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Managing Asia's Financial Sector Recovery: The Role of Competition Policy and Corporate Governance

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Executive Summary

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At a time when Asia, and indeed the entire world, is reexamining the virtue of competition, it is worthwhile to ask some basic questions. What is the relationship between soundness and competition in financial markets? Is a highly competitive system inherently unstable? How important are regulatory structures in maintaining financial market soundness?

Just a week before the Asia Pacific Economic Council (APEC) ministerial meeting in Kuala Lumpur, the Asian Development Bank Institute (ADBI), the Institute for Southeast Asian Studies (ISEAS), the Pacific Economic Cooperation Council (PECC), and the Institute for Financial and Monetary Policy (IFMP) of the Ministry of Finance of Japan convened a distinguished group of policymakers, academics, and government regulators from the APEC economies for a workshop in Singapore, November 9-10. The workshop dealt with two broad issues that are deemed crucial in the context of the Asian crisis - the role of financial sector competition policy and corporate governance in the Asian recovery.

I. Competition Policy: Conceptual Issues

In outlining PECC's principles for a competition policy framework for APEC economies, New Zealand economist, Kerrin Vautier, laid stress that "competition policy" is a very broad concept, which goes beyond competition law and anti-trust. The scope of competition policy is not limited to trade issues alone. Rather, competition policy should be taken as an umbrella and integrating concept whose principles underlie all policies that can affect the competitive process in globalizing markets. The motivation for tabling this framework for adoption by APEC economies is that competition and efficiency will remain the most appropriate and central force for organizing economic activity in globalizing markets. Thus, it is considered central in attaining APEC's goal of more open, competitive and growing markets in the region.

Recognizing that this issue is quite new and complex, and that there exist significant differences in the levels of economic development and experiences among APEC economies, PECC deemed it appropriate to focus on these broad nonbinding principles for guiding policy instead of formalized prescriptive rules or laws that govern competition. It is left to the different economies to decide the specific competition-related policies that best fit their individual economic circumstances.

Kerrin Vautier proceeded to outline some of the key requirements for upholding the aforementioned principles. These include eliminating government regulations that create or maintain efficiency-reducing barriers to market entry, or being vigilant so that agents avoid engaging in anti-competitive business behavior as governments proceed to deregulate and open markets. She added that enforcement efforts should be directed at the competitive process rather than the interests of individual competitors. Finally, she stated that the APEC economic and technical cooperation has an important role in the strategy of promoting competition through education, sequencing, implementation, and institutional capacity building.

II. Competition Policy in Financial Markets

The second session centered on issues involving the application of competition policy to the financial markets. These issues are certainly contentious, especially in the light of the Asian crisis, where some blame has been laid on excess competition and reckless liberalization. Was there a "failure of competition" in Asia? Does the general competition law apply equally to the banking sector or are banks special? Different perspectives were offered by Arthur Grimes, from Victoria University of Wellington, especially on how to translate the PECC competition policy framework to the financial markets, and Edward Graham of the Institute of International Economics, who discussed the current debate on competition issues including the major cases involving Microsoft and Long Term Capital Management (LTCM) in the United States. The third speaker, Masamichi Kono of the World Trade Organization (WTO) gave a multilateral perspective on these issues, especially on the approach of the General Agreement on Trade in Services (GATS) on financial services liberalization.

Contestability of Markets

Grimes reiterated a long held premise that a competitive process is welfare enhancing and that countries should look into adopting guidelines that foster competition. In essence, this means removing government regulations that fetter the greater workings of the market economy. At other times, it may mean imposing regulations that enhance market competition where unfettered markets would otherwise result in restrictive practices or in other noncompetitive outcomes. One set of principles that guide competitive markets is the PECC Competition Principles proposed for APEC. The overarching theme of the competition framework is the openness of markets to contest from all sources of supply

Banks are special

While the competition framework covers all sectors and industries, applying it to financial markets require certain qualifications owing to basically two characteristics: (a) crucial information (e.g. credit worthiness of borrowers and of banks themselves) is often asymmetrically distributed and is costly to obtain; and (b) the failure of major financial institutions may impose considerable external costs on other agents. On the strength of these characteristics rests the case for government regulation of the financial markets in the interest of maintaining soundness in the system.

Soundness vs Competition

The challenge is how to apply the General Competition Principles to the financial sector, taking into account the need to balance the aspects of soundness and competitiveness in the financial markets. Grimes raised several arguments for justifying the intervention in the financial markets. It has been observed that more competition among banks and financial institutions has been associated with an upsurge of bank failures. Second, owing to the diversification benefits, there exists increasing returns to scale in the financial services industry. Thus, there is potential for market power by a dominant firm. Third, competition may prevent efficient networks emerging. And fourth, opening up of competition through a lowering of barriers to entry without any prudential restrictions may lead to an increase in risk taking by financial institutions faced with greater competition in light of informational asymmetries. He remarked that save for the fourth argument, the general competition law, as it stands, could apply.

