# Responding to the Challenges of the Asian Economy and Financial Markets

# — Crisis Prevention and Realization of Stable Economic Growth –

July 5, 2002

The Expert Group on the Challenges of the Asian
Economy and Financial Markets

Council on Customs, Tariff, Foreign Exchange and Other Transactions

Subcouncil on Foreign Exchange and Other Transactions

The Expert Group on the Challenges of the Asian Economy and Financial Markets was established in the first Subcouncil on Foreign Exchange and Other Transactions in the Council on Customs, Tariff, Foreign Exchange and Other Transactions in January 2001. In the eighteen meetings held to date, the Group has discussed the challenges facing the Asian economy and financial markets in light of current economic and financial conditions in order to prevent the recurrence of the Asian currency and financial crisis and to realize the stable economic growth in Asian countries.

This report summarizes the opinions, views and discussions of the Group.

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## Expert Group on the Challenges of the Asian Economy and Financial Markets

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Provisional Translation

# Council on Customs, Tariff, Foreign Exchange and Other Transactions

## Subcouncil on Foreign Exchange and Other Transactions

## Report of the Expert Group on the Challenges of the Asian Economy and Financial Markets

## Responding to the Challenges of the Asian Economy and Financial Markets – Crisis Prevention and Realization of Stable Economic Growth –

### Summary

#### 1. Introduction

In order to prevent the recurrence of the Asian currency and financial crisis (hereafter referred to as "Asian crisis") and to realize the stable economic growth, Asian countries must surmount a series of economic and financial challenges. In this context, the major challenges they face are "the development of efficient and stable financial systems," and "appropriate choice of foreign exchange regimes and the management and control of capital flows." This Expert Group has held eighteen meetings to deliberate on and to summarize a series of policy recommendations for coping with these challenges in light of current economic and financial conditions in Asia.

#### 2. Current Economic and Financial Conditions in Asia

While considerable disparities are observed among Asian countries, in general, Asian economies recovered at an accelerated pace from the Asian crisis of 1997. Exports served as the primary driving force in this recovery. With the slowdown of the U.S. economy at the end of 2000, Asian economies experienced a general downturn in economic conditions. More recently, economic conditions have been improving again. China in particular was barely affected by the Asian crisis and has been able to maintain a high rate of growth.

Asian countries are engaged in various structural reform programs, including the reorganization and restructuring of the financial and corporate sectors. While considerable progress has been achieved in these areas, banks have not fully regained their functions of financial intermediation, and problems remain here. While progress has also been made in removing non-performing loans from the balance sheets of banks, there are concerns that the restructuring of corporate liabilities may be delayed. Capital markets have not developed to the level where they can perform their market functions satisfactorily.

With regard to foreign exchange, the currencies of such countries as Thailand and Indonesia that made the transition from the dollar peg regime to the floating exchange rate regime after the Asian

crisis have generally remained weak. On the other hand, the real effective exchange rate of the currencies, such as Malaysia with the fixed exchange rate regime has followed an upward trend. Moreover, it is notable that even those currencies that have made the transition to the floating exchange rate regime have recently been returning to a stronger linkage to the dollar.

## 3. Efficient and Stable Financial Systems

### (1) Establishing a Sound Banking System

#### ① Developing Countries and the Banking System

The banking sectors of Asian countries sustained heavy damages in the Asian crisis. Nevertheless, the banking sectors must play extremely important roles in supporting future economic developments.

To create efficient and stable financial systems in Asian countries, it is necessary to strengthen the function of the banking sectors and develop the capital markets. For this purpose, it is important to establish an economically rational division of functions between local and foreign banks, between private and public financial institutions, and between the banking sector and the securities market. This division of functions must be designed to draw out the merits of each component part.

#### ② Problem of Non-Performing Loans and Their Disposal

Since the Asian crisis, Asian countries have focused their attentions on reconstructing the banking sector which constitutes the core of their financial systems. A series of measures have been implemented, including the disposal of non-performing loans, recapitalization, and consolidation and dissolution of banks. Non-performing loans have been eliminated from the balance sheets of banks and transferred to asset management companies (AMCs). However, with the exception of a few countries, the final disposal of non-performing loans is not proceeding smoothly. There are concerns that these may reemerge as non-performing loans, or that they may lead to additional fiscal burdens. Corporate restructuring, including improved profitability is indispensable to the disposal of non-performing loans. However, such efforts have not often gone beyond the rescheduling of corporate debt, with the result that corporate restructuring has become bogged down.

#### ③ Reinforcement of Supervisory and Regulatory Frameworks

Since the Asian crisis, these countries have been strengthening their prudential regulations. However, considerable room for improvement remains in the following areas: rationalization and reduction of policy intervention in the financial system; easing of entry restrictions on foreign banks in accordance with the stage of financial development; reform of the

ownership structure of banks; adoption of higher standards of statutory disclosure. Other essential requirements include arrangements for the early exit of failed banks, and the development of operational rules which conform to international standards and principles, as well as to the domestic conditions of individual countries. Regarding prudential regulations, the speedy introduction of the best practices of developed countries without due consideration of local conditions should be avoided. On the other hand, in response to the internationalization of finance, banking audit must target the international consolidated operations of banks. International cooperation and collaboration are also vitally important in implementation of regulations.

Establishment of governance in banking is an essential factor in the development of sound financial systems. For this purpose, banks must be independent of government development policies and must not be the "institutionalized banks" of corporate groups.

④ Revitalizing Local Banks

Since the Asian crisis, progress has been made in the consolidation of local banks through mergers and other means. While it was hoped that consolidation would improve the competitive position of local banks, this has not significantly affected management efficiency and profitability. This is because the corporate lending activities of local banks have declined in total due to the full-fledged entry of foreign banks subsequent to the easing of regulations. The following actions must be taken to revitalize local banks which play an important role in the development of small- and medium-sized businesses which constitute the foundation of domestic industries: further progress in corporate restructuring, including the resolution of the problem of corporate debt; strengthening the monitoring function of local banks; development of an environment for autonomous and efficient bank management which is independent of intervention by government and corporate groups; improvement of human resources; reform of management structures; and, further promotion of information disclosure.

(2) Improving Long-Term Funding Mechanisms

① Limited Availability of Long-Term Credit

Asian countries have access to large pools of domestic savings which, if properly utilized, can finance the necessary investments for achieving high economic growth rates. It has been pointed out that these countries have arrived at a point where they can maintain high levels of sustained economic growth without becoming excessively dependent on foreign funds. Notwithstanding their high savings ratios, the ability to maintain adequate domestic supplies of long-term credit is widely held in doubt. To prevent future crises while sustaining economic development, it is essential to heighten the capability of domestic financial systems to supply long-term credit.

② Improving the Capacity to Supply Long-Term Credit

It is necessary to heighten the domestic capability to supply long-term credit. For this purpose, it is important to promote the procurement of investment funds based on market mechanisms, as well as to work towards strengthening of market mechanisms.

③ Improving the Capacity of Banks to Supply Long-Term Credit

To heighten the domestic capacity to supply funds, it is important to heighten the capability of banks to supply long-term credit. For this purpose, the following lines of action are important: development of an environment conducive to the supply of long-term credit by banks; improvement of risk-management and maturity formation-capacities; boosting of bank capitalization; use of syndicated loans and other risk-reducing methods; and, promoting the entry of foreign banks with the ability to accept higher risk burdens.

④ Use of Securitization

It is important to strengthen systems for direct procurement of long-term funds from investors through the issue of corporate bonds. Because banks hold a dominant position in the financial systems of Asian countries, in the early stages of this process, it is important to utilize credit-evaluation function of banks to generate information on borrowers. While the provision of bank guarantees on corporate bonds is a possible approach, such measures as loan participation and loan securitization should be more effective.

⑤ Development of the Systemic Infrastructure

The expansion of long-term credit requires the development of the systemic infrastructure and the training of experts. It is appropriate to gradually add new methods for the supply of long-term credit in line with the various stages in the development of systemic infrastructure as follows: increasing the supply of long-term credit by banks; introduction of new risk-sharing methods by banks; collaborative development of long-term credit by banks and institutional investors; and, involvement of general investors in the expansion of long-term credit.

(3) Improving Financing for Small- and Medium-Sized Businesses

① Importance of Small- and Medium-Sized Businesses

Throughout all Asian countries, small- and medium-sized businesses perform extremely important social and economic roles. The sound development of small- and medium-sized businesses is an indispensable element for economic development.

② Problems of Financing for Small- and Medium-Sized Businesses

Because of asymmetrical information and inadequate collateral, small- and medium-sized businesses have no choice but to depend on friends and relatives, informal financing, and banks with which they interact on a daily basis for the procurement of funds. As a result, they are unable to procure adequate volumes of funds. Profit growth is frequently obstructed by a shortage of funds. In addition to the limited experience of banks in lending to small- and medium-sized businesses, it has been pointed out that the full-fledged entry of foreign banks and the strengthening of prudential regulations have weakened the ability of banks to lend to small- and medium-sized businesses.

③ Expanding Financing Facilities for Small- and Medium-Sized Businesses

When expanding financing facilities for small- and medium-sized businesses, it is important to separate such initiatives from the objectives of social policy and to focus on economic rationality. Specifically, the following efforts are important: improving the transparency of small- and medium-sized businesses; improving the capabilities of banks (improved screening and monitoring functions, improved risk management capabilities, ability to cope with higher risk burdens); and, improving the systemic infrastructure of financing facilities for small- and medium-sized businesses (strengthening of credit guarantee systems, expansion and improvement of credit information organizations, training of experts for improvement of information disclosure by small- and medium-sized businesses, strengthening the function of chambers of commerce and industry as sources of information for small- and medium-sized businesses).

④ Nurturing Venture Capital

Financial support measures must be developed for small- and medium-sized businesses engaged in developing new businesses whose profitability cannot be readily determined, including businesses utilizing state-of-the-art technologies. The development of venture capital resources is an effective response to this need, as venture capital engages in the collection of information, while also utilizing the advantages of the securities markets.

(4) Developing Transparent and Fair Capital Markets

The following matters should be considered concerning the development of the Asian capital markets. First, the diverse possibilities of complementarity between the financial system and the banking sector should be considered, while taking into account the diversity in the developmental stages and financial structures of financial systems. Secondly, attention must be paid to create transparent and fair markets capable of winning the confidence of overseas investors.

① Efficiency and Fairness of Capital Markets

The proper function of capital markets depends on their efficiency (appropriate pricing function and the ability to facilitate the transfer of risks and maturities), and fairness (transparency in price formation and transaction process, equal opportunity for market participation). While the banking sector is expected to continue playing a central role in Asian countries, when financial development reaches a certain stage, the proper growth of capital markets becomes indispensable from the perspective of promoting the effective use of savings. The question of how to establish capital markets must be considered in light of the stages of development of individual countries and their purposes in introducing capital markets.

② Capital Market Challenges in the Post-Crisis

In their efforts to clear away the aftermath of the Asian crisis, prevent the recurrence of crises, mobilize domestic funds to promote further development and to activate inward investment, Asian countries must review their capital-market development policies which have thus far been unduly biased towards the development of stock markets. They must also more fully develop the foundations of the capital markets to win the confidence of the markets. The challenges facing the Asian capital markets can be summarized as follows.

a) The development of government bond markets represents an urgent issue from the perspective of providing a benchmark for gauging the risks of bonds in general, and for serving as a sound foundation for corporate bond markets.

b) To avoid excessive dependence on banks and to promote the stable transfer of long-term funds, it is necessary to promote the development of corporate bond markets and to promote bond ownership by a large population of general investors. There is the view that the participation of banks in the issue of bonds can reduce the information gap and contribute to the smooth expansion of the bond market. However, if the capital-market operations of banks are to be conducted through their internal organizations, it is important to erect firewalls to separate these operations from other banking functions.

c) Investment banks have an important role to play as market intermediaries from the perspective of promoting the development of capital markets in line with the stages of economic development and financial structure. It is probably necessary to utilize foreign investment banks to launch new capital markets.

d) From the perspectives of autonomy in asset management and corporate governance, and to perform those functions which are expected of institutional investors, it will be necessary to develop an asset-management industry in the private sector.

e) The presence of foreign investors can contribute to promoting the vitalization of the market and achieving greater transparency. Cross-regional listing can improve corporate disclosure and corporate governance and can also have a complementary effect on

augmenting the function of home markets and heightening possibilities for the expansion of regional markets.

## 4. Appropriate Foreign Exchange Regimes and Capital Flow Controls

### (1) Foreign Exchange Regimes

#### ① Foreign Exchange Regimes and Capital Flow Controls

Foreign exchange regimes and the capital flow controls should be viewed under two separate sets of objectives: crisis prevention under normal economic conditions, and crisis management under crisis situations. The followings are important under normal economic circumstances: (a) management of aggregate demand; (b) preventing the inflow of excessive overseas funds through banks and others; (c) preventing major corporations other than banks from taking on excessive exchange risks. For Asian countries with adequately high savings ratios, such measures are not incompatible with economic growth. On the other hand, in crisis situations where the currency is depreciating and capital is exiting rapidly, control of capital flows is a viable option for effective crisis management and resolution.

#### ② Freely Floating Exchange Rate Regime or Fixed Exchange Rate Regime

It has been argued that the only two foreign exchange regimes capable of withstanding currency crises are the freely floating exchange rate regime or fixed exchange rate regime (two corner solutions).

Under the freely floating exchange rate regime, the monetary authorities do not intervene in the foreign exchange markets, so that foreign reserves are not depleted. Therefore, by definition, the currency crisis cannot occur. However, floating regime can give rise to volatility (short-term fluctuations) and misalignment (deviation from fundamentals over a certain period of time). On the other hand, stringently fixed exchange regimes are prone to speculative attack. The currency board regime has the additional problem of preventing the central bank from functioning as the "lender of last resort" because the issue of currency is bound to the foreign reserve position.

#### ③ Currency Basket Regime

Others have argued that intermediate options are more desirable than extreme foreign exchange regimes. Asian countries affected by the crisis have tended to opt for more flexible exchange rate regimes. However, given the problems of volatility and misalignment, some degree of the stability of exchange rate is desirable. Asian countries have close ties, not only with the United States, but also with Japan and Europe. Therefore, the adoption of an

intermediate exchange rate regimes utilizing currency basket comprised of the dollar, yen and euro should contribute to effectively stabilizing the Asian currencies.

④ Foreign Exchange Regimes, Macroeconomic Policies and the Financial System

The optimal choice of foreign exchange regimes and optimal regime management depend on specific economic conditions. Moreover, whatever regime is chosen, the appropriate macroeconomic policy and the sound financial system are prerequisites for the achievement of exchange rate stability.

⑤ Coordination of Foreign Exchange Regimes

Regional coordination of foreign exchange regimes must start with a common understanding of the impact of currencies on other regional currencies. In Asia, the promotion of regional coordination of foreign exchange regimes must be based on a long-term perspective and must be pursued in tandem with broadly-based initiatives for regional cooperation, including regional financial cooperation and policy dialogue.

(2) Capital Flow Controls

① Objectives of Control of Capital Flow Controls

Capital flows may be controlled for various purposes, such as achievement of independent monetary policy and exchange rate stability, and prevention and resolution of domestic financial and currency crises. It is argued that capital inflows should be controlled for the prevention of crises, while capital outflows should be controlled for the management of crises.

The effectiveness of capital flow controls depends on the duration and expected duration of controls. In addition to the ability to implement administrative regulations, successful control of capital flows is predicated on the maintenance of public confidence in government policies. This requires proper accountability in policy implementation.

② Advantages and Disadvantages of Capital Flow Controls

Capital flow controls are undesirable because they can distort resource allocation over the long run. However, the introduction of short-term and temporary controls may be necessary in such emergency conditions as liquidity and currency crises because controls allow the implementation of flexible monetary policies and can prevent over-shooting as a currency depreciates.

③ Strengthening the Financial System and Sequencing the Liberalization of Capital Flows

The free movement of capital can be a driving force in economic growth by promoting optimal resource allocation and capital accumulation. However, an accelerated pace of capital liberalization which undermines the stability of macroeconomy and domestic financial system carries the risk of generating a financial crisis. Hence, capital liberalization must be predicated on sound and consistent macroeconomic policies, a sound domestic financial system, and the proper sequencing of liberalization measures.

The liberalization of capital flows should begin with the liberalization of direct foreign investments based on long-term perspectives. The liberalization of short-term capital flows should proceed with due consideration given to necessary conditions.

