The Need for Stronger Regional Financial Institutions in East Asia

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1 Introduction

The financial crisis, which affected several South East Asian economies in the middle of 1997, has now been analyzed numerous times by scholars, policy makers, and market players. Thus far there is no agreement on any single cause for this complex phenomenon, though, different analysts have highlighted different causes, and assigned to them varying degrees of importance.

The typology of causes covers a broad field, stretching from borrowing and lending decisions at the level of enterprises and institutions to distortions in the financial and economic system and to weaknesses in the international financial system (see for instance Krugman 1998; Radelet and Sachs 1998; Montes 1998 and Moreno, Pasadilla and Remolona 1998). Depending on which economy is analyzed, and who the analyst is, the relative importance given to any of the causes varies.

The scholars who have focused upon the close relationship between government and business, previously touted as a factor for the roaring success of the East Asian tiger economies, point to crony capitalism as a core cause of the crisis. Indonesia is cited as a clear case, where this financial crisis has led to wider and deeper consequences, in large part due to the incestuous relationship between government and business, see Radelet (1998) for a discussion on the events leading to the crisis in Indonesia.

Other scholars emphasize financial and economic distortions. Pegged exchange rates in smaller economies, while the much bigger economies surrounding them have observed more flexible exchange rates, led to distorting policy actions and consequences. These included higher relative interest rates, the attraction of short-term foreign exchange flows, over-expansion of credit, over-investment and the ‘bubble’ in asset prices in several sectors, *e.g.* real estate and construction, and ‘irrational exuberance’ in the stock markets. Thailand is presented as a prime example in this regard.

Still others prefer to give full weight to the imperfections of the international financial system. Prime Minister Mahathir has blamed big institutional investors, who can move huge financial resources in and out of relatively small economies, and who have few scruples about exploiting opportunities to feed their greed for profits. The United States has been blamed for being long in rhetoric and advice, but short in financial contributions to rescue and aid packages for the crisis-affected economies. Many have been blaming the IMF for prescriptions that were wrong and merely aggravated the crisis situation.[1] Moreover, it has been claimed that the 'relief' in the IMF (International Monetary Fund) rescue packages was too little and too late.

Considering the depth to which the crisis affected specific economies, it is possible that several causes may have converged and mutually reinforced each other. Each of these causes may have an element of truth, but the degree to which each cause holds may vary from one economy to another. Thus, it is possible to highlight the differences between the economies and in particular the extent to which the crisis adversely hit different countries.

But it is also possible to highlight the fact that the East Asian economies were all affected by the crisis. Indeed, the speed and the breadth in which the crisis spread in the region of East Asia, may indicate that the causes have been broadly similar, and that the economies in the region have become much more inter-dependent than they were a decade or two ago.

If this is the case, then the approach to the crisis can not be confined to single reform measures undertaken separately by individual economies in the region. If the crisis can be traced to a complex set of causes, then each economy should look at a broad range of reform measures, which may have varying degrees of relevance. Moreover, it would be more effective for all the economies in the East Asian region to undertake the range of reforms in consultation, and where called for, also in cooperation with each other.

2 A package of reforms

Reforms, to be effective, have to start at home. In fact, before the economies of East Asia can consider working closely with each other, each one of them may have to look more closely at the internal dynamics of its constituent units, and then figure out which reform should be undertaken at home first. Unless each one of them focuses its priority efforts on strengthening the internal economy, any collective efforts at forging economic cooperation in order to strengthen the East Asian region, the

[1] See for instance, Feldstein (1998). The IMF has recently released a preliminary assessment of its programs in Indonesia, Korea and Thailand in Lane *et. al.* (1999).

broader APEC region, and the international financial system would be in vain.

The effort at strengthening the internal economy should begin with improving corporate governance. Reform should start at the enterprise level, since enterprises are the basic units of any economy. Enterprises, which increasingly have to operate in more open and free markets, must also increasingly go through the paradigm shift of anchoring success on the building up of institutional strength, rather than on the firming up of the iron grip of personal, patriarchal authority. This is because open and free markets, operating under the rule of law, tend to place much greater premium on institutions, particularly those with a corporate juridical personality, rather than on patriarchs, with their more limited individual or personal juridical personalities.

