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East Asian Dilemma: Restructuring Out or Growing Out?*

Yung Chul Park
Korea University

I. Introduction

The financial crisis that broke out in Thailand in June 1997 and then spread to other parts of East Asia has had devastating effects on the economies involved. It brought about a deep recession, causing a sharp decline in living standards, rising unemployment, industrial breakdown, and social dislocation.

A region that had been proud of its achievements as an "economic miracle" was suddenly reduced to being a region of reckless investors, non-transparent and insolvent financial institutions, highly geared corporations, corrupt governments, and crony capitalism.

Fortunately, however, these crisis economies have been able to manage impressive recoveries in the past few months. According to recent forecasts by the IMF and other institutions, all crisis countries except Indonesia will record substantial growth, ranging from 4 percent in Thailand to over 9 percent in Korea.

Even more encouraging is the expectation that the recovery currently under way may continue into the next year, raising the hope that these economies may grow out of the recession. Not everyone is sanguine about East Asia's growth prospects, however. The recent turnaround has brightened the region's economic prospects, but some argue that it has also brought about a false sense of complacency, which has been

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building up pressure to slow down the process of structural reform by financial institutions, corporations, labor organizations, and most of all politicians with the expectation that economic recovery will reduce the scope of further reform.

Krugman (1999) and many others voice a pessimistic view that the structural vulnerabilities that brought the crisis countries to their knees have not yet disappeared and that the prospects for these countries regaining their vitality are even less promising than before the crisis. Echoing this concern and recognizing the growing complacency, the IMF and World Bank have been warning these countries that recovery may take longer than it is often expected and that only further and more aggressive financial and corporate restructuring will strengthen the foundation of the economy for both durable growth and a quicker recovery.

The East Asian crisis countries have, therefore, reached a critical juncture where difficult decisions will have to be made as to whether structural reform efforts should be intensified at the risk of interfering with the ongoing recovery or whether the fragile recovery should take priority even if this means derailing the reform process, unless they can develop an alternate policy regime that would allow them to pursue the two objectives simultaneously.

The purpose of this paper is to analyze the progress and prospects of structural reform in the East Asian countries with a view to identifying a set of policy choices that will help the crisis countries accelerate economic recovery without jeopardizing the reform process. Section II discusses the central features and the progress of the reform programs implemented by the crisis countries are analyzed. An assessment of financial and corporate restructuring in East Asia is made in Section III. Agenda for sustaining the current recovery is proposed in Section IV. The need for regional cooperation for prevention of future crisis is discussed in Section V. Concluding remarks are found in a final section.

II. Progress and Prospects of Financial and Corporate Restructuring in East Asia

A central element of the IMF programs for Indonesia, Korea, and Thailand was an extensive and imposing array of structural reforms ranging from operational restructuring of insolvent financial institutions and firms, to improving corporate governance in financial, corporate, and government sectors, to addressing labor market rigidities, to deregulating and opening domestic markets, and to introducing a free floating exchange rate system.

These reforms were intended to build a strong foundation for the recovery of sustainable growth by correcting the structural weaknesses that the IMF considered to have contributed to the crisis. Much of the statistical and factual information in this section is drawn from the World Bank (1999a, b, and c). At the outset, the strategy for recovery included those measures to deal with the crisis itself¹ or to stop the bleeding, and financial and corporate restructuring together with institutional reforms to restore confidence in markets and attract capital inflow. The restructuring and reform were regarded as imperative to minimize the likelihood of a recurrence of the crisis. In light of the IMF's assessment that distortions and weaknesses in the financial sector played such a critical role, it was logical that financial restructuring was featured as one of the crucial elements of the reform agenda.

Feldstein (1998) and many other critics of the IMF programs argue, however, that what the crisis countries (except Indonesia, perhaps) needed was coordinated action by foreign financial institutions with an exposure to these countries to restructure their short-term debts, lengthening their maturity and providing additional credits to help meet the interest obligations, because essentially they were suffering from a liquidity problem. In this sense, they did not need the reform to restore their access to international capital markets.

Even if it were desirable for the crisis countries to undertake those IMF

¹ Short-run priorities were to stop bank runs, protect the payment system, and stem capital outflows.

imposed reforms, it may have been better to carry them out more gradually and with fewer shocks to the financial and corporate sectors. Making the transition required by the IMF in the midst of a crisis was very poor timing (Feldstein, 1998 and Stiglitz, 1999c).

These critics' arguments are often summarily dismissed by IMF officials as reflecting ignorance of the real nature of the crisis, which was the result of the accumulation of structural weakness rather than short-run macroeconomic imbalances. As such, attempting to ease the liquidity problem without structural reforms would have been akin to treating symptoms without curing the causes of the disease. Furthermore, because of complementarities between different reform measures, abandoning some of the reforms from the package for the reason that they were too costly or difficult to implement, they argue, would have reduced the effectiveness of other reforms (Lane *et al.*, 1999).

Over the past two years, the East Asian crisis countries have made great strides in resolving insolvent financial institutions and recapitalizing weak but viable ones. Somewhat less significantly, they have also made considerable progress in corporate debt workout and operational restructuring. In light of the depth and scale of the crisis, their achievements are indeed impressive, but as Claessens *et al.* (1999) conclude, much remains to be accomplished.

As shown in Table 1, most of the banks in the crisis countries remain undercapitalized and still hold a large amount of NPLs in their balance sheets. The application of stricter criteria for loan classification is likely to require more provisioning and will therefore reveal further capital shortages in the near future. This shortage together with the necessity of meeting an international standard for CAR will require further recapitalizations of the banks. According to World Bank estimates, capital shortages as a percentage of total bank assets ranges from 1.7 percent in Malaysia to 18.5 percent in Indonesia. Despite the progress in corporate restructuring, many firms, both small and large, are saddled with huge debts that they are unable to service and with unprofitable investments that will have to be written off (Claessens *et*

al., 1999).

Among the four crisis countries, the authorities in Korea and Malaysia have actively intervened in addressing the insolvency of financial institutions and overindebtedness of corporations. Partly as a result of this intervention, Korea has achieved a great deal more than the other three countries, yet it still has a long way to go before completing the IMF reform program. In contrast, the Thai government has taken a market-based approach in which banks are allowed to raise equity capital over a long period through phased-in requirements for loan provisioning. Malaysia decided not to accept the IMF's rescue plan, opting instead to go its own way. It nevertheless took many radical measures to deal with the crisis. Indonesia lags behind the other three and only recently has taken steps to deal with their banking problems and corporate distress (See Table 3).

In all four crisis countries, financial sector reform covers four elements of restructuring. Immediately after the crisis broke out, the priority was to stabilize financial markets and prevent runs on banks and capital flight. For this purpose, some of the governments of the crisis countries had to issue guarantees on the payment of deposits and other bank liabilities in the absence of a deposit insurance scheme.

A second element involved the liquidation, mergers, and government takeover of failed banks and other insolvent non-bank institutions. This has been followed by recapitalizing and rehabilitating weak but viable financial institutions through the infusion of public funds. Those banks receiving public support also had to go through drastic changes in their management and operational structures. In dealing with the disposal of non-performing loans (NPLs), centralized and state-owned asset management companies have been established in Malaysia, Korea, and more recently in Indonesia. Thailand has adopted a decentralized approach in which each bank is encouraged to set up its own AMC to which it can transfer assets at market value.

Finally, banks were mandated to meet international standards of capital adequacy, loan classification, provisioning, and accounting and disclosure requirements. Together with these changes, banks were also asked to institute new corporate

governance and develop a new operational framework for prudent risk management and sound lending practices.

In order to restructure overindebted and insolvent corporations, the East Asian crisis countries have implemented a large number of measures, which include:

- (i) eliminating tax and other regulatory obstacles for mergers, debt/equity swap, and bankruptcy procedures;
- (ii) establishing out-of-court settlements for debt workout (London Approach);
- (iii) enforcing bankruptcy procedures; and
- (iv) improving corporate governance and broadening ownership.

The following section briefly summarizes recent developments in financial and corporate restructuring in the four crisis countries.

Table 1 Non-Performing Loans and Recapitalization Requirements

	Indonesia	Korea	Malaysia	Thailand
NPLS as % of total bank loans	60-75 ¹	8.5 ²	22 ³	46.5 ⁴
Current capital ⁵	-15.1	-1.0	1.8	-4.5
Capital shortfall ⁶	18.5	4.0	1.7	8.1

Source: Claessens *et al.* (1999) and World Bank (1999).

¹ Radelet (1998.)

² End-March, 1999.

³ End-July, 1999.

⁴ End-June, 1999.

⁵ As percentage of total bank assets.

⁶ Assumes a 40% recovery rate on non-performing loans, a constant ratio to deposits, and loan growth in line with GDP growth. The capital shortfall is applied to the entire banking system. The calculation on loan loss recovery and growing out of the crisis assumes that the corporate sector will be able to cover the increased interest spread margin.

Table 2 Costs of Financial Sector Restructuring (% of GDP)

	Indonesia	Korea	Malaysia	Thailand
Gross cost	45	15	12	32 ¹
Fiscal recapitalization cost to date	37.3	15.8	10.9	17.4
Expected additional fiscal cost	12.7	10.7	5.5	15.4
Public debt/equity	98.3	37.0	48.0	39.3

Source: Baliño *et al.* (1999).

¹ As of November 1998, World Economic Outlook: Interim Assessment, IMF, December 1998.

Table 3 Financial Distress Resolutions and Bank Recapitalization Strategies

	Indonesia	Republic of Korea	Malaysia	Thailand
Initial government response				
Substantial liquidity support	\$21.7 billion (17.6% of GDP)	\$23.3 billion (5% of GDP)	\$9.2 billion (13% of GDP)	\$24.1 billion (20% of GDP)
Financial distress resolutions				
Bank shutdowns	64 of 237	None	None	1 of 15
Shutdowns of other financial institutions	Not applicable	More than 117	None	57 of 91
Mergers of financial Institutions	4 of 7 state banks to merge	11 of 26 absorbed by other banks	58 to be merged into 6 groups	3 banks and 12 finance companies
Nationalizations	12	4	1 and 3 finance companies	4
Resolution and recapitalization Instruments				
Instrument / Received	Bonds / Equity Bonds / NPLs Debt to equity conversions / Equity	Bonds or cash / Equity or preferred shares / Equity or preferred shares Shares / NPLs Bonds /	Bonds or Cash / Convertible Preferred shares or Subordinated debt Bonds / NPLs	Debt to equity conversions / Equity Bonds / Equity Bonds / Subordinated debt
Asset management Companies	Became fully operational in April 1998 within IBRA	KAMCO was reconstituted as an AMC in late 1997 ¹	Danaharta was Established in Mid-1998	FRA was to auction off the assets of the closed financed Companies
(Amount purchased by end-April % of GDP)	20%	10%	17% ²	17.5% AMC was set up to act as bidder of "last resort" for assets of closed finance Companies 4% ³

Sources: Claessens *et al.* (1999), and Baliño (1999).

¹ KAMCO existed before the crisis.

² End-June 1999.

³ This 4% is included in the 17.5%.

II-1. Indonesia

By the end of October 1997, three months after accepting the first IMF rescue plan, there had been little improvement in the prospects of the Indonesian economy. In fact, market confidence in the economy continued to weaken. Alarmed by this deterioration, the Indonesian authorities had to issue external guarantees to all creditors and depositors of all locally incorporated banks and to promise compensation of small depositors of closed banks to stop bank runs in January 1998.

At the same time, the Indonesian government developed an institutional framework for financial restructuring that consisted of two major institutions. One such institution was the *Indonesian Bank Restructuring Agency (IBRA)*, an independent organization, which was designed to restructure troubled banks and their assets. The other was an *Asset Management Unit (AMU)* within IBRA created to acquire NPLs from closed or merged banks. At the end of May 1999, IBRA had assets worth Rp. 243 trillion (about US\$35 billion). The agency, however, has done very little to resolve and recover these assets, although the legal, organizational, and regulatory framework is in place. Indonesia's efforts also include a bank recapitalization scheme and the closure of non-viable banks.

Only in recent months have the Indonesian authorities taken steps to assess the soundness of domestic private banks and to restore the health and profitability of the banking sector. As a result of this delay, most institutions remain insolvent or undercapitalized, their lending operations severely curtailed. By some estimates, NPLs have reached as high as 60-75 percent of total loans outstanding (Radelet, 1999). The banking sector as a whole shows a negative net worth amounting to 15.1 percent of its total assets. The IMF estimates that the costs of bank restructuring will be on the order of 45 percent of GDP, but many observers believe that the final tally will be higher (Radelet, 1999).

At the end of July 1997, there were a total of 160 private banks. According to the bank recapitalization strategy announced in September 1998, all private banks were

classified into three groups (A, B, and C) on the basis of their capital adequacy ratios (CARs), and all group C and non-viable group B banks were to be closed.² Over the period of a year, 66 were closed and 12 were taken over by the state. At present, 73 private banks meet the 4% capital adequacy standard, and they account for only about 5% of total bank deposits. The other banks will be either partially or fully state-owned for several years (Radelet, 1999).

As a result of the restructuring of the private banks, the state banking system now accounts for 75 percent of total liabilities of the banking system and 90 percent of its negative net worth. Although the state banks are largely responsible for the losses of the banking system, the restructuring, merger, and privatization of these banks has only just begun in earnest and will be a major challenge in coming years.

As in the other crisis countries, the absence of an effective bank supervision system was one of the major causes of the collapse of Indonesia's banking system. Realizing this weakness, Indonesian authorities have taken measures to improve prudential norms, bank supervision, and enforcement capabilities. However, senior management at the central bank which is in charge of supervision, has been reluctant to enforce existing prudential regulations and has not accorded bank supervision a higher priority. For this reason and the lack of trained staff, the capacity of bank supervision remains very limited (World Bank, 1999b).

As for corporate restructuring, the Indonesian authorities have also developed a very elaborate policy and institutional framework that includes:

- (i) the *Jakarta Initiative Task Force (JITF)* for voluntary corporate restructuring: out-of-court settlements for debt workout (London Approach);
- (ii) establishing the *Indonesian Debt Restructuring Agency (INDRA)* to act as an intermediary between debtors and creditors and to enable debtors and creditors to protect against exchange risk; and
- (iii) improving corporate governance.

² Group A: banks with a CAR over 4 percent.
Group B: banks with a CAR between 4 and -25 percent.
Group C: other remaining banks.

Although such a comprehensive framework has been in place and nearly half of Indonesian corporations are insolvent, and difficulties in meeting debt service obligations are widespread, little has been done for corporate restructuring. At the end of June 1999, only 80 bankruptcy cases were registered, and only 251 debtors were registered at the JITF accounting for US\$21 billion out of US\$70 billion in total foreign debt and Rp. 13.6 trillion out of Rp. 215 trillion in total domestic debt. Of these only 16 were the agreements in principle and another 6 had standstill agreements.

The INDRA serves as an intermediary between creditors and debtors to provide protection against foreign exchange risk i.e. a rate of depreciation exceeding the inflation rate and making available foreign exchange for payments. However, the scheme did not provide either cash relief for debtors or incentives for creditors to adjust their loans. On its part, the JITS has not been able to address the issue of burden sharing between debtors and creditors largely because of the concerns of the bureaucracy over the possible criticism and retribution it might face after the expected change in government in October 1999.

One of the major constraints on Indonesia's debt restructuring has been the weak banking system, which suffers from bad debts and undercapitalization. Indonesian banks simply have not had the resources or technical skills to manage the workout of corporate debts within the framework of the Jakarta Initiative. Radelet (1999) argues that Indonesia's debt burden has become so large that the country will not be able to service its debt, in particular the US\$36 billion owed to foreign banks, without significant relief from foreign creditors, including the Japanese.