④ Monitoring of Short-Term Capital Flows

It is inappropriate for countries with vulnerable financial systems to become overly dependent on foreign borrowings and short-term funds which are easily affected by investor behavior. Therefore, for the effective prevention of crises, it is necessary to upgrade the monitoring of capital flows, with particular attention to short-term capital flows. It is desirable to establish a cooperative monitoring framework for the Asian region. The developed countries, on their part, should contribute to reducing the risks of turbulent and short-term capital movements through such measures as the disclosure of information by lenders.

⑤ Conditions for the Introduction of Capital Flow Controls

In certain situations, it may be necessary to introduce market-friendly indirect controls to prevent the inflow of destabilizing funds or to introduce controls on capital outflows on an exceptional basis during periods of crisis. However, capital flow controls should be introduced only on a temporary basis during periods of crisis. Moreover, it is necessary to clearly indicate a schedule for the easing and elimination of capital flow controls from the time that they are introduced.

Restrictions on capital outflows can generate large costs in the long run and must not be employed as a substitute for structural reform of the financial sector. To prevent capital flow controls from delaying the reinforcement of the financial sector, a schedule for financial reform must be announced and every possible effort made to abide by this schedule.

## 5. Japan's Responses and Actions

A series of actions and initiatives which Japan should take in relation to the challenges which Asian countries face regarding their financial systems and foreign exchange regimes, and currency transactions and capital flow controls are outlined below.

(1) Responses of the Japanese Government

① Japan's Economic Recovery and Market Improvement

Japan and Asian countries are bound together closely through trade, investment and other activities, such that the recovery of the Japanese economy is an extremely important factor for the future development of the Asian economies. It is particularly important for Japan to take all necessary measures to ensure the stability of its financial system and to make the maximum possible effort to promote the ongoing program of structural reform. It is also important for Japan to make continued efforts to render its markets more attractive.

② Cooperation with Asian Countries

To prevent future crises in Asia and to promote the stability of currency and financial systems in the region, Japan must participate in the global undertakings initiated by the IMF, World Bank and other international organizations. Parallel to this, it is important for Japan to strengthen and actively promote its own cooperative programs for Asia.

a) Regional Monetary Arrangements (Chiang Mai Initiative)

It is hoped that the Chiang Mai Initiative and other regional frameworks for monetary cooperation will perform the following functions: suppress excessive fluctuations in the flow of funds; prevent currency crises; and, quantitatively supplement IMF lending in the event of a currency crisis. Japan must continue working actively for the establishment of regional network structures.

b) Intra-Regional Economic Review and Policy Dialogue in ASEAN+3

To realize the monetary stability in the Asian region, it is important to strengthen the review of regional economic conditions and policy dialogues, and to engage in frank exchanges of views by considering the creation of frameworks with a fully functional secretariat. Japan should continue utilizing the ASEAN+3 framework to develop even closer cooperative ties with the related countries.

c) Intra-Regional Capital Flows

Japan plays a critical role in Asia's regional flow of funds. Hence, in preventing the recurrence of crises in Asia, it is important for Japan to be actively engaged in monitoring short-term capital flows and in various other measures related to capital flows. Likewise, Japan's continued support and cooperation with Asian countries is of key importance.

d) Economic Cooperation

Japan has proposed the Initiative for Japan-ASEAN Comprehensive Economic Partnership. It is important to use such initiatives for economic cooperation to further deepen the mutual relations between Japan and Asian countries and to strengthen the competitive positions of both Japan and Asia.

e) Bilateral Assistance

To prevent future crises in Asia and to realize the stable economic growth in Asian countries, it is important for Japan to provide appropriate and timely bilateral assistance to support structural reform efforts in Asia.

f) Technical Assistance and Human Resource Development

Technical assistance and human resource development are important factors in promoting structural reform in Asia and achieving autonomous economic management. Japan must bolster its human-resource contributions and continue to engage actively in these initiatives.

(2) Activities of Financial Institutions and Others

① It is hoped that Japanese banks will adopt an active stance in identifying business opportunities in Asia and that they will contribute to the development of the Asian domestic markets through the localization of their operations and other measures.

② Investment banking operations have an important role to play in the development of capital markets.

③ Institutional investors can, by turning more of their attentions to the Asian markets, by performing the function of long-term investors and by fully demonstrating their capabilities of engaging in corporate management as shareholders, contribute to the development of the Asian capital markets.

**Council on Customs, Tariff, Foreign Exchange and Other Transactions**

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# Report of the Expert Group on the Challenges of the Asian Economy and Financial Markets

## Responding to the Challenges of the Asian Economy and Financial Markets – Crisis Prevention and Realization of Stable Economic Growth –

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## Report of the Expert Group on the Challenges of the Asian Economy and Financial Markets

## Responding to the Challenges of the Asian Economy and Financial Markets -- Crisis Prevention and Realization of Stable Economic Growth --

1. Introduction

(1) While considerable disparities in economic performance are observable among Asian countries because of differences in industrial structure, in general, most Asian economies were able to recover at an accelerated pace after incurring serious damage in the Asian currency and financial crisis of 1997 (hereafter referred to as "Asian crisis"). Exports served as the primary driving force in this recovery. However, with the slowdown in the U.S. economy beginning in the end of 2000, the Asian economies experienced a general downturn in economic conditions. More recently, conditions have been improving as a result of expansionary domestic economic policies and export growth buoyed by global economic recovery.

Since the Asian crisis, Asian countries have been engaged in various structural reforms, including the reorganization and restructuring of the financial and corporate sectors. In this context, the implementation of structural reforms and other appropriate economic policies is becoming an increasingly important factor in the achievement of stable economic growth.

Beginning in January 2001, this Expert Group has held 18 meetings to deliberate on the matters. The Expert Group has adopted as its starting point the following series of questions: What must be done, and what must not be done to prevent future Asian crises? In the five years since the Asian crisis, what problems have been solved through Japan's international cooperation and the efforts of Asian countries, and what problems remain to be solved? From this perspective, and in view of the current economic conditions in Asia, the Expert Group endeavored to identify major economic and financial challenges facing the countries of the region in achieving stable economic growth, and discussed the various available responses to these challenges.

(2) Asian countries must overcome the following major economic and financial challenges in order to prevent future Asian crises and to achieve stable economic growth: ①development of efficient and stable financial systems; ②resolution of problems related to foreign exchange regimes and the management and control of currency trading and capital flows.

① Efficient and stable financial systems must be developed to achieve sustained economic growth, as such systems are indispensable in the realization of efficient resource allocation. The extremely high savings ratios of Asian countries adds to the significance of this challenge. Domestic capital markets must be developed to efficiently allocate the ample supply of domestic savings, and frameworks must be created for the supply of long-term credit. The development of such financial systems are also important from the perspective of preventing future Asian crises by forestalling undue dependence on foreign funds in the process of pursuing economic growth.

Since the Asian crisis, Asian countries have been engaged in restructuring their financial sectors and have pursued such initiatives as the reorganization of banks, the disposal of non-performing loans, and the reinforcement of prudential regulations in such areas as the supervision and monitoring of banks and the boosting of equity capital. While there are some disparities among the countries of the region, in general, most banks have yet to fully regain their optimal functioning and position in financial intermediation. Hence, bank lending remains sluggish, and no significant improvements in bank earnings has been seen. From the perspective of supplementing the financial activities of banks and ensuring the provision of long-term credit, improvement of the intermediating functions of the stock, bond and other securities markets remains a critical challenge for Asian countries.

② The Asian crisis was triggered by a sudden outflow of short-term funds in currency markets which were effectively pegged to the U.S. dollar (hereafter referred to as, "the dollar"). In light of this fact, and in order to prevent future crises and to achieve sustained economic growth, it is vitally important for Asian countries to examine what constitutes an appropriate foreign exchange regime and how currency trading and capital flows should be managed and controlled.

Since the Asian crisis, most Asian countries have made the transition to more flexible foreign exchange regimes in recognition of the fact that the virtual dollar peg regime was one of the factors undermining stability in their currency markets. As such, the maintenance of stable currency markets has become an increasingly important challenge for the economic authorities in these countries.

Regarding the management and control of capital flows, it is necessary to examine available policy measures in order to prevent crises like the Asian crisis in the future.

(3) Having defined the issues on hand as outlined above, this Expert Group proceeded to discuss and to summarize its deliberations on the following matters from the perspective of preventing future Asian crises and achieving sustained economic growth: issues to be addressed by Asian countries for the development of efficient and stable financial systems; viable foreign exchange regimes, and management and control of currency trading and capital flows; and, Japan's responses and actions.

Note: For the purpose of this report, "Asia" refers to the East Asian area bounded by the Republic of Korea in the north and Indonesia in the south. The term "country" is used in referring to both countries and regions.

## 2. Current Economic and Financial Conditions in Asia

### (1) Current Economic Conditions

#### ① Asian Economies in a Recovery Phase

While considerable disparities in economic performance are observable among Asian countries because of their differences in industrial structure, in general, Asian economies registered a V-shaped recovery from the dramatic setbacks of the 1997 Asian crisis which bottomed in the fourth quarter of 1998. Recovery was spurred by such factors as sharply lower exchange rates and the rapid growth in exports responding to booming conditions in the U.S. economy. The accelerated growth in the export of IT-related products, such as semiconductors and electronic components, played a central role in boosting manufacturing output. The adjustment of the IMF policies instituted immediately after the crisis and the subsequent easing of fiscal and monetary policies have provided support for capital investment and personal consumption.

However, the recovery hit a snag after the end of 2000 as both the U.S. and European economies registered significant slowdowns following an adjustment in stock prices. The situation deteriorated further after the terrorist attacks of September 2001 which clouded the outlook for the global economy. In addition to the ongoing cyclical adjustment in the global output of IT industries, these developments exerted a negative impact on non-IT manufacturing as well as on tourism and other services. Thereafter, the Asian economies once again entered a contractionary phase, with the NIEs experiencing a particularly conspicuous downturn in demand. More recently, the Asian economies have been moving towards recovery buoyed by the strong export performance of IT industries following the faster-than-expected global recovery. The export recovery reflects the rapid response of Asia's intra-regional division of labor to demand from the U.S. and other final-goods markets.

With respect to China, it is notable that the Asian crisis had only a marginal impact on the Chinese economy. China has effectively maintained its accelerated pace of growth thanks to strong domestic demand and outstanding export competitiveness.

The drastic currency depreciations of the Asian crisis resulted in a ballooning of the local-currency value of the foreign-currency denominated liabilities of financial institutions and operating companies. In the case of banks, this additional debt burden triggered a credit contraction which led to a stagnation of domestic demand. Consequently, while export industries were reporting strong performances, the financial status of non-export local companies was deteriorating. Although the ratio of non-performing loans has declined, banks have not effectively regained their credit-creating functions. The speedy recovery of this function stands as a prerequisite for the revitalization of non-export companies as well as small- and medium-sized businesses.

#### ② Currency Market Trends and Changes in the Flow of Inward Funds

After dropping sharply in the Asian crisis, Asian currency markets generally bottomed during 1998 and have thereafter remained stable at relatively low levels. While some Asian countries experienced a new round of currency depreciation during 2001 as their economies stagnated, recent trends in currency markets have been generally stable.

Over the years, all of the Asian economies, with the exception of the Philippines, have consistently registered high savings ratios. However, given their state of development, their

investment ratios were also high. Consequently, current account deficits were registered on a continuous basis. After the Asian crisis, a fundamental change occurred in this situation as almost all Asian countries began showing current account surpluses. Sluggish domestic demand had reduced imports, while cheaper currencies fueled an accelerated growth in exports.

Turning to the flow of inward funds, through the 1980s, public-sector funds accounted for a majority of foreign funds entering the Asian economies. However, an explosive growth in incoming private-sector funds was experienced during the 1990s. This flood of funds consisted not only of foreign direct investment, but also included massive amounts of portfolio investments and short-term bank lending. After the Asian crisis, the inflow of funds declined precipitously during a brief period of time. Thereafter, as economic conditions improved and structural reforms were implemented, the outflow of funds subsided.

While foreign direct investment in the entire Asian region has remained firm, the level of intra-regional competition for attracting new direct investments is expected to be intensified in the future.

Asian currency authorities responded to the inflow of foreign funds during the first half of the 1990s by intervening in currency markets to maintain their fixed exchange rates. The steady purchase of dollars and selling of local currencies resulted in the rapid growth of the foreign reserves of these countries. This process was reversed during 1997 as dollars were sold to protect the level of local currencies. Consequently, countries affected by the Asian crisis experienced serious erosions of their foreign reserve positions. After the crisis, reserve positions were again bolstered. Given the decline in short-term foreign liabilities, this positive development in reserve positions means that Asian countries now have more favorable ratios of foreign reserves to short-term foreign liabilities than they had before the Asian crisis.

③ Changes in Macroeconomic Policy Stance

In compliance with IMF policy prescriptions, Asian countries initially adopted tighter fiscal and monetary stances after the crisis of 1997. Parallel to this, these countries were experiencing credit contraction as a result of the explosive growth in non-performing loans. The combination of these factors dampened domestic demand and led to a serious deterioration in business conditions. The severity of these conditions eventually led to an adjustment in economic policy stances in which many Asian countries opted for expansionary policies, including monetary easing and fiscal stimulus. When the economic downturn gained momentum after the terrorist attacks of September 2001, steps were taken toward additional monetary easing. The downward trend in currencies which had switched to floating exchange rates (including managed floats) and low inflationary pressures provided room for this new round of monetary easing at this time.

The drastic depreciation of Asian currencies during the Asian crisis led to a ballooning of the local-currency value of foreign-currency denominated liabilities. In the case of Indonesia, the absence of deposit insurance schemes and other safety net mechanisms precipitated widespread bank runs as a series of financial institutions showing negative net worth were being dissolved. (Indonesia thereafter introduced a deposit insurance system providing full coverage of deposits in May 1998.) To cope with the liquidity crisis, the central bank stepped in as the "lender of last resort" to supply the economy with high-powered money. This in turn triggered a new round of currency depreciation. However, most of the countries that had made the transition to floating exchange rate regimes have adopted a policy of inflation

targeting and have reinforced the autonomy of their central banks. As a result, monetary policy is now more disciplined than in the past.

In the area of fiscal policy, Hong Kong, Malaysia and Singapore have opted for an expansionary stance. In the case of Korea and other countries with low levels of outstanding public debt, considerable room is available for budgetary expansion. On the other hand, Indonesia and other countries with high levels of pubic debt have limited options for fiscal stimulation.

(2) Current Financial Conditions

① Structure of Financial Intermediation

A salient feature of the structure of financial intermediation in Asian countries is the high level of dependence on indirect financing. Due to the demands of their development policies, many of Asian countries have maintained interest rates at artificially low levels, giving rise to credit rationing and strong government intervention. In turn, these factors have generated moral hazards, introduced distortions and have rendered Asian financial systems generally inefficient.

A review of stock-ownership structures in Asia reveals a high level of corporate cross-ownership and a concentration of ownership in a limited group of major shareholders. Furthermore, most Asian countries share the features of a high dependence on banks and underdevelopment of securities markets.

It has been argued that the qualify of lending assets tends to be undermined by the following factors: (a) bank lending is backed by implicit government guarantees; (b) extended group lending is encouraged because banks and finance groups are dependent on conglomerates that are run as family enterprises. The presence of government guarantees and extended group lending encourages the dependence of banks on the government. It has been argued that this feature of the financial structure seriously erodes the incentive of banks to properly monitor their corporate borrowers.

Throughout the Asian region, small- and medium-sized businesses account for a large ratio of the corporate population. The improvement of the financing of small- and medium-sized businesses which are dependent on indirect financing, and the development of local cooperative-type financial institutions stand as important issues for these countries.

Turning to the capital markets, the scale of Asia's capital markets remains extremely narrow for the following reasons: the small number of mature corporations with high credit standing; underdevelopment of legal and systemic infrastructures, including bankruptcy laws and accounting systems; inadequate disclosure of corporate information; and, the absence of rating institutions and other information-generating organizations. Because of small investor populations, transaction volumes in secondary markets are extremely low. Banks play very important roles in the capital markets and are permitted to engage in a wide range of activities, including underwriting and issuance. On the other hand, penalties on insider trading and other illegal transactions are lax.

Asian countries must undertake to develop their financial intermediation functions by making improvements in both indirect and direct financing. Of particular importance is the development of primary and secondary markets for government bonds which function as benchmarks in the capital markets. The volume of outstanding government bonds has risen

rapidly in Asian countries as they have acted to dispose of non-performing loans. This is taken to be an indication of the need to quickly develop primary and secondary bond markets centered on primary and secondary markets for government bonds.