To address the argument that agents in financial markets are prone to take excessive risks in unfettered markets, Grimes said that the appropriate action is to ensure that appropriate information (disclosure) is made available to actual and potential clients, and their monitoring agents. Hence, two policies were recommended: mandated disclosure of all relevant information at the level of the individual bank and mandated accounting treatment for all types of disclosed information. Grimes admitted that though these policies may correct for key informational problems in the financial services industry, they do not necessarily correct for contagion or the "runs" problem that beleaguer the industry. Nor do disclosure policies alone correct for contagion effects, a breakdown in the payments system caused by a failure of a single institution. For these reasons, Grimes suggested that extra legislation to prevent runs and to ensure the smooth functioning of a payment system should be put in place in the interest of maintaining soundness. To this end, a policy to establish real-time settlement and giving the authorities the power of suspension of convertibility were suggested.

Beyond these restrictions or regulations, there appears to be little room for further government regulation to promote competition and soundness. Thus, there is little reason to insist on capital adequacy requirements or limits on maximum exposures or exchange rates, interest rate or derivative exposures. Furthermore, Grimes reiterated that from a competition standpoint, as long as the transparency measures are adhered to, there is no good reason for imposing foreign ownership controls in the financial services sector. Open entry would facilitate the allocation of credit to the most efficient potential borrowers without the need for government directives and without fears of monopoly foreign control.

Measures in crisis times

Grimes said that a country undergoing financial crisis will wish to adopt measures that promote confidence in the system and delay measures which may reduce confidence in the short term even where they are designed to increase confidence in the longer term. When a crisis is underway, mandatory disclosure is of little use, and may even be detrimental for it may instigate a "run." For this reason, it is recommended that countries only adopt this approach once banks are in a sound position. He further recommended that a disclosure regime may be enhanced by imposing on banks the requirement that they also hold a minimum level of subordinated debt. The advantage of imposing this restriction is that a subordinated debt holder does not face the same risk-taking incentives of an equity holder and have greater motivation for monitoring bank soundness.

Competition policy and international financial architecture

In his paper, Edward Graham contended that the relationship of competition policy and the international financial architecture is currently in a state of flux. Reiterating Grimes' earlier point, he said that the goal of competition policy is to foster efficiency by making markets contestable. Because not all markets are contestable, government interventions via regulations come in. However this carries with it its own problems.

Financial markets have a central role in financial intermediation, absolutely critical to the functioning of the economy. Thus if the financial intermediation function breaks down, the consequences are immediate and severe. This was the case of regulation to prevent such a breakdown, and a consensus emerged that some minimum regulation is important. In the Asian crisis, this minimum level has not been adequately reached-especially in the area of bank supervision and enforcement of banking standards. One consequence of the central role of the financial sector is that the "too big to fail" problem is magnified, another point consistent with Grimes' presentation.

The Asian Crisis: An excess of competition?

The Asian crisis came partly as a result of inefficiencies of banks as well as creditor of banks in appraising the soundness of projects that they financed. The fact that this nonperformance was facilitated by market liberalization was considered to be very disturbing from a competitive perspective. The situation has been made more problematic by moral hazard elements. For instance, moral hazard arises when prospects of bailouts for failed investment decisions are discounted in the risk-taking calculus that managers perform. Deposit insurance considerations and lack of transparency also introduce elements of moral hazard.

Competition policy and moral hazard

Greater contestability of markets is supposed to foster efficiency. In the context of the Asian crisis, the opposite happened. Edwards exhorted that policymakers should not abandon financial market liberalization, but that liberalization should be accompanied by insistence that financial institutions meet standards of soundness, and financial accountability and transparency. The challenge here is to strike a balance between achieving healthy financial institutions and maintaining as much market contestability as possible. If the prospects of moral hazard leads to recklessness in the financial markets, governments should take steps to eliminate moral hazard, not to reduce contestability. At this stage, Edwards admitted that unless the the full nature of moral hazard is known, it is difficult to make progress.

Multilateral perspective on liberalization and competition policy

Masamichi Kono talked about the financial sector reform and competition policy in the context of the General Agreement in Trade in Services (GATS) framework. He said that there is a close relationship between trade liberalization and competition policy and that they play complementary roles in promoting efficiency, consumer welfare, growth and development. Trade liberalization aims to reduce government-imposed barriers to international trade in goods and services, while competition policy principally addresses anti-competitive practices of enterprises.

To date, there has been some progress made in liberalization as governments try to minimize measures to restrict or distort the conditions of international competition. However, according to Kono, more work has to be done in competition policy, the area of private sector practices, which have similar effects on trade but are not always subject to international trade rules. This imbalance has to be addressed because neither liberalization nor competition policy would be completely successful without the other.

The WTO promotes the equality of competitive opportunities for its members in the multilateral trading system. For the financial sector, GATS provides the basic framework for liberalizing financial services trade not only through cross-border supply of those services, but also through commercial presence of foreign service suppliers with the idea of improving the competitive environment of the domestic financial markets. Under the aegies of GATS, 102 member countries, which includes the affected Asian economies, agree to make binding commitments for the liberalization of financial services trade under the GATS.

According to Kono, financial sector liberalization under the GATS is not the cause of the financial crisis, but an important part of the solution. Why so? The GATS seeks to create a financial sector that is more accountable since openness means that institutions need to answer to investors and to adhere to international rules. The GATS provide the necessary incentives to promote further transparency and better corporate governance. These incentives are the best guarantee of a well functioning market economy because they contribute to improving the overall competitive environment. It would diversify the structure of capital flows and would help develop a broader and deeper financial system more immune to external shocks. Furthermore, the GATS will provide multilateral rules to build confidence in the financial systems of WTO members, developing and developed alike. It will introduce greater competition by allowing presence of foreign financial institutions, and to build a new and more open financial infrastructure on a foundation of secure and transparent multilateral rules.

