerous than inflation and will not help to regain the credibility in the monetary environment.

All in all the strategy of pegging the exchange rate of a high inflation country to an anchor country with low inflation can be a reasonable approach in an environment of open markets for a very limited period of transition. But the strategy will inevitably lead to a currency crisis sooner or later. If there are no precautionary arrangements to limit the degree of speculation against a single currency the currency crisis may easily turn into a major financial crisis. In Asia there had been no precaution and thus the effects on the company and the banking sector had been of an unprecedented dimension. But the huge devaluations, despite their negative effect on the banking system, in the end have been the main factor to explain the turnaround in the real economy and thus may be the seeds of a new and long-lasting recovery of the Asian economies. A restructuring of the banking system will be anyway necessary in the medium run. But as the crisis was not primarily the result of institutional factors in the financial sector the existing weaknesses there will not hinder the recovery of the real economy as they have not hindered the long-lasting catching-up before the outbreak of the crisis.

## **Money, Capital and the Central Bank**

Another aspect of the banking system is very important to understand the Asian “miracle” before the crisis and the banking problems in and after the crisis. Central banks in Asia in the past have played a different role than in many western economies. Central bank independence, which is seen by many economists as one of the main achievements of economic policy “restructuring” has not been a topic of

widespread concern in Asia. Although, by their legal status, some central banks have a certain degree of independence, the consensus approach which dominates the system of policy making in nearly all the Asian countries didn't give the central banks an outstanding position within this system of policy making. Even more so, price stability was an important ingredient to the success of the catching-up process. But price stability was primarily seen as the "natural" outcome of the consensual policy approach and not as the result of monetary rigour. By judging Asia today it is very often forgotten that the consensus approach had economic merits which lie beyond its political aspects and the traditional values of Asian societies.

Throughout the modern history of the global economy, failure to achieve monetary stability, in particular stability of the overall price level, has often prevented countries from even remotely living up to the full potential of their real economies. On the other hand, those nations that achieved monetary stabilisation without too much friction, such as Japan and other Asian nations from the 60s to the end of the 80s, often were extremely successful with regard to the real economy performance. In addition, countries engaged in the process of catching up tend to be net importers of capital precisely because they are trying to close the gap in the standard of living, which requires them to import "a high level of productivity". Under these circumstances, "creditworthiness" may prove to be a constraint of paramount importance, as the current crisis in Asia illustrates so amply.

However, the role of money and capital in the process of development is fiercely debated among economists over the last decades. For many members of the profession, capital markets do not fulfil any noteworthy function in the process of development. Instead they are merely a marginal aspect in the overall framework. Monetary policy pursues price stability in order to prevent inflation from distorting the allocation of economic resources. Capital markets have to finance the process of development by allocating existing savings efficiently to the best available investment opportunity. Available savings are the result of the decision of private agents not to consume today but only at a later stage.

This theory has given rise to far-reaching economic policy conclusions which are sometimes named the "Washington Consensus", i.e., the consensus among major

donors and the financial institutions located in Washington. Thus, some economists recommend central-bank independence, as it exists in a number of successful countries, so as to promote price stability to the rank of a “constitutional” condition. Others conclude that countries without tangible savings of their own, such as the transition economies of Eastern Europe, should open their borders for international capital in order to finance economic development. Furthermore, they argue, these countries should offer attractive interest rates as well as a low exchange-rate risk.

The “Washington Consensus”, however, is confronted with a number of puzzles, for which there have not yet been reliable solutions. Why, for example, were many countries unable to initiate successful economic development for several decades, and to acknowledge price stability as a condition of such development, although their inflation rates, as high as they were, never moved in the direction of hyperinflation.<sup>7</sup> The governments of these countries were by no means trying to use steadily accelerating inflation as a way to push up the inflation tax (“seigniorage”). Rather, they tolerated extensive indexation, that is, the economy’s adjustment to high inflation rates. Another question that still waits to be answered concerns the reason why countries with very different monetary regimes were similarly successful in stabilising prices and in getting the process of economic development and even a catching-up under way. In some Asian countries, such as South Korea, monetary policy has never been even in a semi-independent role. Quite to the contrary, monetary policy has always been directly used to serve the purpose of economic development. Yet, this never led to frequent bouts of accelerated inflation and, despite the recent troubles, has resulted in a remarkable catching-up process of the Korean economy.<sup>8</sup>

Even more important is the question why no major country has yet succeeded in setting off a process of sustained development by relying to a very large extent on foreign capital. By contrast, many nations very successfully started and completed the process of economic development, largely without foreign assistance, and

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7. See, for instance, Dornbusch/Fischer (1993).