At present, Indonesia's problem with corporate debt restructuring is not to design a better institutional framework but to ameliorate the existing framework. Given the large number of both creditors and debtors, low trust, and the lack of reliable information, resolving Indonesia's corporate problems will take a long time. Indonesia's weak institutions will compound the problem (World Bank, 1999b).

In the short-run, the priorities should be to focus on restructuring state banks, improving financial supervision, and speeding up asset recovery. Equally critical is the

necessity to consolidate the existing institutions to facilitate out-of-court workout settlements and to strengthen bankruptcy procedures. One of the reasons for the severity of the crisis was that Indonesia's institutions were not strong enough to manage the crisis when it broke out. Two years later they remain as weak as before, and herein lies Indonesia's dilemma. Building and deepening institutions is and perhaps should be a medium-term objective, but without these institutions, the Indonesian authorities will continue to find it difficult to achieve the short-run objective of completing the operational restructuring of banks and corporations.

II-2. Malaysia

When it came under a speculative attack in July 1997, Malaysia attempted to defend its currency, the ringgit, by implementing tight monetary and fiscal policy as well as other measures, as did other neighboring countries. Unlike Thailand and Indonesia, Malaysia had been able to weather the initial attack for almost a year after the Thai crisis erupted. By mid-1998, however, it was clear that the initial policy response to the crisis was not encouraging. Faced with a deteriorating situation, Malaysia had two options--either accept an IMF rescue package or take radical measures of its own to deal with the crisis. Malaysia decided to fend for itself without receiving any outside assistance.

Even before the crisis hit the economy, however, Malaysia had developed more effective bankruptcy and foreclosure laws and a stronger supervisory capacity as compared to the other Southeast Asian crisis countries. The banking sector was also well capitalized, with an average CAR exceeding 10 percent before the crisis.

Beginning in May 1998, the Malaysian authorities responded to the crisis by building and consolidating an institutional framework for structural reforms. One component of the framework was *Danaharta*, an asset management company, established to acquire NPLs from banking institutions. Another was *Danamodal*, which was created in July as a special agency with the purpose of recapitalizing those financial institutions whose capital adequacy ratios fall below 9 percent. A third was

the *Corporate Debt Restructuring Committee (CDRC)*, which was established in August to facilitate the restructuring of corporate debts outside of courts through voluntary agreements between creditors and debtors. Each of these organizations has made considerable progress in restructuring and consolidating the financial sector.

Danaharta has so far acquired approximately 36 percent of the total NPLs, or RM 39.3 billion. Malaysian financial institutions still hold RM 71.7 billion in NPLs on their balance sheets, approximately 22 percent of their total loans. Adding the NPLs of other financial institutions, the total NPLs are more than 40 percent of GDP. *Danamodal* has also injected RM 5.7 billion into nine of the weaker but viable institutions. As a result of this injection, the CAR of the banking system as a whole has risen to 13 percent, making the system capable of absorbing a substantial portion of the losses emanating from writing down or selling NPLs to *Danaharta* and also enabling it to increase lending operations.

Malaysian banks were in a relatively more favorable situation for addressing their NPLs and corporate workout problems, but as in the other crisis countries, the Malaysian banks as well as corporations have been reluctant and slow in disposing of their poor quality assets. *Danaharta* has not begun to restructure the NPLs it has acquired from financial institutions, although such a shift in operation could release its resources for more productive uses.

With an adequate legal system and a well structured institutional framework for financial restructuring in place, the prospects for Malaysia successfully carrying out the restructuring of its financial system are more optimistic than in Indonesia and Thailand. For example, Malaysia may be able to finance bank recapitalization using internal resources with NPLs peaking at 20 to 25 percent of total loans (Claessens *et al.*, 1999).

Since July 1999, the Malaysian authorities have embarked on an ambitious plan of consolidating its financial institutions, which is hoped to make the financial sector more resilient and competitive. Responding to the worldwide trend of mega-mergers between banks and other financial institutions, the Malaysian government plans to consolidate the nation's 58 financial institutions into six large financial groups, each of

which will consist of three large entities specialized in commercial and merchant banking and finance company operations. While the consolidation strategy may, in the long-run, help improve the efficiency and competitiveness of the financial sector, it has had difficulty in taking off from the drawing board, because of the opposition of major stockholders of many institutions to be absorbed into the groups and other technical problems related to their due diligence.

The corporate sector in Malaysia was in a comparatively stronger position, with a relatively low leverage and low exposure to foreign debt, than the sectors of the other pre-crisis East Asian economies. Although Malaysian corporations were hard hit by the rise in interest rates as they were heavily dependent on bank financing, corporate distress is not systemic and is concentrated in the real estate, construction, and infrastructure sectors, unlike in Korea where it is concentrated in manufacturing.

Ailing corporations in Malaysia are restructured through the bankruptcy court, out-of-court voluntary settlements between creditors and debtors with the assistance of the CDRC, and through *Danaharta*. In addition to the already existing market and legal remedies, including the CDRC, the government established new institutions to deal with corporate restructuring. They include:

- (i) the Loan Monitoring Unit of the central bank, which is assisting small corporate borrowers with total outstanding debt of less than RM50 million to receive financial support while restructuring their operations;
- (ii) a rehabilitation fund for SMEs that was set up in 1998, to help viable SMEs restructure; and
- (iii) the Finance Committee on Corporate Governance in March 1998, for the reform of corporate governance practices.

As stated earlier, *Danaharta* has purchased NPLs with a nominal value of RM 39 billion from the financial system. There were 40 cases of restructuring through the bankruptcy procedure. The CDRC and *Danaharta* are expected to shift operational emphasis to asset sales, reallocation of capital, and operational restructuring. While the process for corporate debt resolution is in place, the debt workout and operational restructuring through the CDRC/*Danaharta* framework have been slow, because

of the inadequacy of trained staff with technical skills. The CDRC is expected to exist for less than two years and is hoping for most of the restructuring work to be done by the end of 1999.

Although the banking sector has been strengthened through the disposal of NPLs and recapitalization, its lending operations have not expanded in tandem, in part because so many sectors are still struggling with excess capacity, in particular the property sector. Together with the repressed state of the economy, a large volume of NPLs is not likely to stimulate bank lending as long as the banks are not able to find viable businesses to lend. What should then be policy priorities in the short-run? Should the Malaysian authorities step up the operations of both *Danaharta* and *Danamodal* to improve further the soundness of the banking sector? Alternatively, should they shift the focus of policy to reflation of the economy while maintaining the current speed of bank restructuring?

After deciding to take an independent course of action on 1 September, 1998, the government announced measures of capital control to halt the movement of short-term capital.³ The ringgit was pegged to the US dollar at the rate of 3.80 on the very next day. These measures could be considered a reversal of the liberalization policies Malaysia pursued and implemented during the last two decades.

The immediate reaction to such policies was clearly negative. It is, however, interesting to note that the regional markets showed more stability in the weeks following September 2, 1998 than before. One possible explanation for such market stability is that the speculative attacks had eased and the currency and stock market had already stabilized by the time Malaysian authorities announced capital controls. Another explanation is that IMF's designed policies had helped Thailand, Korea, and Indonesia to recover from the worst phase of the crisis. This recovery may have contributed to the regional stability, which in turn might have exerted positive effects on the Malaysian economy.

On September 2, 1999, exactly one year after capital controls were imposed, the

³ It is important to note here that the capital control measures were to control short-term capital only. Capital movement in FDI, transaction for trade in goods and services, interests, profits and dividends of long-term capital, and current account do not come under these control measures.

authorities in Malaysia decided to relax some of these controls. It is worth mentioning here that the IMF's annual review of the Malaysian economy released on September 10, 1999 acknowledged that the capital control measures adopted by the Malaysian authorities to deal with the financial crisis did help in early economic recovery. The capital controls provided a 'breathing space' for the authorities to initiate and implement the financial sector restructuring and reforms.

II-3. Thailand

As in the other crisis-affected countries, the Thai government's program for structural reforms included a wide range of measures directed to resolution and restructuring of financial institutions as well as improvement in bank supervision and corporate governance.

Three months into the crisis, the Thai government established the *Financial Sector Restructuring Authority (FRA)* and the *Asset Management Company (AMC)* for the resolution of the failed finance companies and the disposal of their assets. In December 1997, the FRA closed 56 out of the 58 suspended finance companies and since then has been in the process of disposing of their assets. The AMC, however, had been dormant until March 1999, when for the first time it purchased loans at an FRA auction.

Unlike in other crisis countries, the Thai government adopted a more market-based approach in resolving and recapitalizing banks and other remaining financial institutions early in the crisis. It was expected that these institutions would be recapitalized by private investors, if they were tightly supervised, more transparent, and were able to obtain fresh capital through a progressive introduction of a more strict loan classification scheme and the gradual strengthening of provisioning requirements (World Bank, 1999c).

The market-led strategy was not effective, because private investors had little incentive to invest in those banks and other financial institutions, which were amassing large amounts of NPLs as a result of the continuing recession. Realizing the

ineffectiveness of the market-based approach, the government shifted to a more interventionist approach in August 1998. A new comprehensive financial restructuring package announced on August 14, 1998 included the injection of public funds into financial institutions for their recapitalization, regulatory changes on the composition of capital base, and creating individual, privately-owned AMCs. If banks and other financial institutions are prepared to comply with a new loan loss provisioning earlier than the targeted year 2000, they were allowed to issue preferred stocks to the government in exchange for government bonds, which are counted as part of tier one capital.

These measures have been complemented by a revision of the legal and regulatory framework for regulation and supervision of financial institutions designed to strengthen the role as well as capacity of the Bank of Thailand as the supervisory institution in line with international standards.

At present, Thai commercial banks still hold on to a large amount of NPLs estimated to be almost 47 percent of their total loans and have a negative net worth, equivalent to 45 percent of their total assets. The high NPL ratio makes it almost impossible for the banks to recapitalize through earnings. Yet the Thai bank owners have resisted the pressure to write down their capital in return for public funds, as they are determined to maintain ownership and control of their institutions. Only two banks have accepted the August 14, 1998 government scheme of recapitalization, whereas most banks have resorted to complex arrangements to raise capital such as issuing preferred stock linked with subordinated debentures and to curtailing new lending.

In contrast to the other crisis-affected countries, small and medium sized enterprises (SMEs) account for more than two-thirds of the aggregate corporate debt in Thailand. Since they are dispersed throughout the country and their loans are small in size, SME restructuring has been slow and far more difficult than otherwise. The major components of the Thai corporate restructuring includes:

- (i) providing tax and other incentives to corporations and banks;
- (ii) developing an effective legal framework for the recovery of debt through

bankruptcy liquidation, and reorganization; and
(iii) creating the *Corporate Debt Restructuring Advisory Committee (CDRAC)* to facilitate an out-of-court process for debt restructuring negotiations.

While some progress has been made, corporate restructuring has been a demanding as well as disappointing process as the growth of NPLs in the financial sector has kept up with the rate of completion of restructuring. The CDRAC has targeted 689 debtors for facilitation, representing 56 percent of the NPLs. So far 34 debtors have signed on a 6-8 month restructuring process. Only 52 of these cases have completed the process, whereas 165 cases have been non-cooperative.

Businesses have been unwilling to engage in debt restructuring because of the huge losses they will have to sustain in a fire sale of unprofitable investments. And they will continue to resist the restructuring as long as asset prices remain depressed. The traditional preference for debt financing as opposed to equity financing and insensitivity to maturity mismatching has also impeded the restructuring process.

At the same time, banks have been reluctant to take losses resulting from debt write-downs and debt-equity swaps in preference to debt rescheduling, in part because many of the restructured corporations have not been able to service their loans. In large banks, for instance, 16 percent of the restructured loans became non-performing again under the new terms because the continuing depression brought down the actual level of cash flow below the projected level at the time of restructuring.

Commercial banks have been unwilling to expand their lending operations, because they are undercapitalized and more importantly for fear of inviting government intervention and the loss of ownership control in case they run further losses. In this milieu, SMEs have been the major victims of banks' scaling back of their lending operations.

Thai banks have been inactive in restructuring the debts of insolvent SMEs, because it is costly to conduct due diligence of a large number of non-transparent SMEs scattered all over the country. In an effort to speed up corporate recovery, the Thai authorities have unveiled a new policy package designed to stimulate domestic

investment on August 10, 1999. The package includes a reduction in tariffs on a number of imported inputs, accelerated depreciation schedules, the creation of three investment funds, and setting up a series of Financial Advisory Centers with the purpose of providing advice to SMEs on their operational and debt restructuring.

II-4. Korea

Immediately after the crisis broke out, the top priority of crisis management in Korea centered on restoring market confidence to prevent bank runs and capital flight. Once the bleeding phase was over, the Korean authorities moved to the next stage of resolving insolvent financial institutions and rehabilitating weak but viable institutions. The financial restructuring plan also included the adoption of international standards of regulation and supervision and a scheme for capital market development. Since then numerous actions have been taken for financial recovery. Some of these important measures include:

- On April 1, 1998, the *Financial Supervisory Commission (FSC)* was established as the overreaching financial regulatory agency by consolidating the existing supervisory institutions for banks, non-bank financial institutions, securities, and insurance. Since then, the commission has taken charge of implementing and the coordinating policies for financial and corporate restructuring.
- On July 15, 1998, five insolvent commercial banks were closed down and absorbed by other healthier banks through a purchase and assumption scheme. Two banks, Korea First and Seoul Bank, were recapitalized with public funds and *de facto* nationalized in early 1998. Korea First Bank has been sold to a foreign consortium while negotiations with HSBC for the sale of Seoul Bank have been terminated. Mergers involving the nation's five largest banks have been completed.
- Of the 30 merchant banks, 16 have been closed, merged, or suspended, and the remaining 14 are being closely monitored. *Hanaram* bridge bank was created in late December 1998 to take over, manage, and liquidate assets and liabilities of

insolvent merchant banks.

- The government decided to mobilize W64 trillion (US\$49.2 billion), about 15 percent of GDP for fiscal support for restructuring. Public funds have been provided through the purchase of bad loans by and through *Korea Deposit Insurance Corporation (KDIC)* in the form of equity capital injections. The corporation was also established in April 1999.
- *Korean Asset Management Corporation (KAMCO)*, was reconstituted to serve as an AMC, and had purchased W46 trillion (US\$38.3 billion) of NPLs, paying an average 45 percent of the face value of these assets at end-June, 1999.

KAMCO has not been very successful in disposing of bad assets transferred from financial institutions. So far they sold W5.8 trillion worth of the NPLs they acquired. Most of the banks, including those restructured ones, have seen a substantial improvement in the quality of their assets and the profitability of their operations. Their lending capacity has also increased, supporting the ongoing recovery of the economy. However, financial restructuring is far from over. The FSC has been struggling with the resolution and recapitalization of the three largest investment trust companies, which hold a large amount of corporate bonds issued by those insolvent corporations engaged in out-of-court workouts with their designated lead banks including the Daewoo group.

On November 4, 1999, the Korean government announced a reform plan for the investment trust industry, including:

- An injection of public funds amounting to W3 trillion into the nation's two largest ITCs for their recapitalization.
- *KAMCO*'s purchase of non-guaranteed bonds issued by Daewoo, Korea's third largest chaebol before its breakup, amounting to W18 trillion at market prices discounted by prevailing interest rates.
- W2 trillion of liquidity support for the two ITCs through Korea Securities Finance Corporation.
- Setting up of high yield junk bonds funds (gray funds) at ITCs with tax benefits.

- Purchase of ITCs' bond holdings by the Bond Market Stabilization Fund without limits to prevent investors' redemption of their holdings of beneficiary certificates issued by ITCs.

The FSC will also turn to resolving and rehabilitating a large number of non-bank financial institutions, including life insurance companies.

