THE ASIAN TALE, TWICE TOLD

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Since the Asian crisis, analysis of how markets and the institutions that govern them operate has become the focus of policy agendas in the region. This article examines the root cause of the Asian crisis and looks at how new market systems are being formed.

The 'miracle' that was East Asia came to a sudden halt in 1997. After growing by an annual average of more than 8%, Asian economies not only shifted to lower gear, they even reversed course. The collapse of the Thai baht in July 1997 sparked off a massive financial and economic maelstrom in the region. As exchange rates and stockmarkets plunged, foreign debt denominated in foreign currencies soared. Many domestic firms became insolvent, interest rates skyrocketed and credits dried up as panic by domestic and international investors ensued. Meanwhile ethnic tensions, erstwhile contained by strong economic growth, flared up again, particularly in Indonesia. This, in a nutshell, was the 1997-1998 Asian financial crisis.

The crisis was largely unanticipated. Not even Paul Krugman (1994), a non-admirer of the Asian miracle who did forecast an eventual slowdown, was able to predict this cataclysm. What happened in Asia soon became the topic of the decade. Although explanations differ, most accounts now agree that the weakness of Asian financial systems was pivotal.

One scenario is that liberalisation of capital accounts and financial systems in Asia interacted with poor and inadequate regulatory structures. This led to rapid domestic expansion, as reflected in asset price bubbles, which in turn fuelled more borrowing. As a result, the economy was held hostage to shocks like changing investor expectations. When external events pricked the bubble, the spiralling increase in asset inflation became a downward spiral of asset collapses.

Another scenario highlights the role of short-term maturity debt and the term structure mismatch between assets and liabilities that made these economies extremely sensitive to investor expectations. The short-term liabilities of Asian economies were very high, with some—particularly Thailand, Korea, Indonesia, and Malaysia—far exceeding their liquid reserves prior to the crisis. This made them extremely vulnerable to sudden calls for repayments (Athukarala & Warr 1999).

Yet another scenario emphasises the policies of fixed exchange rates followed by Asian governments, which encouraged overborrowing and contributed to the fragility of the financial sector. When the US dollar appreciated against major industrial currencies, the Asian economies whose currencies were pegged to the dollar also appreciated, thus worsening their export competitiveness. Poor export performance due to lower competitiveness was compounded by weak domestic demand from Japan, and low cyclical demand for semiconductors worldwide. This, combined with the vulnerability of Asian financial systems, changed the overly optimistic outlook on Asia. The stage was thus set for the currency attack and financial crisis.

The question still being debated, however, is what made these economies pursue policies that rendered them vulnerable to external shocks, and what economic

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incentives or disincentives led to the weakening of the Asian financial structure, apparently to its very core?

Although much has been written about the Asian financial crisis, two competing explanations dominate the debate over the root cause of the crisis. One story is that the Asian financial crisis was caused by a panic-induced illiquidity of capital markets—the 'panic hypothesis' or 'illiquidity hypothesis'. The other story maintains that the Asian financial crisis stemmed from latent structural defects, induced by adverse incentives, which then encouraged excessive risk taking—the so-called 'moral hazard' hypothesis.

Both explanations concur that Asian financial systems were at the centre of the crisis. They therefore contrast with earlier currency crises hypotheses that highlight either large fiscal imbalances or costly trade-offs as the root cause of speculative attacks. Moreover, both explanations agree that significant economic vulnerabilities existed in Asia prior to the crisis, and that both 'panic' and 'moral hazard' elements were present. The two, however, part ways when it comes to identifying the main factors that sparked the upheaval.

Panic and illiquidity

The 'panic' view, simply told, is that the frenzied haste to divest out of the region resulted in costly asset liquidations, asset price collapses, domestic bank runs and the drying up of credit. According to those in this camp, economic fundamentals—including government policies—in crisis countries may have been unsatisfactory, but did not warrant a crisis. Real exchange rates, for instance, were only slightly overvalued. Instead, the crisis occurred because of adverse shifts in market expectations. These shifts can generally be precipitated by almost anything—the collapse of a big bank, political turmoil or lacklustre export performance. Once panic prevails, however, sound fundamentals become irrelevant. Market expectations are therefore the key to understanding crises.

What the 'panic' hypothesis highlights is the inherent instability of international financial markets. The creditor grab that ensued in Asia resulted from a coordination problem among investors. This was not quelled because there was no international lender-of-last-resort, whose presence on the domestic front usually restores confidence in the financial system. What this immediately implies is that the high interest rates, rapid bank closures and tight fiscal bind imposed by the International Monetary Fund (IMF) on Thailand and other affected countries were uncalled for. An alternative solution, according to the 'panic' hypothesis, for calming markets and dispelling panic would be to provide a coordinating function, such as a lender-of-last-resort, for all foreign creditors. Proponents of this view therefore argue that a more accommodating monetary policy should have been pursued, instead of the tight policy imposed by the IMF, because low interest rates allow firms to continue operating, abate bankruptcies and restore confidence faster. In contrast, precipitate bank closures only exacerbate runs on the financial system.

