ADB Institute - IFMP Workshop on Current Asian Financial Developments (APEC Round)

Tokyo, 19 March 1998

Executive Summary

The ADB Institute conducted an APEC workshop on operationalizing the Manila Framework Agreement principles, in Tokyo on 19 March 1998. The Institute of Fiscal and Monetary Policy of the Ministry of Finance of the Government of Japan co-sponsored the workshop. The Workshop brought together academics, representatives of international investment banks, and high-level official (present or past) with policy-making responsibilities. There were 40 participants from 15 APEC economies (the 14 that participated in drafting the Manila Framework Agreement and Taipei, China.) The Tokyo APEC workshop addressed the following issues: 1) in the short run, what policies will help economies get out of crisis?; 2) in the medium and long run, what policies will prevent recurrence of, or reduce vulnerability to, future crises?; and 3) how could regional surveillance prevent future crises?

I. Causes of Crisis

Macroeconomic Explanations

Reasons why the Asian crisis has been so severe and widespread were again briefly discussed. Participants cited factors discussed in previous workshops (see for example ADBI-ASEAN Economic Forum Executive Summary), including exchange rate pegs with free capital flows, unhedged short-term debt, financial liberalization without adequate prudential supervision, unsophisticated financial institutions, overheating, indiscriminate lumping together of countries by investors, high interest rates differentials and risk premia, and dominance of portfolio investors. However, none of these explanations appears to be entirely satisfactory. For example, traditional macroeconomic explanations of currency crises do not seem to apply, given the high rates of domestic savings, and generally prudent fiscal and monetary policies in the region. Neither was the weakness of the financial sector a sufficient condition since there are other countries with worse systems that are not in crisis.

The participants generally agreed that Thailand was not the source but merely the trigger for the region’s woes. In fact, one participant said that Asia should thank Thailand for bursting the bubble early enough before things got worse. Others said that Thailand only highlighted some fundamental problems in the Asian economies.

Runs on currencies and financial systems

One discussant interpreted events in Asia as a series of runs on financial institutions and currencies. These runs have threatened payments systems, disrupted balance sheets of financial institutions and borrowers, and interrupted flows of credit. Because banks are at the center of the crisis, the systemic effects on the financial system explain the unexpected severity of these crises. The run on the Thai financial system prompted a reassessment and testing of all other emerging financial markets in the region which eventually triggered similar runs on other countries with particularly vulnerable financial systems.

There are two alternative explanations for the runs on the financial sector, which may influence policy responses. One view is that these are *classical liquidity crises*, i.e. the system is fundamentally sound, but a run disrupts the financial sector due to liquidity or maturity mismatches. Under these circumstances, policies that correct such mismatches may suffice to solve the situation and thus no financial reform is needed.

Another view is that the financial crises resulted from certain weaknesses in the financial system. Banking crises experienced by two-thirds of IMF member countries between 1980 and 1996 are typically attributed to certain features like lack of transparency, or government guarantees that lead to imprudent lending, which makes the financial sector vulnerable to a shock. Such vulnerabilities may persist unnoticed for years, but they may emerge as fully fledged crises in the presence of sufficiently large shocks. In Thailand, the shocks involved a slowdown in exports and economic growth, associated with a deflation in asset prices. These developments ultimately triggered a financial sector crisis. Under this view, the appropriate policy response should be a thoroughgoing reform of the financial sector to remove the sources of vulnerability.

One important source of vulnerability emphasized in the discussion is the tendency for implicit or explicit government guarantees that encourage imprudent lending behavior (moral hazard), along the lines suggested by Krugman. The extreme stability in exchange rates and the accumulation of central bank reserves from purchases of borrowed dollars became an implicit bailout fund. Hence banks made money by borrowing in dollars and lending in local currency, financing both a stock market and real estate bubble, without worrying about hedging their foreign exchange exposure. Moreover, since investors knew that bailout funds were limited, it became an incentive to grab while the grabbing was good thus leading to booms and bubbles. The baht devaluation in July 1997 became the signal that the bailout game was over - not only for Bangkok but also for the other markets playing the game - thus the rush for the exits and the bursting of the bubbles.

II. Short Run Responses

Participants highlighted the need to restore investor confidence and financial flows immediately. It was suggested that countries such as Indonesia should just concentrate on how to keep the economic crisis under control and keep growth concerns at the side for the moment. One participant, however, bewailed the dearth of crisis management discussion in the economics literature. Participants agreed that the Indonesian situation is complicated because what the country needs is a very credible commitment to reform. Thus far, new cabinet appointments have failed to impress the markets.