Banks are also required to adopt forward looking criteria in evaluating the quality of their assets and to attain a minimum of 10 percent capital adequacy ratio before the end of 1999.

The Daewoo group defaulted on the payment of its debt (estimated to be \$50 billion) in July and since then has been subject to a restructuring process agreed upon between Daewoo and its creditor banks. An interim due diligence of 12 Daewoo affiliates disclosed on November 4 shows that the value of their combined assets was W61.2 trillion while that of liabilities came to W86.8 trillion, revealing a negative net worth amounting to as much as W26 trillion.

Korea's financial institutions will be required to reschedule W31.2 trillion out of their total exposure to the Daewoo units over a certain unspecified period of time through write-downs and debt equity swaps. As a result of the rescheduling, the banks and other financial institutions may lose in value as much as 50 percent of their rescheduled loans. The FSC, however, is confident that the banks have built up enough loan loss provisioning to absorb potentially large losses on Daewoo loans.

Despite the enormous losses Korea's financial institutions will have to sustain from the adverse repercussions of the Daewoo workout, domestic as well as foreign investors have shown a positive response to Korean government's plan for Daewoo and ITC restructuring as evidenced by the recent gain on the stock market. While recognizing the possible dislocation in several industries where Daewoo was a major producer and exporter, many foreign as well as domestic investors were encouraged by government's workout plan as it was going to pave the way for clearing the economy of Korea's debt heavy chaebol.

In addition to the Daewoo breakup, the big five chaebol are mandated to lower

their debt-equity ratio to 200 percent before the end of 1999. This debt adjustment may require further debt write-downs and debt/equity swaps at financial institutions, which will in turn cut into their earnings.

These problems related to corporate restructuring suggest that Korean banks may not be able to meet the CAR requirement and at the same time to raise an adequate amount of loan loss provisioning needed to absorb the losses emanating from corporate workouts. According to recent estimates, including the one made by Korean Development Institute, the Korean government will have to mobilize additional public funds on top of the 64 trillion won it has already secured for the reform of the financial sector.

In restructuring the corporate sector, the Korean government has taken a three-pronged approach. The five largest chaebol (so-called Big Five) are in the process of restructuring under the *Capital Structure Improvement Plans (CSIPs)*. The CSIPs require the top five chaebols to (a) reduce the debt-equity ratio to 200 percent by end-1999 from 302 percent at end-June 1999, (b) to eliminate existing cross guarantees between different subsidiaries in different lines of business, and (c) to shed non-core businesses by exchanging their affiliate units with other chaebol (Big Deals). The "6-64" chaebol and other large corporations have been subject to out-of-court workouts with their designated lead banks, following the London Approach of voluntary settlements between debtors and creditors.

Unlike in the other crisis countries, small and medium enterprises in Korea account for a relatively small fraction of banks' outstanding loans and, hence, their restructuring has been somewhat neglected and a less pressing item on the restructuring agenda. So far the government efforts have focused on extending emergency loans of working capital to keep SMEs from going bankrupt, thereby gaining time and preserving employment, although SME debt workout and operational restructuring are urgently needed (World Bank, 1999c).

The restructuring of the big five industrial groups and also the workouts of smaller chaebol and other large corporations have drawn mixed reviews since they were

launched more than a year ago. As for the restructuring of the 6-64 chaebol, at the end of June 1999, 90 corporations were selected for a formal workout. 47 of these workout candidates belonged to 16 chaebol ranked between 6 and 64 in size. 80 firms have reached an agreement with their creditor banks on a workout scheme.

In the workout process the lead banks have been accused of being negligent in conducting due diligence of candidate firms for restructuring, as their plans included many entities that should be liquidated. Since the banks are severely constrained to absorb additional losses, they have been tempted to keep on their balance sheets many non-viable firms with the hope that at least some of these firms may be able to survive the crisis. At the same time, the lead banks have not been able to devise a comprehensive set of workout criteria involving debt/equity swap, debt write-downs, and debt rescheduling.

For these reasons, the workout process has raised the question of fairness and effectiveness as well as the concern of whether the process has been overly influenced by political pressure and favors. The workout process has been further complicated by the disagreement on an appropriate level of loan loss provisioning at the banks and the resistance of the workout firms to the loss of management control. It is expected that a large number of restructured firms will fail to meet the obligations they agreed upon with their lead banks.

As for the Big Deal, many of the proposed business swaps among the big five chaebols have been mired in asset valuation disputes, and the concluded big deals have failed to address the excess capacity problems. In fact, encouraged by the ongoing recovery together with low interest rates and a bullish stock market, the big five groups have been accused of backtracking on their earlier promises, including improving corporate governance, and even showing fresh appetite for branching out into new businesses, contrary to their repeated pledges to slim down to a few core businesses.

III. Financial and Corporate Restructuring: An Assessment

At the beginning of the crisis, there was a widespread belief that commitment of the crisis countries to structural reforms was critical to the recovery in East Asia. The commitment would create the expectation that East Asia would emerge from the crisis with more stable and efficient financial and corporate sectors than before. This prospect of reform espousing a market-oriented system would then help restore market confidence, thereby inducing the return of foreign lenders and investors to the region.

Two years into the reform process, the crisis countries have accomplished a great deal in improving soundness and profitability of financial institutions and alleviating corporate distress. Yet much remains to be done. In all four countries, banks are still holding in their balance sheets a large volume of non-performing loans (NPLs) and remain under capitalized. Many corporations in the region are still unable to service their debts. New accounting standards, disclosure requirements, and rules for corporate governance have been introduced, but they are not rigorously enforced. It will take many years for the new system to take root.

Experiences of financial crises in other countries suggest that it takes on average three years for an emerging market economy to return to the pre-crisis trend rate of growth. Korea, Malaysia, and Thailand have been able to engineer a faster pace of growth than expected, but it is not clear whether and to what extent financial and corporate restructuring has contributed to the ongoing recovery. If indeed financial and corporate restructuring in East Asia is not half way there as Claessens *et al.* (1999) argue, not to mention of Krugman's pessimistic view, then it would be reasonable to argue that the current recovery has begun very much independently of the reform efforts of the crisis countries. And there are several pieces of evidence that support this view.

Credit rating agencies including Moody's report that the reforms in the banking sector in the crisis countries have not gone enough to ensure that these economies would be able to fend off another financial crisis. Major economics journals such as the *Economist* and the *Financial Times* echo similar concerns. Only very recently, Moody's and S&P suggested that the debt ratings of some of the crisis

countries would be raised in November. They upgraded the sovereign credit ratings of Korea and Malaysia to the lowest investment grade from the speculation grade of February 1999. Reflecting the rating improvement, capital inflows in East Asia have been rising, but still modestly and certainly below the pre-crisis level.

According to the World Bank (1999c), the recession in the East Asian crisis countries bottomed out in the second half of 1998, less than a year after the crisis had broken out. The current recovery in East Asia has been led mostly by a surge in consumption and export earnings. Fixed investment has yet to show any sign of rebound.

Despite the fact that numerous measures have been implemented to increase the supply of credit, in particular to those sectors that were hit hardest by the crisis, credit supply in real term has been declining in some of the crisis countries. These pieces of evidence through lead one to conclude that the restructuring efforts cannot be credited with the recovery and may not even have triggered the turnaround of the crisis countries.

Restructuring may require more infusion of public funds into banks and other financial institutions for their recapitalization. This additional fiscal support could speed up corporate restructuring, but the capacity of the crisis countries to mobilize additional resources through taxation and debt issue for restructuring is limited. If they have to pour in more public resources, as is likely, the resulting overhang of a large public debt could, unless managed carefully, endanger the incipient recovery as it will eventually necessitate fiscal tightening to slow the growth of public debt (Claessens *et al.*, 1999).

In the process of restructuring, the state had to nationalize a large number of weak financial institutions, including banks, and to control a substantial portion of corporate assets, in particular in Indonesia. Although the crisis countries have given a high priority to the divestiture of state-owned banks and assets, they have not been able, and are not likely, to find many willing and qualified buyers.

Despite these developments and continuing pressure on these countries by

international financial institutions, the process of reform has slowed down considerably, and in some cases, suffered relapses and backtracking in recent months. After two years of implementation of what was designed as a three-year program, it appears the crisis countries have reached a stage where they must reassess their restructuring efforts to determine whether the reform programs should be accelerated or modified to take into account some of the lessons they have learned over the past two years.

The World Bank (1999a) and IMF (1999) maintain that further financial and corporate restructuring is needed for a return to sustainable growth on the grounds that only a decisive and accelerated pace of restructuring can and will ensure medium-term durable growth. Their message is that further structural reforms must be carried out even if they interfere with the recovery in the short-run.

Many critics of the IMF, however, predicted that the IMF programs were so misguided and inappropriate that they would not work. The experiences of the crisis countries over the last two years seem in part to bear out their argument. In what follows, this section discusses some of the institutional and other constraints that may have limited the effectiveness of the IMF programs in East Asia and that point to the need to readjust the current reform strategy.

III-1. Dismantling East Asian Model

After the crisis broke out, the East Asian crisis countries were forced to eschew a development model that had worked very well for almost three decades in industrializing and raising living standards, in favor of an Anglo-American market oriented system, but policymakers as well as the general public in East Asia were, and still are in many cases, confused and certainly not persuaded why they had to do so. As Stiglitz (1998 and 1999c) points out, "East Asia remains the best model of development the world has probably ever seen," despite the crisis that beset the region. Furthermore, "the East Asian miracle was real and was based on a set of sound fundamentals and public policies." Perhaps, as he puts it, the region was not any more

vulnerable to the crisis than other regions and some of the alleged institutional weaknesses played little role in the crisis.

As case in point is the chaebol reform in Korea, the Korea authorities have been pressured to break up the diversified industrial groups--chaebol--that dominate the private sector, which has been singled out as one of the major institutional weaknesses of the Korean economy. A recent study, however, argues that since these groups "substitute for the institutions that support effective markets in capital, labor, and goods and services," rapid dismantling of the chaebol could weaken the competitiveness of Korean companies as it will exacerbate Korea's institutional voids while an alternative industrial organization is nowhere in sight (Khanna and Palepu, 1999). If the dissolution of Korea's industrial groups deemed desirable for efficiency, then the reform programs should at least have identified the type of industrial organization that could replace the chaebol system.

The bank-dominated financial system on which East Asian governments had relied for the implementation of industrial policy has often been pointed out as another institutional vulnerability that precipitated the crisis. All IMF programs therefore include a capital market development plan. As the discussion in appendix suggests, developing a more balanced financial system in which capital markets complement and substitute for the banking system as a source of corporate financing is undoubtedly one of the reform objectives, but it can only be a long-term priority, in particular as it is not altogether clear whether the bank-dominated system was as serious a weakness as it is often made out to be and cannot be replaced by a market-oriented system overnight.

III-2. Institutional Weaknesses

As discussed at length in the preceding section, in the East Asian crisis countries, in particular in Indonesia and Thailand, institutional weaknesses have been the major obstacle to a speedy and efficient implementation of the IMF programs. Long accustomed to rapid growth with financial stability, these countries had failed to

develop social infrastructure--government and market institutions, and legal system--and skilled manpower indispensable for financial restructuring and corporate debt resolution before the crisis.

Suddenly almost overnight, a host of new institutions had to be grafted on these economies after the crisis, but understandably they have not been effective in responding to the crisis and carrying out the reform programs because these institutions have been plagued by a lack of trained staff, leadership, and often corruption. For example, the administrative work for the closing of finance companies and banks in Thailand and Indonesia required 5000 people respectively, many of whom were experts in bank restructuring. An elaborate institutional framework for financial and corporate restructuring has been in place in all crisis countries. However, it is unclear whether the Southeast Asian crisis countries will be able to make these institutions function properly.

To make the matters more complicated, economic policy leadership in the crisis countries did not change after the crisis. In fact, those policymakers, long accustomed to an interventionist regime, who should be held accountable for the crisis were in fact entrusted with the tasks of restructuring and reforming their financial and corporate sectors and liberalizing and opening the domestic markets. It is not, therefore, surprising that they did not fully understand either the need or urgency of the overall reform.

III-3. A Blurred Road Map

As the IMF report (Lane *et al.*, 1999) admits, from the outset, the reform programs for the crisis countries did not have any road map to guide the formulation and implementation of financial and corporate restructuring and institutional reforms, except perhaps the broad guidelines of the Washington consensus. The IMF should not be criticized for the failure of developing a comprehensive framework *ex post facto*, however. After all, the IMF did not have the luxury of spending many months in

designing a coherent program while the crisis was deepening every day, threatening the total collapse of the crisis countries. The program packages therefore had to bring in various reform measures that were presumed to help restore market confidence, reduce the likelihood of a recurrence of crisis, and improve the long-term economic performance of these countries without much thinking about the short-run consequences as well as possible conflicts between different measures for different reform objectives.

Since the IMF programs did not anticipate the sharp downturn of the economy, a massive currency depreciation, and the full extent of the financial and corporate sector problems, the reform had to be implemented in a reactive manner and therefore had to be modified as new information about the effects of the initial measures and the depth of the unsoundness of financial institutions and corporate distress became available.

In this reactive process of implementation, the strategy and operational targets of restructuring and institutional reforms could not be clearly defined beforehand and have had to be adjusted repeatedly. These frequent adjustments have raised several problems. First, they have raised the fundamental question of what would constitute realistic targets of operational restructuring and institutional reforms that would be sufficient to reduce the vulnerabilities of the crisis countries in terms of bank capital adequacy, the size of NPLs, and loan provisioning. For example, the rationale behind the reform mandate in Korea that banks must raise their BIS ratios to over 10 percent before the end of 1999 was never made clear. Second, the frequent changes provoked strong resistance by many domestic constituents to the pace and extent of reform as the initial targets were unrealistic, while they have been viewed as evidence of the unwillingness on the part of policymakers to implement the required reforms by foreign financial market participants.

Third, in the course of implementation, the injection of public funds into banks led to government ownership of a growing share of corporate assets and also financial institutions to speed up the reform process against the spirit of the IMF programs, which essentially espouse a market-led approach in financial and corporate restructuring. Since privatization of financial institutions often takes a long time, the pervasiveness of

government in the restructuring process has raised the concern that the crisis countries may return to their old dirigisme regimes.

By following a reactive process of implementation, the authorities of the crisis countries may not have given due consideration to the question of whether the prescribed reforms were appropriate or consistent to one another. For example, the IMF reform programs appear to have underestimated the seriousness of the possible conflicts between microeconomic objectives of financial and corporate restructuring and macroeconomic objectives of restoring employment and growth.

The reform programs were initially designed to restore market confidence and to develop a strong institutional foundation requisite for durable growth in the medium term. However, completion of operational restructuring and institutional reforms does not automatically guarantee recovery and resumption of growth. As the experiences of the crisis countries suggest, the restructuring and reforms could deepen economic downturn in the short-run, unless they are complemented by expansionary macroeconomic policies. In all crisis countries, there has been a certain amount of confusion and indecisiveness as to when reflation of the economy should begin and what instruments--monetary and fiscal--should be employed. In many cases, banks were trying hard to reduce their exposure to those weak but viable borrowers, while the policy authorities were busy in providing special credit facilities and credit guarantees to the same borrowers.

During the early months of the crisis, a large number of different financial institutions were closed down, but then the programs did not have any clear picture as to which types of institutions, new or old, should replace those liquidated institutions so that the existing customers could be served, not to mention the reemployment of a large number of skilled professionals shed by the failed financial institutions. The programs for all three countries saw the need to upgrade loan classification, provisioning, capital adequacy, and corporate governance, but they did not carefully examine whether the planned regulatory upgrading could be completed within a three-year period and whether it would interfere with bank recapitalization and recovery.