② Disposal of Non-Performing Loans

Non-performing loans are being disposed of by eliminating them from balance sheets through such means as write-offs, asset liquidation and the transfer of assets to asset management companies (AMCs). As of the end of 2001, Korea's non-performing loan ratio has dropped to about 5%, while those of Malaysia, Thailand and Indonesia have declined to approximately the 10% level. These figures indicate that, at least on a balance-sheet basis, non-performing loan ratios have declined in these countries. The two problems that remain are whether the assets transferred to AMCs can be smoothly liquidated, and whether companies can free themselves from the restrictions placed on their growth by making good progress in restructuring their liabilities. In the case of Indonesia, the Indonesian Bank Restructuring Agency (IBRA) is playing a central role in the privatization of nationalized banks and the liquidation of non-performing loans. The fiscal burden of this initiative will multiply if liquidation does not proceed as scheduled. A similar risk exists in Korea. Because bonds have been issued to fund AMCs and the deposit insurance system, the fiscal balance may be affected in the future by growing interest payments.

In the process of the disposal of non-performing loans, numerous banks accepted infusions of public funds and were nationalized. It is expected that foreign capital will play an important role in the reverse process of privatization. For instance, foreign investors have been successful bidders in the privatization of nationalized banks conducted by Indonesia's IBRA. This points to the key role that foreign capital can play in financial reorganization. Foreign participation can also be expected to provide other advantages, such as qualitative improvements in terms of human resources and risk management.

Turning to the question of equity capitalization, the infusion of public funds has reinforced the financial standing of banks to the point where minimum capitalization requirements have now been cleared in most Asian countries. Also, most Asian countries have achieved significant reductions in the number of their banks and financial companies by accelerated financial reorganization through bank closures, mergers and nationalization.

Corporate debt is being restructured mainly through the equitization of liabilities and debt forgiveness. In most instances, this process has stopped short of management restructuring. It is feared that the restructuring of corporate debt may be delayed for the following reasons: (a) while certain improvements have been made in bankruptcy laws and the legal framework for corporate dissolution, these systems are not necessarily functioning optimally because of the exercise of judicial discretion; (b) corporate governance continues to be weak; and (c) various problems remain in the area of corporate accounting practices.

While both non-performing loan ratios and equity capitalization ratios are improving, banking portfolios are heavily skewed towards government bonds and short-term securities. As such, in general, banking sectors throughout Asia remain far removed from regaining their credit-creating functions. A particularly important challenge will be to ensure smooth fund procurement by small- and medium-sized businesses.

③ Prudential Banking Regulations

In Asian countries, financial liberalization frequently preceded the institution of prudential banking regulations. The weakness of prudential regulations is seen as one of the factors contributing to the vulnerability of financial systems. The absence of efficient supervision and monitoring allowed banks to take on excess risks and to fall prey to moral hazards.

In light of this fact, since the Asian crisis, Asian countries have indicated that they will abide by the Basel Core Principles for Effective Bank Supervision (minimum standards for effective bank supervision established by the Basel Committee on Bank Supervision). In addition to this, capitalization requirements have been raised in many Asian countries to above the 8% standard.

④ Current Conditions in Capital Markets

When currency values dropped sharply during the Asian crisis, foreign-currency denominated liabilities ballooned in these countries, sending numerous banks and companies into negative net worth. The funding difficulties experienced by such banks and companies generated a credit contraction with very serious macroeconomic repercussions. In light of this lesson, Asian countries have endeavored to develop a diverse range of fund procurement methods to supplement bank borrowing. In this context, a very strong awareness has emerged for the need to nurture the capital markets, particularly for the development of highly liquid domestic bond markets centered on local-currency denominated corporate bonds. In fact, many major Asian companies turned to bond issuance as a means of fund procurement when faced with the credit crunch that followed the Asian crisis. However, it cannot be said that the Asian corporate bond markets are functioning on par with similar markets in the United States and other advanced countries. Some of the remaining problems include underdeveloped market infrastructure, government intervention and bank guarantees of corporate bonds.

(3) Foreign Exchange Regimes and Capital Flow Controls in Asian Countries

① Current Foreign Exchange Regimes

Asian countries can be broadly categorized into three groups based on their current foreign exchange regimes. The first group consists of countries that have shifted to floating exchange rates since the Asian crisis and includes Thailand, Korea, Indonesia and the Philippines. It should be noted that Taiwan has been operating under floating exchange rates since before the Asian crisis. The second group consists of those adopting fixed exchange rate regimes and includes China and Hong Kong with their currency board regimes, and Malaysia with its dollar peg regime since 1998. The third group consists of Singapore which utilizes the currency basket regime.

The exchange rate of those countries that shifted to floating rates after the Asian crisis has generally depreciated since 1999 for the following reasons: (a) political instability (the Philippines and Indonesia); (b) the IT recession which began at around the end of 2000.

On the other hand, Malaysia, China and Hong Kong, which have maintained fixed rates, have experienced a rise in their real effective exchange rates. This has had a growing negative impact on current accounts and economic conditions in these countries. Nevertheless, in the case of China, upward pressure on the Renminbi persists as a result of mounting current account surpluses. As a result, China's foreign reserves are continuing to grow.

② Linkage to the Dollar

As outlined above, Asian countries, with the exception of such countries as China and Malaysia, made the transition to floating exchange rates after the Asian crisis. However, regression analysis indicates that the linkage between Asian currencies and the dollar has risen again since the second half of 1998. As the virtual peg to dollar of many Asian currencies is recognized as one of the causes of the Asian crisis, this recent resurgence in dollar linkage calls for some concern.

③ Management and Control of Currency Trading and Capital Flows

Capital transactions have in principle been liberalized in Korea, Thailand and Indonesia. However, in order to avert currency speculation, Thailand and Indonesia have strengthened their restrictions on currency transactions not involving real demand since the Asian crisis.

Malaysia attempted to ameliorate the negative impact of the Asian crisis by adopting a fixed exchange rate regime and implementing various restrictions on currency and capital transactions. These restrictions included a one-year ban on the overseas remittance of the proceeds of stock sales and currency trading restrictions. However, six months after the introduction of these restrictions, the ban on remittances was replaced by a remittance tax. This tax rate was gradually reduced until it was completely eliminated in 2001.

④ Foreign Exchange Regimes and Monetary Policies of Developing Countries

Many developing countries generally lack mature financial markets and their foreign exchange markets tend to be narrow. Furthermore, their financial institutions also tend to be underdeveloped. The absence of mature forward markets results in extremely high hedging costs for market participants. Foreign exchange policies are of particular importance in highly liberalized small economies because shifting currency values can have a major impact on the real economy of such countries. In the event of an external shock, priority is given to exchange rate stability with the result that interest rates and foreign reserve positions can exhibit high levels of volatility.

Even in Asian countries officially committed to a "floating exchange rate regime," an implicit fluctuation band has been established in many instances. Consequently, there are very few Asian countries that have adopted a fully floating regime. Countries that have made this transition sometimes opt for exchange rate stabilization policies, including exchange market intervention and currency trading controls.

In countries where domestic equilibrium has failed and monetary discipline has been lost fixed exchange rate regimes are sometimes adopted to act as a nominal anchor to monetary policies in order to suppress inflationary expectations. Another option for developing countries with underdeveloped financial systems is to link monetary policies to exchange rate policies as a measure for eliminating discretionary elements from monetary policy. Fixed exchange rates as a nominal anchor have been shown to be highly effective in suppressing inflationary pressures. However, correctly timing the transition to a flexible currency regime (exit policy) constitutes a critical issue in the success of this approach. As seen in the crisis in Argentina, the social cost of this policy can be too high when a transition is attempted after foreign-currency denominated liabilities have ballooned.

While many countries that have made the transition to floating exchange rate regimes have already adopted inflation targeting, these countries also have a tendency to simultaneously implement various measures for exchange rate stabilization. In view of the fact that the price structure in developing countries tends to be affected by price controls and import controls, it

is necessary to leave considerable room for discretionary action when adopting inflation targeting. Monetary targeting must necessarily be assigned a supplementary role in developing countries where money demand functions are frequently unstable.

## 3. Efficient and Stable Financial Systems

### (1) Establishing a Sound Banking System

#### ① Developing Countries and the Banking System

The banking sectors of Asian countries were heavily damaged in the Asian crisis. No doubt, banking sectors must continue to play an extremely vital role in supporting future economic development by properly performing their settlement and fund allocating functions. In order to create efficient and stable financial systems in Asian countries, it is important to establish an economically rational division of functions between local and foreign banks, between private and public financial institutions, and between the banking sector and the securities markets. This division of functions must be designed to draw out the merits of each component part.

#### ② Problem of Non-Performing Loans and Their Disposal

The first and foremost requirement in reconstructing a sound banking sector is to dispose of non-performing loans and to re-establish financial soundness.

##### a) Disposal of Non-Performing Loans

Since the Asian crisis, one of the top priorities of Asian countries has been to rebuild the banking sectors which stand at the center of their financial sectors. In pursuit of this objective, non-performing loans have been disposed, equity capital has been reinforced, and banks have been reorganized through a series of consolidations and dissolutions.

The following methods have been employed in the disposal of non-performing loans. Write offs and transfers to third parties have been used as means to final disposal. Non-performing loans have also been transferred to government-operated agencies for the disposal of non-performing loans and to AMCs formed as subsidiaries of asset management companies and banks. Another approach has been to re-categorize non-performing loans as sound assets upon agreement on corporate debt restructuring plans.

Parallel to the disposal of non-performing loans, efforts were made to reinforce the equity capitalization of banks. Methods for recapitalization differed from one country to another. Some vigorously promoted government infusion of public funds, while in other countries private banks took the initiative in procuring new equity. While minimum capitalization requirements were raised after the Asian crisis, these new requirements have been generally met in all countries using the above methods.

While banking sectors were being rebuilt, as part of the efforts toward the disposal of non-performing loans and recapitalization, Asian countries also made substantial progress in the reorganization (consolidation and dissolution) of banks through a series of consolidations, mergers and acquisitions. The following specific methods were employed in promoting reorganization. Non-viable banks and non-banks were either closed down or nationalized (disposal and recovery of transferred assets, and the privatization of nationalized banks) or sold to foreign banks and foreign investors. Holding companies were used in consolidating and concentrating local banks (establishment of new core banks). Prior to the Asian crisis, the banking sectors of Asian countries were prone to "over banking." However, through this process of reorganization, the number of banks has been substantially reduced while notable progress has been made in forming core banks.

By disposing of non-performing loans and reinforcing equity capitalization, banks throughout the Asian region have been able to effectively lower their ratios of non-performing loans. If we are to restrict ourselves to the balance sheets of financial institutions, it can be said that the problem of non-performing loans no longer presents a crisis situation.

b) Problems in the Disposal of Non-Performing Loans

While the balance sheets of financial institutions indicate that the crisis of non-performing loans has passed, other major difficulties remain. First of all, the final disposal of much of the non-performing loans that have been eliminated from the balance sheets of financial institutions is not proceeding smoothly. With the exception of such countries as Malaysia, the liquidation of non-performing loans transferred to government and privately operated AMCs has become bogged down. In the case of Thailand, very large amounts were categorized as sound assets upon agreement on corporate debt restructuring plans. However, due to a downturn in economic conditions and corporate performances, many of these assets have once again become non-performing.

Secondly, corporate borrowers whose liabilities have been identified as non-performing have failed to achieve real improvement in their business performances. Consequently, their restructuring plans have become bogged down. The improvement of corporate profits and the fundamental resolution of the problem of corporate debts are essential for the successful resolution of non-performing loans. However, in many instances, corporate debt restructuring negotiations have failed to address the issue of management restructuring and have instead focused exclusively on the rescheduling and equitization of debt and debt forgiveness by lenders. Companies burdened with large volumes of debt are finding it difficult to generate enough profits to retire debts incurred prior to the Asian crisis and are therefore hard pressed to maintain adequate levels of working funds. Furthermore, there is always the possibility that a deterioration in economic conditions will undermine corporate performances and generate new non-performing loans.

Thirdly, the governments of Asian countries have issued massive volumes of bonds to finance the rebuilding of the banking sector. These funds have been used to provide liquidity support, to protect deposits, to purchase non-performing loans, and to infuse new equity capital into the sector. In the countries affected by the Asian crisis, fiscal outlays have also risen sharply to stimulate the economies that have suffered negative growth, resulting in the enlargement of fiscal deficits. These governments will face additional fiscal burdens in the future as losses are realized from the resolution of the non-performing loans that have been acquired. There are concerns that further fiscal burdens will be generated as funds are procured to retire the government bonds that have thus far been issued.

Numerous problems remain to be solved before the banking sector's problem of non-performing loans is ultimately resolved. The restoration of sound bank management cannot be said to have been achieved in the true sense until existing non-performing loans are finally disposed of, corporate management improved and macroeconomic stability achieved.

③ Reinforcement of Supervisory and Regulatory Frameworks

An important factor of the Asian crisis was the progress made in financial liberalization in the absence of adequate prudential regulations. It has been pointed out that this combination

generated various undesirable problems, such as the inflow of excessive foreign funds and excessive lending by banks. For this reason, financial reform programs undertaken after the Asian crisis have identified the reinforcement of the supervisory and regulatory frameworks of the banking sector as key policy issues.

a) Market-Based Regulatory Approach

The reforms that have been pursued after the Asian crisis subscribe to a market-based regulatory approach and are based on the principle of the self-responsibility of market participants. For this approach to function properly, it is first of all necessary to strengthen market discipline based on the monitoring and evaluation of market participants. Furthermore, in order to create appropriate financial systems, it is necessary to strengthen prudential regulations based on market discipline. Therefore, prudential regulations must not be such as to negate initiatives taken by banks, and their purpose must be to prompt banks to institute proper risk management.

Following the Asian crisis, most Asian countries have basically adopted this policy and have acted to reinforce prudential regulations through such measures as the introduction of the Basel Core Principles for Effective Bank Supervision. Specifically, the following measures have been instituted: restrictions on large-scale lending; restrictions on real estate lending; more rigorous definition of the categories of non-performing loans; raising of bad loan reserve requirements; regulations concerning capitalization requirements; control of foreign exchange risks; improvement of internal risk management systems; and, improved disclosure. At the same time, steps have been taken to strengthen the powers of the banking supervisory authorities.

b) Current Regulatory and Supervisory Problems

Certain problems still remain under the ongoing reforms. Firstly, market competition and information transparency are essential requirements in strengthening market discipline. Further improvements are needed in these two areas as indicated in the following instances. (A) Government policy intervention in the financial system for purposes other than the original purposes, including the establishment of a fair, equitable and sound financial system, should be minimized. Furthermore, systems for such policy interventions must be consolidated and reduced. (B) In order to reinforce a competitive market environment, it is important to allow both domestic and foreign banks to freely enter a market when they satisfy the necessary requirements. (C) Bank operations should be protected from distortions introduced by family management. For this purpose, arm's length rules should be strengthened to avoid the impairment of banks' sound management through conflict-of-interest transactions with companies of the same corporate group. For instance, further progress must be made in reforming the structure of ownership through prompt public offerings of shares and other measures. (D) Transparency in banking information must be promoted. For this purpose, the supervisory authorities should raise the standards of statutory disclosure, while also raising the level of disclosure to market participants. With regard to (B) above, in light of the experiences of Japan and many other advanced countries in protecting and promoting the development of domestic banks during the developmental stages of their financial systems, it has been argued that the process of liberalization should be partial and gradual.

Secondly, when introducing exchange risk management and other prudential regulations, it is important to avoid overly-rapid introduction of the best practices of advanced countries without due consideration of local conditions. For instance, in the case of advanced

countries, it is desirable for individual banks to develop their own internal risk management models in ensure efficient risk management. However, it is not necessarily appropriate to apply this prescription as is to developing countries banks with weak risk management capabilities. Another example is the application of equity capital requirements or other indicators that can be relatively easily applied. While such indicators may be effectively utilized in developing countries, it should be noted that it is not enough to rely solely on such indicators to assess management conditions.

The third problem is that sufficient measures have not been taken to prepare for the possibility of bank failures. Any delay in the disposal of failed banks has a definite tendency to deepen the economic damage and to elevate the costs that society must ultimately bear. To preserve the market principle of survival of the fittest, it is vitally important to develop a mechanism for the prompt exit of failed banks. For this purpose, the following measures should be taken. (A) A system for early correction orders should be developed for use when problems have been identified in the management of a bank. (B) Certain principles should be put in place concerning the disposal of failed banks and the infusion of public funds into troubled banks. (C) To facilitate decisive action on disposal, safety net systems must be established to minimize the negative social impact of the disposal of failed banks. This requires the expansion of deposit insurance systems, increased allocations to insurance reserves, and the improvement of social security systems. (D) Most importantly, the measures that have been developed must be implemented in a timely and appropriate manner.

