Part III

Asian and Other Views on the Functioning of the Global Financial System

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An Asian View on the Global Financial System

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It is difficult to present a unified Asian view on the global financial system. But, as an emerging market, Asia has its independent interest which provides some clues.

I would like to concentrate on three issues which have attracted most of our economists' and policymakers' attention during the past two to three years. These are: (i) given the competition in global financial markets, what are the costs and benefits of financial integration for Asian economies?; (ii) in response to the shock on benefits of global financial integration, how can we build a new Asian policy cooperation regime after the crisis of 1997-98?; and (iii) given the post-crisis policy option between currency stability and financial deepening, how should Asia's goals be clearly defined?

As many Asian economies express their views in various ways, an Asian view on the global financial system can be concluded as follows. First, the recent initiatives on intra-regional financial cooperation reveal the intention of Asian countries to combine their economies as a subset within the global financial system, following the European Union mode, rather than remain isolated countries linked separately to the world economic system. The Asian economies are expected to unify their foreign exchange systems, bond markets, stock markets, and finally their currencies. Second, at the operational phase, Asian financial development is on the crossroad between collective action and individual growth. In order to minimise a conflict of interests, collective action within the

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ASEAN+3 framework is a better choice; intra-regional crisis prevention and control will be more efficient given the dramatic growth of global capital flows. Third, the instability of global capital flows results in foreign exchange rate volatility; however, a vulnerable financial system is more likely to be attacked by speculative forces than a robust one.

1 Cost-Benefit Analysis: What Is Asia's Role Within International Financial Integration?

An Institutional Explanation of Financial Globalisation

Financial globalisation is a trade-off between institutional innovation, which reduces the individual country's transaction cost, and the increase of uncertainty. On the one hand, as Obstfeld (1994) and Acemoglu and Zilibotti (1997) show, international financial integration (IFI) facilitates risk-sharing and thereby enhances production specialisation, capital allocation and economic growth. Further, in a standard neoclassical growth model, IFI eases the flow of capital to capital-scarce countries with positive output effects (Edison *et al.*, 2002). Also, at the institutional level, IFI enhances the functioning of domestic financial systems through the intensification of competition and the importation of financial services, with positive growth effects (Klein and Olivei, 2000; Levine, 2001). On the other hand, as Boyd and Smith (1992) show, IFI only promotes growth in countries with sound institutions and policies since capital may actually flow from capital-scarce countries to capital-abundant countries with better institutions. In order to measure IFI, Edison *et al.* (2002) compare five-category indicators: IMF-Restriction, Quinn measure, Stock of Capital Flows, Flow of Capital, Stock of Capital Inflows, and Inflows of Capital. They find four statistical stylised facts. First, rich countries tend to be more open. Second, countries with well-developed financial intermediaries, stock markets, legal systems, and low levels of government corruption tend to have greater capital account openness. Third, IMF-Restriction negatively correlates with capital account openness. And fourth, IMF-Restriction, Stock of Capital Flows and Flows of Capital are not significantly correlated with economic growth; however, Stock of Capital Inflows and Inflows of Capital are.

Based on the above literature, Asian economies may draw the following lessons. First, IFI is an innovation for breaking down domestic financial restrictions, through which transaction costs in cross-border capital flows can be reduced. Second, IFI and capital flows are double-edged swords. Poverty reduction or growth is never the task of IFI. Therefore, since Asia as a whole is a developing region, an overestimation of the positive effects of a too early openness and an underestimation of the positive effects of capital restrictions are both unwise. The optimal solution is a sequencing arrangement, i.e. reforming the domestic financial sector in advance, then cooperating within the region and building up of fair play circumstances within the global financial system, and finally, thoroughly opening up to the rest of the world.