As far as financial restructuring was concerned, the IMF and the policymakers of the crisis countries knew at least what should be done, drawing on the experiences of other countries that had suffered a similar crisis. However, there was no known best practice for restructuring when practically all of the non-viable corporations were concentrated in manufacturing as in Korea. Debtors and creditors did not understand why such an alien approach as the London Rules had to be chosen for the workout of corporate debt, and why reducing the debt/equity ratio so drastically in the short-run was critical. As for management and disposal of NPLs at banks, opinions were divided on the advantages and disadvantages of government-owned, centralized AMC versus privately-owned, decentralized AMCs.

All four countries introduced voluntary, out-of-court settlements for corporate restructuring (London Rules). The adoption of the London Rules was to some degree dictated by the absence of necessary market and government institutions for a market-led approach such merger and acquisition and a well functioning court-based resolution procedure. In this framework of out-of court workouts, the government plays the role of mediator, facilitating an orderly debt-resolution and banks as creditors manage the workout of corporate debt.

In retrospect, corporate structuring should have been treated as an integral part of financial restructuring. It was not, however. Banks were to be restructured first by cleaning up their balance sheets and building up their equity base, and then to varying degrees letting them take charge of restructuring ailing corporations because the structure of governance and prudential framework of banks provide powerful levers to bring about corporate restructuring (Baliño, 1999). This strategy has not been very effective and is likely to result in repeated bank recapitalizations in the future unless the recovery picks up.

Since it is difficult to identify potentially non-viable firms and to forecast accurately how many of the restructured firms would be able to survive the current difficulties, corporate restructuring could easily impair again the balance sheets of those recapitalized banks, depending on the speed of recovery. Given the difficulties of

forecasting cyclical developments with little experience in investment banking and the unreliability of corporate financial statements, distinguishing non-viable corporations from viable ones have been difficult, contentious, and time consuming. Under these circumstances, the banks had to be conservative in their lending and asset management and hence retrenched from their normal lending operations. The scaling back of bank lending has also exacerbated the financial conditions of many heavily indebted but viable corporations. The bank-first strategy therefore was susceptible to the danger of creating a vicious circle in which recapitalized banks become more prudent and risk averse in lending. This retrenchment in lending leads to a further deterioration in the debt-servicing capacity of corporations. This deterioration is then translated into a further increase in NPLs at banks.

Banks in the crisis countries are also mandated to increase their CARs to an internationally acceptable level, that is, over 8 percent, adopt stricter criteria for loan classification and provisioning, and improve risk management. However, insufficient resources have made it impossible for them to meet these requirements in the short-run and at the same time to increase the supply of credit. Furthermore, once public funds or tax payers' money are injected into insolvent banks, the authorities of the crisis countries set a higher standard of performance for these institutions than others in terms of net profits and the volume of NPLs. Knowing that the government will hardly tolerate any further losses or deterioration in the quality of assets, bank management has become more averse to taking risks in lending than before.

In Thailand, for example, the tightening of regulation and supervision brought about a downward spiral as it made banks more reluctant to lend. This in turn led to a credit crunch--a decrease in real supply of credit--and more business failures, thereby deepening the recession. At the same time, the stock exchange of Thailand stipulated prerequisites for new entrants, stringent minimum profits for some consecutive years, and a minimum number of shareholders, among other things. Most small-and medium-sized enterprises were hardly able to meet these requirements. At the same time, their access to commercial banks and finance companies was drastically reduced

(Pakorn, 1999).

For due diligence of financial statements and the restructuring of financial institutions, the crisis countries sought the services of U.S. and Europe based accounting firms, consulting agencies, and investment banks simply because there were no credible domestic counterparts. Understandably, they followed Anglo-American standards in due diligence and restructuring, which were unfamiliar to and more stringent than those of the crisis countries. Furthermore, given the pessimistic outlook of the economy, they were inclined to overstate the size of NPLs at the banks.

They were also concerned about their potential liability in case they overvalued assets (Baliño, 1999). These new and tougher criteria for due diligence have made it difficult for the lead banks and debtors to reach agreement on the modality of debt workout. The insolvent corporations objected to what they perceived to be the fire sale of their assets. On the other hand, commercial banks did not have staff experienced in managing corporate debt workouts.

Instead of evaluating project viability and debt service capability of workout candidates, banks in Thailand, for example, were more inclined to recover their loans as much as they could by foreclosure on the assets if the candidate clients had pledged enough collateral or guarantees from reliable entities. If they did not, then banks would keep them on their books and continue to provide short-term emergency financing in order not to incur any further losses (Pakorn, 1999).

Institutional reforms, including the reform of government bureaucracy and the legal system, were essentially medium-term priorities. At the beginning, however, the institutional reforms were perceived to be necessary to win back the confidence of foreign lenders in the crisis economies rather than to address over a longer period the underlying structural weaknesses of the economy. This misconception has interfered with the implementation of institutional reforms in two ways. Policymakers in the crisis countries have not made clear distinctions in policy management between the short-run priority of liquidity management and the medium-term priority of building a strong institutional foundation to help prevent a recurrence of crisis.

They rushed out to introduce new corporate governance, a new regulatory and supervisory structure, and new accounting standards, and even to initiate legal and judicial reform. They simply ignored how difficult it would be to graft a set of Anglo-American institutions onto these countries. These reforms must be forcibly enforced to be successful, and even with strict enforcement may require a long period of time to take root.

Once the recovery got under way, it has been difficult to maintain the momentum of reform, because the recovery has diminished the need to improve foreign investors' confidence in the crisis countries. On the other hand, foreign investors and lenders, who withdraw entirely their investments as they were so surprised and dismayed by the structural weaknesses of the crisis countries, have shown a remarkable lack of interest in monitoring whether these countries are moving in the right direction in carrying out the planned reforms. There has been little market pressure on these economies to stay on course with the initial reform program. In adjusting the sovereign ratings of the crisis countries, for example, the rating agencies attach more weight to improvement in the external liquidity position and macroeconomic variables than the progress in restructuring.

IV. Agenda for Sustaining Recovery

IV-1. Setting Priorities

The preceding assessment of the progress in financial and corporate restructuring and institutional reforms in the East Asian crisis countries leads to the conclusion that the current strategy unless adjusted is likely to inhibit and hence delay the ongoing recovery in these economies. This is no longer acceptable or justifiable. In this section, it will be argued that the crisis countries must adopt a strategy different from the one designed by the IMF in terms of priorities of short-and medium-term policy objectives to manage better the current crisis and to prevent future ones. This

strategy focuses on the following four policy priorities:

- (i) Accelerating growth through the promotion of investment should stand at the top of the agenda of a new strategy. To this end, there should be a shift of emphasis from financial and corporate restructuring to economic growth with institutional reforms and institution building;
- (ii) For rehabilitation and recapitalization of financial institutions and corporate debt workout, the authorities of the crisis countries except for Indonesia should minimize direct intervention and instead rely more on the existing frameworks developed for a market-led strategy;
- (iii) For institutional reforms regarding legal, judiciary, and civil service systems, standards, corporate governance, bankruptcy procedures, and industrial organization, the crisis countries must develop a detailed long-term plan to guide the formulation and implementation of the reform program with due consideration of their capacity to change and adapt; and
- (iv) In cooperation with other economies in the region, the crisis countries are well advised to take the lead in developing various arrangements for better policy coordination and financial cooperation in the region for the prevention of future crises.

IV-2. Growing Out rather than Restructuring Out

Looking into the future, what are the prospects of the East Asian crisis countries to return to the pre-crisis trend of growth? In setting national economic objectives, which ones should be given the highest priority in these economies? East Asia must direct and consolidate its efforts and resources to move out of the current recession as fast as it could. The crisis has inflicted enormous damage on the region for the past two years. Too many people in the region have suffered from the misery of the crisis for too long, and the vulnerable segments of the society, including poor urban workers, suffered disproportionately. More importantly, the erosion of social and

organizational capital as a result of the increasing number of bankruptcies of firms and financial institutions may no longer be tolerable (Stiglitz, 1999c).

There is therefore widespread consensus that the most urgent task facing the authorities of the East Asian crisis countries is to steer the economy back to a path of durable and stable growth. To this end, sustaining the incipient growth is of critical importance. What then should then policy priorities be in the short-run? Although there cannot be a single strategy applicable to all crisis countries, the discussion in the preceding section makes it clear that the highest priority is to pursue expansionary monetary and fiscal policy together with institutionally-supported policy designed to revive capital investment.

While sharing the urgency of restoring growth, the IMF and World Bank argue that neither banks nor corporations are likely to grow out of their insolvency problems, in particular in Indonesia and Thailand. In fact, they suggest that the recovery under way may become short-lived unless the restructuring is intensified (World Bank, 1999a). The reason is that banks will not be able to be active in restructuring insolvent corporations as their capacity to absorb losses will be limited as long as they are undercapitalized and carry a large amount of NPLs in their books (Claessens *et al.*, 1999). This view is contrary to the realities of the East Asian crisis countries.

As noted in the preceding section, banks that have been recapitalized through the injection of public funds, not to mention undercapitalized ones, have not been able to return to normal lending operations because they are hard pressed to find viable and promising borrowers and they will be for as long as the economy is in recession. The banks have been also slow and unwilling to engage in the workouts of weak but potentially viable corporations, because such restructuring is bound to increase their holdings of NPLs and hence to undermine their profitability. The banks' inactivity has been further compounded by the tightening of regulatory requirements and the concern that bank management may have to assume liabilities related to the workout losses.

The experiences with financial and corporate restructuring in East Asia for the last two years suggest that it will take many years for the crisis countries to clean up

their banks and reduce the overhang of corporate debts. During this period of restructuring, capital investment is likely to suffer, since most weak corporations are not in a position to contemplate new investment while undergoing debt workout, whereas viable corporations may not have access to bank lending. Capital investment, which was the major source of growth, has remained depressed for the last two years. If the crisis countries are going to be as mired in the restructuring of corporate debt and operational structure as they are now, there is little hope that investment demand will rebound anytime soon.

All of the crisis countries depend heavily on their exports to Europe and North America for economic growth. In a rapidly changing global market, these countries have to invest in developing new lines of products and businesses and new technologies to remain competitive. If investment demand continues to stagnate for the next two or three years, then these countries risk the danger of losing out in global competition and therefore may not be able to return to the global market. That is, the ability of these countries to maintain the competitiveness of their industries will be undermined beyond recovery and their engines of growth may be damaged irrevocably.

Baliño *et al.* (1999) argue that, at present, direct and indirect measures to stimulate credit are not likely to increase banks' lending capacity and that only regaining profitability and solvency in the banking and corporate sectors will change the bank behavior. If this is the case, the authorities then have two policy options. One option would be to intervene more aggressively in the restructuring of banks through the removal of NPLs and injection of public funds for recapitalization.

Alternatively, they could shift emphasis in policy management to the reflation of the economy while continuing with a market-based approach to the restructuring of banks and corporations with phased-in compliance of new regulatory requirements as a medium-term objective.

The estimates made by Claessens *et al* (1999) show that fiscal costs incurred so far by the restructuring programs as a percentage of 1998 GDP range from 11 percent in Malaysia to 37.3 percent in Indonesia. Although they do not specify target levels of

financial and corporate restructuring, expected additional costs would amount to 15.4 percent of GDP in Thailand and 12.7 percent in Indonesia to complete the restructuring process. If the ongoing recovery is derailed, the expected costs are likely to multiply. Do these countries have the ability to mobilize such a large amount of additional public resources, when public debts as a proportion of GDP already stand at 37 percent in Korea and almost 100 percent in Indonesia?

Given this high debt burden and a limited tax base, it is reasonable to argue that the crisis countries will find almost impossible to raise the required amount for restructuring, in particular in Indonesia and Thailand. For the sake of argument, however, suppose they are. How will these public resources be allocated under the current restructuring arrangements? A substantial portion of the public funds used for rehabilitation and recapitalization of banks and other financial institutions will be dissipated in repaying and servicing foreign debts, increasing banks' CARs and provisioning, and adding to banks' holdings of liquid and safe short-term assets. If banks do not increase lending in preference to investing in short-term securities, while some of new loans are extended to non-viable firms, the fiscal support may not necessarily succeed in augmenting financial resources available for corporate investment. Such being the consequences of injecting additional public funds into financial institutions, then one could make a strong case for allocating any additional fiscal resources the authorities could mobilize to the financing of public expenditure, including that of social infrastructure outlays, and most of all to the provision of incentives for private investment.

According to Claessens *et al.* (1999), at the current levels of interest rates, about 17 percent of corporations in Korea, 25 percent in Thailand, and more than 50 percent in Indonesia might not be able to cover interest expenses from operational cash flows by the end of 2002. This is one of the reasons why they believe corporations are unable to grow out of their debt problems and why more aggressive corporate restructuring through the participation of banks must precede or at least be carried out in conjunction with expansionary policy.

Although reliable statistics are not available, the share of distressed firms appears to be declining much faster than expected in Korea, where GDP is forecast to grow 10 percent in 1999. It would not be surprising if similar developments are observed in other crisis countries where growth is accelerating in recent periods. However, if indeed such a serious problem of corporate distress still exists in these countries then the interest rates should perhaps be kept at a relatively low level through expansionary monetary policy, and the scope of bank restructuring adjusted by lowering the required levels of CAR and loan provisioning, and by relaxing the restrictions on debt/equity swaps, so that banks could engage in corporate debt workout more actively than before.

The adoption of international standards of banking, the tightening of regulations, and improved bank balance sheets may make the crisis countries less vulnerable to future crisis as they may help restore foreign investors' confidence in financial institutions, but these preventive measures could be also counterproductive to the extent that they exert deflationary effects and hence delay recovery in the short-run. Prolonging the recession will expose these countries to a greater risk of inviting another round of speculative attack, because foreign lenders and investors are likely to be dissuaded from investing in these countries more by a deterioration in macroeconomic performance than slow progress in reform as illustrated by the behavior of the rating agencies. In raising the sovereign ratings of the crisis countries, the rating agencies often cite an improvement in the external liquidity position as a result of large current account surpluses as one of the most important reasons for their actions.

There are other reasons why the East Asian countries should shift to the growth-first strategy. Many skeptics of the East Asia's progress in reviving the economy, including Krugman (1999), have expressed their concerns that the crisis countries will experience a sharp deceleration in growth after a years of resurgence, suggesting they will go through a period of several years characterized by a "W" shaped pattern of growth. Strong and sustained investment will therefore be needed to smoothen out the large fluctuations in growth and employment often experienced by

other crisis countries in the past.

Since actual output will fall short of potential output even if actual growth rates exceed the expected levels in 1999, and since inflation is relatively low while the current account is strong, the crisis countries do have ample room for expansionary policies.

A market-based approach is likely to be slow and unreliable, and often produce results that are contrary to what policymakers expect. This reason does not provide justification for active government intervention. If governments choose to intervene in the restructuring more extensively than before, they will most likely end up taking over the ownership of most of the financial institutions and managing directly corporate debt workout. In fact, that is what has taken place in Korea to some extent. While such a drastic approach may speed up the corporate reform, it may in the end draw out the restructuring process, because the transition to a market-oriented approach at a later stage through divestiture can be costly and time consuming as it will meet strong resistance and suffer from corruption and bureaucratic delays. Therefore, the government involvement is likely to necessitate the second round of restructuring: privatization of government-owned financial institutions and corporations. Moreover, there is no assurance that the government-controlled restructuring would be more efficient and expedient than a market-based one since it carries the risk of consolidating an interventionist regime instead of promoting market principles.