Effects of the Crisis

The disruptive effects of the crises include interruption of international and domestic credit flows, contraction of economic activity, and threats of inflation coming from unprecedented currency depreciations and monetary pressures to increase liquidity. The stock markets of Bangkok, Jakarta, Kuala Lumpur, and Manila lost $370 billion or 63% of the four countries' combined GDP. South Korea’s stock market alone lost 60% of its value. In addition, as experiences in other countries indicate, the fiscal burden of repairing the financial sector is expected to cost a significant portion of GDPs in the most affected economies. Chile’s banking sector collapse in the 1980s had cost around 40% of GDP, while Mexico’s efforts to support creditors and debtors amounted to at least 10% of GDP.

Role of the IMF

The IMF plays a key role in restoring international confidence and regional financial stability. Some participants felt that it should be more understanding of the country situation and that its macroeconomic prescriptions need to be reviewed as the situation changes. It was pointed out that the toughness of IMF prescriptions for Asia have tended to ease over time, particularly as economic conditions deteriorated. Some participants expressed doubt about the IMF’s orthodox policies of fiscal restraint in the context of Asian economies. Others disagreed about the IMF bailout because it gives creditors a way out of the situation leaving governments with the fiscal burden of repairing the financial system.

One participant stated that one should also ask if the government authorities responded properly at the early stage of the crisis before the IMF is asked to assist. There is a payoff to prompt policy action and that in the absence of firm domestic policy response to restore credibility, there is no way for large bailouts to succeed. The experience of the current crisis suggests that the timing of policy responses do matter.

Restoring Financial Flows

One of the primary measures to achieve short run stability is the restoration of both external and domestic financial flows. To this end, large programs have been put together through multilateral organizations to reassure investors and to meet short-term financing needs. Rescheduling agreements to enhance debt servicing ability is another way as the Korean experience suggests.

One participant cited a number of suggestions towards restoration of global credit flows. These include expansion of short-term insurance guarantees and reinsurance to creditworthy buyers in Asia, creation of emergency finance mechanisms from multilateral development banks for countries cut off from private international capital, and use of a standby facility from private international banks, as in the case of Argentina, which has over $6 billion credit facility.

An immediate priority to restore domestic financial flows is to recapitalize financial institutions. It was also pointed out that caution should be exercised in shutting down insolvent banks because close downs can induce more fragility to the payments systems.

Short Run Macroeconomic Policies

The other major area of concern is the appropriate macroeconomic policy mix needed to stabilize expectations and restore growth in the short run. There is a tradeoff involved in running tight monetary policy. On one hand, tight monetary policy can attract financing by curbing inflation induced by sharp depreciation. On the other hand, it might prove counterproductive if it damages the financial sector.

The choice of the instrument to repair the financial restructuring process presents another policy dilemma. Policy instruments such as money creation, deficit financing, or tax revenue have potentially different implications on the economy. One participant pointed out that if there is no adverse investor reaction, financial repair can be made via deficit financing in these traditionally fiscally prudent Asian economies.

The participants also underscored the need for strong macroeconomic fundamentals to enhance the resilience of domestic financial systems to shocks.

Corporate Relationships

One participant mentioned that the issue of corporate governance needs to be addressed. In particular, a solution has to be found for the private debt workouts.

It was noted that changes in creditor-borrower or corporate relationships may provide another avenue to the restoration of confidence and voluntary financial flows. Foreign financial institutions can acquire weak domestic institutions, and in the process promote large savings in the budget, gain in efficiency, and accelerate the speed of economic recovery. Thus, apart from creating entry opportunities for other investors, these changes can actually reduce the chances of future crisis. However, there was concern that assets may be sold to foreigners at "fire-sale" prices.

Debt-Equity Swaps

One participant raised the potentials of debt-equity swaps to restore financial flows. Debt-equity swaps occur because there are holders of debt willing to sell at a discount and there are investors, who sees business opportunities in a country, willing to buy. However, issues such as unclear bankruptcy laws or foreclosure proceedings, among others, retard the possibilities of debt-equity swaps. Also, given the present state of affairs in affected economies, investors yet see few opportunities. However, participants left open the possibility that debt-equity swaps can work later.