Structural defects and moral hazards

The 'moral hazard' view attempts to explain why economies like Thailand, Korea, and Indonesia reached such a level of vulnerability that they were like disasters waiting to happen. This view maintains that the root cause of the crisis lies in the wrong economic incentives—induced by implicit or explicit government guarantees, connections with the powers-that-be or interlocking ownership structures—which then led to overborrowing, overlending, and overinvestment.

In other words, the 'moral hazard' view places bad government policies at the heart of the crisis (Moreno, Pasadilla & Remolona 1998), even though these very policies were once lauded for achieving fast growth and material improvement for so many people. The point, however, that the 'moral hazard' camp tries to drive home is that the vulnerability of the Asian economies resulted from the accumulation of many years of bad habits, glossed over while the going was good. Some of these bad habits were actually residues of the industrial policies and winner-picking that, ironically, were thought to have propelled these economies to tigerhood.

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Moreover, the 'moral hazard-structural' view demonstrates that if public guarantees of bailouts are in place, foreign creditors willingly lend to unprofitable projects and cover cash shortfalls of these firms. This leads to overlending and overly risky projects, as well as persistent and unsustainable current account deficits. Liabilities are manageable if macroeconomic shocks are mild, but when a sizeable macroeconomic shock occurs, the financial fragility associated with overinvestment and risk taking is fully revealed. The government is then forced to step in and guarantee outstanding external liabilities, a gesture

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that increases and fuels expectations of future monetisation of the deficit. The market's expectation of inflationary financing causes the collapse of the currency, eventually leading to a financial crisis.

It is important to note that the 'moral hazard' view is consistent with the facts of financial liberalisation, in that deregulation of interest rates, and entry and competition in the financial sectors, were both promoted before the crisis. It also tallies with the credit boom that preceded the crisis. The elimination of controls and regulations without the establishment of an appropriate regulatory structure, however, allowed borrowers to take excessive risks or engage in unprofitable activities.

From a policy perspective, there is clearly a need for both greater financial transparency and a show of resolve when undertaking structural reforms, either by closing, merging or recapitalising insolvent institutions. The 'moral hazard' camp therefore considers the 'panic' view's policy recommendation of an accommodating monetary policy and lender-of-last-resort function untenable. The risk is that increased lending may merely be gambled away; it would be like throwing good money after bad.

Lessons learned and policy implications

Far from being a mere academic exercise, the divide between the two views extends to policy implications for a post-crisis, global financial environment. On the one hand, the 'panic' camp's main policy focus is on reform of the international financial system, the inherent instability of which was spotlighted in the Asian crisis. Grand proposals like the need for an international lender-of-last-resort, an international bankruptcy court, burden sharing between private creditor and borrower alike in the event of a systemic crisis, and better provision of information to minimise uncertainty, are the major policy prescriptions of 'panic' view adherents.

The 'moral hazard' camp, on the other hand, is more concerned with removing the incentives that gave rise to economic vulnerability. It proposes an arm's length relationship between banks, instead of the old cosy relationships. It also advocates increased transparency and improved corporate governance, as well as the strengthening of banking supervision and regulation.

Domestic reforms

Most of the policy recommendations for strengthening the international financial system focus on the home front. Regional and international responses—ASEAN Surveillance or a new international financial architecture—are significant, but are not likely to be effective unless the domestic groundwork is carried out first. Two of the biggest and most crucial domestic challenges include improved corporate governance and financial restructuring.

Improving corporate governance means addressing the bad incentives or moral hazards stemming from certain ownership structures. In Asia, these structures include interlocking directorships between banks and firms; family-dominated, corporate ownership; ineffective legal and regulatory frameworks; and a lack of transparency and adequate disclosure rules. These all contributed to the overleveraged characteristics of Asian corporations. Family ownership, for example, tends to rely excessively on debt financing so as to avoid diluting family interest, according to Juzhong Zhuang (1998). Once a firm becomes highly leveraged, the greater the incentives are to take on high-risk projects, making it highly vulnerable to economic shocks.