What could the authorities of the crisis countries do to stimulate private fixed capital formation if the banking sectors' ability to supply fresh loans to a large number of struggling but potentially viable firms is limited? Most of the crisis countries have turned to fiscal stimuli for reviving domestic investment for the past year and a half. For example, Thailand introduced a fiscal stimulus package that contained a cut in the value-added tax rate and an income tax waiver in March 1999. This was followed by another package of fiscal expansion that reduced import tariffs for a number of imported commodities used as inputs in manufacturing and allowed the use of accelerated depreciating schedules. The Thailand authorities have also established three new investment funds for investments in large restructured firms and small-and medium-

sized firms in cooperation with ADB and IFC (World Bank, 1999a).

While the major components of any fiscal stimulus package, including tax benefits and public expenditure needed for are likely to be similar in all crisis countries, selection and implementation of particular measures among a large menu of alternative instruments will differ a great deal from country to country. The policy authorities of the crisis countries know what fiscal policy instruments are at their disposal and how effective they are. What is required at this stage is not debate on the relative effectiveness of alternative fiscal tools but the authorities' commitment to support domestic investment through the implementation of a set of expansionary monetary and fiscal policies in recognition of the nature of the recession and institutional constraints.

IV-3. Market-Based Restructuring and Institutional Reforms

The emphasis on growth does not mean that the crisis countries can afford to delay or forgo financial and corporate restructuring and institutional reforms. While active state intervention in the restructuring through the injection of public funds into financial institutions is not likely to be effective, the crisis countries should strengthen and focus on a market-led approach to improve the soundness of the banking sector and remove corporate debt overhang. As shown in Section II, all crisis countries have established an elaborate institutional framework for financial and corporate restructuring. So far the lack of skilled staff with experience and bureaucratic inertia have limited the role as well as the effectiveness of these institutions, and this institutional problem will not go away anytime soon. However, a pick up in growth will help lubricate the institutional machinery for restructuring as both creditors and debtors will have greater incentives for participating in the restructuring process with the recovery of asset prices.

The market-led approach does not necessarily apply to Indonesia, however, where the state controls more than 75 percent of the banking sector in terms of liabilities and own corporate assets valued at Rp. 430 trillion or 40 percent of GDP through the

IBRA. The Indonesian authorities must therefore speed up the plans for restructuring, merger, and privatization of the state-owned banks and consolidate the IBRA to accelerate the sale of NPLs transferred from unhealthy banks.

Some of the measures that constitute a market-led restructuring strategy include:

- **Easing restrictions on foreign entry into the domestic financial services industry**
Economic forces driving the globalization of finance have been gathering speed in recent years and will continue to do so. Regardless of their policy and strategic preferences, the East Asian countries will be forced to adjust to this trend by opening their intermediation markets and providing a level playing field to foreign competitors. If the ongoing worldwide financial integration is going to be a natural and unavoidable development, the East Asian authorities should consider taking advantage of their market opening as an opportunity to exert pressure on domestic financial institutions to prepare themselves for foreign competition by improving their balance sheets and operations and also by consolidating among themselves through mergers and acquisitions. Foreign competition will serve as a credible threat to the domestic financial institutions in that unless they reform themselves voluntarily, they will not only lose their market shares but also could be driven out of the domestic intermediation market.

- **Recapitalization through the stock market**

In recent months, the equity markets of the crisis countries have recorded considerable gains in terms of market capitalization, most notably in Korea. The East Asian stock markets will continue to be bullish with the ongoing recovery. The upswing will increase the scope of and facilitate bank recapitalization through the equity market. In this respect, recent developments in Korea may be instructive.

A recent financial statement analysis by the Bank of Korea shows that at the end of June 1999 the average debt-equity ratio of 1,829 sample firms in manufacturing fell by 55.8 percentage points to 247.2 percent from 303 percent six months before. 36.6 percentage points of the drop were accounted for by

recapitalization through rights issue. During the first half of 1999, net profits of the sample firms as a percentage of their total sales rose to 4.2 percent compared to -0.4 of the corresponding period in 1998 due largely to a decline in market interest rates and a sharp increase in aggregate demand.

Encouraged by the booming market, a large number of financial institutions, including banks, are now making plans for public offerings of both common and preferred stocks in the domestic equity market and also for issuing global depository receipts to foreign investors. The rapid recovery with a recent upward adjustment in Korea's sovereign rating will ease a great deal in marketing these instruments.

- Using both centralized and state-owned AMCs and individual privately-owned AMCs for better management of NPLs

In order to deal more effectively with the management of non-performing assets, Korea, Malaysia, and more recently Indonesia have established centralized AMCs while Thailand has chosen a decentralized process in which each commercial bank is encouraged to establish its own AMC. AMCs could be effective in resolving insolvent financial institutions and selling their assets, although they are not expedient vehicles for corporate debt workouts, in particular for those in manufacturing (Klingebiel, 1999).

A centralized AMF is often more effective in forcing the operational restructuring of insolvent financial institutions and has the advantage of centralizing scarce skilled personnel. It could, however, become a place where NPLs and collateral are parked for a long period instead of liquidation (Baliño, 1999). Choice regarding centralized versus decentralized AMCs and their specialization either in corporate debt workouts or asset disposition should be also determined by the authorities of the individual crisis countries according to the nature and depth of the financial and corporate problems, legal and institutional constraints, and strategic preferences of the governments in question.

The market-based approach will be more successful if it is accompanied by

regulatory improvements and other institutional reforms involving the legal system and bureaucracy to be achieved over a period of several years as a medium-term objective.

The crisis countries should therefore develop a medium-term strategy for regulatory reforms involving CAR, loan classification, loan-loss provisioning, and risk management and corporate governance based on international best practices, codes, principles, and standards. These regulatory authorities should also consider stricter separation of banking from commerce, in particular in Indonesia and Thailand.

In promoting institutional reforms and institution building, the East Asian countries must be careful not to simply transplant an Anglo-American system. Instead, the strategy of institutional building should be an indigenization of the new system as a gradual adaptation to and assimilation of the Anglo-American system. Such strategy requires a careful planning with a phased-in introduction over time.

Institutional reforms should also not be intended as a means of restoring market confidence in the short-run. Instead, they should be designed and carried out to build a strong foundation for more durable growth and at the same time help harmonize East Asian institutions, systems, and rules and regulation with those of western countries, thereby facilitating the integration of East Asia into a global economy where a new set of rules governing trade in goods and services and investment will be written in Europe and North America.

The East Asian model of development may be based on a set of sound policies and may provide a better framework of development. However, all of these economies have been pursuing an export-led growth strategy and will have to rely on the large markets in the U.S. and EU for their exports. Since the U.S. and EU control the largest markets, they will be effectively writing the rules for trade and investment and East Asian economies will have to adopt these rules as the *de facto* operating system. However, this need for reform, how imperative it may be, does not mean that the East Asian model must be dismantled and replaced by an Anglo-American system without

modification in a short period of time.

V. Regional Cooperation for Prevention of Crises

Institutional reforms will be necessary but not sufficient to help prepare East Asia to fend for itself from future crises. In order to prevent crises and manage them better in the event that they occur, the East Asian countries must consider bringing into existence more effective regional arrangements for financial cooperation and better policy coordination.

In retrospect, there is the question of whether the crisis that touched off in Thailand could have been contained and hence its contagion throughout the region could have been minimized. The answer is clearly yes. Since the panic reaction and herd behavior exhibited by foreign institutional lenders was an important cause of the crisis contagion in East Asia, any effort of crisis prevention and information exchange should begin with correcting the glaring failures of financial markets both at the regional as well as global level. This would mean strengthening the prudential regulation and supervision of banks, securities firms, and other institutional investors operating out of capital markets in the region. Since the financial markets of the East Asian economies are developing closer links among themselves with the progress in capital market opening, financial supervision and regulation of individual countries would not be effective, unless they are coordinated across the countries. This calls for a regional cooperative mechanism for supervision among the East Asian countries.

While strengthening regional cooperation, the East Asian countries should join forces to actively participate in the current debates on international financial reform to articulate the region's concerns and interest in building a new international financial system. Prevention of crisis may also require a reexamination of exchange rate policy in the region, developing an efficient system of control of short-term capital movements, and creating regional monetary arrangements.

V-1. Exchange Rate System and Capital Controls

As part of the IMF rescue programs, the East Asian crisis countries were required to jettison a fixed or managed floating exchange rate system in favor of a free floating system. A majority of professional economists believe that greater flexibility in the nominal exchange rate helps diffuse the impact of adjustment to external shocks on domestic financial markets in emerging market economies. Flexible exchange rates are also expected to give banks and corporations an incentive to hedge their foreign exchange exposures and in so doing reduce the frequency of foreign exchange crises. Many studies have shown that the defense of an exchange rate fixed at an untenable level was invariably one of the major causes of financial crises as in the cases of Mexico, East Asia, and Russia. Blinder (1999) argues that floating rates should be the accepted norm in the new financial architecture. According to Dornbusch (1999), countries in East Asia have no option but to move to a flexible exchange rate system.

Despite the overwhelming support for the flexible exchange rate system in emerging market economies, many countries in East Asia have been reluctant to accept the advice of the IMF. Malaysia decided to adopt a fixed exchange rate system in the midst of a crisis, China continues to adhere to what they call a managed floating system, and other East Asian countries with a free floating system intervene extensively to stabilize their nominal exchange rates. An important question is why these emerging market economies in East Asia have so little confidence in the flexible exchange rate system. It is perhaps too early to assess the effects of the flexible exchange rate system on East Asia's recent recovery. However, judging from the available evidence, contrary to expectations, the free-floating system is not likely to reduce the frequency and depth of financial crisis and has not clearly enabled East Asian countries either to regain their monetary autonomy or to reduce their holdings of reserves.

There are a number of structural and other reasons that may explain the unwillingness of many emerging market economies to allow exchange rates to move

around over a wide margin. Perhaps the most common argument against a free floating system is that under flexible rates, exchange rates often move too much, and these movements are unrelated to fundamentals and hence cause undesirable movements in real exchange rates. The high degree of volatility of exchange rates also make business more costly for firms, especially for those small and medium sized firms specialized in foreign trade.

Foreign exchange markets are relatively small in terms of the volume of transactions in emerging market economies. Therefore, even a small change in capital flows or market expectations could trigger a large change in the nominal exchange rate. At times, the high degree of volatility in exchange rate movements may become unbearably high, in particular, when traders have limited access to or have to pay high costs of hedging. In Korea, for example, only the big five chaebols have been able to hedge their foreign exchange exposures through the forward exchange market. SMEs are required to provide collateral for a forward cover, making the cost of hedging much higher than that of large firms.

Most of the SMEs do not have skilled staff who could manage complex arrangements forward market transactions require. Currency futures and options are available in some emerging market economies, but cannot be used as a means of hedging, because the markets for these instruments are not liquid and are still in an early stage of development. For these reasons, small and medium sized firms specialized in foreign trade often find that the hedging costs are too high and undermine their export competitiveness.

A second argument for favoring stable exchange rates is related to the changing nature of foreign exchange markets in these countries where capital movements have increasingly dominated the determination of the nominal exchange rate with deregulation of capital account transactions in recent years. Capital movements in and out of these economies have largely determined the direction and scope of fluctuations and also resulted in an overshooting of nominal exchange rates. Changes in the real exchange rate in these economies may therefore not be consistent with, or may make it

difficult to maintain balance in the current account. To elaborate further on this point, consider a cyclical expansion in an emerging market economy.

The country in question may experience a deterioration in its current account, which may, other things being equal, lead to a currency depreciation. The current account deficit may be a short-run cyclical development and could be sustainable. Nevertheless, foreign investors may regard it as a structural problem and decide to pull their investments out of the country. This withdrawal could cause a much sharper depreciation of the currency than otherwise. Conversely, a surplus on the current account may lead to a large appreciation of the exchange rate more than when capital account transactions are small in volume or regulated.

A third reason centers on the effects of changes in the exchange rates of the three major currencies, namely the dollar, Euro, and yen on the currencies of emerging market economies. In most East Asian countries which trade heavily with Japan and compete against Japanese exporters in third markets, the dollar-yen exchange rate is an important variable in determining their real effective exchange rates. A high degree of volatility of the yen-dollar exchange rate is then translated into a high degree of instability of the real effective exchange rates. For example, a depreciation of the yen against the U.S. dollar will, other things being equal, cause an appreciation of the real effective exchange rates of the East Asian economies. While these countries may experience an erosion in their export competitiveness *vis-à-vis* Japanese exporters, their exchange rates *vis-à-vis* the U.S. dollar may not change. In order to prevent real appreciation, they have to intervene in the foreign exchange markets to bring about a depreciation of their currencies against the U.S. dollar. One might argue that foreign investors may curtail or withdraw their investments in the East Asian countries once they observe a weakening of the yen and subsequently force a depreciation of the East Asian currencies *vis-à-vis* the dollar. However, there is no empirical evidence supporting this type of adjustment.

A fourth reason is that stability of a flexible exchange rate system in a world of free capital mobility has not been established. The system could easily generate

a cycle of boom and bust in emerging market economies, and more so in export-oriented economies.

For example, consider a large increase in capital inflow in an emerging market economy attracted by the prospect of a boom. The inflow initially creates pressure for currency appreciation. However, the initial appreciation may not create an expectation of the depreciation of the currency and may not deter or reverse the inflow insofar as the foreign investors' perception of the economic expansion does not change. The expected future exchange rate may simply appreciate also as the spot rate appreciates. The nominal exchange rate may follow a random walk, and even if it does not, the prospect of boom may lead to an appreciation of the future nominal exchange rate.

Suppose that the stock market of an emerging market economy is expected to gain continuously because of the ongoing expansion.⁴ This expectation may make foreign investors believe that the local currency will also continue to appreciate because the bullish stock market will attract further foreign capital inflow. In the absence of central bank intervention, the inflow will lead to monetary expansion and subsequently increase the prices of assets, including real property. The asset price increase keeps the currency strong, but the booming asset markets and domestic demand expansion do not generate any expectation of depreciation, hence resulting in further inflow, which in turn feeds on the speculation in the asset market. The appreciation of the currency will eventually slow down export earnings and bring about a deterioration in the current account. It may take anywhere from six to nine months to observe such an effect of the appreciation on the trade account.

Only when the current account begins to show signs of deterioration would an expectation of currency depreciation set in. Once they see an incipient current account deficit, market expectations suddenly shift and foreign portfolio investors and lenders pull out their investments all at once.

⁴ For the sake of simplicity, it is assumed that the domestic bond market is underdeveloped and closed to foreign investors as it is in many emerging market economies.

e. Such an exodus of foreign investors could easily precipitate a major financial crisis, because capital markets are relatively small in terms of their market capitalization and foreign exchange markets are also shallow, narrow, and often brittle in emerging market economies.

In many East Asian countries, foreign portfolio investors have become dominant forces in determining the direction of asset price movements, since these countries began opening their capital markets in the early 1990s.⁵ Many domestic investors tend to mimic the portfolio choices of foreign investors in the belief that foreign market participants have more accurate information on and better capability of analyzing market developments. This imitative behavior of domestic investors could aggravate the instability of financial markets further.

East Asian policymakers are under constant pressure to keep both the nominal and real exchange rates stable. The monetary authorities in these countries usually attempt to sterilize some of the capital inflows. Sterilization helps achieve the policy objective, because it either increases the money supply or interest rates (when combined with an open market sale of securities). Although they are often fighting a losing battle, the monetary authorities continue to use monetary policy as the main tool for stabilizing the nominal exchange rate. As a result, these countries do not enjoy any degree of monetary autonomy and suffer from a high degree of volatility of domestic asset markets, although they are on a flexible exchange rate system.

Should East Asian countries then eschew a flexible exchange rate system in favor of other arrangements with less flexibility? Whatever its merits, East Asian countries would not find it practical or politically acceptable to move to a currency board. Other arrangements such as crawling pegs with wider bands have their share of problems, and while the experience with a flexible exchange rate system is not encouraging, it is not li

⁵ There is also evidence that foreign investors have tended to augment fluctuation of asset prices in East Asian financial markets. At least, one empirical study shows that foreign investors are positive feedback traders and exhibit herd behavior. See Kim and Wei (1999).

kely that an alternative regime appropriate to emerging market economies will emerge in the near future.