III. Long Term Policy Issues

Financial Restructuring and Supervision

The current situation presents a good opportunity to push for bank reforms. Such reforms could include adopting the Basle capital adequacy standards, establishing Best Practice guidelines (i.e. asset classification to promote greater transparency, loan loss provisions, capital adequacy, etc.), and discouraging automatic bailout practices, among others. One participant, however, expressed doubts on the feasibility of Best Practices guidelines because it is still unclear what ‘best practices’ actually means and how it relates to Asian practices.

Another contended that adherence to the core principles in sound banking may suffice.

One discussant emphasized that adopting risk-based capital standards is not a substitute for good prudential supervision. The range of supervisory practices such as enforcing arms-length lending, enhancing on-site and off-site examinations, and identifying new risk concentrations are equally important in fostering more robust financial systems. It was proposed that supervisors take prompt corrective action to quickly close down insolvent institutions, and to be made accountable if a bank failure imposes costs on deposit insurance. However, it was pointed out that supervision needs the right political economy and more information disclosure. In this context, allowing foreign banks into the market can increase the pressure for good supervisory practices. It was observed that current supervisory practices in Asia still have a wide scope for improvement. There certainly is an urgent training need for securities regulators and bank supervisors.

Another participant raised the point that effective monitoring and supervision should keep up with the rapid developments in the global financial system. Otherwise, these functions may simply be overtaken by events. For example, the supervisors should get information on large positions and large transactions by key players in the market.

Policies towards Capital Flows

Problems associated with capital flows were also discussed. Capital flows, particularly massive ones, if not handled well, can introduce imbalances to the macroeconomy in terms of excessive monetary expansion, exchange rate appreciation, and increases in interest rates through sterilization policies. To the extent that capital flows may finance risk-taking by banks, it impinges on the prudential aspect of bank lending. Participants, nevertheless, cautioned against capital controls as a substitute for good supervision. One discussant maintained that capital control can be a bigger problem than capital inflows. It may give the signal that bank supervision is so inadequate that capital controls have to be resorted to.

One participant emphasized that contrary to press reports, ASEAN economies are not stepping back from economic liberalization. It was pointed out that rather than focus on controlling capital flows, efforts on the part of policy makers could be better employed to the task of mitigating the negative effects of such flows. To this end, it may not be useful to differentiate portfolio flows and foreign direct investments. Rather the focus should be on devising right incentives for market players to contain the adverse effects of capital flows. Mention was made of Singapore's demarcation of foreign and domestic financial markets through differential corporate tax as a model for devising the right incentives. Even more fundamental, policies should be also geared towards better mobilization of domestic savings to fund investments. In this way, an economy becomes less dependent on relatively more volatile foreign inflows.

In defense of foreign investors, a market player remarked that instead of foreign investors the locals actually helped precipitate capital flight and are also the ones continuing to sell their own currency. It can also be said that the real risk takers were the locals who borrowed in dollars.

Another participant said that the Tobin tax on capital flows, as far as exchange rates modeling is concerned, is equivalent to an increase in risk. Hence imposing a tax on short term flows may run the risk of making the crisis worse.

Some raised concern that it is more prudent for countries to develop the right institutions before engaging in capital account liberalization. While it was acknowledged that full capital account liberalization is imperative (for China, for instance,) they cautioned that such a move demands intense preparation, specifically in the area of developing institutions to regulate or supervise the financial system. One participant mentioned that the successful reforms done in New Zealand would not have been possible without a strong institutional framework.

Exchange Rate Policy: To Peg or To Float

Some participants expressed skepticism about the desirability of exchange rate pegs or managed floats, involving the yen or any other currency. While exchange rate pegs helped Latin America bring down inflation by providing a nominal anchor, inflation is not the biggest problem in Asia. The problem with pegs is that sharp devaluations can be deadly when the financial system is weak. Also, under a pure float, small daily adjustments expose currency risks and therefore encourage hedging. Floating also allows price discovery with changing fundamentals and discourages foreign borrowing. A managed float is not a viable alternative because it always degenerates into a single-currency peg.

Countries must learn to live with floating exchange rates. New Zealand's experience is particularly illuminating. New Zealand freed capital flows and allowed exchange rates to float in the 1980s, and in the process had to deal with skyrocketing interest rates and bankruptcies. The government responded by opening up even more, encouraged greater transparency of information, established accounting standards for banks and firms, and improved supervision to ensure that information is reliable. The result is that the exchange rate is stable even if there is no attempt to peg.

One participant said that it is better to move out of a peg when you are in a position of strength. Another said that the long term solution of floating exchange rates cannot be assumed for the short term.