For this reason, an effective legal and regulatory framework, coupled with strict rules of transparency and disclosure, is fundamental—indeed indispensable—for sound corporate governance. This means that the

reporting of offshore borrowings, consolidated financial statements and non-performing loans should increasingly become the norm. The quality of corporate governance can be enhanced by equipping firms with checks and balances that increase the accountability of management to shareholders—and the majority shareholders to minority ones— through reliable audits, the establishment of a two-tier board (executive/supervisory) as well as by strengthening the votes of minority shareholders. Banks can also play an important role in monitoring corporations, but only if Asia does away with its cosy, bank-customer relationships and adopts an arm's length alliance. The problem of governance can be minimised if there is a market for corporate control, because well-functioning equity markets, where prices of equity signal market approval or censure, can partially provide the discipline needed by firms.

The problem with promoting these reforms is that Asia has always prided itself on being 'different' from the West. Suggestions like those discussed are almost always considered an imposition from a culturally distinct West. But should Asia really do things differently all the time? The Asian crisis has demonstrated that Asian distinctness is both a virtue and a vice. To be sure, Asian governments should retain all the elements that fuelled the success of East Asia for several decades, like the pragmatic focus on growth, the stress on exports, etc. But Asian governments should shed the bad habit of 'cronyism' or 'Asian way' of doing business.

This kind of cultural resistance to reform filters through to corporations, as evidenced in the generally slower pursuit of institutional restructuring. The resistance at the level of individual firms is also because the focus of financial restructuring is much closer to the core of the corporation—the scope of its business, production efficiency, systems and procedures, and return on equity, among others. Indeed, corporate governance cuts a wide swath through corporate culture, systems and procedures, and standards in transparency and accountability. A change in any of these elements will therefore have a deep and long-lasting impact on the internal dynamics and decision-making process of the corporations themselves.

Closely connected to corporate governance reforms is the supervision of banks and the financial sector. In contrast to governance issues, however, this is more straightforward. Bank restructuring, for instance, has had a slow start but has nevertheless advanced. Solvent firms have been closed, some banks have been recapitalised, mergers are taking place, and Asian governments have established appropriate agencies to take care of foreclosed assets. Rules on the foreign ownership of banks and financial institutions have also become more liberal, non-performing loans are finally being tackled, and securitisation attempted.

If Asian economies are to continue moving forward, financial restructuring must go hand in hand with better corporate governance and an improved regulatory and supervisory structure. Supervision needs to be tight and strong, professional and arm's length. The risk is that governments will recapitalise banks without changing the ownership structure, without changing or improving management, and without promoting greater roles for outside investors. Yet, as the 'moral hazard' view cautions, recapitalisation without fundamental changes in banking behaviour will not address the root cause of financial sector weakness. A strong institutional and legal framework is essential for resolving distressed financial institutions and for dealing with non-performing assets. A developed capital market can also accelerate the process, as it can be a funding source for restructuring while reducing the overdependence on bank loans.

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Regional cooperation

The imperative for maintaining the momentum of systemic and institutional restructuring lies with national governments, but there is some scope for support at the regional and international levels. Opportunities exist, at a regional level, for East Asian governments to engage in policy consultation and to share their experiences in reforming the corporate and banking sectors. For example, they can discuss ways and means to set up prudential norms and standards. In this manner, the policy formulation process at the country level is enhanced. At the same time, through peer pressure, countries are emboldened to pursue reforms. Owing to the complexity of some issues, regional authorities can also tap technical assistance from international financial institutions in order to enhance bankruptcy laws, update corporate laws, raise accounting and disclosure standards, and adopt competition policies, among others. In short, Asians can learn from the long development experience of the West in ways that cut across cultural differences.

The formation of the ASEAN Surveillance process is a significant development along these lines. Its main purpose is to set up a monitoring and early warning system for the region, but it also provides the institutional setting where a frank exchange of views on policy directions in ASEAN can take place and where joint action, if appropriate, can be forged. By providing an institutional mechanism, it is hoped that the spillover effects from individual country policies can be minimised.

Another idea currently being mulled over in regional circles is the establishment of a regional stability forum (Estanislao 1999). The proposed forum offers a venue where refining, adapting and internalising the codes of corporate governance and competition policies (to cite a few areas) could take place. The forum itself is limited to being an arena for the exchange of experiences, insights and perspectives garnered from reform efforts.

In this way, the regional stability forum can promote closer cooperation and pooling of training resources, particularly with regards to banking supervision and the strengthening of financial systems. At present, there are a number of standards, codes and other 'best practices' benchmarks in this area which are being studied or implemented, to varying degrees, by the central banks and ministries of finance in the region.

A regional forum provides a common framework for these activities. Capital adequacy and asset quality standards can be set regionwide, eventually becoming consistent with global standards. Guidelines on liquidity and treasury operations, transparency and disclosure standards, procedures for deposit insurance, bank rescue, foreclosure, liquidation and bankruptcy are just a few of the initiatives that can be undertaken at the regional level, under the aegis of a regional stability forum.