The fourth issue concerns the application of certain standards that have come to be widely used throughout the world (hereafter referred to as, "international standards") in ways that conform to local conditions. To facilitate this process, prompt action must be taken to develop operating rules that can serve as a bridge between international standards and local conditions. In the process of reform that followed the Asian crisis, countries have been developing banking regulations and supervisory standards, related accounting systems, disclosure rules and various other economic laws and ordinances which parallel the requirements of the international standards. However, a simple formalistic introduction of the standards of the advance countries leaves a major gap between local business practices as well as the available level of information. Therefore, such standards and systems have not necessarily functioned adequately in real situations. Effective steps must be taken to reduce this gap. This implies the prompt development of operating rules which can function as operational standards which reflect both local conditions and international standards and principles.

The final problem relates to the lack of international cooperative frameworks. In the globalized economy, banks perform a very wide range of functions and engage in various forms of cross-border transactions. Hence, banking supervision must go beyond the monitoring of non-consolidated operations to cover consolidated operations on an international scale. At the same time, international cooperation and collaboration in supervision and regulation are indispensable in the world of internationalized finance. Further progress is needed in the following areas. (A) Supervisory systems must be reinforced in both the home and host countries where banks operate. (B) Asian supervisory authorities should promote the sharing of information concerning the problems that they face, their experiences, and information concerning human resources development. (C) Given the importance of compliance with the Basel Core Principles, the IMF and World Bank are promoting compliance in their technical assistance programs. As a result, many countries are instituting these principles. In this context, the reinforcement of banking supervision, including rigorous application of arm's length rules and the introduction of

restrictions on bank holding-companies and other shareholder regulations, are of special importance.

④ Strengthening Governance in Banks

One of the features of the Asian corporate landscape is the family-owned company. In certain areas, this has encouraged a lack of transparency in financing and discretionary management decisions leading to the creation of massive debts. It has often been argued that this contributed to the Asian crisis by encouraging the following type of system in which banks lacked adequate governance. Bank financing in Asia was frequently incorporated into a corporate group where banks functioned as "institutionalized banks." Secondly, the explicit and implicit demands of the government on financing, and the government's guarantee of such financing undermined governance.

Strengthening the governance of banks constitutes an essential element in any effort to create a sound financial system. The following lines of action must be pursued for this purpose. (A) Banks must be separated from the government's development policies and allowed to function as purely private financial institutions. (B) It is important for banks to escape from institutionalized banks in corporate groups. Specifically, as has already been done in Asian countries, entry barriers should be lowered for foreign investors so that governance can be strengthened through the active participation of foreign institutions. Another approach to upgrading governance is to promote disclosure and upgrade audit so that complex internal structures involving cross-lending and cross-guaranteeing of liabilities can be placed under external monitoring and scrutiny.

⑤ Revitalizing Local Banks

The onward march of globalization and the IT revolution have shifted the paradigm of development financing in today's international economy. Foreign companies are playing an increasingly important role in the introduction and nurturing of new industries which are indispensable to economic development. Likewise, foreign banks are now key players in financial systems supporting growth. Foreign direct investment into newly industrializing economies serve to transfer both capital and management resources to host countries and contribute to the acceleration of economic growth by expanding exports and stimulating domestic demand. However, this does not mean that domestic obstacles to development have been eliminated. In order to attract direct investment and foreign funds, constant efforts must be made by host countries to improve their investment environment. Local banks certainly have a very major role to play in developing the social infrastructure which, widely defined, includes education, insurance and other institutions. Similarly, they should also be actively engaged in road building and other aspects of developing the economic infrastructure, as well as nurturing various basic industries, such as components industries.

The functions and operations of local banks must be strengthened in order to achieve these objectives. First of all, local banks must maximize the mobilization of domestic funds. Secondly, local banks must provide financial services for investments in education and for development of broadly-defined social infrastructure. Financial services must also be provided to local small- and medium-sized businesses which constitute the foundation of domestic industries. If the local financial sector fails to properly address these challenges, foreign investment will stagnate, as will the process of economic development.

a) Reorganization of Local Banks

Since the Asian crisis, local banking sectors have been undergoing a process of consolidation through mergers and integration. While it is hoped that this process will improve the management efficiency, profitability and competitiveness of local banks, no conspicuous improvements have thus far been observed in most countries. The following factors contribute to a situation in which banks are unable to pursue autonomous and efficient management strategies. (A) Reorganization has often involved coercive mergers with small-scale banks with very poor management efficiency. (B) Given the large size of non-performing loans that remain, banks have been unable to undertake sufficient levels of investment. (C) In certain countries, the government continues to interfere in bank management. (D) Banks are expected to play a social role under certain social conventions which remain unchanged.

b) Foreign Banks and Local Banks

The entry of foreign banks has added to the difficulty of the business environment facing local banks since the Asian crisis when many countries significantly relaxed their restrictions on the entry and local activities of foreign banks. The entry of European and American banks has been particularly conspicuous during this period. With the exception of Malaysia, all countries affected by the Asian crisis have used foreign banks in the disposal of failed financial institutions. Under these conditions, foreign banks have entered the retail market by acquiring local banks and their branch networks. This has significantly raised the level of competition with local banks for winning customers.

In addition to serving as a source of funds, foreign banks also play an important role in raising the standards of corporate behavior by providing resources for management know-how, technologies and governance. Through management team replacements, local banks acquired by foreign banks are accelerating the disposal of non-performing loans and re-directing themselves toward profit-oriented strategies. By competing with foreign banks for higher-quality corporate borrowers, it is hoped that local banks will find a strong incentive to shift towards corporate management that emphasize profitability and efficiency.

However, under current conditions, the full-fledged entry of European and American banks into domestic markets has narrowed the range of business activities available to local banks in many countries. It has been pointed out that, as a result, local banks have chosen to concentrate on small-lot and consumer financing and have actually reduced their overall corporate lending positions.

⑥ Strengthening the Monitoring Functions of Local Banks

a) Importance of Monitoring Functions

Local banks have certain advantages over foreign banks in such areas as the absorption of domestic funds, the provision of domestic settlement systems and providing financing to local companies. These advantages are derived from their access to extensive branch networks and to an established domestic customer base. Local banks have been extensively reorganized and consolidated in the course of the financial reforms which followed the Asian crisis. Equity capitalization has also been boosted in this process. In particular, the core banks have taken steps towards ferreting out the unprofitable portions of their branch networks and customer bases. These activities will be effective in contributing to improving the absorption of domestic funds and to strengthening domestic settlement systems.

However, as mentioned above, the credit-extending function of local banks has not recovered to adequate levels. To truly revitalize local banks, it is necessary for such banks to expand their lending to local companies by making use of the advantage that they enjoy over foreign banks in terms of access to local corporate information. An essential requirement in achieving this objective is to improve the monitoring capacity (including credit-evaluation capacity) of banks. Success in this area will bolster the information-gathering ability of local banks, which in turn will allow local banks to contribute to economic development by undertaking certain supplementary functions which foreign banks cannot provide. Progress in this direction requires the following improvements.

b) Measures for Strengthening Monitoring Functions

First of all, local banks must be allowed to pursue autonomous and efficient operations. As mentioned earlier, Asian banks have traditionally had very low incentive to monitor their corporate borrowers for two specific reasons: the explicit and implicit demands and guarantees of the government, and their status as "institutionalized banks" in corporate groups. These problems have obstructed the proper development of the risk-management and credit-evaluation capabilities of banks and have left their internal control systems in an underdeveloped stage. Therefore, any effort to strengthen the monitoring functions of banks must contain measures for separating local banks from government development policies and for freeing the banks from their status of captivity in corporate groups. These constitute essential measures for upgrading the governance and facilitating the autonomous management of banks.

Secondly, banks face a serious shortage in human resources, and measures must be taken to rectify this need. In order to survive market competition and to establish autonomous management, banks must be able to undertake comprehensive risk management of their assets and liabilities. The problem is that experts with the requisite skills are not available to local banks. Current efforts generally go no further than monitoring individual liquidity indicators. To overcome this problem, it is desirable to further step up technical assistance in this area from the IMF, World Bank and Asia Development Bank, as well as bilateral assistance.

Thirdly, there is a need to improve the corporate-group oriented management structure which continues to be very powerful in Asian countries, and to thereby inject the corporate sector with greater transparency. Problems specific to corporate-group orientation include the following. (A) Because banks are made into “institutionalized banks,” adequate monitoring is not performed, and therefore financing controls do not function properly. (B) Corporate organizational structures are such that internal lending quickly elevates leverage ratios. (C) Auditing functions are rendered difficult by extremely complex internal structures featuring cross-capitalization and cross-guaranteeing of liabilities. To remove such obstacles, corporate groups must also act to improve corporate governance and to upgrade the standards of disclosure.

Fourthly, measures (such as wider application of accounting standards) must be implemented to achieve greater transparency in the management of small- and medium-sized and individually-owned businesses which account for the great majority of local companies. Generally speaking, strategic complementarities come into play in the propagation of any economic system. Hence, a newly introduced system is unlikely to generate its own momentum until it has reached a certain level of penetration. Reaching this critical level of penetration involves certain costs. These costs should be borne by the

banks and their corporate borrowers, as well as through policy measures. Policy support should be given to small- and medium-sized and individually-owned businesses to achieve greater transparency in management. At the same time, it is desirable to take steps to strengthen centralized credit information agencies and to develop frameworks for the pooling and joint use of corporate credit information available to individual banks.

## (2) Improving Long-Term Funding Mechanisms

### ① Limited Availability of Long-Term Credit

Asian countries have access to large pools of domestic savings. If properly utilized, these savings can finance the necessary investments for achieving high economic growth rates. Thus, it has been argued that most countries of the region do not need to become excessively dependent on foreign funds since enough domestic savings are available to sustain a high level of development. It is quite true that with the exception of some countries, such as the Philippines, GDP ratios of domestic savings are at very high levels exceeding 30%. Similarly, there is no doubt that in comparison to the developing countries of other regions of the world, Asian countries boast very high ratios of principal financial assets to GDP.

Notwithstanding their very high savings ratios, the ability of Asian countries to maintain adequate domestic supplies of long—term credit is widely held in doubt. When income levels throughout Asia rose rapidly during the 1990s, domestic financial assets accumulated quickly and the supply volume of domestic funds also increased. However, this had no significant impact on the ratio of long-term funds in the total supply of domestic funds. Consequently, this ratio has remained at relatively low levels.

It has been argued that the limited volume of long-term credit available in Asian countries has generated various obstacles and has generally exerted a negative influence on the region's economies. For instance, some subscribe to the view that this tendency has hampered domestic investment, particularly domestic investment in plant and equipment. Given the long gestation period required in plant and equipment investment and technology development investment, the idea here is that the shortage of long-term credit suppresses these types of investment. Others have argued that the inability of domestic financial systems to provide adequate volumes of long-term credit encouraged a high level of dependence on foreign funds, and that this was one of the background factors contributing to the Asian crisis. In other words, Asian countries had all the domestic savings they needed to maintain high investment ratios, and the heightened dependence on foreign funds reflected the excess level of domestic investment that was going on.

These views provide certain insights into what Asian countries must do to achieve sustained economic development while avoiding the recurrence of currency and financial crises. Specifically, it is essential for the financial intermediating functions of the domestic financial system to be improved; in particular, the ability to supply long-term credit must be developed. The development of the domestic bond market provides one possible route to the procurement of long-term corporate credit. But it will take a considerable amount of time for results to emerge. For the immediate future, parallel to the development of domestic bond markets, it will be necessary to consider viable measures for building up the supply of long-term credit in Asian countries. (For example, the establishment of specialized financial institutions or the procurement of long-term credit from overseas sources.)

### ② Improving the Capacity to Supply Long-Term Credit

Various reasons can be given for why Asian financial systems have difficulty in providing long-term credit. One of the possible reasons is that since the second half of the 1980s when Asia moved towards policies of financial liberalization, these countries implemented significant changes in their policies for development finance. In the traditional approach, the domestic financial system was mobilized to support domestic companies which would lead the process of industrialization. This was transformed into a system in which foreign companies were extensively used to pull the economy up to increasingly more sophisticated levels of industrial structure. Because both foreign companies and major domestic corporations enjoyed close ties with overseas financial markets and foreign banks, it was possible for them to procure long-term credit and funds for plant and equipment investment from these sources and through these routes. Consequently, it is argued, the need to internally generate long-term financing for industrialization receded.

In the Japanese and Korean experiences, it is said that policy-oriented financing played a notable role in promoting the development of industries and companies. This is probably because in the pre-globalization development paradigm, governments needed to play a vital coordinating role in order to reduce investment risks and to improve the generation of information. Developing countries today find themselves in a completely different situation where success is often determined by how effectively a country can utilize the forces and realities of globalization. The market mechanism functions as the source of the dynamism of globalization. In turn, the market mechanism is driven by profit-seeking economic activities undertaken on a global scale. This is why it is essential for developing countries to adopt market mechanisms. Developing countries must eliminate distortions in their financial markets and create an environment in which foreign companies, foreign capital, foreign technologies and foreign markets can be readily and effectively utilized. This is what developing countries must do first and foremost to achieve economic development.

While it is understood that domestic capacity to supply long-term credit must be developed, the path to the procurement of investment funds must be based strictly on market mechanisms. In this context, what is important is to eliminate obstacles and to thereby strengthen market mechanisms. Therefore, artificial methods and approaches to procuring domestic long-term credit and supplying funds for plant and equipment investment should be avoided insofar as such methods and approaches will distort market mechanisms.

Conversely, the pre-crisis situation in which exchange regimes effectively pegged to the dollar encouraged the procurement of dollar-denominated foreign funds for financing plant and equipment investment must be avoided. Fixed exchange rates led the markets to erroneously underestimate exchange risks. Consequently, funds for plant and equipment investments, which should have been financed from domestic sources, came to be procured from foreign sources. The distortion of market signals effectively weakened the incentive to procure funds domestically and may have thereby stunted the development of the domestic capacity to supply long-term credit.

③ Improving the Capacity of Banks to Supply Long-Term Credit

The banking sector stands at the core of the financial systems of Asian countries. This implies that improving the capacity of banks to supply long-term credit is central to improving overall domestic capacity for supplying long-term credit. First of all, to be able to supply long-term credit, it is essential to create viable links between long-term savings and demand for long-term funds. In turn, this requires the development of an environment in which banks are able to attract time deposits and other forms of long-term funds. The achievement of such an environment is predicated on steady efforts in the following areas: maintenance of stable

macroeconomic conditions that will contribute to a stable economic environment, which in turn will generate demand for time deposits; and, regaining public confidence in banks by reinstating sound bank management.

Secondly, the maturity formation capacity of banks must be improved by upgrading their total risk management capabilities. In the globalized economy, liquidity risk is not the only form of risk which banks must cope with. Rather, they must take into full consideration a diverse scope of risks which include credit risks, interest-rate risks, market risks and exchange risks. Given this fact, the improvement of maturity formation capacity cannot depend solely on improved management of liquidity risks. What banks need to do is to develop total risk management capacity which extends to other types of risks and to all aspects of operation. It is reported that banks' risk management has been improved through the reforms implemented since the Asian crisis. However, the problem is that the level of risk management has yet to exceed the basic stage of individual risk control. Consequently, considerable room remains for future improvement.

Thirdly, to develop the capacity to supply long-term credit, banks must boost their capitalization and heighten their capacity to accept the risks involved in maturity formation. It has been pointed out that in the developed countries, banks have heightened their capacity to cope with risks by effectively expanding their capital base through mergers and integration. Since the Asian crisis, considerable progress has been made in the reorganization of Asia's banking sectors through integration. However, further progress must be made in raising capitalization levels in order to improve the capacity of banks to supply long-term credit.

Fourthly, syndicated loans and project financing should be more extensively used as a means to reducing the risk burden of banks. Because these methods are closely linked to market-based indirect finance, they can also be expected to function as effective bridges to these types of services.

Fifthly, raising the level of market participation by foreign banks can function as an effective means to boosting the supply of long-term credit based on domestic funds. Foreign banks are able to accept higher levels of risk and are also capable of providing the long-term credit that is needed for plant and equipment investment. However, in the past, foreign banks faced various barriers to market participation. Limited access to branch networks has functioned as a particularly serious constraint curtailing the ability of foreign banks to access domestic funds. Restrictions on foreign banks have been generally alleviated in post-crisis Asia, and the acquisition of local banks has allowed foreign banks to effectively improve their access to domestic funds. In the future, it is hoped that foreign banks will utilize these funds to provide long-term credit.