Corporate entities follow a pattern of organization, with a clear structure that delineates responsibility and specifies accountability. Responsibility and accountability are not only internal, but also external. The latter is a recognition that enterprises have different stakeholders, which naturally include the enterprises' shareholders, but are not limited to them.[2] Among the other stakeholders are the enterprises' customers, creditors, and regulators. In the case of creditors and regulators, in common with management, labor, and shareholders, they have an interest in obtaining information about the conduct and results of corporate operations.

Only objective, accurate, regular and timely information can satisfy such an interest. But the provision for this kind of information calls for proper book keeping, which adheres to accounting standards, adopted nationally, and in keeping with international norms. Standards and norms call for monitoring to check and ensure compliance with them and with other prudential rules as well as regulations. External auditors and the participation of external professionals in the Board of Directors can reinforce the principle of checks and balances and allow for independent opinion and advice. They provide additional guarantees of objectivity and transparency in corporate decision-making as well as in the public reporting of corporate information.

Objectivity and transparency of public information are required of corporations because they are vested with responsibilities to the public, especially their different stakeholders. But those to whom corporate information is made available should incorporate such information into their

[2] Zhuan (1998) discusses how moral hazard arises from the different preferences of different stockholders of a firm, and why corporate governance is important. Among others, one argument is that the accumulation of private risks could lead to systematic risks and eventually to a crisis.

regular assessment and eventually into the judgments they make about the corporation. Regulators must see to it that all norms of prudence are observed in corporate decisions and operations.

In fact, over time, as markets become more open and free, there should be no reliance on guarantees and protection which corporations may enjoy from governments. Protective tariffs are falling down rapidly. Guarantees, whether explicit or implicit, often prove to be illusory in practice, and particularly in times of crisis. Safety nets do not open up and generally come up short, when the going gets rough. Indeed, governments are being forced to keep some healthy distance from business enterprises, which must rise or fall on the basis of economic performance in the playing field subject to market competitive discipline, rather than at the behest of their political connections.

Competition principles are increasingly applied and adhered to. More and more sectors and industries are opened up. Only an exceptional few industries are reserved to national groups. This development should not be construed to mean the removal of all rules and regulations. Instead, a solid regulatory framework should be provided, to ensure an even playing field for all market participants, rather than to continue mercantilist and nationalist practices. These practices are increasingly becoming an anachronism in a more inter-dependent world.

In individual economies committed to implement the principles of competition policy, there is a need for rules which are kept simple but strictly enforced. In the enforcement of these rules, especially at the enterprise level, supervisory authorities can focus their attention on financial institutions and their relations with the enterprises that borrow from them. Rules are best enforced on financial institutions, which in turn can help enforce them on the enterprises that come to them for loans. Financial institutions can insist on the observance of basic norms of financial prudence such as capital adequacy, proper asset valuation and loss provisions, conservatism in observed financial ratios, and adherence to standards of financial and over-all corporate performance. Through the credit evaluation and screening process, financial institutions can provide an important line of defense for the financial and economic soundness and strength of the enterprises to which they lend.

In turn, banks themselves should have to meet financial standards set up within the financial system. They too must prove that their capital is adequate and their capital base is strong. Moreover, together with the supervisory authority, they must agree on and observe reasonable mechanisms for asset valuation and loan loss provisioning. In addition, benchmarks would have to be adhered to so that all the fundamental supervisory principles covering issues such as licensing, information submission requirements, prudential norms for all facets of banking operations, adequate supervisory powers to enforce those norms, are observed. In this regard, there is no need to re-invent the wheel. The Basle core principles for banking supervision have already been adopted by various national supervisory authorities. For those authorities that have yet to do so, all they need to do is to conform, adopt, and implement them. Stiglitz (1998), however, argues that Basle standards do not deal adequately with the broader aspects of risks to banks.