Asia's Costs, Risks and Benefits in the Current Global Financial System

Although, as mentioned above, IFI brings benefits to open economies with sound institutions, the crisis in 1997 still suggests a deep thinking on costs and risks that the whole region takes. Financial globalisation usually refers to the growing financial interdependence of countries worldwide brought about by the increasing volume and variety of cross-border financial transactions and international capital flows (Wagner, 2001). IFI imposes both persisting and transitory effects on Asian economies. As Citrin and Fischer (2000, p. 27) show, FDI and capital inflows are driving forces for growth, while IFI forces Asian governments to ensure sound institutional and political frameworks, and limits 'the scope for countries to pursue policies that are incompatible with medium-term financial stability'. Therefore, the persisting effect is that competition among economies with a similar infrastructure is going to be more intensive.

On the other hand, the transitory effect is contagion in a region. Theoretical research shows that contagion could happen through three channels: global shocks, weak fundamentals, or "pure contagion". In the global-shock model, crisis is triggered by common external shocks, such as war. Contagion as a result of weak fundamentals (Kaminsky and Reinhart, 1999) is also called "spillover" (Masson, 1998). Eichengreen, Rose and Wyplosz (1996) show how a currency crisis in one country can have a real effect on

the economy of its trade partners. In the third mechanism, contagion can be caused by herding behaviour of investors (Calvo and Mendoza, 2000), by a shift in investor's expectation (Masson, 1998, Rorik and Velasco, 1999), or through a "liquidity squeeze effect" (Valdés, 1998). Asia's crisis in 1997 shows a mixed contagion of weakness of fundamentals and herding behaviour, imposing significant costs on Asian economies.

The Role of Finance in Asian Economies

The role of finance in economic stabilisation and growth has produced one of the most passionate debates in economic literature. As Joseph E. Stiglitz writes in "The Role of the State in Financial Markets", "financial markets essentially involve the allocation of resources. They can be thought of as the 'brain' of the entire economic system, the central locus of decisionmaking: if they fail, not only will the sector's profits be lower than would otherwise have been, but the performance of the entire economic system may be impaired" (Stiglitz, 1994). However, financial liberalisation remains a special topic because successful financial markets have identical characteristics, while successful economies have not. For example, transparency, full information disclosure and mature accounting standards are necessary conditions for all major financial markets, hence there is no institutional difference between the New York market and the Hong Kong market. But successful economies, such as the US, the EU, Japan and Hong Kong, have their own rules and norms.

At the theoretical level, the theorists can be classified into two categories: the financial structuralist and financial repressionist schools (Gupta, 1987). The former contends that the quantity of financial variables and its composition affect the growth and stability of the economy, and financial deepening (e.g. aggregate financial assets in relation to GDP) is the path to a modern economy (Gurley and Shaw, 1960; Goldsmith, 1966, 1969; Patrick, 1966). On the other hand, the financial repressionist school, which lays the emphasis on price variables such as real interest rate and real exchange rate, believes financial repression, especially in the form of below-equilibrium real interest rate and domestic currency overvaluation, retards growth. Accordingly, its policy recommendation is financial liberalisation (e.g. introducing a flexible market price regime) (McKinnon, 1973; Shaw, 1973; Fry, 1987).

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However, the financial crises in Latin America and East Asia show that neither financial deepening nor financial liberalisation is a sufficient condition for financial development and steady economic growth. Therefore, a new but simple framework is needed to analyse the structure of the Asian countries' financial markets and find a practical dynamic path to financial development.

Neo-Financial Dualism Hypothesis: Financial Intermediation and Risk-Sharing Mechanism

The traditional financial dualism theory defines a developing country's financial system as two parts: a formal financial sector and an informal one (Emmerij, 1991; Germidis *et al.*, 1991), in other words, a regulated and an unregulated market (Wijnbergen, 1982). However, this classification is not helpful for discovering the nature of developing countries' financial structures as well as the deep cause of crisis. First, government intervention distorts a financial sector's intermediation activities, and this leads to corruption and weak contract enforcement in financial transactions (Krugman, 1998a, b; Demirgüç-Kunt and Detragiache, 1998). Second, while the informal sector is believed to be a more "liberalised" institution, the narrow information base and the limited capacity for risk-pooling may also make the transaction less efficient (Cho, 1990; Fischer, 1989).
Therefore, both sectors may create distortions in resource allocation. If we follow the remedy offered by the traditional financial dualism hypothesis, i.e. "to achieve a single, homogeneous financial system by expanding and transforming the formal financial sector so that it fully absorbs informal financial activities" (Germidis *et al.*, 1991, p. 214), we just substitute one inefficiency for another.