Kono further remarked that the GATS framework take into consideration the special nature of financial systems. Hence, it asks for commitments from members to include regulatory and administrative guidelines on competition policy during the negotiations.

III. Developed Country Experiences

The developed countries have had long experiences with financial instabilities. These countries had confronted complex issues related to financial reforms with a view to enhancing competition in the financial sector. What specific policies worked? Which ones didn't? What were the different constraints present in addressing competition issues in the financial markets? Of course, different countries operate in different legal and institutional environments and structures. Notwithstanding the different financial development models pursued, valuable lessons can be still be learned from the various attempts to address competition issues. To this end speakers from the developed economies from North America, Australasia, and Asia gave insights on the various lessons learned in the history of financial reforms in their respective countries

Canada

John Carr, Professor of the University of Toronto, traced the different policy regimes governing the Canadian banking system circa 1890-1966. In favorable contrast with the banking experience of other developed economies, Canada had far less fewer incidence of bank failures during the said period. Carr contended that there are two complementary factors that can account for the relative stability of Canadian banks. The first one is the absence of any form of deposit insurance before 1967 which provided incentives for both prudence on the part of bank management and monitoring by depositors and bank regulators. Depositor monitoring was motivated by risk bearing while the monitoring of bank regulators was motivated by the fact that lobbying by depositors in failed banks and the electoral consequences of depositor discontent were costly for them. This confluence of interests was usually effective in identifying poorly managed banks before the situation deteriorate.

The other factor was the absence of unit banking and other regulatory barriers to competition. This facilitated the emergence of a relatively small number of efficient banks. Because the regulators did not consider spatial concentrations of banking power as an impediment to efficiency-enhancing mergers, the merger movement among banks proceeded which allowed these institutions to reap regional diversification benefits and scale economies. Currently there are five large banks in Canada which control over 90% of banking assets. Their sizes allow these banks to operate in international markets where size and competitive prices are crucial for survival.

What are the lessons learned from Canada's experiences that can be applied to the Asian financial systems? Carr asserted that the introduction or maintenance of a no risk-bearing deposit insurance scheme in the context of a liberalizing financial market environment is an unsound policy mix. The reason being that deposit insurance introduces a major moral hazard problem as it subsidizes risk and encourages the undertaking of risky activity. The Canadian evidence of failures of financial institution after the introduction of deposit insurance in 1967 supports this contention. Although deposit insurance schemes did encourage new entries, these new entrants held risky portfolios and failed when the economy experienced difficulties. Carr suggested that deregulation of financial markets should be accompanied by either outright elimination of deposit insurance schemes or making participation in such schemes voluntary. Furthermore, he said that foreign competition in the financial markets should be encouraged and that there should be more transparency in rules and less room for ministerial discretion in regulating the banking industry.

New Zealand

Arthur Grimes presented the lessons and policy experience of Australasia in the course of liberalizing the financial markets. New Zealand had a policy turnaround from over-regulation to liberalization in the financial sector in 1984. In the course of the reform process, the authorities of New Zealand removed all capital and current account restrictions; floated the New Zealand dollar; removed all liquidity ratios on all financial institutions, interest rate controls and all credit restrictions and directed lending criteria. Since then, the outcome has led to a trend of improving macroeconomic performance. Furthermore, in New Zealand's experience, a liberalized financial system is hardly any more volatile than a tightly controlled one.

The reforms initiated in 1984 opened up the banking sector and banking functions are fully carried out by nonbanking institutions and there is no distinction between domestic and foreign banks. In terms of institutional development, the nature of banks and nonbanks are increasingly being blurred. The only difference is that banks need to be registered so that a new bank entry is facilitated and prudential controls could be put in place. One motivation for financial institutions to opt for "bank" status is that registration (and using the term "Bank" in the name) may give some degree of quality assurance. Grimes pointed out that of the 19 banks currently registered, 18 are predominantly foreign-owned.

New Zealand does not impose prudential rules applying to asset quality, large exposures (except connected lending), country risk, liquidity, or market risk. However, the authorities demand disclosure which requires all banks to publish quarterly disclosure statements over a range of information areas. Together with disclosure requirements, the Reserve Bank of New Zealand places very clear accountabilities on bank directors for ensuring that regulatory and accounting standards are adhered to and disclosures are correct. The Reserve Bank, likewise, has powers to place a troubled bank into "Statutory Management" whereby it can immediately take over the running of an institution. Grimes remarked that overall, the prudential supervision regime adopted appears to be working effectively in terms of disciplining bank management and directors to adopt sound banking practices, in the knowledge that considerable information has to be disclosed. Together with relatively free entry to market, the banking system becomes competitive without compromising soundness.

Australia provides a contrast to New Zealand on the issue of mergers. Whereas Australia holds a deep concern on potential market dominance or concentration ratio of the resultant entity of mergers, New Zealand stresses the role of potential competition (i.e., contestability) much more strongly than in other jurisdictions. Grimes said that technological and other considerations appear to be making financial markets much more competitive than was previously the case for any given concentration ratios.