8. Concerning the question of central-bank independence, growth and the development of inflation see also Barro (1995).

without previously accumulating any notable savings of their own. Here, the prime examples once more are Japan, the Federal Republic of Germany and South Korea. Germany, for instance, became a net exporter of capital early in the 1950s, just a few years after incomes and savings had collapsed in the wake of World War II.

Apparently, a comprehensive theory of intertemporal structural change including the monetary sphere is necessary to answer these questions. Such a theory of development was propagated, in particular, by J.A. Schumpeter and F.A. Hayek.<sup>9</sup> According to their theory of development, an unbreakable and extremely narrow link exists between intertemporal structural change and a country's monetary system. Rapid economic development as envisioned by Schumpeter, that is development initiated by pioneering firms in product markets, is only possible if monetary policy finances this process of development in advance. This means, as Schumpeter says explicitly, that monetary policy has to finance a potentially inflationary process. In the end, however, this process does not turn inflationary, because pioneering companies use the financing advanced by monetary policy for the successful expansion of output. Or, as Hayek puts it, only the creation of fresh money by the banks including the central bank system allows the process of economic development to continue much more rapidly and successfully than would be possible if it had to be financed solely out of existing savings.

In view of this theory, it is easy to see why countries prone to high rates of inflation usually are not very successful in starting and continuing the process of development and catching up. Every attempt to finance development in advance through the creation of money fails, as wage and price inflation rapidly flare up, only to be subdued at once by monetary policy through high interest rates. Conversely, in countries that cultivate a highly disciplined attitude towards price stability, monetary policy is able, with impunity as it were, to let this kind of advance financing take place again and again, without immediately sparking off repeated bouts of inflation. On the contrary, a faster real expansion duly justifies the provision of advance financing, i.e., the trust displayed by monetary policy in advance, while any inclination towards inflation is weakened further.

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9. See Schumpeter (1964), Hayek (1933).

This theory also disposes of the question whether it is really possible to enjoy the results in a developing country or in a country in transition. It is precisely because monetary policy must finance economic development in advance that countries without any disposable savings of their own can be successful, too. This is true because the savings that correspond to investment are not a prerequisite of investment but its result. Savings are derived from profits and additional income because investment is taking place, not the other way round. This also implies that opening the borders for capital is by no means a necessary condition of successful intertemporal structural change. Rather, the decisive factor is the domestic accumulation of capital as the result of economic development based on investment<sup>10</sup>.

According to the theory of Schumpeter and Hayek, countries are successful not because they rely on their central bank's independence, but because they manage, largely irrespective of the central bank's status, to keep inflation under control. The crucial point is to reach a social consensus to avoid distributive struggles which could easily become inflationary. In effect, such a consensus allows a rapid economic development, and the resulting opportunities for profits. Profits in the long run are either tolerated or made tolerable by giving all groups an adequate share in national income.<sup>11</sup> Monetary policy steps in only when this consensus is threatened by inflationary pressures, for example, during periods of full or over-employment.

Given this theory, the wisdom of trying to attract foreign capital with the help of high interest rates and a fixed exchange rate must be questioned as well as the idea that only with a restrictive monetary policy and high real interest rates domestic savings can be mobilised for domestic investment. Instead, the high level of interest rates required by these strategies threatens the domestic potential for development.

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10. See Flassbeck (1999) for the Keynesian or Kaleckian roots of this approach.