If East Asian countries are going to stay with flexible exchange rate system, they may therefore have to consider introducing a system of control over short-run capital movements to ease the burden of adjustment through exchange rate fluctuations. In this respect, the IMF, while advocating an overall liberalization of capital account transactions, points to the need to implement measures to influence the volume and characteristics of capital flows. Such measures could include taxes on short-term foreign borrowing and prudential limits on offshore borrowing.

The Chilean experience with short-term capital controls has been widely accepted as a successful case. During the 1990s, Chile imposed a 30 percent reserve requirement on all capital inflows with no interest and also required foreign direct investment to stay in the country for at least one year. These measures were effective in lengthening the average maturity of the country's foreign currency debt.

In a recent article, however, Edwards (1998) disputes Chile's successful management of capital inflows. He shows that the capital control measures did not sufficiently reduce the share of short-term to total debt, did not succeed in slowing the appreciation of Chile's currency, and did not appreciably increase central bank control over monetary policy. On the other hand, Chile's capital controls had the problem of raising the cost of borrowing. As expected, large firms were able to find ways to circumvent the controls.

There is another potential dilemma with the Chilean type of control: the adverse selection problem. Some foreign investors, including commercial and investment banks, are not always intent on speculating for short-term profits. Indeed, many international lenders often move into emerging markets in search of long-term investment opportunities and then establish long-term relationships with local financial institutions. Yet a uniform reserve requirement on all capital inflows penalizes not only short-term speculators but also those long-term investors who will help stre

ngthen and stabilize links of emerging market economies with the international financial community. If the tax rate is very high, these desirable investors will avoid countries with capital controls. Their withdrawal will in the end lower the quality of international investors, even more so when foreign investors move together in a herd.

The issues related to capital control raise the question of whether there is a need for a region wide cooperation and coordination of policies of individual countries to stabilize short-term capital movements.

East Asian countries, in particular those which have experienced a financial crisis, are taking measures to build up their foreign currency reserves above the level that has been regarded as adequate in terms of their import requirements even when they are on a flexible exchange rate system. For instance, Korea is currently targeting a level of reserves equivalent to 17-18 percent of its GDP, largely because of an increased volume of capital account transactions. By any measure, this level is excessive, costly, and represents a clear case of resource misallocation.

To reduce the amount of reserve holdings, at least some of the East Asian economies could enter into an arrangement for precautionary lines of credit with private financial institutions. They could also rely on the IMF as a lender of last resort, which could provide an additional issue of SDRs.

There are other schemes for reducing the holdings of foreign currency reserves. For instance, East Asian countries could organize cooperative arrangements among their central banks to enlarge swap arrangements, both within the region as well as with other countries such as G-7 (Griffith-Jones and Kimmis, 1999). The enlargement as well as effectiveness of swap arrangements with G-7 will be limited, however. The central banks of the G-7 countries will not have strong incentives to enter into the swap arrangements with any emerging market economies, because the swaps are, in effect, equivalent to direct lending their swap partners.

Another possible regional cooperation could develop a scheme in which a group of countries from the region may decide to pool a certain percentage of their res

erves to create new credit facilities for the participating countries. An individual country belonging to the arrangement would not have to hold as large an amount of reserves as it would otherwise if it could borrow from the credit facility in the event of a reserve draw-down.

V-2. Regional Cooperation

In a recent paper, Fischer (1999) argues that the IMF can act as crisis lender or as crisis manager, although it does not have the power to create international reserves. As crisis lender it has access to a pool of resources contributed by its members, which it can lend to member countries. Because it has the responsibility of negotiating with member countries in a crisis and of arranging financial packages, it serves as crisis manager.

There is the question of whether the IMF will have enough resources at its disposal to serve as an effective crisis lender, but let us assume it could and would.

Then, looking into the future, the IMF would mostly be lending to emerging market economies and other developing countries in a crisis and would serve as their crisis manager, because other developed countries including G-7 are not likely to borrow from the IMF even when they are in a crisis.

The structure of the IMF is similar to that of a credit union. However, unlike a typical credit union, there is a clear demarcation between net depositors (lenders) and net borrowers. Advanced countries constitute the majority of lenders, whereas developing countries make up practically all of the IMF's borrowers. Rich industrial countries control the decision-making process as well as the operations of the IMF. This dominance raises a legitimate concern that the IMF may be "too responsive to its principal share holders, which are high income, international credit or countries and whose interests do not necessarily coincide with those of global society as a whole" (Gregorio, Eichengreen, and Wyplosz, 1999).

One might go one step further by saying that the IMF is constrained in articulating the needs and wishes of

emerging markets and other developing economies. Even though international credit or countries are as much responsible for the East Asian crisis as East Asian countries themselves are, it is also true that the IMF has been preoccupied with structural reforms in the developing world, while ignoring the problems on the supply side of capital flows.

In order to redress the imbalance between advanced and developing countries in managing the IMF, non G-7 members should be given the opportunity and be prepared to contribute more resources for the operation of the IMF. Commensurate with their enlarged contribution, these countries as a group should be accorded greater representation both on the board of directors and in management. Many emerging market economies, in particular those in East Asia, are more willing and able to share the burden of financing various IMF credit facilities than ever before. This issue of representation will become more contentious in the future if the IMF is given a central role in surveillance and the enforcement of various standards.

One should, of course, recognize that the IMF is an international institution providing the public good of international financial stability, and that crisis management and prevention does have externalities and is not only the responsibility of non-G-7 members but also of advanced countries. Nevertheless, it is only natural and logical for emerging market and developing economies to have a greater voice in managing the organization that is primarily serving as their crisis lender-manager.

Advanced countries will likely object to the idea of giving other smaller and less influential members a large representation in running the IMF. They may argue that without the dominant participation of advanced countries, the IMF may suffer from leadership problems, a deterioration in the quality of staff work, and become lax in the enforcement of standards and loan conditions. The same types of criticisms have been leveled against those who support the establishment of regional monetary funds. If the decision-making process at the IMF is not politically neutral, and if for this reason emerging market and developing economies cannot expect

t more active participation in the IMF decision-making process, then the G-7 and IMF should be more positively disposed to and East Asia actively promote the idea of creating regional monetary arrangements.

The Uruguay Round established the WTO with much-enhanced enforcement powers and gave birth to a large number of regional economic arrangements. In fact, more than 90 percent of all the contracting parties in the GATT are signatories to such arrangements. Indeed, if one can argue that regional economic arrangements that number more than () could serve as building blocks rather than stumbling blocks for creating a free global trading regime, then the same argument can be made for establishing a constructive role for regional monetary arrangements insofar as they are structured in a way that could complement, not substitute for, the role of the IMF in developing a stable global financial system.

In discussing the reform of the IMF, there has emerged the consensus that it cannot be the sole locus for future financial liberalization and stabilization of international financial markets. Regional arrangements could be presented as a complement and supplement to the IMF efforts to liberalize capital account transactions, provided that such arrangements are subject to an outside discipline and do not become preoccupied with regional issues and initiatives.

Financial crises tend to be regional because trade tends to be regional (Rose, 1998). With a large increase in intra-regional trade in East Asia in recent years, financial crises are more likely to spread through trade linkages than ever before. Along with the expansion of intra-regional trade, there has also been a substantial increase in intra-regional capital movements in the region. This development also indicates the need for closer policy coordination among the countries in East Asia to regulate and supervise regional financial institutions.

VI. Concluding Remarks

The recent economic recovery in the East Asian countries has been impressive by any measure of performance. Approximately one year after the crisis erupted in July 1997, recovery began and has accelerated in the past few months. Recent forecasts show that the rates of growth of GDP will range from 5 percent in Thailand to almost 10 percent in Korea. Even Indonesia is expected to register substantial growth in 1999. What are the developments that are responsible for the rapid recovery in these crisis countries? More important, could the ongoing recovery continue into the next few years? Or, does the upswing simply reflect a sharp rebound in the economy often experienced by crisis-affected countries after sustaining a major adverse shock? If this is the case, will these countries go through a period of adjustment characterized by a "W" shaped pattern of growth?

If the ongoing recovery is likely to be durable and sustainable, how much have the restructuring efforts in the crisis countries contributed to the current economic upturn? These are some of the questions this paper addresses.

Krugman (1999) argues that none of the vulnerabilities that brought the East Asian countries to their knees have disappeared and that prospects for the East Asian countries regaining their vitality are even less promising than before. He may be right, but then the available pieces of evidence do not necessarily agree with his view. Our analysis supports the view that the East Asian crisis countries had a short-run liquidity problem, not an insolvency problem. Economic fundamentals of Korea, Thailand, and Malaysia appear to be strong, and this is the reason why these countries have been able to recover so soon. Most of the structural weaknesses alleged to be the causes of the crisis are not necessarily unique to these countries and cannot be proven to have precipitated the speculative attack.

The East Asian crisis countries have made impressive progress in restructuring financial institutions, reforming corporations, and building market and government institutions, progress that will strengthen the foundation of the economy for durable growth and that will reduce the likelihood of recurrence of financial crisis. However, much remains to be done. Should these countries then continue with and step up their

restructuring efforts at the risk of interfering with the current recovery?

In order to speed up the restructuring at this stage, the governments will have to intervene extensively in the rehabilitation and recapitalization of financial institutions. The government-led strategy is not going to be effective or desirable as it will require another round of restructuring for the privatization of government-owned financial institutions and corporations. This paper supports the alternate view that a growth-first strategy with a market-led restructuring of financial institutions and corporations is more viable and realistic than a restructuring-first strategy with a government intervention.

The current debate on the East Asian recovery raises a number of other fundamental questions that have an important bearing on the prevention of future crises and on the reform of the international financial system. One question is whether market participants care about and monitor the thrust, objectives, and progress of structural reforms in the East Asian crisis countries.

If the crisis countries have done as little in the way of restructuring their economies as Krugman (1999) asserts, then it is disturbing that so many international lenders are returning to the region so soon without asking whether the East Asian countries are determined to reform their financial and corporate sectors. After all, was Feldstein (1998) not right in arguing that the East Asian countries did not have to reform their economies to regain access to the international financial market? Since policy changes and structural reforms are subject to many uncertainties and require a long period of time to take effect, international banks and global institutional lenders may not have either the patience or ability to monitor and assess the effects of structural reforms. This is particularly true when they are preoccupied with the short-term performance of their portfolios.

Are foreign investors not, once again, lured to investing in East Asia by growing current account surpluses, reserve accumulation, and a pick up in GDP growth rate? Are they not, in so doing, complicating the reform process that they demanded in the first place? If markets are not able to do a good job of evaluating whether the str

uctural reforms are being carried out as planned in the crisis countries, who should be doing it? The IMF, the World Bank, and other multilateral institutions are possible candidates, but experience shows that market participants do not trust or make use of the information made available by these institutions on developments in the crisis countries.

As East Asian economies have begun to rebound in the past few months, some of the urgency of reform has diminished and been overtaken by a sense of complacency. The rebound is likely to slow down financial and corporate reform, leaving the structural vulnerabilities of the East Asian countries to crisis unamended. Knowing this dilemma, East Asian countries have been searching for a policy regime that will keep the momentum of reform while supporting economic recovery. Such a regime has been elusive.

The East Asian crisis management also raises an important question as to when the market should take over the reform process initiated by policymakers. Can the market provide incentives to continue with the desirable reforms, and when should the policymakers leave the reform process to the market? Insofar as these questions remain unanswered, the East Asian countries will not be able to escape easily from the danger zone of crisis, no matter how hard they try to restructure their economy. Should they wait and hope that their efforts are judged acceptable by international lenders, even without knowing when that will be or what the conditions are? In the meantime, East Asia watches helplessly from the sideline as the debate on reforming the international financial system largely ignores the anomalies of international financial markets. These are some of the reasons why the East Asian crisis countries should consider turning to a strategy of growing out rather than the current strategy of restructuring out.

Appendix I: Policy Responses to Financial Crisis

I. Indonesia

Date	Description of Reforms
1997:	
July 11	Rupiah looses ground after speculative attacks spread to Indonesia. Bank Indonesia widens the rupiah intervention band from 8% to 12%.
August 13	Rupiah comes under heavy pressure and hit a new low of 2628 against US dollar. Initial currency defense by Bank Indonesia cost it US\$0.7 billion.
August 14	Governor of BI announces the abandonment of the exchange rate band system. The value of rupiah is to be determined by market forces.
August 16	Rupiah fell to 2980 per US dollar. BI responded by increasing interest rate and tightening liquidity, and eventually suspending SBPU (commercial bank money market certificate).
September 3	Indonesian authorities announced to scrap the 49% foreign ownership limit in Indonesian stock. This leads to an 11% surge in the Jakarta Stock Exchange Index (JSEI). Rupiah strengthened temporarily.
September	Closure of 16 insolvent banks: conditional liquidity support to other.
October 6	Rupiah hits a new low of 3895 per US dollar.
October 8	Indonesia seeks IMF assistance. The currency improves to 3600 per US dollar.
October 28	Following the regional trend, Jakarta Stock Index fell by 8.6%.
October 31	First IMF package announced. The program approves a US\$23 billion bailout for Indonesia for a 3-year period. This includes US\$4.5 billion from the World Bank. Regional countries contribute an additional US\$17 billion as a second line of defense.
November 1	Authorities announce the closure of 16 unhealthy private banks (including three banks owned by Suharto's family). Rupiah improves slightly.
November 5	IMF's Executive Board approved a 3-year Stand-By Agreement for US\$10 billion (additional US\$8 billion pledged by World Bank and Asian Development Bank while other countries, mainly Asian, contributed US\$18 billion). Focus: Restore market confidence, adjustment to current account, limit declining growth, and contain the inflationary pressure of currency appreciation.
November 17	President Suharto instructs state-owned Social Insurance firm (PT Jamestock) to deposit Rp 1 trillion of its funds at state-owned bank (Bank Tabungan Negara; TBN) at a rate lower than the market rate. PT Jamestock was also asked to deposit another Rp 2 trillion at state-owned banks at 14% interest rate per annum to enable the latter to provide 17% interest rate credit to small scale firms.
November 21	State-owned companies are instructed to use 1% of their net profits to buy shares on the Jakarta Stock Exchange.

December 31	The authorities announces the merger of four major banks into single institution by end-June 1998 and the privatization of state-owned banks as well as greater participation of foreign institutions in owning their equity shares. Placement of weak regional banks under BI supervision.
1998:	
January 6	The government presents FY98/99 budget. The budget shows a 32.1% increase as compared to the previous budget. The budget is based on unrealistic assumptions such as an exchange rate of Rp 4000 per US dollar, annual economic growth rate of 4%, and an inflation rate of 9%.
January 8	Black Thursday: Rupiah falls to 11,000 per US dollar.
January 15	Indonesia reaches 2 nd reform accord with IMF. Letter of intent signed. The new agreement calls for the revision of the draft budget presented on January 6, asking Bank Indonesia to continue a tight monetary policy, strengthening the legal and supervisory framework for the banking sector, accelerating the privatization program, and restructuring state-owned enterprises.
January 21	Rupiah falls to 16,000 per US dollar.
January 23	Revised budget for FY98/99 announced proposing 1% GDP deficit under new assumptions such as an exchange rate of Rp 5000 per US dollar, zero economic growth, and an inflation rate of 20 percent.
January 27	Establishment of Indonesia Bank Restructuring Agency (IBRA); external guarantees to all creditors and depositors of all locally incorporated banks; compensation of small depositors of closed banks.
February 10	Currency Board system is proposed and detracts attention from IMF package.
February 13	International pressure to drop currency board system. Transfer of 54 weak banks to IBRA; new loan classification and provisioning rules based on international standards.
March 4	First review of the IMF program Focus: Exchange rate stabilization and inflation control.
March 7	US\$3 billion IMF aid is deferred (due to political transition).
April 8	3 rd Letter of Intent signed with IMF.
April-May	Increasing tension and political instability. Rupiah falls to 17,000 per US dollar.
May 4	First Review of the stand-by-arrangement - Disbursement of US\$1 billion.
May 18	World Bank postpones two loans (due to political instability).
May 19	Announcement by Suharto indicating his resignation improves rupiah from 17,000 to 13,000.
May 21	Suharto resigns. Habibie becomes new president. Rupiah shows some improvement.