Japan

Nobuyuki Uda, Deputy Director of the Planning and Legal Division of the Financial System Planning Bureau, Ministry of Finance of Japan, reported on the Big Bang, the major reform of Japanese money and capital markets to be completed by 2001. He said that the Big Bang was prompted by the decline in Tokyo's status as an international financial center. While the high costs of the Tokyo market, the difficulty of offering diversified products, and the time-consuming procedures have often been cited as reasons for the "hollowing out" of the Tokyo's financial sector, he reckoned that the major reason was the collapse of the bubble economy around 1990. The overall aim of this reform is to turn the Tokyo market back to international financial market comparable to New York or London by the year 2001.

In the area of competition policy, the Big Bang was suppose to address the convoy system of Japanese financial structure where various categories of financial institutions are segregated by law into different niches, thereby eliminating competition as much as possible. Because this type of arrangement was deemed inefficient and overprotective, elements of competition in the reform package was introduced following the principle of creating free, fair and global systems.

Carrying out the Big Bang necessitated liberalization of cross-border capital transactions, complete liberalization of foreign exchange business, and a shift from licensing to a registration system for securities companies. While there were calls for a delay of the Big Bang owing to the present difficulties of Japanese banks, the government decided to press on with the reforms. It should be noted though that the scope of the Big Bang does not extend to banks but is limited to securities, investment and insurance houses.

Taiwan

In her paper, Tina Chen of the Central Bank of China discussed the Asian Financial Crisis and the Competition Strategy of Taiwan's Financial Sector. She emphasized that Taiwan was not as badly hit by the Asian crisis as other ASEAN economies due to favorable macroeconomic conditions, abundant foreign exchange reserves, low foreign debt, sound financial system and an orderly approach to liberalizing foreign capital. Notwithstanding the encouraging macroeconomic performance, Chen admitted that the financial sector was somewhat affected by the regional crisis. Due to the limited exposure to Southeast Asian credit risk, Taiwan's banking sector was able to weather the financial turmoil.

Recognizing the need to strengthen its financial sector, the Taiwanese authorities initiated a competition strategy. This strategy called for a gradual or step-by-step approach to liberalizing capital under a flexible foreign exchange rate policy. Other elements involve integration of financial and industrial policies where direct financing is encouraged; privatization of government-owned banks; restructuring of financial institutions through mergers, acquisition or conversions; and enhanced prudential regulation and supervision which called for greater transparency provisions.

IV. Developing Country Experiences

The crisis ushered in a paradigm shift for Asian countries. Many changes have been adopted and many more are underway. A panel composed of policymakers from Korea, the Philippines, Thailand, and Indonesia, offered some insights into the problems in competition policy which the crisis unmasked, and some updates on reforms that are in place and that are being debated

Thailand

Vicharat Vichit-Vadakan, Secretary-General of the Financial Sector Restructuring Authority (FRA) commented on Thailand's experience in competition policy and financial market development. He said that as early as May 1990, Thailand embarked on a financial liberalization and competition policy when it accepted certain obligations under the IMF. Thailand relaxed foreign exchange controls, liberalized current account restrictions and reduced restrictions on capital movement. In line with this policy thrust, the Bank of Thailand removed controls on interest rates, lifted foreign exchange controls, established the Bangkok International Banking Facility and facilitated the entry of foreign service providers into the domestic financial markets.

The crisis of 1997 did not bring about a policy reversal for Thailand. The country remained committed to the belief that the internationalization of financial market and promotion of financial competition is the way to strengthen the financial sector and to avoid future crisis. Under IMF recommendations, Thailand continued to pursue market-opening measures and attract foreign capital inflows. To carry this out, programs on financial sector reforms; legal reform and revision to enhance foreign investment; as well as privatization of state enterprises were implemented. The underlying rationale for these measures is liberalization and competition policy.

The current crisis has unveiled the urgent need for a comprehensive structural reform in the context of financial liberalization and market opening to enhance competition. Under the different programs, noncompetitive financial institutions have to be closed while foreign equity participation is encouraged. It was hoped that foreign financial services providers would bring along with them better quality, more sophisticated and more diversified products and services to the local market.

Vicharat gave insight that Thailand should shift from a policy that focuses simply on improving the competitiveness of local financial institutions to one that also considers the consumers as the ultimate beneficiaries. Such a "total" and "consumer-centered" policy would mean the creation of an environment wholly conducive to competition, regardless of whether the firms are local or foreign. The FRA, which is the government's main agency in recuperating the financial sector, has steadily adhered to the competition principles as the only way of reviving the financial sector and of restoring confidence in the Thai economy.

Korea

Hynchul Shin, Director if the International Department of the Bank of Korea discussed Korea's approach to competition policy in the financial sector. Competition issues in the financial sector of Korea emerged only in the 1980s. However, owing to the government's gradual approach to financial liberalization, its adoption was rather slow. There was acceleration in the 1990s, which was expedited even more following Korea's accession to the OECD in 1996. By the mid 1990s, the lifting of interest rate controls and capital market opening were proceeding well. However, despite the rapid progress of financial liberalization, adequate prudential regulation had not been sufficiently put in place, thus undermining the soundness of the financial institutions.

One of the objectives of the ongoing financial sector restructuring in Korea is to establish fair rules of the game based on market and competition principles. Thus, consistent with this goal, insolvent financial institutions were allowed to fail. Another element in the restructuring process is to reduce moral hazard, which had become deeply embedded in the financial industry due to the idea of "too big to fail." This can be accomplished by imposing transparent rules for any rescue loans to financial institutions.