④ Use of Securitization

While banks constitute the core of Asia's financial systems, there are clear limits to how far these countries can rely on banks as suppliers of long-term credit. One of the key functions of banks is to maintain the safety and reliability of its settlement function. For this purpose, banks are subject to strict regulations and requirements designed to preserves sound bank management, such as capital adequacy requirements. This implies that for companies capable of procuring funds directly from investors, the intermediation of banks in the supply of long-term credit frequently involves some additional costs. To increase the supply of long-term credit, it is absolutely necessary to develop and strengthen the systems for direct access to long-term credit whereby companies are able to issue bonds and procure funds directly from investors.

However, there are certain obstacles to this approach in Asia's bank-centered financial systems. Specifically, it is very difficult to reliably rate issuers based on disclosed information. Institutional investors who are suppliers of long-term credit cannot be expected to fair any better in this respect. Hence, at the initial stages, it will be important to utilize the credit-evaluation function of banks to generate information on borrowers.

The following approaches can be taken in utilizing the information-generating function of banks. (A) Bonds backed by bank guarantees can be sold to institutional investors. However, other approaches may be better from the perspective of risk diversification. (B) Loan participation can be an effective method, whereby banks initially extend loans to borrowers based on their own credit evaluation and thereafter transfer the original loans to institutional investors. (C) The use of loan re-sale markets can be a viable option, whereby original loans are sold in a financial-institutions market whose participants include banks, securities companies, insurance companies and others. Given the difficulty in handling corporate loan assets, a more realistic approach would be to start with the securitization of housing mortgages which are relatively easier to handle.

⑤ Development of the Systemic Infrastructure

The expansion of long-term credit requires the development of systemic infrastructure and the training of experts. Of particular importance is the ability to undertake a complex series of risk-disposal operations involving securitization, loan syndication and project finance in order to reduce the burden of risk while supplying funds. Therefore, it would be appropriate to gradually add new methods for the supply of long-term credit in line with the various stages in the development of systemic infrastructure as follows: increasing the supply of long-term credit by banks; introduction of new risk-sharing methods by banks; collaborative development of long-term credit by banks and various groups of institutional investors, including life insurance companies, pension funds and investment trusts; and, involvement of other investors in the expansion of long-term credit.

(3) Improving Financing for Small- and Medium-Sized Businesses

① Importance of Small- and Medium-Sized Businesses

Throughout all Asian countries, small- and medium-sized businesses account for a high share of the corporate population as well as total employment. As such, they have an extremely important role to play in these economies and societies. Moreover, included in the small- and medium-sized businesses are numerous promising enterprises that can be expected to achieve rapid growth in the future. Hence, the sound development of this sector constitutes an indispensable requirement in economic development. While the agricultural sector continues to play a key role in Asian countries, the following discussion will focus primarily on the small- and medium-sized businesses in the manufacturing sector.

Globalization has delivered capital and management resources to newly industrializing economies and promoted their economic growth. However, in order for a country to effectively utilize the benefits of globalization, it must develop its investment environment in the broadest sense of the term. Obviously, the development of social capital and economic infrastructure are essential requirements. Similarly, there is a very strong need to develop

components industries and other basic industries. Small- and medium-sized businesses have a highly significant role to play in these processes.

② Problems of Financing for Small- and Medium-Sized Businesses

In reality, there are numerous problems and obstacles to the growth of small- and medium-sized businesses. Key challenges include access to human resources, low technological levels and difficulty of access to information. An equally crucial problem relates to difficulties in fund procurement. Generally speaking, because of inadequate levels of disclosure, the management and use of funds by small- and medium-sized businesses lack transparency. From the perspective of fund suppliers, this creates a marked asymmetry in information. The situation is further complicated by inadequacy of collateral due to small asset scale. Under these conditions, it is basically impossible for small- and medium-sized businesses to directly procure from the market funds without the intermediation of banks. This limits the scope of available options for financing to the following: dependence on friends and relatives with ready access to internal information; dependence on informal financing; and, dependence on borrowing from banks with access to internal information through day-to-day business interaction. The problem is that these routes can only supply limited amounts of short-term financing at relatively high costs. Hence, businesses with strong future prospects and high potential profitability are unable to procure adequate external funds to finance their investment needs. It is argued that growth is frequently stymied by this limitation.

Banks are also responsible for some of the financing problems of small- and medium-sized businesses. In most Asian countries, the market environment has remained regulated for a long period of time. At times, governments guided the banks to concentrate on lending to major corporations. Moreover, because of restrictions on competition, banks were able to generate profits by simply providing short-term financing to major corporations with high credit ratings. Consequently, banks lack adequate experience in lending to small- and medium-sized businesses. It has been argued that this lack of experience has led banks to over-estimate lending risks and prompted them to adopt inefficient methods of loan recovery.

In Asia's post-crisis financial reform, foreign banks made a full-fledged entry into Asian countries and prudential regulations were reinforced. It has been argued that these developments are undermining bank financing for small- and medium-sized businesses. The European and American banks that have been gaining market share maintain a cautious stance on lending to small- and medium-sized businesses because of their limited capacity to gather information on local companies. On the other hand, the operational scope of local banks is being hemmed in and they are being forced to adopt a more passive stance. As a result, they are scaling down their lending to small- and medium-sized businesses, primarily because of difficulties in risk management. Reportedly, they are instead beginning to shift towards small-lot consumer financing activities. It is quite likely that these developments will have a negative impact on financing for small- and medium-sized businesses.

③ Expanding Financing Facilities for Small- and Medium-Sized Businesses

In undertaking to expand financing facilities for small- and medium-sized businesses, it is important to separate such initiatives from the objectives of social policy and to focus on economic rationality. The majority of small- and medium-sized businesses have inferior technological capabilities, poor profitability and poor future prospects. Increasing the supply of funds to such businesses may be important from the perspective of social policy, but such a course of action certainly lacks economic rationality. In this connection, lending should not be

restricted to domestic small- and medium-sized businesses. Rather, it is appropriate to remove all forms of discrimination and to be prepared to finance any promising business, whether it be a foreign entity or a joint-venture between foreign and domestic companies.

To expand financing, small- and medium-sized businesses must first of all achieve greater transparency. Technical guidance and support must be bolstered for this purpose. At the same time, banks must improve their screening and monitoring functions, upgrade risk management capabilities and reinforce their ability to cope with higher risk burdens. Specifically, the following actions must be taken. (A) Banks must bolster their capital base to be able to finance their own modernization investments. This should be done through continued integration and reorganization of the banking sector to achieve larger scales of operation and capitalization. (B) Active efforts must be made to acquire necessary new skills.

The following systemic improvements should prove to be effective: (a) development and strengthening of loan-guarantee systems; (b) development and strengthening of credit information agencies; (c) training of experts for improved transparency of small- and medium-sized businesses (including small- and medium-sized enterprise management consultants, accountants, tax accountants and lawyers); (d) strengthening the information provision functions of chambers of commerce and industry to small- and medium-sized businesses. The creation of specialized financial institutions to provide ample policy financing for small- and medium-sized businesses has been strongly advocated. The advantages and disadvantages of this course of action need to be examined in light of the experiences of various countries.

④ Nurturing Venture Capital

It is generally believed that banks enjoy an advantage over securities markets in generating information on small- and medium-sized businesses. However, venture capital may function as a more effective source of financing than banks when a project involves new technologies or new business model whose profitability cannot be readily ascertained and projected. Therefore, banks are not necessarily an appropriate source of funding for small- and medium-sized businesses in Korea and Taiwan where such enterprises are engaged in developing new businesses based on state-of-the-art technologies. The nurturing of venture capital constitutes an effective response to this type of financing need, as venture capital derives its effectiveness from the combination of two factors: gathering information through close contact with start-ups, and the ability to utilize the advantages of the securities markets. In developing venture capital resources, laws will be needed to promote the flow of funds required for the establishment of venture capital. Given that venture capital assumes long-term investment positions, start-ups need to maintain high standards of corporate governance. Hence, not only will the development of venture capital provide an effective means of delivering financial support to small- and medium-sized businesses, but it is important to realize that this will also contribute to the achievement of sound management in small- and medium-sized businesses.

(4) Developing Transparent and Fair Capital Markets

The Asian crisis clearly showed that architectural problems contributed to the vulnerability of financial systems by serving to concentrate excessive risks in the banking sector and by allowing stock markets to expand before the necessary market infrastructure was in place. For developing countries with sufficiently high savings ratios, the following lessons can be gained from these experiences. (1) Preventive action should be taken to restrain excessive investment financed by the inflow of foreign capital. Hence, as a rule, large current account deficits should

be avoided. Also, the current account must not be allowed to remain continuously in the red. (2) When foreign funds are flowing in through banks and quasi-bank financial companies, measures must be taken to prevent mismatching in the denomination and maturities of the domestic use of these funds. (3) Companies with outstanding fund-procurement capabilities in overseas markets (such as the Korean chaebols) are able to procure large enough amounts of capital from foreign sources that these may become the cause of corporate failure. Therefore, such companies should be required to keep their foreign exchange risks within a certain limit, as is required of banks. These three rules constitute the basic prescription for preventing currency and financial crises in developing countries with high growth potential and high domestic savings ratios. In light of these lessons, the central challenge of financial markets in post-crisis Asia boils down to two points: to strengthen the functions of the banking sector, and to find a way to promote the development of capital markets.

The key factors to the development of Asia's capital markets can be summarized in the following two points. Firstly, to improve the efficiency of their financial systems, it is important for Asian countries to examine the diverse possibilities of complementarity between the financial system and the banking sector, while taking into account the diversity in the developmental stages and financial structures of their financial systems. Secondly, given the growth in Asia's intra-regional investment and the globalization of capital markets, these countries must consider how to create transparent and fair markets in order to win the confidence of overseas investors.

① Efficiency and Fairness of Capital Markets

a) Conditions for Capital Market Efficiency

Capital markets provide means for the allocation of long-term funds based on the price mechanism. Their fundamental function is to appropriately price the risks and returns on long-term funds, and to facilitate the transfer of risks and maturities. The efficiency of capital markets is gauged by how successfully these functions are performed and depends on the following conditions. The first condition concerns the market participants and poses the following two questions: Who are the sources of demand for risk capital? As suppliers of these funds, what level of risk burden are investors willing and capable of accepting? The second condition concerns the diversity of products available for trading which is critical in providing depth and breadth to the market. The third condition relates to the maturity of market intermediaries, such as investment banks, securities companies and providers of asset-management services, who are engaged in evaluating and transferring risks. Specifically, it is necessary to have a considerable number of intermediaries actively engaged in competition so that the cost of transaction services, such as for underwriting and trading, is competitively determined and adequately low. The fourth condition concerns the development of a viable market environment in which market mechanisms can function properly. This is an essential condition for reducing the disparities in information available to market participants and for effectively reducing transaction costs, and is to be realized through improvements in corporate disclosure, accounting systems, transaction systems and settlement systems.

b) Fairness in Capital Markets

Fairness constitutes the bedrock for confidence in capital markets and consists of the following five elements. The first element is transparency in price formation. This not only depends on the proper functioning of disclosure and accounting systems, but also requires internal corporate governance and transparency in external evaluation and rating systems.

In this context, careful attention must be paid to the argument that the most fundamental and important requirement is for companies to comply with anti-monopoly laws. The second element is transparency in the transaction process. This relates to transaction rules and penalties under securities trading laws and the internal discipline of market intermediaries. The third element concerns equal opportunity for market participation (ex-ante fairness). This relates to the protection of investors from elimination due to disparities in access to information, including regulations on insider information and manipulation of information, and the development of conditions conducive to market entry. The fourth element is clarity in procedures for dispute settlement and the disposal of failed companies (ex-post fairness). This relates to the establishment of clear market exit rules and the enactment of laws to protect market participants from unfair ex-post treatment. The fifth element is transparency in government intervention in the markets. Intervention based on rules and explanations which market participants find convincing contributes to improved market transparency and fairness, and is a prerequisite for the efficient functioning of the market.

c) Economic Development Stages and Capital Market Design

In the past, opportunities to procure funds from the capital markets of Asian countries were restricted to public agencies and a limited group of companies. At the same time, the population of domestic investors was small, so that the role played by public agencies and foreign investors was by no means negligible. During the ten years preceding the Asian crisis, the Asian stock markets grew rapidly as trading volume increased. But the growth in public offerings was primarily dependent on government policies aimed at promoting new listings. As a result, the asset-management industry failed to develop properly. The market environments in these countries generally progressed towards automated transaction systems in stock exchanges, and computerization and paper-less processing of back-office functions. However, disparities in access to information by market participants persisted as a result of inadequate disclosure systems and ambiguous accounting standards. Had these systems operated properly, markets and shareholders could have contributed to effective corporate governance. These problems are believed to have undermined efficient fund allocation. It is argued that these problems also undermined fairness in the markets from the perspective of transparency in price formation and transaction processing, and equal opportunity among market participants. In many countries, government intervention during privatization of public corporations and problems related to rules for the disposal of bankrupt companies and dispute settlement have undermined the development of confidence in the markets.

Needless to say, the above conditions must be satisfied to ensure that capital markets function properly. Given that even in Japan these conditions have yet to be fully met, most Asian countries will require considerable time to correct the present shortcomings. While the banking sector will have to continue to play a central role in the financial systems of Asian countries, upon reaching a certain point in financial development, the growth of capital markets becomes indispensable to the effective utilization of domestic and foreign funds as a tool for the allocation of risks. In the Asian crisis the introduction and utilization of capital market functions were not properly synchronized with developmental progress. Consequently, financial systems became increasingly vulnerable through over-dependence on banks and the concentration of risks in banks.

Hence, the key issue is how to bring the capital markets into play. The degree to which a country can satisfy the above conditions for supporting capital market functions will depend on the country's current stage of economic development and its financial structures.

Various problems can be identified when examining differences in capital market formats from the perspective of market organization. First of all, market environments have not been properly developed to mobilize individual investors. Even in cases involving the financing of high-risk companies or projects, the presence of mature market intermediaries would create possibilities for the efficient transfer of long-term funds and risk allocation. For instance, limited groups of wealthy individual investors and institutional investors can be mobilized to create efficient private equity markets for the private placement of securities and investment in unlisted companies. Another possibility is to use sophisticated financial tools, such as derivatives and securitization, in markets for experts.

Credit evaluation by banks can effectively reduce the information gap between issuers and lenders concerning credit risk. Therefore, major corporations which have attained a certain level of acceptance in the financial system through their transactions with banks can procure funds from general investors through the bond markets. Even when investors do not have adequate access to credit risk information, companies can still become bond issuers if backed up by ratings or credit guarantees. On the other hand, stock markets must function as a mechanism for the sharing of business risks through the participation of large numbers of investors with a diverse range of risk-bearing capabilities. Because these investor decisions must be based on disclosed information on corporate activities, there is a very strong need in stock markets for the development of proper market conditions and the attainment of market transparency and fairness.

What procedures should be followed in establishing these different forms of capital markets, and how should these markets be combined? These are questions that must be considered in light of each country's developmental stage and purpose of establishing such markets. Then there is a further series of questions: Should the focus be on nurturing a broad population of domestic investors, or should emphasis be placed on mobilizing foreign investors? Should these countries turn to foreign entities to act as market intermediaries, or should issuers select overseas markets for listing of shares and floating of bonds? These are all options that must be examined from the perspective of creating capital markets and upgrading their functional performances.

② Capital Market Challenges in the Post-Crisis

Asian bond markets remained underdeveloped in the pre-crisis, with the exception of Singapore and Malaysia. In this environment, policies for promoting the development of capital markets featured the introduction of stock markets into financial systems centered on banks. The following measures were also implemented as part of this initiative: public listing of shares was encouraged to diversify the range of available products; overseas investors were brought in to broaden the scope of market participants; and, the doors were opened to foreign institutions in the hope that these would function as market intermediaries. Asian stock markets enjoyed strong quantitative expansion thanks to the accelerated pace of economic growth. However, necessary improvements in the market environment could not keep up with this growth to ensure proper fairness and transparency. Given the systemic weaknesses and lack of depth of domestic stock markets, an increasing number of Asian companies opted for listing in foreign markets and sought to receive overseas ratings as a means of gaining the confidence of foreign investors.

It has been pointed out that the inflow of foreign funds added to the volatility of Asian stock markets. On the other hand, empirical research provides evidence that foreign investors are more keenly interested in corporate governance than their domestic counterparts and that they

have contributed to upgrading the monitoring of corporate activities. It has also been argued that parallel listing in foreign stock markets and receiving of ratings from foreign organizations have contributed to the development of capital-market infrastructures in Asian countries by supplementing the inadequacy of information available in domestic markets and by promoting inter-market competition.