11. The adoption of a consensus-based strategy early on also prevents the sort of gridlock in economic policy that can currently be observed in several CIS countries. There, policymakers stick to restrictive macroeconomic policies, as they wait for restructuring to proceed successfully at the microeconomic level before they are ready to switch to an expansionary course. However, this ignores the fact that only a change in macroeconomic policy, especially in the form of lower interest rates, permits successful readjustment to take place at the microeconomic level.

## Conclusion

The answer to the question put in the title is a simple one. Not everything may be okay with the Asian banking system but there is no reason to believe that with a different, a western style banking system the financial crisis of 1997 and 1998 could have been avoided. The heavy exposure of banks during the crisis was the result of a misguided and misunderstood exchange rate policy in the case of the countries outside Japan and the result of speculative attacks on the yen in the case of Japan. In Japan the extraordinary overvaluation of the Yen during the first half of the 90s had deteriorated banks balance sheets. The attempt to contain the effects of the unavoidable loss of competitiveness on the Japanese society had put most of the burden of adjustment on the company sector in the first round and on the banking sector in the second. Only now the consolidation of balance sheets with the assistance of the government puts the burden where, in a western style institutional arrangement, it had been in the first round, namely with the government.

Outside Japan banks were heavily exposed because companies had been borrowing in western markets at stable exchange rates and low interest rates during the phase of disinflation. After the large and overshooting devaluation of these country's currencies the debt burden exploded and funds from the rest of the world were withdrawn. Any banking system would have suffered under these circumstances. Bad loans were accumulated to a very large extent and in a very short period of time as the devaluation took everybody by surprise. Given the fact that no rating agency, no government and no international institution had submitted an early warning banks could not act cautiously enough to avoid the impact of the big devaluation of currencies and loans at the same time. In western countries sound banking systems may be able to avoid losses which are due to microeconomic mismanagement. But, as many events have shown, they cannot avoid losses which result directly from macroeconomic mismanagement or from exogenous shocks.

In all the Asian countries a special relationship between banks, companies and government plays a certain role in the explanation of the size of the problem of the banking system. But this is no reason for western arrogance. Responsibility for macroeconomic distress may be assumed to the government alone as it is the case

in some of those countries which have not been hit by the world financial crisis. Other countries which could keep out quite well have different assignments of responsibility assuming a role for banks and big companies too. For the “rating” of a country as a whole this is not a decisive factor. In the least analysis all groups of the society suffer in case of a big external shock like a devaluation or a overvaluation. Each society may decide how to distribute the effects of a shock among the different groups and individuals. In the history of mankind there are many examples to prove the fact that societies where consensus is the dominating rule instead of conflict can be quite successful regarding nearly any aspect of economic life. Asia provides the most outstanding example in the last 30 years – despite the big turmoil it had to go through in the last 30 months.

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## **French Summary of the Task Force Overview Report**

### **Résumé du rapport de synthèse du groupe de travail**

*Les relations économiques entre l'Europe et l'Asie ont connu au cours des 15 dernières années une phase de rattrapage, avec aujourd'hui un volume d'échange de biens similaire au commerce États-Unis/Asie. La crise financière de 1997 a en outre mis en lumière la forte présence européenne en terme de prêts bancaires. Parallèlement à l'approfondissement des relations économiques entre l'Asie et l'Europe, il est devenu nécessaire depuis le milieu des années 90 de rééquilibrer la relation euro-asiatique à tous les niveaux. C'est là l'ambition de l'ASEM (Sommet Europe-Asie) : lever les craintes asiatiques d'une Europe protectionniste et engager une coopération fondée sur l'ouverture des marchés asiatiques.*

*La crise financière de 1997 et ses répercussions ont valeur de test et de défi pour ces perspectives de rapprochement. Les déséquilibres des marchés financiers et les interrogations quant à l'architecture financière internationale qui ont suivi la crise asiatique ont montré que celle-ci n'était pas spécifique à l'Asie et risquait de ne pas rester confinée aux autres économies émergentes. La crise a été l'occasion d'un nouvel élan de coopération financière et monétaire internationale : l'intervention financière concertée de tous les acteurs internationaux en Asie du Sud-Est de 1997 à 1999 est sans précédent.*