Last December, Korea agreed with the IMF to launch an extensive financial restructuring program together with reforms in the corporate sector and labor market, as conditions for receiving financial assistance from the international community. The government adopted the strategy of initiating bank reforms first before nonbank sector reforms. These were harsh measures because they involved lay-offs, mergers, closures, and transfers of wealth. However, the Korean authorities proceeded with the intention of resolving ailing financial institutions and strengthening the soundness of viable ones. The government encouraged similar "self-rescue" efforts by large shareholders of nonbanking institutions.

The authorities also introduced institutional changes to support the financial restructuring process. Most notable is the relaxation of rules on foreigners' acquisition of shares in domestic financial institutions. Now foreigners are allowed to establish joint-venture banks as well as securities companies, and subsidiaries. Financial supervisory and disclosure standards, likewise, have been substantially strengthened.

While Korea had made important steps in promoting competition in the financial sector, Hyunchul Shin commented that the government remains as a large shareholder in the recapitalization of ailing banks. This was so in the interest of resolving issues quickly and because the laws and procedures relating to structural adjustments were inadequate. Currently, Korea has ceilings on the ownership of bank stocks by a single person. Removing this provision should ideally strengthen managerial accountability. However, it would also enable the industrial companies to become the banks' major shareholders, thereby introducing a moral hazard element. He said that the appropriate time to ease the regulations on ownership of banks should come when the average debt ratios of large companies are at a more normal level, and when corporate governance and management become more transparent. Hyunchul Shin concluded his talk by saying that the financial crisis in Korea provided an opportunity to address structural problems in its financial sector.

Indonesia

Normin Pakpahan of the Ministry of Finance of Indonesia recounted his country's experience in dealing with competition issues in the financial sector. He said the centralized form of government was successful in delivering economic growth for many years prior to the collapse of oil prices (one of Indonesia's primary export commodities) in the 1980s. During these years, the crony system was adopted to provide a locomotive for growth. However, the cronies expanded their economic activities on the basis of highly leveraged borrowing activities. The consequence of this action is mismatched maturities. Furthermore, as the banking sector was deregulated, many cronies opened their own banks using public funds. Many of these banks failed when the Asian crisis erupted.

To deal with the systemic banking and corporate failures, Indonesia created the Indonesian Bank Restructuring Agency (IBRA) and the Indonesian Debt Restructuring Agency (IDRA) . The IMF, in negotiation with Indonesian authorities highlighted the need for a competition policy/law. According to Pakpahan, the concept of competition law was not very easy to grasp because Indonesia traditionally recognizes consensus as a system. He said that there exist difficulties in translating general competition principles into actual policies. He cited that handling monopolies could be problematic since state monopolies are acceptable in Indonesia if it serves the public welfare.

Philippines

Reflecting on the Philippine experience, Dr. Cayetano Paderanga Jr., Member of the Monetary Board of the Bangko Sentral ng Pilipinas, said that the Philippines is no stranger to a currency and banking crisis, having suffered through a bad patch in 1983-85. The crisis was triggered by the political assassination of Senator Benigno Aquino Jr., a leading figure in the opposition to the Martial Law under the Marcos regime. Confidence in the economy was shattered, economic plans and programs were shelved, and foreign exchange crisis ensued under heavy capital flight.

The central bank responded by imposing a moratorium on foreign debt, imposing direct controls on foreign exchange, and suspending bank branching and application of new banks. The consequence of such moves was the curtailment of competition in the financial sector, primarily in banking and foreign exchange. As the crisis abated, the authorities gradually lifted the aforementioned restrictions starting with foreign exchange controls in 1984 and ending with the restrictions on new banks in 1990.

In hindsight, while the curtailment of competition did reduce the cash outlay of the central bank in resolution costs, the abnormal returns afforded by the limitations on competition surfaced very soon. The very high returns on equity of incumbent banks raised questions as to above normal differential between deposit and lending rates as well as the incentive to innovate and provide cutting edge financial services. Paderanga raised the issue that inhibiting competition to ameliorate systemic failure should be balanced by the consideration of implicit costs to the economy of limited and lower-quality service and higher interest rates due to the limitation on banking services and higher intermediation costs.

Paderanga underscored the importance of diligent supervision and monitoring of the banking system. The current Asian crisis unveiled that elements of moral hazard has led to the maturity mismatches and foreign exposure that were unsustainable once the market sentiment shifted against the Asian economies. Lack of transparency and information, on the other hand, sparked the panic and herd instinct which made banks and economies extremely vulnerable. The practice of good monitoring could have averted the consequences of these factors. One lesson of the Asian crisis is that more effort should be expended to bolster the capacities of central banks to monitor and supervise.

V. Competition Among Regional Financial Centers

Before tackling competition among regional financial centers and globalization of finance, Leslie Young, a professor at the Chinese University of Hong Kong addressed a number of basic issues in competition such as: Why is there a worldwide commitment to free markets? Do the assumptions, which underlie the efficient outcome in free markets, hold in the financial markets? What then are the implications of violations of these assumptions?

Young said that the socially desirable outcomes of free markets only materialize if markets are complete (prices reflect all information) and competitive (prices cannnot be manipulated by any player). While these assumptions may hold in certain goods market, the same cannot be said of financial markets. The fact that financial innovation continues implies that the financial markets are incomplete. Moreover, the presence of perverse incentives, principal-agent problems, scale economies in information, and herd behavior indicate that the financial markets are not purely competitive.