Financial supervisory authorities should have to pay special attention to systemic and economic information that can make apparent the state of strength of the financial system. The range of information of concern here should not be limited to inflation and real GDP growth. It should include trends and turning points for real exchange rates, current account deficits, and asset prices. Kaminsky, Lizondo and Reinhart (1998) present a number of indicators that signal when a currency crisis may take place within the following 24 months. Special attention has to be paid to the expansion of bank credit, and particularly of short-term foreign debt. The recent crisis has also revealed the need for giving information that is as accurate as possible on any possible encumbrances on the economy's foreign exchange reserves. It should be noted that forward contracts may render reports on the absolute level of such reserves inaccurate and misleading.

On a sub-regional ASEAN basis, and subsequently also on a broader, East Asian basis, it should be possible for the financial supervisory authorities of the different economies to exchange information with each other. The information exchange can include only a few critical items, such as those that have just been cited. But the value of such an exchange should lie in providing a basis for the different financial supervisory authorities to exchange policy experience and insights into making the exercise of their supervisory functions more effective. Once such a basis is provided, these authorities can explore possible avenues to tightening supervision, strengthening their respective financial systems, and eventually devising mechanisms and arrangements by which to anticipate and prevent future sub-regional and regional financial crises.

In sum, before we begin to think about a new financial architecture for the global economy, we should first address the need for reforms much closer to home. In the first instance, each individual economy must craft a program by which gradually, but with the least delay, they can comply with the basic principles of corporate governance and competition policy. Then, in an almost parallel move, each economy needs to strengthen its financial supervision. In fact, several economies in East Asia have recently set up such separate authorities and have vested in them autonomy, independence, and broad powers for effective supervision, not only of banks, but also of other financial institutions.

In this regard, with all the work that needs to be done, it is only proper that in the foreseeable future, the different autonomous financial supervisory authorities in East Asia should get together. They can now do so productively, if they exchange information and experience, and agree on basic items that can be monitored on an East Asian-wide basis. They can also learn from each other on issues of common and vital interest to them. These issues relate to the strengthening of individual financial systems. Over time, when conditions are ripe, they can and should be gradually expanded to include possible cooperative endeavors for the strengthening of the inter-related financial systems in East Asia.

3 The ten East Asian economies

The history of cooperation in Southeast Asia is three decades old. At the time when the financial crisis was beginning to hit the original ASEAN members, ASEAN was celebrating the 30th anniversary of the Bangkok Agreement, by which ASEAN was launched. In fact, it would have been a much happier celebration, were it not for the financial crisis. After all, ASEAN could point to many feathers in its cap. Its accomplishments have been held with pride, and have justifiably earned it great respect from the international community.

But the fragility and limitations of those accomplishments have been revealed by the financial crisis. Since the accomplishments were generally in the area of international good will, good neighborliness, and the liberalization of trade and investments, the mechanisms that ASEAN set up for consultation and coordination were ill suited to take on the challenge presented by the financial crisis. ASEAN Finance Ministers had resumed meeting only in the early 1990s. In the IMF, the World Bank, and ADB ASEAN economies belonged to different constituencies, as they do up to the present. While the avenues for consultation and cooperation between ASEAN Finance Ministers and Central Bank Governors have always been open, and each year there are a few occasions when they could do so, still the fact remains that they were peripheral to the core ASEAN process. Foreign Ministers and Trade and Industry Ministers have always been the ones to tend to the ASEAN process.

The cooperation process, especially during the past few years, has led to greater integration of ASEAN economies.[3] At the start, the process

[3] See Tan (1996) for a discussion of the impact of AFTA on ASEAN.

moved on very slowly. Indeed, for most of the initial years of ASEAN, its call for economic cooperation has always been much sharper than its bite. But in the past decade, greater economic inter-dependence gradually began to take on more substance, reckoned from the standpoint of trade. Trade inter-dependence becomes more significant if we expand the subregion from the original ASEAN (the ASEAN 5 of Indonesia, Malaysia, the Philippines, Singapore, and Thailand), and include the other East Asian economies (the 3 Chinese economies of China, Hong Kong, Chinese Taipei, plus South Korea and Japan).

Trade and investments do tend to reinforce each other. Once trade flows between inter-related economies, their links soon expand beyond trade to include finance. The financial crisis of July 1997, which affected all the original ASEAN members almost simultaneously, has highlighted this close linkage in financial and monetary developments between ASEAN economies. Moreover, as the evolution of the crisis has shown, it has revealed that such close linkage goes beyond the original ASEAN 5.