*Aujourd'hui, la sortie de crise invite à des changements structurels : la question d'une plus grande transparence au sein des institutions financières privées ou publiques, celle de la cession des entreprises en difficulté, les modèles de traitement de la crise sociale ou l'avenir des modèles de croissance eux-mêmes, sont des thèmes essentiels de débat.*

*Notre groupe de travail a choisi de se concentrer sur des questions qui appellent à la fois une analyse rétrospective de la crise financière et une action commune entre Européens et Asiatiques. Les conclusions issues des travaux de ce groupe sont à la fois un diagnostic de la reprise asiatique, une évaluation des actions gouvernementales pour promouvoir les changements nécessaires, et des propositions de coopération régionale et euro-asiatique.*

## **La reprise asiatique : au milieu du gué ?**

*La reprise actuelle des économies asiatiques ne peut s'expliquer par la seule application d'une politique unique et cohérente. Elle est d'abord le résultat de facteurs macroéconomiques tels que l'évolution des taux d'intérêts, de la demande globale et la stabilisation des monnaies de la région, ainsi que d'une multitude d'actions menées par les uns et les autres pour sortir de la crise. La reprise traduit donc la primauté du pragmatisme asiatique sur les théories économiques.*

*Cet empirisme pose tout de même la question de la solidité d'une telle reprise et donc des transformations amorcées en Asie depuis le début de la crise. Il est largement admis que la crise a permis de mettre en place de vraies réformes. Néanmoins, les effets de cette crise sont considérables et la reprise ne peut donc être ni rapide ni sans peine. La reprise reste également étroitement liée à la poursuite de la croissance américaine, à la bonne santé de Wall Street et du yen. La surproduction industrielle, les nécessaires restructurations, mais aussi l'accroissement des dépenses budgétaires demeurent des points de fragilité.*

*L'importante dette publique et privée, souvent sous-estimée, est l'autre grand point faible de la reprise économique asiatique. Les capitaux massivement distribués par les organisations internationales et gouvernementales ne sont pas nécessairement reconvertis en investissement privé et ne servent pas forcément à promouvoir la demande privée. La mise en faillite et la liquidation d'entreprises surendettées est nécessaire pour permettre l'épanouissement de nouveaux acteurs économiques au sein d'un système de règles transparentes et égales pour tous.*

## **Le rôle des pouvoirs publics dans la conduite des réformes**

*La convergence des systèmes économiques vers un modèle en voie d'unification est une réalité. Le modèle économique asiatique n'existe plus en tant que tel. Aujourd'hui, l'enjeu d'une convergence réussie est d'harmoniser les normes légales, éthiques et de gestion tout en respectant certaines préférences culturelles ou sociales.*

*L'internationalisation et la mise en place de réformes sont donc inséparables. Le fossé qui sépare la libéralisation du marché d'un côté et les réformes institutionnelles et de régulation de l'autre est une des explications de la crise asiatique. Différer ces réformes institutionnelles pour des raisons de stabilité politique ou sociale nécessite aussi de différer l'ouverture économique proprement dite, en particulier lorsque les marchés financiers sont sollicités. La réforme bancaire ne peut se concevoir hors de la transformation de la gestion et du contrôle des entreprises elles-mêmes, sans quoi un secteur bancaire assaini sera victime des mêmes spirales d'endettement et d'irresponsabilité. L'accès durable des acteurs asiatiques aux marchés financiers internationaux dépend de leurs progrès dans cette voie.*

*Certes, des mesures de sauvetage à court terme qui limitent les flux de capitaux peuvent être utiles en cas de crise, mais l'Asie, comme d'autres régions dans le monde, a plus à perdre qu'à gagner en restreignant la liberté des mouvements de capitaux. C'est plutôt l'autonomie des politiques monétaires asiatiques, due jusqu'ici à l'absence d'instruments communs à la région, qui devra être à l'avenir limitée. Le calendrier des réformes a donc une importance essentielle pour la région. Les changements administratifs et sociaux doivent aller de pair avec la libéralisation économique. La gestion publique, souvent remarquable sur le plan budgétaire, doit s'étendre aujourd'hui à des objectifs prudents dans des domaines tels que l'endettement extérieur, les réserves de taux de change ou le contrôle du crédit. Le risque d'inflation des actifs, les mouvements de capitaux soudains, les limites à la compétitivité et, plus généralement, la mise en place de règles transparentes qui s'imposeront à tous, ne peuvent plus être négligés.*