It should be noted that incomplete markets undermine efficient resource allocation via the price mechanism in different ways. For instance, bankruptcy and limited liability permit individuals and corporations to shift downside risk to society, so that asset prices reflect private risk tradeoffs which differ from social tradeoffs. Principal-agent problems in the financial markets mean that asset prices reflect agent decisions that are not aligned with the interest of the principals. Informational economies of scale drive financial institutions to operate on scales such that they manipulate asset prices, rather than allowing them to be determined by competitive market forces. Given the perverse incentives toward risky behavior, competition among financial structure forces them to exploit, and therefore, jeopardize their creditworthiness in a drive to expand the scale, scope and leverage of their arbitrage activities. Lastly, herd behavior lead to asset prices which are the traders' expectations of future price movements or which reflect only the restricted set of signals upon which players in that market choose to focus. All these distortions feed into the real sector via investment decisions and reactive institutional constraints.

Globalization of finance introduces sovereign governments as players and national currencies as another class of assets. At this level, informational economies of scale become even more significant. Large institutions enjoying these economies of scale tend to expand rapidly, thus outpacing the development of management systems to control risk on a global scale. Moreover, the regulation, accounting and financial systems of different countries may not cope with the pace of the introduction of financial innovation of these large financial institutions. These features exacerbate the principal-agent problems.

With globalization, regulators in different jurisdictions find themselves in competition in the business of certifying financial institutions. Competition among regulators can play a useful role in keeping financial transaction costs low. However, because regulatory agencies face the same principal-agent problems and the same perverse incentives as those created by bankruptcy and limited liability in the entities they regulate, they are prone to capture the upside of light regulations in terms of attracting international business but shift the downside risk of the negative effects of regulatory lapses to society or the global economy by way of contagion.

National regulators encounter problems in international bank supervision. International borrowers have novel ways of dressing up balance sheets which makes it difficult for regulators to scrutinize. At the same time, borrowers can book loans among subsidiaries located in different countries to exploit international weaknesses in regulation. To address these problems requires international enforcement of accounting standards and of rules on capital adequacy, plus international pooling about the financial statements of firms and banks. Young asserted that these requirements for a new financial architecture would not be met any time soon, because they infringe upon national sovereignty.

Because of the above considerations, Young argued that competition in financial markets or between financial centers, cannot be assumed to be desirable and that government intervention is not necessarily wrong.

Tan Khee Giap expressed his concern that since the Asian financial crisis erupted, many economies have made a retreat from competition and liberalization. He envisioned that accessibility to financial markets may now be delayed as momentum for greater opening slows down under the name of prudence and stability. Japan had, so far, shown only a half-hearted attempt to liberalize its financial market, for example. Already, as the recent incident that involved the trading of Hong Kong Futures Index in the Singaporean International Monetary Exchange (SIMEX) and Hong Kong's intervention in the stockmarket reveal, market efficiency is beginning to be hampered by restraints on information flows and transparency. He bemoaned the fact that Hong Kong's apparent backtracking of the principles of free markets could nullify important demonstration effects of the benefits of competition. All in all, he warned that increasingly, the trend in Asia's financial markets is toward more intervention than less.

He urged that the two major financial centers in the region, Hong Kong and Singapore, should take the lead in fostering competition. There is little complementarity between the two centers but there is specialization wherein Hong Kong caters to China while Singapore caters to the ASEAN financial service demand. The recent attack on the currency of Hong Kong and the subsequent intervention of the HK Monetary Authority in the stockmarket have fundamental causes which Tan attributes to the "hollowing out" of Hong Kong's manufacturing base. Furthermore, he said that the reason the Hong Kong Futures Markets lags behind Singapore's is that Hong Kong has higher transaction cost.

How many financial centers should Asia have? Tan argued that the viability of setting up a financial center to cater to the needs of the region should be based on comparative advantage. Establishing a financial center requires more than the physical requirements of capital and telecommunication facilities. Other factors such as geographical location, time zones, a strong currency, established legal and accounting systems, high quality English speaking workforce, among others are equally important for the viability. Moreover, the comparative advantage of potential financial centers should be based on market pricing mechanism. Pursuing contrary policies such as directed lending, pre-approved loans, non-market evaluation of assets, etc., he cautioned, are sure recipe for market instability.

Tan ended by outlining some useful lessons from the crisis. First, it is more efficient to foster a robust financial sector than it is for authorities to intervene directly in the financial markets. Second, rather than manage directly capital flows, it would be better for authorities to ensure that the economic and political environment are sound. Third, emerging financial markets should work toward operating within a global monetary order. Last, authorities should be more careful in promoting financial centers for the region. They should only explore and compete on the basis of comparative advantage instead of pursuing policies of unwarranted duplication under the pretext of complementarity

VI. Corporate Governance Reforms

Along with poor financial sector supervision and lax regulation, weak corporate governance is pinpointed as one of the major factors in the East Asian debacle. The consensus seems to be that weak corporate governance was partly to blame for poor investment decisions and risky financing practices that resulted in the spate of nonperforming loans and corporate bankruptcies. The last session focused on this major issue, making the concept of corporate governance and its link with investment decisions clear, and how the different affected economies of Korea, Thailand, Japan, and Indonesia are dealing with this important problem.