Before 1997, it was said that the movement in the exchange rate of the yuan and of the yen, relative to the US dollar, gradually created to some degree pressure on the currencies of ASEAN.[4] Most of the original ASEAN economies decided to turn a blind eye to this pressure, and failed to make the appropriate adjustments in their exchange rate. But by mid-1997, such pressure, exacerbated by a number of other factors, which varied from one economy to another, could not longer be resisted. Market pressure forced several ASEAN economies to adjust their exchange rates to levels which were broadly comparable with the rate of depreciation earlier of the yuan and of the yen.

The defensive move of Chinese Taipei, which devalued its dollar by 10% in October 1997, raised the fear that a competitive devaluation in East Asia could worsen and prolong the crisis. The same fear has always loomed large with respect to China, and today this remains one of the 'threats' to the recovery of several South East Asian economies. The Hong Kong dollar was subjected to occasional speculative attack, and this forced the government to intervene and abandon its longstanding hands-off policy with respect to financial markets. Commencing with the Thai baht and the resulting contagion throughout East Asia, the South Korean won had to be devalued within less than 6 months after the start of the crisis.

The existence of the contagion argues for some cooperative arrangement on financial and monetary issues in ASEAN and in East Asia. The

[4] See Noland *et. al.* (1998) for an empirical investigation of the impact of the devaluation of the Chinese yuan on Asia.

trade interdependence they had built up within the past decade has arguably made them into an economic region, and financial markets have started to regard them as one.

ASEAN has already taken the initial move to broaden cooperation in the field of finance. The ASEAN Finance Ministers decided in early 1998 to start a mechanism for consultation and cooperation, which can include peer review. The same decision has also been taken by APEC, which counts among its member economies the 10 economies of East Asia. These initial moves, which are taking a long time to implement, form part of the general response to the crisis.[5]

But both groupings are not co-extensive with the parts of East Asia that have been most directly affected by the financial crisis. ASEAN has new members, which are still in the early stages of integration into the international market economy. APEC has become a very broad grouping, which includes economies way beyond East Asia. Within APEC, there has been some recognition that the 21 economies comprising it would be too broad a grouping for the financial crisis that started in East Asia. Within it, a more limited Manila Framework Group has been set up. But again, this is not co-extensive with the East Asian ten. It excludes Chinese Taipei, but includes the USA, Canada, Australia and New Zealand.

For the 10 East Asian economies that have been thrown into the forefront of having to confront the financial crisis, there is a clear and urgent need for functional arrangements of consultation and cooperation, which are flexible and open. Such arrangements should initially and generally be limited to them. Under the principle of subsidiarity, they should be implementing joint solutions to the problem that started in the East Asian region. They should be able to consult freely with each other, without anyone else complaining that a great divide is being artificially made between the eastern and western side of the Pacific, and between the northern and southern portions of the Western Pacific. In fact, each time the Europeans get together, everyone hails the effort as potentially constructive and positive. Similarly, everyone welcomes the Free Trade Area of the Americas (FTAA), which puts together virtually all the economies of the Americas, as a building bloc towards the construction of a more open and free international trading system.

But as with the FTAA, the functional grouping becomes a building bloc towards a bigger, more global system, provided it remains open. Similarly, the 10 East Asian economies that should consult with each other more closely, can become a positive group contributing towards the build-

[5] See Manzano and Moreno (1998) for a discussion of the regional responses to the crisis.

ing up of a new global financial architecture, only if they remain open and flexible. Indeed, it is only realistic for them to include the United States in many of their meetings. It is also of strategic long-term importance for Australia and New Zealand to be invited to their consultative meetings.

In fact, before they can move on to anything else, the 10 East Asian economies should spend a great deal of time implementing mechanisms for more regular consultation amongst themselves. They can share information. They can exchange assessments. They can make arrangements so that a regional dimension is introduced into each one's day-to-day information assessment of developments in financial markets. In this regard, they already have the model of the G-7, which meet very often informally, and exchange assessments of financial market movements frequently, many times over the phone, even on a daily basis. It is proposed that what the G-7 already do, the 10 East Asian economies should also do. In this way, national financial authorities simply parallel what the inter-connected global financial market does, and which now happens to regard East Asia as one region.