In order to clear away the aftermath of the Asian crisis, prevent a recurrence of the crisis and to mobilize domestic funds and attract overseas investment to support future development, Asian countries must follow a course of action which addresses the following two requirements: review of past and current policies for promoting the development of capital markets which have been unduly biased towards the development of stock markets; and, reinforce the foundations of capital markets in order to establish higher confidence in the markets. In the pursuit of these objectives, Asian countries will have to resolve a series of dilemmas and contradictions. The challenges facing the Asian capital markets can be summarized as follows.

a) Development of Government Bond Markets

In the post-crisis government bond markets were extremely small in most countries and secondary markets were barely functional. In countries affected by the Asian crisis, massive volumes of government bonds were issued to provide the banking sector with capital infusions and to purchase non-performing loans. Most of these bonds were purchased by financial institutions, public agencies and organizations. In Malaysia, most of the bonds issued to finance capital infusions and the disposal of non-performing loans were allotted to financial institutions, pension funds and others. In Indonesia, the bonds were allotted to pension funds. It is argued that these policies of holding on to bonds have distorted the financial systems of these countries.

Looking to the future of Asia's government-bond markets, issuance of government bonds can be expected to increase for the following reasons and purposes: (a) to ensure soundness in financial systems; (b) to finance fiscal outlays for buffering the post-crisis from economic downturns; (c) to cover losses realized from the liquidation of non-performing loans; (d) to finance bond redemptions and cover fiscal deficits. There are obvious problems of depending solely on the banking sector and institutional investors to absorb massive volumes of government bonds. This approach is at odds with the restructuring needs of the banking sector; it obstructs the development of an asset-management industry; and, price formation external to the market mechanism will have a negative impact on the growth of corporate bond markets. The history of the development of capital markets in the advanced countries points to the critical importance of government-bond markets with proper depth and breadth in setting a benchmark for gauging the risk of bonds in general and thereby providing a sound foundation for corporate-bond markets. The development and improvement of government bond markets constitutes an urgent challenge for clearing away the aftermath of the Asian crisis, as well as for establishing sound capital markets.

b) Strengthening the Function of Corporate Bond Markets and the Role of Banks

To avoid excessive dependence on banks and to promote the stable transfer of long-term funds, it is necessary to promote the development of corporate bond markets which are highly substitutable for bank borrowings and to use these markets to promote bond ownership by a large population of general investors. For lenders, investing in bonds has the following advantages over lending: the risks of long-term holding can be kept within the limits of credit risk; liquidity risk can be avoided by short-term exit through secondary

markets; and, the markets constantly perform a monitoring function. The major advantage to borrowers is that large volumes of long-term funds can be procured from large populations of small bond purchasers.

As previously mentioned, bond issuance is an advantageous method of fund procurement for major corporations with established credit standings. It is also possible to take the view that banks which are able to properly evaluate issuers as a result of long-term transactions can close the information gap between borrowers and lenders by acting as underwriters, investors and providers of credit guarantee services when an issue is being floated. In this scenario, banks would be able to facilitate the development of smooth functioning of the bond markets by rendering a larger number of companies eligible as issuers.

In this context, we should keep in mind that discussion of banks performing complementary functions to capital markets and participation of banks in the issuance of securities by their customers must be clearly separated. Bank activities with a linkage to capital markets fall under three categories. The first involves the sale of securities by banks to their customers. This serves to diversity the available sales channels for risk assets and to extend the range of investors in general. The second involves using credit-risk information accumulated through indirect financing to perform the role of information intermediation; in other words, acting as an investment bank and underwriter and provider of credit guarantee services. The third category positions banks as users of the market; in other words, as investors and issuers.

It has been argued that throughout Asia intimate and unhealthy relations between banks and their customer companies have resulted in opaque financial transactions and undermined corporate governance. The traditional banking operations of deposit acceptance and lending are based on private information generated through business transactions. Conversely, capital-market related operations are based on publicly disclosed information. Certain problems may arise when underwriting of corporate bonds, credit guarantee services and activities related to investment by the banks themselves are conducted in parallel in their normal internal organizations. Specifically, price formation may not only become less transparent, it will even widen the information gap in the market and may undermine the best interests of general investors. Similar problems also arise when a bank directly markets the following products to its customers: bonds backed by the bank's own guarantees, bonds underwritten by the bank, and bonds issued by the bank.

Banks can contribute to the development and expansion of capital markets by restraining their lending activities while providing guarantees to corporate bond issues, and by underwriting entire issues and selling these to investors through the markets. This approach is also desirable in that the transfer of credit risks through the market reduces the concentration of risks in banks. However, this approach may give rise to some dangers if the necessary capital-market conditions have not been met. Specifically, the combining of underwriting and credit-guarantee functions may result in the sale of high-risk securities to investors; or, if banks purchase the corporate bonds issued by their own customers, this may lead to excessive dependence on banks, and may raise the risk burden on banks while rendering the credit risk of borrowers ambiguous. In other words, the policy authorities must be fully aware of the possibility that excessive dependence on banks can generate moral hazards and can create distortions in the function of capital markets.

Can banks contribute to the development of the Asian capital markets? The answer depends on how effectively internal information accumulated in banks can be transformed into disclosed information. When banks undertake capital-market related activities in internal

organizations, it is necessary to erect firewalls between these activities and traditional banking activities of deposit acceptance and lending, as well as among these capital-market related activities. The critical problem here is that the erection of proper barriers is both more important and more difficult to achieve in Asian countries than it is in the developed countries. A related problem arises when banks or their affiliates are utilizing their internally accumulated information to function as market intermediaries. In this case, it is necessary to have rating agencies and other independent information-generating organizations to act as a countervailing force to the banks.

c) Role of Investment Banks

Investment banks have an important role to play as market intermediaries from the perspective of promoting the development of capital markets in line with the stages of economic development and financial structure. Investment banks are market intermediaries who function as underwriters of bonds and stocks, and also act as financial advisers to major investors and companies. In this capacity, investment banks function as information intermediaries linking issuers and investors in the capital markets. The salient feature of investment banks functioning as information intermediaries is that they increase the transparency of corporate activities and improve the efficiency of markets by lowering the information costs and risk-burden costs of investors through the development of sophisticated assessments of corporate and asset values. They also play a coordinating role in market-making by keeping a close eye on both fund procurement and investment demand.

As market intermediaries, investment banks are called on to develop responses to the following series of questions. Should funds be procured through an issue of stocks or bonds? What type of investor should be targeted in the issuance plan? Should the focus be on general investors or institutional investors? Or, should private equity markets be created around a small group of investors? Investment banks should be able to play a vital role in identifying a diverse range of investors in Asia and in promoting the development of capital markets. Instead of asking whether to focus on the stock market or bond market, it is more important to view the capital markets as multi-tiered entities. In this context, investment banks can make a vital contribution to the development of capital markets by locating demand for funds and linking this demand to potential investors.

Local banks are also expected to use their accumulated corporate information to enter the investment banking business and to play a certain role in this field. However, because investment banking requires highly sophisticated technologies and know-how, it will be necessary to make use of foreign investment banks to launch new capital markets. It would be more realistic for local banks to make their entry into this sector through joint ventures with foreign investment banks.

d) Role of Institutional Investors

Institutional investors, such as investment trusts, pension funds and life insurance companies, play a key role in strengthening and expanding the functions of capital markets. They function as long-term investors who represent individual investors through various types of collective investment schemes which provide certain advantages in the following areas: matching of maturities and risks between the demand and supply for funds; risk diversification by exploiting the benefits of scale; promoting the indirect market participation of individual investors and acclimating them to risk investment. The asset-management services provided by these institutional investors are indispensable in

bringing in individual investors and thereby creating broader markets. Furthermore, as recently seen in the developed countries, institutional investors have made certain contributions to the improvement of corporate governance through their position as major shareholders and bond holders.

Among Asian countries, large-scale institutional investors already exist in Malaysia and Singapore, and they are claiming an increasing share of the securities investments in these markets. The problem is that major institutional investors are backed by the government. Consequently, they have not necessarily performed their expected functions in terms of independent management of assets and the promotion of corporate governance. If institutional investors are to fulfill the functions expected of them, it will be necessary to promote the development of a private-sector asset-management industry.

e) Role of Foreign Investors and Foreign Institutions and Cross-Regional Listing

For developing countries lacking large and diverse populations of investors, the presence of foreign investors can be a two-edged sword: while contributing to the vitality of markets, foreign investors can also augment market instability. However, empirical studies indicate that, in the case of both Japanese and Asian companies, standards of corporate governance tend to improve as the ratio of foreign ownership rises. In order to attract foreign investments, Asian companies are beginning to undergo audits by international auditing organizations and are raising their standards of disclosure. It is believed that such cross-border transactions are contributing to improved transparency in domestic markets. The participation of foreign investors is particularly important from the perspective of the dispersion of large-scale risks. Similarly, as long-term investors, foreign pension funds, life insurance companies and investment trusts can be expected to play a vital role in this area.

Beginning in the first half of the 1990s, Asian companies began to undertake parallel listings in their home markets and in overseas capital markets. This strategy is frequently used by companies with a strong interest in tapping outside sources of capital when their home markets are either poorly developed or too narrow. While some have feared that this cross-regional listing may lead to the hollowing-out of domestic markets, this approach can also deliver valuable advantages. For instance, it can improve the standards of disclosure and corporate governance in listed companies. Cross-regional listing can also have a complementary effect on augmenting the function of home markets and creating possibilities for the expansion of regional markets. The participation of foreign investors and foreign financial institutions should be actively promoted, as should be the use of overseas markets, as effective methods for improving the function and operations of Asian capital markets. The same approach should be applied to problems pertaining to the standardization of transaction systems, accounting standards and settlement systems.

## 4. Appropriate Foreign Exchange Regimes and Capital Flow Controls

### (1) Foreign Exchange Regimes

#### ① Foreign Exchange Regimes and Capital Flow Controls

While one of the key contributing factors to the Asian crisis was the excessive expansion of domestic demand in the countries affected by the crisis, other important lessons were also gained concerning foreign exchange regimes and the control of capital flows. Regarding foreign exchange regimes, countries which had effectively pegged their currencies to the dollar experienced a steady appreciation in their real-effective exchange rates after 1995 when the value of the dollar began to climb. In addition to weakening the export competitiveness of these countries, the pegging of exchange rates to the dollar numbed the responsiveness of both lenders and borrowers to exchange-rate risks, and thereby generated a massive influx of short-term funds. During the Asian crisis, the accelerated exit of these short-term funds added to the severity of the currency and financial crises. These lessons must be committed to memory and utilized in preventing the recurrence of currency and financial crises.

Foreign exchange regimes and the capital flow controls must be viewed under two separate sets of objectives. Under normal economic circumstances, the principal objective is crisis prevention, while under crisis situations, the principal objectives must be crisis management and resolution. Under normal circumstances, the focus must be on three key goals: (a) management of aggregate demand to prevent prolongation of excessive current account deficits; (b) preventing the inflow of excessive overseas funds through banks and other financial institutions (this can be done through prudential regulations related to exchange risks); (c) in addition to banks, preventing major corporations from taking on excessive exchange risks which may lead to bankruptcy. For Asian countries and other developing countries with adequately high savings ratios, it is possible to maintain economic development while implementing such measures. On the other hand, in crisis situations, foreign reserves are quickly depleted as countries attempt to protect their currencies. At a certain point, it becomes impossible for countries in crisis to continue unilateral intervention in the exchange markets. This leaves them no choice but to move to floating rates. But this frequently gives rise to a vicious cycle in which depreciation undermines confidence in a currency and leads to further rounds of depreciation. Consequently, the currencies of affected countries tend to over-shoot their mark as they tumble in crisis situations. Further problems arise from the accelerated exit of funds during a crisis at which time standard regulations cease to function effectively. When, as a result, domestic financial institutions are holding large amounts of foreign-currency denominated short-term liabilities, this combination of events can trigger a liquidity crisis which may later develop into a financial crisis. Hence, under such conditions, control of capital flows emerges as a viable option for crisis management and resolution.

#### ② Freely Floating Exchange Rate Regime or Fixed Exchange Rate Regime

A two-corner solution approach is possible for identifying exchange rate regimes capable of withstanding currency crises. The conclusion drawn from this approach is that there are only two exchange rate regimes which can withstand the forces of the currency crisis: the freely floating exchange rate regime or stringently fixed exchange rate regime.

If currency crisis is defined as "a situation involving the drastic depreciation of a currency, combined with a sharp drop in foreign reserve positions resulting from efforts to protect the currency," by definition, a currency crisis cannot occur under a freely floating exchange rate

regime because the monetary authorities will not intervene in the markets and foreign reserves will not be depleted.

However, even if crises are by definition avoidable, floating rates can give rise to problems of volatility and misalignment.

Volatility refers to short-term fluctuations in foreign exchange markets. By augmenting exchange risks, volatility can have an adverse effect on trade and direct investment. Even if exchange risks can be properly hedged through forward contracts, options and other derivative transactions, the fact remains that hedging involves certain costs. Consequently, the possibility remains for trade and direct foreign investment to be obstructed by either exchange risks or by hedging costs. Empirical studies have shown that, in certain cases, exchange rate volatility has in fact had a negative impact on trade and direct foreign investment.

Misalignment refers to deviation of exchange rates from levels justified by economic fundamentals over a certain period of time. While generally discussed as a problem of fixed exchange rate regimes, misalignment can also occur under freely-floating rates. When misalignment remains uncorrected for some time, companies will begin moving their production sites based on such temporary under-valuations or over-valuations. Because these movements involve sunken costs, companies cannot easily re-locate their production sites when the misalignment is corrected and exchange rates return to levels consistent with fundamentals. Thus, misalignment can distort resource allocation through its impact on direct foreign investment and the movement of production sites.

Currency misalignments can also have a very major impact on countries with large foreign-currency denominated liabilities who also face a significant currency mismatch in their claims and liabilities. That is, when the home currency is depreciating relative to the currency in which foreign liabilities are denominated, foreign liabilities will increase while claims are shrinking. Domestic financial institutions will experience the same problem, with the possibility that balance sheets will deteriorate to ultimately show negative net worth. Thus, significant currency depreciations can cause domestic financial institutions to fail and to thereby trigger a currency and financial crisis.

The currency board regime is an example of a stringently fixed foreign exchange regime. Under a currency board regime, high-powered money is backed by the foreign reserve position. It has been argued that, theoretically, a currency board regime can avoid a currency crisis if the markets for goods and labor are flexible enough. The experience of Hong Kong, which maintains a currency board regime, is instructive. During the Asian crisis, speculators attacked Hong Kong in a double-market play which involved both its foreign exchange market and its stock market. Argentina, another currency-board country, experienced a currency crisis at the end of 2001 and was forced to abandon its currency board regime in favor of floating exchange rates. Liberalization of capital movements under a stringently fixed exchange rate regime can easily lead to the ballooning of foreign-currency denominated liabilities. During the course of any subsequent devaluations, these liabilities are prone to undergo explosive growth. Other problems of fixed exchange rates include the reduced range of responses to changes in the real economy, and difficulties in making smooth adjustments and exit.

Another series of problems related to stringently controlled fixed exchange rates pertain to the currency issuing authority and the loss of seignorage (the benefits accruing to the currency issuer). In particular, when a liquidity crisis occurs in the financial system of a country

operating under a currency board, the central bank may become unable to function as a "lender of last resort" because the issue of currency is tied to the foreign reserve position.

On the other hand, it has been argued that the loss of freedom in monetary policies under stringently fixed exchange rates may have some beneficial effects. With reduced monetary freedom, the private sector may conclude that irresponsible inflationary monetary policies are less likely to be taken. This determination would create greater confidence in monetary policies and would also help maintain confidence in the currency. Moreover, greater confidence in the currency will lower the expected rate of devaluation. This in turn would reduce the risk premium arising from exchange risk and lower the level of domestic interest rates.

③ Currency Basket Regime

Some have argued that intermediate options are more desirable than the two-corner solutions. This position is represented by J. Williamson[1] who has advocated the BBC (basket, band and crawling) rule which combines currency baskets, exchange rate bands and crawling pegs. On the other hand, in his comparison of extreme and intermediate regimes, J.A. Frankel[2] has concluded that the most desirable regime has to be determined on a case-by-case basis. The developed economies are probably able to withstand a certain level of exchange volatility and misalignment under a freely floating exchange rate regime. Regarding developing countries, it has been argued that there is no theoretical ground for concluding that stable exchange rates are preferable, or that extreme regimes are more desirable than intermediate ones.