June 2	IMF and World Bank indicate that they will resume the loan extensions and next tranche.
June 4	Indonesia and Bank Steering Committee signed a debt agreement to design a framework for the external debt restructuring.
June 24	Indonesia issues Supplementary Memorandum of Economic and Financial policies on additional measures.
June	Merger of two state-owned banks; legislation enabling state bank privatization and removing limits on private ownership of banks; Establishment of new asset resolution entity.
July 15	Second review of IMF program Focus: Restore distribution system, strengthen social safety net. New Measure: Stand-By agreement increased by US\$1 billion for corporate debt restructuring.
July 29	Letter of Intent and Memorandum of Economic and Financial policies issued for additional measures.
August	Portfolio, systems, and financial review of IBRA and major non-IBRA banks by internationally recognized audit firms.
August 25	Third Review of the stand-by-arrangement - Stand-By Agreement replaced by Extended Agreement. - US\$6.3 pledged for next 26 months (WB and ADB contributed US\$2 billion while US\$1 billion came through bilateral sources)
September 11	Indonesia issues a Letter of Intent and Supplementary Memorandum of Economic and Financial Policies.
September 23	Agreement on the rescheduling and refinancing of bilateral external debt to official creditors.
September 25	First Review of Extended Fund Facility (EFF) completed US\$940 million disbursed.
October 19	Letter of Intent and Supplementary Memorandum of Economic and Financial policies issued.
October	Preparation of restructuring plans for IBRA banks.
November 6	Second Review under the EFF completed US\$960 million disbursed.
November 13	Letter of Intent and Supplementary Memorandum of Economic and Financial policies issued.
December 15	Third review of the EFF completed US\$ 957 million disbursed.
1999:	
January 6	Fiscal Budget for 1999/2000 announced. Highlights are: - 0% GDP growth forecast for 1999/2000 as compared to a contraction of

	13.8% in 1998/99. - expenditures projected to fall by 17.3%. - balanced budget rather than 8.5% expected deficit.
January 12	New banking regulations issued, tightening the rules on related-party and other lending.
January 25	Rupiah depreciates again and hits 9,500 per US dollar.
January 26	Government announced tax exemption of up to eight years of new investments in 22 industries located outside Java and Bali (which have five year exemption only).
January	Inflation declines to 71% from 78% recorded in December 1998.
February 26	Budget passed by the assembly with minor changes.
March	Rupiah improves and stabilizes around 8,800-8,900 per US dollar.
March 10	World Bank issued Country Assistance Strategy for Indonesia.
March 13	Government announced the closing of 38 domestic private commercial banks, the nationalization of seven, and the recapitalization of nine banks subject to their raising 20% of needed capital by 21 April.
March 16	3 rd letter of intent to IMF issued.
April	Standard Chartered Bank of the UK bought a 20% stake in Bank Bali for US\$56 million. ANZ-Panin Bank agreed to buy the credit card business of the liquidated Bank Papan Sejahtera for A\$7 million.
May 14	4 th letter of intent to IMF issued. Disbursement of another tranche of US\$460 million (disbursement of around US\$10 billion by May 1999 of the total US\$12.3 billion committed by the IMF).
May	Rupiah gains and stabilizes around 8,000 per US dollar.
May 17	The new central bank law approved authorising BI to set monetary targets without government intervention. Under the new law, the President is barred from dismissing the governor or any other board member.
May 28	The authorities announced the structure of the bond issue linked to the bank rescue plan. The total amount to be raised under this plan is expected to be around Rp. 157.6 trillion.
June	Rupiah strengthens to Rp. 6,575 per US dollar.
July 7	234 companies registered with the Jakarta Initiative Task Force (JITF) to facilitate out-of-court settlement.
July	In a controversial decision, Sampati Air is declared bankrupt.
July 15	Finance minister announced revised estimates of the bank recapitalisation cost as Rp. 550 trillion (US\$73 billion). Standard and Poor estimate show a cost of US\$87 billion.

July 22	Ten holding companies formed to consolidate Indonesia's 159 state companies.
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II. Malaysia

Date	Description of Reforms
1997:	
July	Bank Negara defends ringgit after it comes under speculative attacks.
August 27	KLSE banned the short selling of 100 blue-chip stocks. To discourage the sale of stocks, sellers were required to deliver physical share certificates to their brokers before selling. The settlement period was also reduced from 5 to 2 days.
September 3	Plan announced to use funds from the Employees Provident Fund (EPF) to prop up share prices by buying stocks from Malaysian shareholders, but not foreigners, at a premium above prevailing prices.
September 4	Ringgit falls through RM# to the US dollar and Kuala Lumpur Composite Index (KLCI) drops below 700 points.
October 17	1998 Budget announced selective import duties to reduce current account deficit.
December 5	Government cuts 1998 growth forecast to 4-5% from 7%. The budget unveils the Reform package including: - Government spending to be reduced by 18%. - all public sector investment postponed indefinitely. - new overseas investment by Malaysian firms stopped. - freezing new share issues. - company restructuring. - salaries of government ministers cut by 10%.
December	Ringgit plunges to a new low of 3.87 per US dollar.
1998:	
January 7	Ringgit falls to RM3.88 per US dollar.
January 9	Government claims sufficient foreign reserves and rules out an IMF bailout.
March	Asset Management Corporation set up to undertake the restructuring and recapitalization of the banking system.
May 30	GDP declines to 1.8% year-to-year in the first quarter of 1998. GDP growth forecast further reduced to between 2 and 3%.
July 24	Moody's and S&P downgrade Malaysia's long-term foreign currency ratings.
July 27	Malaysia abandons roadshow to promote US\$2 billion bond issue.
August 27	Bank Negara announces a contraction of 6.8% in second quarter GDP on year-to-year basis. The authorities indicate a relaxation in monetary and fiscal policy to

	avoid a depression. Any possibility of capital controls is ruled out.
August 28	Bank Negara governor and deputy governor resigns.
August 29	Dr. Mahatir says there is no plan for capital controls.
August 31	Malaysia barred offshore trading of Malaysian company shares. KLSE says trades on Singapore's over-the-counter Central Limit Order Book (CLOB) market are no longer recognized.
September 1	More stringent controls over short-term capital transactions including complete ban on trading in ringgit instruments among offshore banks as well as ban on Malaysian financial institutions offering domestic credit facilities to non-resident banks and stockbrokers. Banned use of ringgit as invoicing currency in foreign trade. All ringgit deposits held outside the country would cease to be legal tender after 30 September. Amount of ringgit for travel purposes restricted to equivalent of M\$1,000. Allowance for overseas investments without prior approval limited to the equivalent of M\$10,000.
September 2	Malaysian ringgit fixed at M\$3.80 per US dollar.
September 9	Bank Negara Malaysia (BNM) reduces intervention rate from 10% to 9.5%. BNM reduced statutory reserve ratio from 6% to 5%. Banks required expanding their loan rate to 8% per year.
September 28	Morgan Stanley Capital International removes Malaysia from Emerging Markets Free and All Country Free Indices.
October 15	The government expects recovery and anticipate 1% growth.
November 28	Third quarter of 1998 GDP shrank by 8.6 percent.
December 10	Malaysia receives 74 billion yen loan under Japan's US\$30 billion Miyazawa Initiative.
1999:	
February 4	Malaysia relaxes capital controls: - 1-year holding rule on portfolio principal is replaced with a system of levies on principal and profits.
March 31	GDP contracted by 6.7 percent in 1998.
May 26	Bank Negara issues US\$1 billion 10-year global bonds.
June 23	KLSE hits 22-month closing high of 851.49.
July 29	Malaysia unveils plan to merge 58 financial institutions into six core groups.

August 12	Morgan Stanley Capital Investment announces that it will reinstate Malaysia in its benchmark indexes from February 2000 barring any financial policy reversals.
August 25	The authorities confirmed the end of recession, as GDP grew by 4.1% in the second quarter.
September 2	Capital Controls further relaxed: foreign money managers are allowed to repatriate funds.

III. Thailand

Date	Description
1997:	
March	Bank of Thailand classifies 100 billion bhat loans owned by real estate sector as non-performing loans.
June 27	Thai Finance Minister orders 16 finance companies to be closed. The order was reversed by the Prime Minister with a bailout plan of US\$28.6 billion.
August	Suspension of 58 insolvent finance companies.
August 11	IMF approves a total support package of US\$17 billion for Thailand.
August 20	IMF Executive Board approved a three-year Stand-By-Arrangement of US\$4 billion. World Bank and Asian development Bank pledged US\$2.7 billion of which Japan and other countries contributed US\$10 billion.
September	Tightened loan classification and bank licensing rules.
October 17	The IMF Executive Board under the emergency financing mechanism procedure reviews the stand-by-arrangement.
November 25	1 st Letter of Intent is issued.
December	Guidelines for assessment of owners, board members, and managers of financial institutions.
December 8	First Quarterly Review of the IMF program. In view of deteriorating economic activity, additional fiscal measures introduced. - Indicative range interest rates. - Time- frame for financial sector restructuring announced.
1998:	
February 24	2 nd Letter of Intent is issued.
March 4	Second Quarterly Review. In view of some improvement (stability) in exchange rate and a relatively less pessimistic economic growth, the program was revised: - Monetary policy continued to focus on exchange rate.

May 26	- Shift to accommodating fiscal policy. - New measures included for social safety net. - Measures included strengthening the core banking and promoting corporate restructuring.
June 10	3 rd Letter of Intent on additional measures is issued.
July	Third Quarterly Review. Minor adjustments to deal with declining GDP including an allowance for increase in fiscal deficit target for 2% to 3% of GDP.
August 25	BOT introduced new loan classifications.
September 11	4 th Letter of Intent on additional measures is issued.
September	Fourth Review of the stand-by-arrangement: - Disbursement of US\$135 million. - Amendment of bankruptcy laws. - Stronger loan classification and provision to meet international standards by 2000.
October	Preparation of restructuring and privatization plan for intervened banks; review of banking supervision laws.
December 1	Memoranda of understanding with financial institutions on implementing stricter loan classification and provisioning rules.
December 15	Revision of Bank of Thailand laws; completion of amendments to foreclosure laws.
December	5 th Letter of Intent issued on additional measures. Fifth Review of the stand-by-arrangement - Disbursing US\$140 million.
	Completion of disposal of assets of 56 (of 58 suspended) finance companies; new prudential regulations; stronger rules governing disclosure, auditing, and accounting practices; new deposit insurance scheme. Development of plans for privatizing institutions undergoing state intervention.
1999	
March	Sixth Review of the stand-by-arrangement The above review and the fiscal budget revealed the following policy changes: - In order to stimulate the economy, the IMF agreed to increase the public sector deficit limit for 3% of GDP (stressed in 1997/98) to 5% (later increased to 6%) of GDP. - Increased 1% of GDP on social safety nets and related labor intensive projects. - IMF agreed to ease the monetary policy to stimulate consumption and encourage new investment. - The authorities decided to go ahead with proposed merger and sale of financial institutions. - Revised time frame for recapitalisation of the above institutions.
March 30	Economic Stimulus Package announced which includes: - Temporary reduction in value-added tax (VAT) rate from 10% to 7% to 2 years

June 16	- Elimination of 1.5% VAT for (small) businesses with a turnover of less than 1.2 million (470 million) baht. - Income tax waiver for those earning less than 50,000 baht per year. - The overall package will cost 53 billion baht. IMF Executive Board approved the release of further tranche of US\$520 million.
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Appendix II: Causes of the East Asian Crisis

Over the past two years, the East Asian financial turmoil has spawned a huge and still growing body of literature on the causes of the crisis. For example, a website on the East Asian crisis created by Roubini lists more than 500 articles on the subject matter. Despite the proliferation of the studies on the East Asian crisis, its causes remain controversial.

Radelet and Sachs (1998), Feldstein (1999), and Stiglitz (1999a) argue that the primary source of the crisis was the sudden shifts in market expectations and confidence. According to these authors, foreign lenders and institutional investors were so alarmed by the Thai crisis that they abruptly pulled their investments out of the other countries in the region all at once, thereby causing contagion of the crisis. Their withdrawal was in turn prompted by the belief that these countries suffered from structural problems, similar to those that invited a speculative attack in Thailand.

As opposed to this financial panic view, many others, including the IMF, pointed to structural weaknesses and policy distortions as the major causes of the crisis, although they acknowledged that the panic reaction also played a role.⁶

For example, a recent IMF report (Lane *et al.*, 1999) argues that the crisis was primarily rooted in the fragilities of the financial system, other structural weaknesses in governance and non-transparency of corporations, financial institutions and government. Exchange rate inflexibility, large unhedged foreign currency denominated debt, and wrong sequencing in capital account liberalization added to East Asia's vulnerabilities.

These weaknesses, which are often characterized as the traits of crony capitalism, and their associated moral hazard had made these countries vulnerable to changes in market sentiment and a deterioration in the external environment. A sudden change of expectations among international lenders and investors then, as the argument goes, claimed East Asian countries one by one.

In the aftermath of the Thai crisis, which destabilized the financial market

⁶ See Corsetti *et al.* (1998), Lane *et al.* (1999), and Eichengreen (1999).

s of both Hong Kong and Taiwan and eventually forced Korea to accept an IMF program, the IMF diagnosis prevailed and the international financial community did not hesitate to lay the blame for the crisis exclusively on East Asian countries. The architects of a new international system would ignore the glaring failures of international capital markets and pay more attention to preventing the East Asians from going off on their own (Veneroso and Wade, 1998).

In numerous formal and informal forums and committees established to reform the international financial system, emerging market economies from East Asia are represented, but accorded, at best, the role of commentators, because in a way they belong to the guilty party. Only three years before, a World Bank report (1993) had touted these countries as economic miracles. Once the crisis broke out, however, everyone forgot the effusive praise for East Asian achievements, and western investors who had been so bullish about East Asian economic prospects were quick to fault East Asian institutions, policies, and even cultures before leaving the region.

Now that the initial shock has worn off, analysts no longer focus on East Asian institutions, development strategy, macroeconomic policies, and culture in search of the causes of the crisis. Instead, they provide a more balanced view, recognizing that international lenders have as much responsibility for the crisis as East Asian borrowers, because for every questionable borrower there is a questionable lender.

The exact causes of the crisis will not be known anytime soon. However, the strong recovery under way in East Asia and recent empirical studies on the East Asian crisis both appear to lend support to the panic view⁷, which is that the East Asian crisis should, in a large measure, be attributed to the panic reaction and herd behavior of foreign investors and lenders rather than a deterioration of fundamentals. In what follows, it will be argued that most of the causes presented by the structural weakness advocates are not supported either by theory or empirical evidence.

⁷ For a recent empirical study on the crisis contagion in East Asia, see Park and Song (1999).

I-1. Financial Repression and Crony Capitalism

According to Eichengreen (1999), for more than three decades preceding the crisis, East Asian countries had relied on the banking system as an instrument of industrial policy--as the means of mobilizing savings and allocating them to strategic industries and favored projects. This strategy was successful in that it sustained rapid growth and industrialization for almost three decades. Such a policy, however, exacted a heavy toll, as it resulted in a very weak and inefficient financial system, deficient in many respects.