Once the 10 East Asian economies make their informal consultation mechanism work, it would soon follow that they cooperate with each other more closely. They could coordinate efforts at speeding up their process of recovery from the crisis. For instance, the Miyazawa initiative, which is now an umbrella for bilateral economic relations between Japan and South Korea as well as several of the ASEAN economies, can be folded into the East Asian 10 mechanism. This could then form a basis for other positive initiatives, which the region as a whole can undertake.

In the wake of the East Asian crisis, there is a gamut of such initiatives, which in time will be called for. In addition to speeding up the recovery in each of the East Asian economies, there are many elements in the reform package, which can be undertaken in close cooperation with each other. The adoption and implementation of competition policy principles, the restructuring of corporations, banks, and industries and, the strengthening of financial supervision, all require a broad vision and deep commitment. If undertaken alone, they will prove to be difficult and expensive. If undertaken on a more cooperative basis, with support from other economies and international financial institutions (IMF, World Bank, ADB, etc.), the possibility for speedy success will be much higher. Effective regional consultation cannot operate in a vacuum. To be of any value, policy support at the regional level must improve the ability of policymakers to identify and respond to shocks in a timely fashion (Manzano and Moreno 1998).

The 10 East Asian economies can never lose sight of their need to restore the stability of their exchange rates and their financial and economic systems. The crisis has brought home the point that stability of the exchange rate is better secured through operational and structural policies, which bring stability and market discipline to their financial and economic systems. This means that it is vain to focus on exchange rate stability alone, unless determined and sustained efforts are expended towards a package of measures for strengthening the banking system and for developing the economy under open market rules. This is a very broad field, with a myriad of specifics, for close cooperation among these 10 economies. Once they get started in this direction, the 10 East Asian economies can begin experimenting with subsidiary arrangements that could more directly bring greater stability to their currency markets.

These ten economies have great stakes in the new financial architecture, which can have an influence in the way the major currencies – the US dollar, the Japanese yen, and the European euro – are going to move in relation to each other. The more stable these major currencies are to each other, the less pressure they have to adjust their own currencies. The more realistic and flexible the proportions they keep of these major currencies in the basket of their individual exchange reserves, the less pressure for adjustment they are subjected to every time the major currencies move relative to each other. This basket of major currencies and their relative proportion in the exchange reserves the 10 East Asian economies each keep should be a topic they could consider amongst themselves.

They should also consider arrangements by which they can avoid competitive devaluation within East Asia. They would already be taking long strides in this direction through the sharing of information and assessment, and in time through their peer review process. But they may also wish to go beyond the early signals they send to each other, and the neighborly persuasion for the early correction of destabilizing trends they create to each other. Since they are decades away from locking firmly and permanently their currencies to each other, they may wish to consider the softer and more realistic alternatives that are available. Surely, they should be able to find a reasonable middle ground between the two extremes of a permanently fixed peg and the completely free float. If they manage to strike a flexible balance between the two, and can show the rest of the world that they can make it work, then they can contribute a meaningful regional structure to the construction of a new global financial architecture.

In sum, Europe has already united even more strongly, with the euro as one more bond that inextricably ties those economies that have decided to join the euro zone. In the Americas, there is an inexorable tendency towards tying the currencies of various American economies to the US dollar. The current dollarization proposal of Argentina follows the example of Panama, and it is gaining momentum due to the instability in Brazil.

In East Asia, there are ten economies that are faced with the financial crisis, and with no clear arrangements or fixed mechanisms even for consultation amongst themselves. The crisis has made it necessary that on financial and monetary issues, these ten economies should begin to consult with each other more regularly and frequently but consultation can and should lead towards cooperative initiatives. For as long as these initiatives, from and for East Asia, lead to arrangements and mechanisms that are open and flexible, they can be viewed positively. They may even be able to contribute a constructive building block towards the new global financial architecture, now being openly discussed in the world economy.

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