A new international financial architecture

The debate over a new international financial architecture owes much to the 'panic' hypothesis and its support for a 'missing institution'—the international lender-of-last-resort. Some advocate a grand redesign of the international financial architecture, with new global institutions—aside from, or instead of, the existing Bretton Woods institutions—that can address the inherent fragility of the international financial system. Others argue that the role of the IMF should be strengthened, along with marginal improvements such as better rules on transparency. The latter view considers the 'save-the-world-financial-system' proposals too unrealistic. It vouches for minimalist but realistic alternatives like strengthening national bankruptcy codes, reinforcing the independence of judicial systems in administering bankruptcy proceedings, and harmonising these laws across countries.

At the very least, the Asian crisis gave us all an opportunity to ask if the world still needs the IMF. Some argue that the institution is anachronistic, and that it exacerbated the Asian crisis because of its overly harsh policies of fiscal cutbacks. Others maintain that a new financial order requires its presence precisely to act as an international financial crisis manager or an international lender-of-last-resort.

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Anna Schwartz (1998) argues that the IMF cannot be effective as a lender-of-last-resort because it does not have the capacity to create high-powered money. Moreover, it cannot act quickly in times of crisis as the IMF board must engage in lengthy negotiations with relevant governments before any reform programme is approved and implemented. To be effective, a real lender-of-last-resort should have the ability to provide liquidity promptly, without seeking external approval.

Stanley Fischer (1999), however, contends that the capacity to create money is not what is required of a lender-of-last-resort; rather, it is the capacity to provide liquidity, regardless of its source, that is important. The IMF is capable of performing this role because it can muster financial support and pledges from different sources for emergency funding. For instance, the IMF has already increased the quotas of its member countries to build up its resources for the increasing demands of globalisation.

Aside from the IMF acting as an international lender-of-last-resort, what other type of institution would be able to take up the slack in the international financial system? Would it be an international bankruptcy court with the power to impose an automatic stay on creditors? According to the 'panic' camp, an international bankruptcy court can, in theory, put a stay on foreign creditors; it can also oversee an orderly restructuring of obligations to prevent a creditor grab (panic) situation. Given current political constraints, however, the concept seems too ambitious because it encroaches on national sovereignty.

Would a 'deep-pocketed', lender-of-last-resort fill the gap in the international financial system by ensuring global financial stability in the same way a domestic central bank's guarantee of the financial system can preclude a run? Again, it sounds feasible in theory. All indications suggest, however, that the G-7 is not ready to put up the necessary resources to stop speculative attacks on developing countries.

Nevertheless, a 'limited-pocket' style, lender-of-last-resort has recently been established through the creation of a special fund dubbed the Contingency Credit Line (CCL), under the IMF. The CCL is for countries that pre-qualify certain macroeconomic and regulatory standards. In this way, CCL membership becomes a signalling device for sound economic fundamentals—a kind of 'good countries club'. This should help dampen financial contagion and reduce currency runs.

Other proposals include an international deposit insurance, a global financial regulator and a world monetary authority that oversees a global currency. But the bottom line remains that these grand plans are not yet feasible in the present geopolitical environment. Perhaps the world will have to wait for a couple more crises before these suggestions become foreordained!

Other features of the international financial architecture favoured by both 'moral hazard' and 'panic' views are improved global standards and transparency, which would limit informational asymmetries. Proponents of the 'moral hazard' view argue that transparency is good because well-informed investors, creditors or economic agents would be in a better position to reward or punish economic decisions early on, without a problem reaching crisis proportion.

To the 'panic' view enthusiasts, transparency is important because panic usually feeds on unfounded rumours and uncertainty. The lack of accurate and timely information makes it difficult for economic agents to distinguish which economies are unsound and which are not, thus exacerbating contagion. Improvements in transparency, therefore, should minimise financial panics.

Conclusion

The Asian crisis was an eye-opener. The Achilles heel of the Asian economies—their financial systems—finally gave in after years of excess. What caused the financial systems to give way is still a matter of academic debate, but there are at least two 'tales'—the 'panic-illiquidity' view and the 'moral hazard' view of the underlying cause of the crisis. Of course, these two explanations are not mutually exclusive, but their policy implications are somewhat different.

A pragmatic reading of the crisis suggests that the bulk of the policy responses has to be carried out on the homefront. It is imperative that domestic reforms focus on both systemic and institutional restructuring. Asia clearly needs to change. It needs to be open to the West and the Western style of business, from the provision of information to business relationships. Domestic efforts should also be supported by regional and international mechanisms.

In terms of addressing the root cause of the crisis, there is no shortage of new ideas, of codes of best practices or of grand proposals for a new financial architecture. The challenge, as always, is how to put all these into practice. ***Policy***

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