With the exception of Hong Kong, the dollar peg and virtual dollar peg regimes adopted in the pre-crisis were not stringently fixed exchange rate regimes. However, the fact is that these regimes provided part of the reason for the currency crises of these countries. Thus, a move towards more stringently fixed exchange rates could have a major impact on the international price competitive positions of these countries, depending on trends in the value of the dollar.

Asian countries affected by the crisis have actually tended to opt for more flexible exchange rate regimes, the sole exception being Malaysia which formally pegged its currency to the dollar in September 1998. The tendency towards more flexible regimes is particularly conspicuous in the case of countries which received IMF support during the crisis. Thus, Thailand, Indonesia and Korea adopted freely floating regimes or managed floats immediately after the crisis. Given the possibilities of volatility and misalignment under flexible exchange regimes, some degree of stability is desirable. However, stability of the currency against the dollar is not what is needed. The critical requirement is to stabilize the currency against a basket of currencies representing countries with which close economic ties are maintained. In terms of trade, direct investment and international finance, Asian countries have close ties, not only with the United States, but also with Japan and Europe. Therefore, the adoption of an intermediate exchange regimes utilizing currency baskets containing the dollar, yen and euro should contribute to effectively stabilizing the Asian currencies. Looking to the future, one option would be to include China's Renminbi in such currency baskets.

The following points must be taken into consideration with regard to adopting a currency basket regime as an intermediate solution. Firstly, the details of actually managing such a regime must be carefully considered. This would include such matters as how to arrive at an

[1] Williamson, J. (2000) *Exchange Rate Regimes for Emerging Markets: Reviving the Intermediate Option,* IIE, Washington, DC.
[2] Frankel, J.A. (1999) "No single currency regime is right for all countries or at all times", NBER *Working Paper*, no.7338

optimum weighting of the basket, and whether or not to disclose the formula. Secondly, it is necessary to pay attention to maintaining confidence in the currency. For this purpose, it is important to implement appropriate monetary and macroeconomic policies, as well as to maintain a sound financial system. To a certain degree, it should be possible to avoid speculative attacks through appropriate macroeconomic policies and policy-consistent foreign exchange regimes.

④ Foreign Exchange Regimes, Macroeconomic Policies and the Financial Systems

For any given country, the most appropriate foreign exchange regime and the optimal management of that regime will depend on the status of its relations with trading partners and its own specific economic conditions. Furthermore, no matter what regime is chosen, one of the prerequisites for exchange rate stability is the availability of necessary support from appropriate macroeconomic policies and a sound financial system.

⑤ Coordination of Foreign Exchange Regimes

Many of Asian countries are once again strengthening the linkage between their currencies and the dollar. One of the reasons for this is said to be the mutual interaction and impact of their foreign exchange regimes.

First of all, it has been argued that the formal pegging of the Malaysian currency to the dollar in September 1998 has had an impact on the foreign exchange regimes of neighboring countries. For instance, it is reported that Singapore has adopted a trade-weighted currency basket regime. However, because the United States and Malaysia are leading trading partners of Singapore, and because of the high weight of the dollar-pegged Malaysian currency in Singapore's currency basket, in the final analysis, the linkage between the Singaporean currency and the dollar has been augmented by this choice.

Secondly, if a country has close trade relations with its neighbors, or if a country competes with its neighbors in exporting to Japan, the United States and Europe, its choice of foreign exchange regimes can be influenced by the choices of its neighbors. Ultimately, choices of regimes can have an impact throughout a region. For instance, when all neighboring countries have adapted a virtual peg to the dollar, individual countries may be unwilling to terminate their dollar peg regimes in the absence of regional coordination because of the fear that unilateral action may undermine their export competitiveness. In this situation, coordination will fail. Motivated by the same fear, all countries of the region will opt to maintain their virtual dollar peg regimes.

It has been argued that the value of a currency basket adopted in the absence of regional coordination (non-coordinated currency basket) will fluctuate more widely than the value of a currency basket adopted through regional coordination (coordinated currency basket). This is because the non-coordinated currency basket is more likely to be affected by the currency fluctuations of neighboring countries. This points to the need for coordination among Asian countries when adopting currency basket regimes.

An example of a regionally coordinated currency basket can be found in the European Monetary System's ERM (exchange rate mechanism) which preceded the introduction of the euro. While ERM was not a perfect system, it can serve as a point of reference for combining a common currency basket and a trading-band regime allowing a range of fluctuation around a central rate. This approach can establish a certain level of stability among regional

currencies, while also allowing the countries of the region to aim for stability against the dollar, yen and euro which comprise the basket.

What will be needed to advance toward regional coordination of exchange rate regimes? First of all, the countries of the region must develop a common awareness of the impact that neighboring currencies have on the currency of individual countries. It is also necessary to develop a common understanding of what policy objectives are being pursued by individual countries through their foreign exchange policies. It has been pointed out that attempts at policy coordination will fail if the participating countries have not reached this common awareness and understanding.

In the European case, monetary union was achieved only after a series of long processes involving, not only monetary affairs, but also trade and finance. Thus monetary union was preceded by the European customs union, regional market integration and financial system integration. Likewise, any effort made towards the regional coordination of exchange markets in Asia must adopt a long-term perspective and be pursued in tandem with broadly-based initiatives for regional cooperation, including regional financial cooperation and policy dialogue.

(2) Capital Flow Controls

① Objectives of Capital Flow Controls

Capital flows may be controlled with various objectives in mind. The first case for the control of capital flows is summarized in R.A. Mundell's trilemma. If the goals of independent financial policy, stable exchange rates and free capital movements cannot be simultaneously achieved, then free capital movements may be sacrificed in order to achieve the goals of independent financial policy and stable exchange rates.

In the second case, capital flows may be restricted to counter a massive exit of funds which threatens financial stability. Such instances may involve speculative attacks on a currency or capital flight. Similarly, capital flow may be restricted as a form of prudential regulation with the intent of preventing banks and operating companies from taking on excessive foreign exchange risks. In other words, capital flow may be controlled either to prevent or to resolve domestic financial crises.

Assuming that Asian countries will continue to maintain relatively high levels of economic growth and domestic savings, the countries of the region may opt to institute controls whose primary objective is the "prevention of the inflow of excessive funds." One of the important lessons to be learned from the Asian crisis is that capital flows should be regulated in order to prevent the continuation of large current account deficits over prolonged periods of time.

Regarding this point, prudential regulations should be effective in the "prevention of the inflow of excessive funds." It has been argued that if banks, finance companies and other quasi-bank companies had been subject to proper regulation, the massive influx of funds experienced in Thailand or Korea would have been prevented, as would have the Asian crisis that followed it. A considerable range of prudential regulations would have served this purpose, including: restrictions on foreign exchange positions as applied in the past in Japan; foreign exchange risk management as applied under the Basel Core Principles for Effective Bank Supervision; or, a somewhat more rigorous application of the Basel Core Principles in line with the current realities of developing countries.

The large-scale influx of funds through channels other than banks and finance companies cannot be ignored. As such flows would not be affected by prudential regulations, it would be worthwhile to consider the introduction of regulations specifically targeting such flows.

The third objective for the control of capital flows is somewhat similar to the case of controls instituted for the purpose of preventing and resolving financial crises and involves control aimed at preventing and resolving currency crises when a currency comes under speculative attack. While the prevention and resolution of financial crises pertains to the financial system, currency crises involve significant reductions in foreign reserve positions following efforts to protect the currency, and significant devaluation of the currency.

The fourth objective is aimed at implementing policies of financial suppression to maintain artificially low interest rate levels. Developing countries have a tendency to implement financial regulations to keep interest rates below equilibrium levels in order to achieve high economic growth. When financial regulations are in place to maintain low interest rates, any liberalization of capital flows will generate an outflow of domestic savings in search of higher interest rates abroad. In this scenario, domestic capital accumulation may be obstructed as domestic savings fail to flow into domestic investments. Capital flow controls may be implemented to prevent this situation.

② Types of Capital Flow Controls and Their Effectiveness

Two major types of capital flow controls are available: direct control through administrative action, and indirect control through the market. Direct administrative control involves such measures as prohibitions and quantitative restrictions on capital transactions, and licensing procedures. These measures are directly aimed at restricting capital transactions or payments and transfers related to such transactions. On the other hand, indirect control through the market is aimed at restraining capital movements and related transactions by raising the cost of capital transactions. Available measures include taxation of international financial transactions and the introduction of unremunerated reserve requirements.

Unremunerated reserve requirements were used in Chile between 1991 and 1998 to restrain the inflow of short-term funds. This system was also adopted by Columbia in September 1993. In the case of Chile, this approach generally received high marks, partly on account of the sound domestic macroeconomic policies which were implemented during this period. On the other hand, Columbia remained wedded to loose fiscal and monetary policies.

A similar measure was taken in Japan in 1977 as part of an emergency program for "restraining the inflow of short-term funds" aimed at preventing an accelerated appreciation of the yen. Specifically, the reserve ratio for yen deposits of non-residents was raised from 0.25% to 50%. The ratio was further raised to 100% in 1978. Notwithstanding the higher reserve requirements, demand for yen assets remained strong because of expectations of continued appreciation. The direction of the yen was reversed in 1979, and reserve requirement on the yen deposits of non-residents was gradually lowered thereafter.

In regard to capital transaction regulation, J. Tobin proposed the taxing of foreign exchange transactions. This Tobin tax consists of a flat-rate levy (generally assumed to be around 0.05%) on foreign exchange transactions and is designed to target only short-term capital transactions by effectively reducing the profitability of short-term transactions. The Tobin tax has been criticized on the following grounds. (A) The Tobin tax cannot function realistically because this levy can be avoided unless all countries adopt it. (B) The development of financial derivative products makes it possible to avoid the Tobin tax. (C) The Tobin tax

cannot restrain speculative transactions because the tax burden is significantly smaller compared to speculative gains. (D) Most of the massive flow of funds which occurs as a currency crisis approaches is characterized as hedging, not speculation. (E) A common tax on all foreign exchange transactions can impose relatively heavy burden in certain cases, such as small countries with high export & import/GDP ratios, and manufacturers specializing in specific export items. More recently, currency trading taxes (CTT) have been proposed as measures similar to the Tobin tax.

Capital flow controls can also be categorized according to whether they target capital outflows or inflows. Unremunerated reserve requirements and taxation of international financial transactions mentioned above aim to regulate the inflow of capital. Examples of controls on capital outflows can be observed in post-crisis Malaysia. In September 1998, Malaysia introduced administrative controls on all capital transactions excluding direct investment. Beginning in February 1999, these controls were gradually replaced with market-based indirect controls which targeted the profitability of transactions. In September 1999, this was replaced by a 10% exit levy on profits. These measures effectively restricted the outflow of capital and thereby contributed to the easing of monetary policies. There are some who argue that these capital flow controls by Malaysia contributed more effectively to economic recovery than the IMF financial support programs implemented in Thailand, Korea and Indonesia.

With regard to currency crises and financial crises in general, it can be said that controls on the capital inflows should be instituted to prevent crises, while controls on outflow should be instituted in support of crisis management. Nevertheless, historically speaking, the focus of attention has been on controlling capital outflows. Perhaps this is primarily because of the policies of financial suppression mentioned earlier. Further, if the effectiveness of these two categories is compared, for example, in regard to investor incentives, with the exception of long-term investments in overseas production facilities, it is unlikely that investments in a foreign country will remain permanently in that country. Hence, investors have a strong and ready incentive for removing their funds from a foreign country. On the other hand, because the investors of developed countries view their capital transactions in the context of their overall international portfolio, the incentive to invest in a certain country can be effectively reduced by the introduction of controls on capital inflows.

The effectiveness of capital flow controls depends to a certain degree on the duration of implementation. If controls are maintained over a prolonged period of time, their effectiveness erodes as methods of avoidance are developed. Effectiveness also differs according to whether controls are expected to be temporary or permanent. Because avoidance involves certain costs, when controls are expected to be temporary, avoidance will have a lower expected rate of return than simply awaiting the lifting of controls. On the other hand, if controls are expected to be permanent, the cost of avoidance becomes relatively small and the incentive to work around capital controls becomes stronger. In addition to the ability to implement administrative regulations, successful control of capital flows is predicated on the maintenance of public confidence in government policies. This requires proper accountability in policy implementation.

### ③ Advantages and Disadvantages of Capital Flow Controls

In coping with the trilemma of international finance, capital flow controls may be instituted to maintain independence in monetary policies and to stabilize the foreign exchange market. This policy choice has the following advantages, assuming that capital flow controls do not generate misallocations of resources. (A) Controls will allow the implementation of monetary

policies which are consistent with the maintenance of currency value, while also leaving room for the introduction of flexible monetary policies to serve as a "lender of last resort" in the event of a liquidity crisis. (B) Controls can reduce foreign exchange risks by contributing to the achievement of stable foreign exchange markets. On the other hand, the free movement of funds promotes optimal resource allocation, and can and is actually expected to function as a propelling force of economic growth by contributing to capital accumulation. This is particularly important in the case of newly-industrializing countries. From this perspective, due thought must be given to the fact that capital flow controls can generate resource misallocations and thereby obstruct economic growth.

Therefore, the decision on whether or not to introduce controls on capital flows must be preceded by a careful consideration of the respective advantages and disadvantages. Given that the disadvantages of controls pertain to capital accumulation and resource allocation, the weight of the disadvantages falls on long-term issues. Conversely, the advantages of controls are related to short-term issues. These include advantages related to coping with liquidity crises, and advantages related to maintaining stable foreign exchange rates by preventing over-shooting of devaluation during a currency crisis. Therefore, controls can be assessed as follows from the perspective of time horizon. From a long-term perspective, capital flow controls are undesirable because they can distort resource allocation. However, the introduction of short-term and temporary controls can be a rational choice in emergency conditions involving liquidity or currency crises.

As seen from the preceding discussion, for newly-industrializing countries, the introduction of temporary controls on foreign exchange transactions and capital movements can be a desirable course of action, particularly when sudden and rapid changes are occurring. However, from the perspective of public confidence in government policies, any stoppage or reversal in the general policy direction of capital flow liberalization and deregulation by newly-industrializing countries may undermine confidence in the country's commitment to liberalization. Attention must also be paid to the possibility that such a course of action may lead to a deterioration of country risk. Decisions should be made with the possibility in mind that, even in the case of temporary regulation of capital flows, the inflow of foreign capital may be adversely affected after the controls are lifted.

④ Strengthening the Financial System and Sequencing the Liberalization of Capital Flows

Private financial institutions will be effectively protected by the government and shielded from competition when financial liberalization has been stalled and domestic private financial institutions remain under government regulation. Protected private financial institutions may even become prone to moral hazards as they become dependent on government guarantees and fail to make proper provisions for the management of financial risks. In certain cases, domestic securities markets will be subjected to regulation, leading to increased emphasis on indirect finance through private financial institutions. Under these circumstances, the lifting of controls on international financial flows results in the massive influx of foreign funds through domestic private banks. The lending of funds by private banks with poor financial-risk management capabilities can easily generate substantial amounts of non-performing loans. This underlying vulnerability of the domestic financial system will deepen any financial crisis that may hit the country. Therefore, it is necessary for the domestic financial system to be properly strengthened prior to the liberalization of capital flows.

It is of course true that the free movement of capital propels the process of economic growth by contributing to optimal resource allocation and capital accumulation. However, an accelerated pace of capital liberalization which undermines macroeconomic stability and the

stability of the domestic financial system carries with it the risk of generating a financial crisis. Hence, capital liberalization must have as its prerequisite the achievement of a sound domestic financial system and the installation of an appropriate supervisory framework.

Capital liberalization must be pursued with due care and in proper sequential order. Any country embarking upon capital liberalization must have in place sound and consistent macroeconomic policies. Likewise, such countries must have developed a proper domestic environment which includes the application of prudential regulations to the domestic financial system. It should be understood that over-dependence on short-term funds can render the economy vulnerable by setting the stage for a rapid exit of funds in the event of a shift in investor confidence. Therefore, in the process of capital liberalization, precedence should be given to the liberalization of direct foreign investments which involve long-term and stable commitments. Conversely, the liberalization of short-term capital flows should take into careful consideration such conditions as macroeconomic stability, the achievement of a sound financial system, and the availability of an appropriate supervisory framework.

⑤ Monitoring of Short-Term Capital Flows

Countries with weak financial systems are particularly vulnerable to external shocks which generate sudden and rapid exit of funds. Therefore, such countries should avoid becoming overly dependent on foreign borrowings and short-term funds. In particular, the flow of short-term funds can easily be affected by a herd mentality, due to imperfect and asymmetrical information, for example, on the part of the investors. This may either lead to an overheating of the economy through excessive influx of capital, or to a reverse process of an accelerated exit of funds.