First, banks, which dominated the financial system, became too big to fail. The moral hazard syndrome associated with this implicit government guarantee led to poor risk management and eventually to massive deterioration in the quality of assets held by the banks.

Second, the direct government control over management and credit allocation at banks and other financial institutions left little room and few incentives for the regulatory authorities to develop and improve their capacity for prudential supervision and regulations. Failure to require banks to follow rigorous auditing and accounting practices in turn made bank balance sheets non-transparent. A lack of transparency created a fertile ground for corruption, and the cumulative effect of corruption was manifested in poor economic performance.

Third, the dominant position of banks in the financial system and the government's reliance on these intermediaries to implement industrial policy interfered with and delayed the diversification of financial assets, institutions, and markets. In particular, this strategy inhibited the development of capital markets. Developing capital markets requires that detailed information on the financial position of firms and their legal structure be publicized, so as to protect minority stockholders. That is, financing through capital markets rather than banks, including the greater use of financial derivatives, and liberalizing the capital account all demand a reliable disclosure system. Finally, the government dominance of banks created opportunities for crony capitalism, since bank owners and managers could easily collude with

politicians to further their interests.

These problems associated with a government-controlled banking system in East Asia are not new. They were well known before the crisis and often characterized as the syndrome of a financially-repressed economy. An important question is why such an inefficient system had not impaired economic performance in East Asia long before the crisis. During the early period of economic development, when high-return investments were abundant in East Asia, the industrial policy of using banks as instruments of resource allocation did not pose any serious efficiency problems. Once these opportunities were exhausted, however, sustaining rapid growth required a more efficient allocation of resources which, in turn, dictated liberalizing and opening domestic financial markets. Instead, according to Eichengreen (1999), the East Asian governments stuck to the old strategy of bank-dominated control. The government directed credit allocation in a way that disregarded market signals.

Eventually, non-performing loans began to pile up at the banks and placed the solvency of these institutions at risk.

Krugman (1994) was the first to point out that East Asia was running into diminishing returns and that rapid growth was only being sustained by massive infusions of capital, much of which came from abroad in the form of short-term credits. Supporting this line of argument, Eichengreen (1999) claims that the East Asian governments decided to liberalize the capital account to facilitate borrowing from abroad, not to improve the efficiency of the economy. Unfortunately, he argues, they did it backward by deregulating short-term borrowing first.

There is no denying that the East Asian policy regime had been interventionist throughout the 1980s. However, *East Asian Miracle*, a World Bank study (1993), shows that the regime was market friendly and as such was not as inefficient as it is often made out to be. The interventionist policies were also in response to coordination problems in the market. Furthermore, East Asian policymakers relied on contests that combined competition with the benefits of cooperation both among firms and

between government and the private sector.

Largely because of this market-friendly feature, directing credit to specific sectors and firms through banks could be justified in theory and worked well in at least some East Asian countries. For example, automatic access to credit for exporters and the strict performance criteria required for the allocation of directed credit minimized much of the inefficiency that often arises from market intervention.

The same World Bank study also makes it clear that there is a limit to the benefits of interventionist policies in a rapidly globalizing world economy. Realizing that integration into the world economy was inevitable, most East Asian countries were moving, albeit at different speeds, to liberalize and open their financial sectors.

I-2. East Asian Miracle or Debacle

Although it has been very much ignored since the crisis broke out, the *East Asian Miracle* by the World Bank and a close examination of the market developments preceding and following the crisis suggest that the weakness of the East Asian financial system was not necessarily the primary cause of the crisis. The financial weakness view tends to support the concerns of international lender but runs counter to both theory and evidence.

The fundamental question is whether by the mid-1990s the East Asian policy regime was crumbling under the inefficiencies of crony capitalism, bringing the period of rapid growth to an end. This question will remain unanswered, although the ongoing recovery and a careful analysis of the developments in financial markets leading to the crisis challenge the validity of the cumulative inefficiency argument.

Even before capital account transactions were liberalized and increasing volumes of foreign capital began to flow into East Asia, most East Asian countries we

re already growing at rates much higher than the rest of the world. In fact, it is this success and the potential for future success that had attracted foreign capital into the region. Not only had there been both rapid growth and domestic stability, but the rates of return on capital had been high before the crisis.

In most East Asian countries, the national budget was balanced or generating a surplus (Park, 1998). Since the mid-1980s, all of the countries in the region had pursued policies of trade and financial liberalization. Given these sound fundamentals and the region's commitment to liberalization, foreign investors saw enormous opportunities for profit and moved vast sums of money into the region. Because of this massive inflow, investment as a proportion of GDP in all of these countries was significantly higher than it had been in the 1980s. At the same time, savings rates were stable, resulting in large increases in the current account deficits.

Therefore, it may not be correct to argue that East Asian countries were intent on borrowing heavily from abroad to meet the ever-increasing volume of capital needed to compensate for the losses in efficiency that were slowing economic growth. Certainly the assertion that these countries began liberalizing the current account to facilitate capital inflows is at variance with the facts. In actuality, East Asian countries were very reluctant to liberalize the capital account and trade in financial services in the early 1990s, although they were committed to doing so in the long run for a number of reasons.

First, none of these countries had enjoyed any comparative advantage in exporting financial services. East Asian economies were understandably concerned that Anglo-American financial institutions could easily dominate their domestic markets for financial services once they were allowed free market access. By the mid-1990s, for instance, American and European financial institutions had already established a dominant position in international investment banking in Asia (Park, 1997).

Second, it was feared that the deregulation of capital account transactions could destabilize domestic financial markets.

The shallowness of financial markets together with unstable institutions was likely to increase the volatility of capital movements, and hence that of the exchange rate, thereby complicating macroeconomic management.

Third, East Asian countries were cautious in opening money and capital markets, because their regulatory and supervisory systems were hardly comparable to those of advanced countries in terms of standardization and effectiveness. A prerequisite to capital account liberalization is the publication and transparency of the financial condition of both banks and firms. None of the East Asian countries, however, were able to meet the necessary information and disclosure requirements. Despite this weak capacity in prudential supervision and regulation, western governments were applying increasing pressure to secure rights of access for their financial firms in East Asia.

Although the same governments knew that accounting practices and disclosure requirements in East Asia did not conform to their standards and that financial supervisory authorities were not capable of enforcing rules and regulations, few western governments demanded the necessary reforms to financial supervision before entering East Asian financial markets. Instead, they were persistent in their demand for equal access and outright opening of domestic capital markets. Their justification for the persistence and impatience was that unless financial opening and liberalization were carried out quickly, the inertia would become too great and these countries would never pursue liberalization. They did not choose to address the possibility that pell-mell liberalization could invite speculative attacks and financial crisis.

Numerous recent publications on the East Asian crisis assert that the lack of transparency and inadequate information disclosure made East Asia vulnerable to financial crises. If this is true, how serious was the problem? In a recent paper, Stiglitz and Bhattacharya (1999) show that increased transparency in the form of disclosure requirements is not needed, since markets can and do provide optimal incentives for disclosure. They also argue th

at under certain circumstances, information disclosure could exacerbate fluctuations in financial markets and precipitate financial crisis. It is also instructive to note that the Nordic countries, which did not suffer from the non-transparency problem nearly as much as the East Asian countries, could not fend off crisis in the early 1990s.

Prior to the crisis, foreign lenders had access to much of the information needed for their investment decisions, including the information that the balance sheets of banks and corporations in East Asia were not reliable. Foreign market participants either ignored or were not able to process the available information.

For example, foreign investors knew quite well that East Asian firms both small and large relied almost exclusively on banks for the financing of their investment and working capital requirements. It is only natural to expect that the debt-equity ratios of these firms are likely to be much higher than those of the firms operating in economies where capital markets are well developed. Before the crisis, apparently foreign lenders did not consider this balance sheet weakness to pose serious default and liquidity risks enough to discourage their lending to those highly leveraged firms. Once the crisis erupted, however, the lending problem was suddenly brought up as one of the major vulnerabilities of East Asian economies.

In retrospect, East Asian countries should have initiated financial reform to develop a more balanced financial system where capital markets complement the banking industry. Why did they not do it? One reason has to do with a theoretical justification for the reliance on a bank-dominated financial system in developing countries.

Problems of incomplete information, markets and contracts tend to be severe in the financial sector, and these problems weaken and sometimes break down the functions of the financial system. In the absence of a sound legal system together with regulation and supervision, governments of developing economies often intervene in and impose restraints on lending and other operations of banks to improve the efficiency of the financial sector.

In a recent paper, Stiglitz (1998) argues that financial restraints or repressive financial policies in East Asia had their share of problems but made an important contribution. For example, they increased the franchise values of banks and discouraged them from taking excessive risks that otherwise might have destabilized the financial system. In his view, the economic costs resulting from financial restrictions, however, were more than offset by the gains from greater financial stability. In fact, he argues that the removal of financial restraints may have contributed to the crisis in East Asia.

The literature on finance and development suggests that the more pronounced the information asymmetries, the more preferable banking arrangements are to direct securities markets. In developing economies, where informational problems are severe because accounting and auditing systems are typically less reliable, the role of banks is thus more important than in advanced economies. In the course of development, institutions specializing in gathering and disseminating information appear, as do regulatory agencies that can enforce greater disclosure by firms. This makes it possible to develop bond and stock markets. In practice, however, banks have remained the dominant source of external financing, even in advanced countries.

Related to this is the implication that intermediaries are more efficient than open securities markets for supplying long-term financing to industry. In fact, intermediaries could lengthen the investment horizon of firms as the intermediary monitors the activities of its borrowers. Banks can also enter repeated relationships with borrowers in order to mitigate informational distortions. This, in turn, can facilitate the provision of long-term (or at least ongoing) credit.⁸

There was also the problem of inertia and complacency. As far as East Asian economies were concerned, the bank-dominated financial system had worked very well

⁸ Coming at this from the other direction, Mayer (1998) argues that competition in financial markets can have time inconsistency costs that result in a decline in long-term financing. Yanelle (1989) shows scale economics and Bertrand oligopolistic competition that imply unfettered competition in financial intermediation are not likely to be realized and that deregulated banking may not lead to an efficient allocation of resources.

for them in sustaining rapid growth and industrialization. There were no compelling reasons for these countries to tinker with the system until they were forced to open their fledgling capital markets to foreign competitors.

I-3. Exchange Rate Inflexibility

Eichengreen (1999) argues that East Asian countries made a critical mistake by maintaining an inflexible exchange rate system or pegging their currencies to the dollar before the crisis. In retrospect this may be true, but then the economic profession, including the IMF, did not know the perils of inflexible rates as it does now. More important, would Thailand, Indonesia, and Korea have avoided altogether or suffered less from the currency attack, had they been on a flexible exchange rate system? Our discussion in Section III suggests that they might not have. Eichengreen's argument also ignores the constraints under which the East Asian countries were managing their exchange rate policy.

Over the last two years, there has emerged a dominant view that emerging market economies should adopt either a flexible exchange rate system or a currency board arrangement. Before the crisis, there was no such consensus on the two corner solutions, and there was also the problem of defining a flexible exchange rate system. By the mid-1990s, the idea of flexible rates for emerging economies was gaining support and was easier to accept than before, because financial markets were deepening and institutions were becoming more stable and predictable in emerging market economies.

The issue was whether speculators were stabilizing. On this, there was a clear divide in the profession. While flexible rates had become more plausible, a broad range of economists mistrusted the capital market and rationality of speculators. On balance, some form of managed rate was given preference, such as the basket-band-crawl system suggested by Dornbusch and Park (1999).

The IMF, reflecting the disagreement in the profession, did not have any position on the type of the exchange rate regime appropriate to emerging market economies

before the crisis broke out (Fischer, 1999). It is therefore unfair to blame the East Asian countries *ex post facto* for having adopted managed floating systems.

Before the crisis, most East Asian countries were not able to conduct an independent exchange rate policy, largely because they were locked in competition for a larger export market share both within the region and in the US and Europe. This competitive structure had made policymakers of the East Asian countries reluctant to let their exchange rates appreciate *vis-à-vis* other currencies lest such a development weaken their export competitiveness.

There was also no mechanism for coordinating the exchange rate policies of East Asian countries. For example, if one country's exchange rate depreciated *vis-à-vis* the U.S. dollar, other countries would immediately engineer a devaluation of their currencies so as not to lose their competitiveness, regardless of their domestic market situations, thereby setting in motion a round of competitive devaluation in the region. Because of this preoccupation with export competitiveness, exchange rate policy had been geared to stabilize trade-weighted real exchange rates, as evidenced by their stability in most East Asian countries before the crisis. Similarly, whenever the yen weakened against *vis-à-vis* the dollar, other East Asian countries did not hesitate to adjust their dollar exchange rates to avoid any deterioration in their competitiveness *vis-à-vis* Japanese exporters.

In the face of an onslaught of capital inflows, policymakers in East Asian countries intervened in local foreign exchange markets in an effort to maintain their real exchange rates at certain levels by keeping nominal exchange rates against the U.S. dollar stable. They were not willing to let their exchange rates float unless their competitors would do the same, and no country was prepared to take the lead in breaking out of this impasse.

I-4. Wrong Sequencing

East Asian countries are criticized for having liberalized short-term capital ac

count transactions before deregulating long-term capital markets and foreign direct investment, and in particular, for not having deregulated and opened the domestic bond markets at an earlier stage of financial liberalization.

Once again, these arguments ignore the institutional and market constraints in the crisis countries that had interfered with the long-term first sequencing. Except for a handful of state-owned banks and blue chip corporations, few of the East Asian banks and firms had access to long-term international capital markets, because they could not obtain an investment grade rating from the rating agencies. Even for those firms that were sufficiently creditworthy to borrow from long-term markets, the risk premium they had to pay was prohibitively high. At best, East Asian financial institutions and firms had limited access to short-term international financial markets before the crisis. The large inflow of short-term capital was not the result of the wrong sequencing in capital market opening but rather the limited availability of long-term financing.

Would deregulating and opening the domestic long-term bond markets have shielded the East Asian countries from the danger of a speculative attack, or at least, minimized the cost of the crisis? Critics of the pre-crisis policy regime in East Asia argue that East Asian companies could have avoided the risk of currency mismatch and the sudden drop in liquidity if foreign investors had been allowed to invest in domestic long-term bonds. However, this argument does not ask whether foreign investors would have purchased domestic bonds for their long-term investments in the absence of any entry restrictions. Clearly, they would not have, since they could extend short-term foreign currency denominated loans or purchase short-term foreign currency denominated instruments free of exchange rate and credit risks. Those foreign investors who held domestic bonds in their portfolios most likely did so for the purpose of speculation, as in the case of their investments in East Asian equities.

In reality, foreign portfolio investments in bonds and equities should be classified as short-term capital inflows, because foreign investors can unload their holdings in the secondary markets and leave the country at a moment's notice. Restricti

ons on foreign investment in local bonds and equities in no way increased the vulnerability of these countries to financial crises.

The bulk of short-term foreign liabilities of East Asian countries consisted of short-term loans and credit lines that commercial banks secured from the inter-bank credit market. East Asian banks were attracted to short-term financing for a number of reasons. For one thing, most short-term foreign currency credits included trade credit facilities and hence were closely tied to the international financial services that they provided for domestic exporters and importers. Before the crisis, it is apparent that East Asian banks abused these credit facilities as a means of financing long-term investment, thereby creating balance sheet mismatches.

The cost of short-term borrowing was lower than the cost of financing from the long-term end of the market. This cost difference in part explains the preference for short-term loans before the crisis. Since short-term loans could be rolled over continuously, they could be converted into *de facto* long-term loans. Long accustomed to relationship banking, East Asian banks did not expect that their foreign counterparts would suddenly cut them off without warning.

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