Conceptual Issues

According to Juzhong Zhuang of the Asian Development Bank, problems in corporate governance arise from the clashes among the different preferences and objectives of the various stakeholders of a firm. Shareholders, for one, want the value of their equity maximized; creditors want to be sure they will be repaid and therefore prefer less risky projects; managers of the firm would like to maximize personal benefits. These differences in preferences and objectives create serious moral hazard problems because of information asymmetries, the impossibility of writing complete contracts, high cost of monitoring, and the need for managers and insiders to have a lot of discretionary control. Elements of moral hazard arise, for example, when managers give themselves a lot of perks at the expense of the shareholders interests; or, when majority shareholders increase their returns at the expense of minority equity owners (outsiders); or, managers and owners may embark on excessively risky projects to the detriment of creditors' interests.

To address the inherent divergence found among stakeholders' preferences, a combination of effective legal and regulatory framework, particular ownership structure, and market for corporate control is necessary for a sound corporate governance. But in East Asia, these mechanisms may neither be existent nor enforced. Some have attributed the source of weakness of corporate governance in Asia to several factors: (a) family dominated corporate ownership; (b) interlocking relationships between financial intermediaries and nonfinancial corporations; (c) lack of transparency and adequate disclosure rules; and (d) ineffective regulatory framework.

But how does weakness in corporate governance link up with crisis? Consider the case of family dominated corporations such as the chaebols in Korea where ownership and control are one and the same. While this may help address the moral hazard problem between shareholders and managers by reducing the principal-agent problem, it creates another moral hazard problem- the divergence in the interests of the majority (insider) and minority (outsider) shareholders and other investors. To prevent dilution of their equity stakes, family controlled corporations tend to excessively rely on debt financing. But when the firm becomes highly leveraged, it has greater incentives to take on high-risk projects because the downside risk would be mostly borne by creditors. If such moral hazard were pervasive, the accumulation of each firm's private risks could lead to systemic market risks and eventually, to a crisis. The suggestion is that ownership concentration should be subject to strict rules of transparency and disclosure to protect the minority shareholders' and creditors' interests.

Consider next the interlocking relationships between financial intermediaries and industrial firms. While this may work well in strengthening corporate governance since banks can monitor more effectively the risk management of corporations and thereby reduce agency cost, it can be potentially damaging if the financial system lacks discipline and accountability. The Asian crisis has borne out the fact that because of inadequate regulation and lack of independence of banks from industrial firms, banks made poor investment decisions and bad loans, and thus became enmeshed in the downward-spiralling relationships with weak firms.

Zhuang concludes that an effective legal and regulatory framework is an indispensable condition for a sound corporate governance system.

Corporate governance in affected economies

The Asian crisis unmasked problems in corporate governance which were previously glossed over because of rapid growth. With the halt in economic expansion, the affected economies clearly recognize the need to deal squarely with the structural weakness, and have thereby put corporate governance reforms among the top of their agenda. Some regulatory provisions addressing cozy relationships between financial institutions and industrial firms, for instance, have already been legislatively adopted in more than one of the affected economies. Empowering minority shareholders, improving transparency and disclosure, increasing accountability of management and auditors are among the changes adopted or tabled which, if followed, can potentially vastly improve the competitive landscape in Asia. These reforms are summarized below.

Korea

In Korea, while the chaebols played an important role in its industrial development, it had also contributed to economic inefficiencies in recent years. Byoung-Hwan Kim of the Ministry of Finance of Korea says that first, chaebols had overdiversified which resulted in dissipated managerial attention, and second, the chaebol's uncontrolled decisionmaking plus the inadequate screening of credit allocation by banks led to overborrowing and overinvestment.

According to Kim, Korea's major corporate governance problems include: (a) the disproportionate control by owners and lack of accountability and transparency; (b) lack of internal control system such as ineffective oversight of management by the board and non-independent auditor because board directors and auditors are appointed by the CEO; and (c) underdeveloped corporate control market because of poor accounting information and passive shareholders, and because of regulatory protection of existing management, e.g. through prohibitions of block shareholding or large issuance of preferred stocks with no voting rights, etc.

These problems, however, are already being addressed. The government is strengthening minority shareholders rights, and reshaping the board structure to improve management accountability. The potentially increased oversight of management is done by requiring transparency in the election and dismissal of outside directors which would comprise a fourth of the board, and mandating the formation of auditor designation committee to improve public confidence on external auditing. It is also improving transparency by requiring consolidated financial statements, and disclosure of certain equity transactions. It is abolishing management protection such as mandatory tender offers, restrictions of hostile takeovers, limits to voting rights of institutional investors which can monitor management more effectively, among others.

Moreover, a number of proposals are under consideration. For example, further refinements in accounting standards, disclosure of forward-looking information, cumulative voting in election of directors to increase minority owners' power, increasing the role of creditors, and improvements in the internal audit function. Kim noted that all these changes, particularly the powershift from management to shareholder, represent a mindshift from size to quality.

Thailand

Prasarn Trairatvorakul of Thailand's Securities and Exchange Commission attributes the crisis to the massive capital inflows which were not accompanied by effective management mechanisms. Thailand's structural weaknesses include weak corporate governance, inadequate supervision and regulation, and insufficient or inaccurate disclosure which resulted in lax credit policies by banks and misuse of funds in the corporate sector.