Therefore, for the effective prevention of crises, it is necessary to consider ways and means for strengthening the monitoring of capital flows, with particular attention to short-term capital flows. The developed countries, on their part, should contribute to reducing the risks of turbulent movements of short-term capital through such measures as the disclosure of information by lenders. Furthermore, participation of the private sector in the resolution of crises should also be considered as a responsibility of lenders. Additionally, the following specific measures should be considered. Postponement of sudden withdrawals of short-term lending by the banks of the developed countries should be considered when there is danger of a liquidity crisis. Regarding the restructuring of the excess liabilities of countries affected by an international financial crisis, as advocated in the Krugger proposal, an orderly plan for crisis resolution should be developed which is patterned after the principles of rehabilitative corporate bankruptcy laws.

The monitoring of short-term capital flows cannot be effective unless an unified monitoring process is developed through the cooperation of the country in question and other countries and regions which serve as channels for the flow of funds. Therefore, it is desirable to establish a regional cooperative framework in Asia for monitoring short-term capital flows. Furthermore, such a cooperative framework should also endeavor to monitor the inflow of short-term funds from Europe and America.

⑥ Conditions for the Introduction of Capital Flow Controls

The influx of unstable funds which may serve to ignite future currency and financial crises should be prevented. One of the available options for this purpose would be to introduce and maintain market-friendly and market-based indirect controls. As for restrictions on the exit of funds, while such restrictions cannot serve as a substitute for sound macroeconomic policies,

in certain instances they may have to be introduced on an exceptional basis during currency and financial crises. However, in view of the effectiveness of capital flow controls and their impact on resource allocation and policy confidence, such restrictions should be maintained only on a temporary basis during periods of crisis. Moreover, it is necessary to clearly indicate a schedule for the easing and elimination of capital flow controls from the time that they are initially introduced.

From the perspective of strengthening the financial system and maintaining a proper sequencing of capital liberalization, it is meaningful for developing countries to introduce controls on the inflow of funds for the purpose of reinforcing their domestic financial systems and supervisory frameworks. When the financial sector is vulnerable, or when the supervisory framework is poorly developed, it is appropriate to introduce safeguard measures designed to limit the foreign-currency exposures of the banking system. It is a fact that, in some countries, more comprehensive restrictions on capital inflows have been adopted as a means to protect the financial sector from market pressures. However, such programs are costly, and should not under any circumstance be employed as a substitute for the structural reform of the financial sector, nor should a country allow the structural reform of its financial sector to be delayed by capital flow controls. Moreover, restrictions on capital outflows can generate large additional costs over the long run. Similarly, restrictions on capital outflows must not be employed as a substitute for the structural reform of the financial sector. There are certain things that a country must do to prevent capital flow controls from delaying the reinforcement of its financial sector. First of all, it must announce a clear schedule for structural reform of the financial sector and make every possible effort to abide by this schedule.

⑦ Summary of Capital Flow Controls

Finally, to cope effectively with risks generated by massive and sudden shifts in the international flow of funds, it is important to implement the following measures. (A) Countries must commit themselves to sound macroeconomic policies. (B) Structural reform must be promoted in order to boost the functions of the market. (C) The financial system must be strengthened. (D) An appropriate foreign exchange regime must be chosen, and must be supported by consistent and highly reliable macroeconomic policies and other measures. (E) Capital liberalization must be properly sequenced.

Capital flow controls generally cannot be a substitute for sound macroeconomic policies and structural reform. At the same time, such controls generate costs through inefficient allocation of resources and the slowing down of economic growth. Controls on capital inflows may prove necessary in certain cases where the domestic financial sector is vulnerable. Such controls can effectively suppress the inflow of short-term speculative funds when appropriately combined with other measures, such as the adoption of more flexible foreign exchange systems. As for controls on capital outflows, while due consideration must be given to the possibilities of avoidance, such restrictions can function positively during currency and financial crises when a country faces the risk of a massive outflow of funds.

## 5. Japan's Responses and Actions

In Section 3 "Efficient and Stable Financial Systems" and Section 4 "Appropriate Foreign Exchange Regimes and Control of Capital Flows," the discussion was centered on what Asian countries must do, in light of their current economic conditions, to prevent future crises and to achieve stable economic growth. Following an analysis and examination of issues related to the financial systems, foreign exchange regimes, foreign exchange transactions and capital flow controls, we presented a series of recommendations on these matters.

This section turns to the question of what the Japanese government, Japanese financial institutions and others should do to support the efforts and initiatives of Asian countries from the perspective of regional cooperation.

### (1) Responses of the Japanese Government

#### ① Japan's Economic Recovery and Market Improvement

Japan and Asian countries are bound together closely through trade, investment and other activities. For this reason, Japanese economic recovery is an extremely important factor for the future development of the Asian economies. Conversely, Asian economic development is a crucial concern for the development of the Japanese economy.

The Japanese government has adopted the position of "no growth without reform" and is working to revitalize the economy through a broadly-based program for structural reform covering the economy, fiscal structure, government administration and society. Regarding the financial system particularly, the government is endeavoring to speed up the disposal of non-performing loans by adopting specific goals for disposal and by actively utilizing the Resolution and Collection Corporation (RCC). Furthermore, the government is carrying out accurate inspections and appropriate supervisory activities as part of an overall program for ensuring the stability of the financial system.

When considering the future development of the Asian economies, it is clear that Japan must make the maximum possible effort to promote its ongoing program of structural reform.

Japan must also make concerted efforts to improve its domestic markets with the awareness that Japanese markets that are more convenient and accessible to overseas investors can play an important role in the development of the Asian markets. From this perspective, it is important for Japan to make continued efforts to improve the institutional aspects of its capital markets so that Asian companies can step up their level of participation in Japan's stock and bond markets.

#### ② Cooperation with Asian Countries

To prevent future crises in Asia and to promote the stability of currency and financial systems in the region, Japan must participate in the global undertakings initiated by the IMF, World Bank and other multilateral organizations. At the same time, it is important for Japan to develop and strengthen its own bilateral and regional cooperative programs for Asia.

The importance of the Asian region in the international economy is growing. At the same time, Asia's intra-regional interdependence is on the rise. Given these developments, and in light of the region's common interests in international trade and investment and common awareness of the risks of intra-regional transmission of crises, it is necessary for Asian

countries to actively promote greater intra-regional cooperation. Regional cooperation should include the following initiatives which have a direct impact on crisis prevention. In addition to this, Japan must act to contribute to the training and education of human resources for the future of Asia, and should also take steps to augment human exchange with Asian countries. For this purpose, Japan must improve the attractiveness of its institutions of higher education and implement a broad range of efforts to accept larger numbers of foreign students from Asia.

a) Regional Monetary Arrangements (Chiang Mai Initiative)

Asian leaders are acutely aware of the need to promote this type of regional cooperation. In the ASEAN+3 (Japan, China, the Republic of Korea) summit meeting held in Manila in November 1999, an agreement was reached on the need for "enhancing self-help and support mechanisms in East Asia." Building on this principle, it was agreed in the ASEAN+3 Finance Ministers' Process to strengthen regional cooperation in the areas of currency and finance. Following consultations by the monetary authorities of the related countries, the Chiang Mai Initiative was agreed upon in the second ASEAN+3 Finance Ministers Meeting held in May 2000. The purpose of the Chiang Mai Initiative is to further strengthen the mechanisms for self-help and support by establishing a regional monetary arrangement supplementing the existing international framework and facilities. The following specific measures were contained in this package. It was agreed to extend the existing swap arrangement among the ASEAN-5 countries (Indonesia, Malaysia, Philippines, Singapore, Thailand) to include all ASEAN member countries. An agreement was also reached on establishing a network of bilateral swap and repurchase agreement facilities among all ASEAN+3 countries.

Based on this agreement, the ASEAN swap arrangement was extended to all ASEAN member countries in November 2000, and the total amount of the facility was raised from $200 million to $1 billion. Regarding bilateral currency swap agreements, the ASEAN+3 countries have established the general rules and operating principles for the system. Bilateral agreements are now in the process of being negotiated and concluded based on these principles. To date, agreements with a cumulative value of $17 billion have been concluded. (With the addition of previously existing agreements, the total value of bilateral swap facilities currently stands at $24.5 billion.) Thus far, Japan has concluded bilateral swap agreements with Korea, Thailand, the Philippines, Malaysia and China. Japan has also started negotiating with Singapore and Indonesia. China has already concluded an agreement with Thailand. Progress has also been seen in negotiations between the ASEAN countries and China and Korea.

It is hoped that the very existence of such a framework for regional monetary cooperation will serve to suppress turbulent fluctuations in capital flows and thereby function to prevent currency crises. In fact, more is expected of this function than the function of quantitatively supplementing IMF financing in the event of an actual currency crisis. We believe that such progress in monetary and financial cooperation represents an extremely significant advance towards the stabilization of regional currency and financial markets. On its part, Japan must continue to actively participate in developing the regional network for bilateral swap agreements among ASEAN+3 countries.

b) Intra-Regional Economic Review and Policy Dialogue in ASEAN+3

During the Asian crisis, turmoil in the currency and financial markets of one Asian country spread to the other countries of the region. In light of this experience, to prevent future

currency crises and to ensure proper responses to any future difficulties that may arise, there is a clear need to strengthen regional monetary arrangements, such as the Chiang Mai Initiative. Moreover, to smoothly manage such frameworks, it is important to bolster policy dialogues and review of regional economic conditions. For this purpose, the policy authorities of Asian countries must be able to engage in frank exchanges of views concerning economic conditions and policy challenges. This requires further consultation on the construction of the framework, including the function of the secretariat.

The ASEAN+3 Finance Ministers' Process is acutely aware of this need. As such, policy dialogue on the ministerial level was conducted at the 5th ASEAN+3 Finance Ministers' Meeting held in May 2002. In a related move, measures for improving the effectiveness of policy dialogue and intra-regional review of economic conditions are currently being examined by a study group on the sub-cabinet level. As co-chair of this study group, Japan has been actively engaged in bolstering policy dialogue. Furthermore, to maintain currency and financial stability in the Asian region, it will be necessary to continue utilizing the ASEAN+3 framework and to develop even closer cooperative ties among the related countries.

c) Intra-Regional Capital Flows

As the only major creditor country in the Asian region, Japan has an critical role to play in Asia's intra-regional flow of funds. Hence, in preventing future currency and financial crises in Asia, it is very important for Japan to be actively engaged in various measures related to capital flows. Likewise, Japan's continued support and cooperation with Asian countries is of key importance.

The intra-regional flow of short-term funds was one of the contributing factors to the Asian crisis. In light of this fact, ways and means are being examined within the ASEAN+3 framework to strengthen the monitoring of short-term capital flows. Japan is contributing to this cooperative system by providing technical support to Asian countries for the realization of improved monitoring. It is important for Japan to maintain an active stance in contributing to such initiatives.

d) Economic Cooperation

Japan enjoys close ties with Asian countries, not only through trade in investment, but over a broad range of other activities as well. Against this background, in January 2002, Japan and Singapore concluded the Japan-Singapore Economic Agreement for a New-Age Partnership. It is important to promote such initiatives in order to supplement and to reinforce the multilateral trading system, as well as to advance further toward liberalization and economic revitalization. With regard to Japan's relations with the ASEAN countries, in January 2002, Prime Minister Koizumi proposed the Initiative for Japan-ASEAN Comprehensive Economic Partnership. This initiative is aimed at strengthening economic cooperation, not only in the areas of trade and investment, but also in a broad range of fields including science and technology, and human resource development. This proposal must be followed up with studies of specific issues leading to an agreement on general principles concerning economic cooperation (areas of coverage, time frame, etc.).

For the future, Japan must examine and strengthen its economic cooperation with Asia in a broad range of fields, including the development of financial and capital markets. Such initiatives will be important from the perspective of further deepening the mutual ties between

Japan and Asia, and for the purpose of bolstering the competitive positions of both Japan and Asia in the international economic sphere.

e) Bilateral Assistance

During the Asian crisis, Japan deployed a series of emergency measures within the international framework comprising international organizations and related countries. As part of these efforts, Japan announced and thereafter implemented the largest bilateral assistance package designed to supplement the support the assistance provided by the IMF. One of the results of the Asian crisis was that it effectively paralyzed trade financing. In response to this situation, Japan provided appropriate and timely financial assistance to eliminate this paralysis. Two-step loans (financial support targeting small- and medium-sized businesses in borrowing countries provided in the form of loans to domestic development finance institutions) were channeled to affected countries through the Japan Bank for International Cooperation, and further financing was supplied through the use of trade insurance and other measures. Japan also responded to the need for medium- and long-term financing. For this purpose, Japan established an "Asian Currency Crisis Support Facility" within the Asian Development Bank. The Facility has been used for infrastructure support, such as partial guarantees on the issuance of sovereign bonds for the procurement of market funds, and support for interest payments.

In addition to implementing such emergency measures in crisis situations, in order to prevent future crises in Asia and to achieve stable economic growth in the region, it is also important for Japan to bolster its support for the structural reform efforts of individual countries. A series of such actions were taken under the New Miyazawa Initiative. The following facilities were developed for this purpose: yen loans were provided and untied loans (loans with no restrictions on sources of goods and services procured) were channeled through the Japan Bank for International Cooperation (the former Export-Import Bank of Japan); and, Japan Special Funds were established within the World Bank and the Asian Development Bank. While cooperating with international financial institutions, these facilities were utilized in supporting the reform of financial sectors, the development of safety nets and other initiatives for the promotion of structural reform. The situation in Asian countries remains unchanged in that they must continue to press forward with difficult structural reforms. In light of this fact, it is vitally important for Japan to continue to offer appropriate and timely financial support to Asian countries.

f) Technical Assistance and Human Resource Development

Technical assistance and human resource development constitute two of the most important factors in building the necessary foundations for effectively reforming the financial and corporate sectors of Asian countries, for developing social safety nets and promoting structural reform, and for achieving autonomous economic management.

In order for Asian countries to achieve sustained economic growth in the future, it is necessary for them to make headway in such areas as banking reform, the disposal of non-performing loans, corporate reorganization, and the development of capital markets. Japan must effectively utilize its various past experiences in these areas in the process of providing technical assistance and support for human resource development. Japan has been providing technical assistance and support for human resources development through the Japan Special Funds established within the IMF, World Bank and the Asian Development Bank. Japan must continue to effectively utilize these frameworks for actively undertaking new initiatives targeting the Asian region.

Because personnel support from Japan plays a vital role in such initiatives and programs, various efforts have been made in the past to develop the necessary human resources: key domestic industries and associations have been approached; lists of eligible persons with expertise in banking and finance have been generated; and, JICA experts have been dispatched to the region on a continuous basis. It will be necessary to expand and to upgrade these activities in the future, particularly from the perspective of ensuring the "visibility" of Japanese support to Asia.

(2) Activities of Financial Institutions and Others

① The entry and participation of foreign banks in the Asian economies can generate a varied range of benefits. In addition to serving as a source of funds, foreign banks can contribute to improving the efficiency of financial intermediation by promoting reform in corporate behavior through the transfer of know-how, technologies and standards of governance.

However, because the Asian crisis coincided with Japan's own domestic financial crisis, Japanese banks have significantly reduced their Asian lendings since the crisis. This reduction in exposure has been carried out notwithstanding the fact that Asia continues to be highly ranked in the international financial strategies of Japanese banks. One of the factors contributing to this development is that Japanese banks have, because of reasons related to risk management and the utilization of limited resources, traditionally focused their activities on lending to corporations, mainly Japanese subsidiaries and affiliated companies, instead of retail banking in general.

It is hoped that Japanese banks will adopt an active stance in identifying business opportunities in Asia and that they will contribute to the development of the Asian domestic markets through the localization of their operations and other measures.

② Investment banks can be expected to play an increasingly important role as market coordinators in the future development of Asian capital markets. It is therefore hoped that Japanese financial institutions will accept to play an important role in investment banking operations in Asia. At the present time, the United States occupies a leadership position in essential infrastructure services which support investment banking operations. These include auditing, consulting and corporate rating services. In view of the future potential of investment banking in Asia, it is desirable for Japanese banks to develop a clear strategy for active participation in these services.

③ The volume of overseas investments made by Japanese institutional investors is growing very rapidly. However, thus far, this growth has been focused on the developed countries. It is desirable for these institutional investors to pay greater attention to the Asian markets in the future where, by performing the function of long-term investors and by becoming engaged in corporate management as shareholders, institutional investors can contribute significantly to the development of more efficient financial systems, and in particular to the development of capital markets.