*Le groupe de travail a souligné les dangers liés à la période de transition, en matière de développement économique et financier. Les pays qui n'ont pas encore adopté*

toutes les règles de marché doivent conserver un contrôle ferme des institutions financières. Cela n'implique pas de maintenir des coutumes contestables ou des abus traditionnels, mais au contraire de conduire d'une main ferme les processus de recapitalisation.

Enfin, l'Asie émergente doit privilégier l'utilisation des marchés d'actions et d'obligations plutôt que l'endettement privé. L'ouverture des entreprises et du secteur bancaire aux acteurs étrangers est un des instruments de cette évolution.

## **La coopération régionale et euro-asiatique**

Le groupe de travail est parti d'une réflexion sur la volatilité des monnaies et ses conséquences, tout en reconnaissant l'utilité des évolutions monétaires à long terme qui sanctionnent les écarts de compétitivité. Il a souligné plusieurs faiblesses des monnaies asiatiques : l'extrême sensibilité à court terme du taux de change dollar/yen, l'isolement des institutions monétaires nationales les unes par rapport aux autres, et la vulnérabilité aux flux de capitaux extérieurs à la région.

Face à ces problèmes, les politiques de change fixe ou semi-fixe adoptées par la plupart des pays asiatiques au cours des dernières décennies sont elles-mêmes fragilisées, notamment par l'explosion quantitative des marchés de capitaux. Le groupe de travail a manifesté une préférence pour les systèmes de parité flottante, plutôt que pour des parités fixes ou des comités monétaires. L'expérience européenne antérieure à 1999 indique néanmoins qu'un tel système nécessite déjà une coopération approfondie. La mise en place d'un panier de monnaies régionales et globales contribue à stabiliser les économies asiatiques et à limiter les variations du cycle des exportations.

Plusieurs des propositions faites en Asie depuis 1997 vont dans ce sens : coopération des banques centrales, accord de mobilisation des réserves, évolution vers un fond de réserves régional. L'ASEAN s'est engagée dans cette voie avec l'assistance du FMI et de la BAD. La proposition d'un Forum de stabilité régional implique aussi la transparence des informations financières et monétaires entre ses participants pour favoriser une meilleure coordination monétaire et régionale : l'un ne peut être obtenu sans l'autre.

*Quel rôle l'euro peut-il jouer dans ce contexte ? Les participants ont souligné les risques traditionnels de tout système monétaire construit en duopole, par exemple avec le dollar et l'euro. Cette situation aggrave les risques de fluctuation. Quoique l'euro devienne une monnaie de réserve pour les économies dont les liens commerciaux avec l'Europe sont importants, il est clair qu'une stratégie globale n'est pas à l'ordre du jour. L'expérience de l'euro démontre par contre la possibilité de systèmes monétaires régionaux et facilite ainsi l'évolution éventuelle de l'Asie vers un système de panier monétaire ou toute autre formule de constitution d'instruments régionaux.*

*Quelle que soit la solution recherchée par les gouvernements, le groupe de travail a appelé à un approfondissement des consultations à différents niveaux sur les questions monétaires et financières. Bien que l'expérience de la crise financière ait démontré l'implication financière de l'Europe et de ses entreprises en Asie, les Européens ont plutôt tiré de la crise des conclusions ambitieuses à long terme sur les réformes de l'architecture financière globale, tout en soutenant à court terme l'ensemble des politiques successives mises en place par le FMI depuis le début de la crise. Il est vrai que l'éclatement d'une crise majeure n'était pas la meilleure occasion pour engager des évolutions monétaires complexes. Le moment est maintenant venu de conduire une telle réflexion.*



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