IV. Implemenation of the Manila Framework

[Finance and Central Bank Deputies in Asia and Pacific region gathered in Manila in November 1997 and agreed on a new framework to enhance Asian regional cooperation and promote financial stability. The framework is now known as the Manila Framework.

It includes four major initiatives: 1) a mechanism for regional surveillance to compliment global surveillance by the IMF; 2) enhanced economic and technical cooperation particularly in strengthening domestic financial systems and regulatory capacities; 3) measures to strengthen the IMF's capacity to respond to financial crises; and 4) a cooperative financing arrangement that would supplement IMF resources.]

Regional Surveillance

The Asian financial crisis underscored the need for both regional and global efforts in responding to the crisis. The participants saw the need for an institutional base that can complement the work of the IMF in the region.

One discussant said that while the IMF has undertaken country surveillance through article IV consultations, regional surveillance is a new concept designed for future prevention of crisis. There was discussion on what the basic features of the proposed regional surveillance should be. First, it will be an informal process much like the OECD.WP3 process rather than the EU. The former is a frank exchange of views, while the latter process has a clear political determination to realize coordination towards a single currency or single market. Second, it will deal with both macroeconomic and structural problems and policies with appropriate focus on the issues common to the region such as analysis of capital flow and debt sustainability, structural fragility of the financial sector and possible impact of reform efforts on the economy as a whole, social impact of the macro-economic adjustment and the structural reforms, and the possibility and process of contagion between the economies in the region, among others.

The role of the ADB Institute in regional surveillance was also discussed. The Institute can contribute by providing objective analysis of, or theoretical frameworks for, issues common to the region.

Other participants also highlighted the need to develop new institutional arrangements and to strengthen existing ones for better crisis management. Since there are important regional elements that need to be addressed, there is awareness that a new institution, dedicated to analyzing the Asia Pacific financial issues is needed. Others, however, expressed reservation about reinventing the wheel and about the need for a new institution to address the problem. From their perspective, all that is needed is to strengthen existing institutions and adapt certain institutions to new problems.

Parallel Consultation Mechanism

The participants generally endorsed a regular informal forum like the ADB Institute workshops as a consultation mechanism or a shadow group with the same agenda for surveillance and consultation as the formal ministerial process. The forum can comprise senior government officials, academics and market players from the Manila Framework economies plus Taiwan. The ASEAN group was deemed too small, and APEC too large as it includes some countries that are unaffected by the crisis and hence have no stake in regional surveillance. The Manila framework economies grouping is more functional.

New Regional Research Institution

Another participant was skeptical about whether the time is ripe for regional monitoring and surveillance. Indicators are not available that could have given advance warning of crises, given the imperfect grasp of the market forces that have precipitated recent international financial crises. Instead, he proposed a center that would study monetary and financial issues in order to enhance understanding of the causes of the crisis. This, in turn, can lead to policy measures that would improve the efficiency and thereby, contribute to the future stability of national and international financial markets. The proposed center would serve three purposes - research, policy advice to policymakers of national governments and international organizations in the region, and public information.

The establishment of such a center would give concrete expression to the principles stated in the Manila Framework agreement adopted by the APEC Economic Leaders, and to the ASEAN Finance Ministers' proposal of launching a process of seeking greater regional cooperation in monitoring and surveillance of regional financial market developments. It is also consistent with many suggestions made in the discusssions at the ADBI- ASEAN Forum Workshop (see ADBI-ASEAN Forum Executive Summary).

It was further proposed that the ADB Institute would be an ideal locale for the center. Organizationally, it should be an integral part of the ADB Institute’s operations.

Technical Assistance

One discussant raised the issue that though technical assistance for strengthening domestic financial systems and regulatory capacities is available, there is lack of coordination. Thus, there is a need for coordination and appropriate division of labor among international organizations. It was, moreover, pointed out that international institutions' expertise in this field is very limited. A participant suggested that it would be better to get technical assistance from practitioners in developed economies in addition to IMF or World Bank resources.

Asian Currency Internationalization

There have been some suggestions in ASEAN circles that some Asian local currencies should be internationalized. One participant rejected the internationalization of Asian local currencies because ASEAN economies are all too small. Once internationalized, they would lose the ability to manage their own monetary policy. But it was emphasized that the time may now be right for the yen to be internationalized and that a greater role for the yen may be crucial for the recovery in Asia. Japan, however, does not want to increase supply of yen unless foreign demand increases first. The problem is that other countries want an increase in supply of yen first before increasing demand, leading to a chicken and egg situation.

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