The changes being considered, designed to equip firms with checks and balances to increase the accountability of management to shareholders, include: (a) requiring the establishment of an audit committee that can oversee the company's financial reporting process and disclosure of financial information as well as review the internal control procedures; (b) establishment of a two-tier board composed of an executive board and a supervisory board. The former will execute corporate strategy and manage daily operations of the business; while the latter will select, evaluate and compensate the executive board, and monitor corporate performance; (c) allowing cumulative voting to strengthen the power of minority shareholders; and (d) barring cross-directorship between business which have the same nature and directly compete with each other. Thailand is also launching a massive program of culture change to increase shareholders awareness of their rights and increase their responsibility to monitor management

To improve transparency, Thailand has been continually improving their accounting and auditing standards to internationally acceptable level. Companies are not only required to make public their annual financial reports accurately, timely and with complete information, but also to disclose the names of major stockholders, the structure of the board of directors, total remuneration of all directors and management team, and intercompany transactions. What is more, the Securities and Exchange Commission will start to disclose the information about offenses of directors, management, auditors and other regulated entities including penalties and orders for remedial actions.

For the Thai financial sector, Pakorn Vichyanond, research director of Thailand Development Research Institute, argues for changes in its ownership structure. He said that the Central Bank should allow more mergers among local banks to dilute ownership to improve corporate governance. The "westernization" of the local banks through mergers or acquisition of local banks by foreign banks provides another way to improve corporate governance. He said that there is a wide scope to improve professionalism among Central Bank staff.

Japan

Should certain forms of ownership structure and transparency procedures be applied to all countries? Yosuke Kawakami, director of international research in the Japanese Ministry of Finance, says no. According to Kawakami, there is no single desirable model of corporate governance, as corporate governance reflects that country's specific historical and cultural background, and that therefore the OECD task force formulating corporate governance reforms can only set out common elements and nonbinding principles of corporate governance.

Nevertheless, the direction of reforms in Japan looks very similar to that of Korea and Thailand. For instance, the two-tier board system (Board of Directors and Supervisory Board), and adoption of independent auditors are designed to minimize agency problem and therefore help protect outside shareholders against insiders. Kawakami favors nonbinding disclosure guidelines regarding the contents of information which companies give out to shareholders and other stakeholders, with the idea of enabling shareholders to monitor corporate performance and empower them to reject management decisions which are harmful to their economic interests. Increasingly, he notes that shareholders in Japan are waking up to their rights as owners of companies to receive dividends and vote. But here, he argues that the scope of economic and common-participation rights differs from country to country.

Tracing the ills of the financial sector to inadequate disclosure and cross-holding of shares, Kawakami said that consolidated financial statements as well as disclosure of nonperforming loans based on the securities regulations in the US, are now required under the new Financial System Reform Law. Further, the extensive cross-holding of shares is being gradually eroded by the underperforming market, shaking the cozy investment relations between banks and firms, and thus possibly leading to more dispassionate emphasis on economic returns. The corporate governance implication of such shake up is deemed positive.

Indonesia

Mari Pangestu of Center for Strategic and International Studies (CSIS) in Indonesia said that while the external incentives, i.e. legal regulations, for firms were on track before the crisis, its poor implementation contributed to the Indonesian fallout. In particular, weak corporate governance in Indonesia is characterized by concentrated ownership and power of large insider shareholders with close tie ups with the government, or cronies in other words.

Such ownership structure, topped with government implicit guarantees and too rapid deregulation without institutional maturity has been the formula for disaster in Indonesia. Even if there was no explicit chaebol relationships in Indonesia, the fact that the banking sector was highly concentrated-the top ten banks control majority of the financial sector-and closely linked to business groups (cronies), led to the intertwining of banks' and firms' downward spiral.

Mari Pangestu emphasized the lack of proper institutional structure for corporate governance in Indonesia. For example, up until the crisis, the bankruptcy law was outdated and took 10-15 years to process a court case. On the other hand, however, it can be considered relatively more transparent than other affected Asian countries. Relative to Korea, Malaysia, and Japan, for instance, more Indonesian listed companies have made more use of auditors.

Reforms mandated as part of the IMF conditionality include establishment of regulations and institutions that can affect behavior of corporate managers and major shareholders, improving competition law, and strengthening and restructuring of the banking system. A new fast track court to deal with bankruptcy and exit procedures is now in place but Pangestu asserts that it is still too early to tell if these courts would succeed. More disclosure requirements are also mandated particularly statistics on offshore borrowings. Auditing of the banking sector by international accounting firms is also required as part of the rehabilitation program.

Finally, she raised the issue of increasing government ownership of the entire banking and corporate system in Indonesia as a result of the recapitalization program. Would governance improve because of government ownership? Against a backdrop of interest group and political dynamics, what would be its implications for management behavior? The outlook for Indonesia is certainly less clear relative to that for Korea and Thailand.

Wrapping up, the dean of the ADB Institute, Jesus Estanislao emphasized that because the ideals of free and open economic systems are matemathical constructs, there is nothing western or eastern about them and thus cultural differences should not be an excuse for pursuing environments that are less conducive to market mechanisms. But it is in the financial sector where greatest care is most essential and thus the demand for transparency and disclosure most highly called for.

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