A neo-financial dualism hypothesis of explicit versus implicit financial transactions is helpful for understanding the financial performance in most Asian developing economies. The dualism only occurs in a financial intermediation system, not in a capital market (i.e. direct investment) system.

Why Financial Intermediation Is Dominant in Asian Financial Markets

One of the financial characteristics of the East Asian developing countries is the dominant role of bank and non-bank financial intermediation (Wade, 1988). For those countries, financial inter-

mediation brings more comparative advantages to private investors, firms and governments than securities markets. First, given the problems of productivity risks, information asymmetry and costly monitoring of finance in developing economies, debt contracts with fixed payments are better than risky share holding (Gale and Hellwig, 1985). Second, with their large and diversified investment portfolios, financial intermediaries can guarantee a yield for their deposits and can commit themselves credibly to monitoring the return of the projects (Diamond, 1984). Third, debt financing does not change the ownership structure and keeps the families or "insiders" (internal shareholders and managers) in control of the firms. Finally, a credit-based financial system provides the government with the necessary political clout to implement its industrial and development strategy (Wade, 1998, p. 134).

Explicit and Implicit Financial Activities

To avoid the problems of adverse selection (e.g. purchasing bad securities due to *ex ante* information asymmetry) or moral hazard (e.g. managers' agency cost because of *ex post* information asymmetry) in capital markets, investors consider financial intermediation a better choice. Unfortunately, they are trapped in another dilemma, the problem of financial dualism. The nature of this problem is the lack of market discipline, even though all financial transactions are in the form of market activities. The neo-financial dualism hypothesis divides a financial contract into two parts, the explicit contract and the implicit one. The former is the "form" of a transaction, such as credit evaluation, auditing, credit terms negotiation, etc. The latter transaction, in the nature of financial behaviour, is not based on profit-risk analysis, but on government instruction or the relations between the creditor and the debtor. This phenomenon can be called an implicit government guarantee problem (Krugman, 1998a, Garnaut, 1998), or a "crony capitalism" problem. In China's financial sector, it is defined as a "relative loans" or *guanxi daikuan* problem (Krugman, 1998b).

Two arguments are extended from this hypothesis. First, without structural reform, i.e. eliminating the implicit financial transaction, neither financial liberalisation nor financial deepening is effective for steady financial development and economic growth, because each emphasises the expansion of the explicit financial transaction

(quantity or price) and ignores the implicit one. Second, the integration of a dual financial structure should not aim at merging the formal and informal financial sectors, but at strengthening market rules. With implicit financial transactions, both regulated financial sectors and more liberalised ones fall into the high-risk category, which may lead to systemic crisis.

Risk-Sharing Mechanism: Hard Versus Soft-Budget Constraints

The dual structure of financial transactions creates an asymmetric risk-sharing mechanism. As we know, financial intermediation divides the fund allocation into two stages: the transaction between private investors and financial intermediaries, and the transaction between financial intermediaries and firms. In the first stage, the debt contract is set with hard-budget constraints, i.e. the financial institution has to pay the deposits in fixed amounts at fixed times. In the second stage, the credit contract may be set with soft-budget constraints (Kornai, 1986) due to the implicit financial behaviour. There are two different cases of these soft-budget constraints. First, the state-dominated financial transactions endow financial intermediaries with systematic risks because the government's strategy is based on a socio-economic plan and not on profit maximisation. If the government's plan is proved to be wrong or an unexpected demand-side shock occurs, the government guarantee is not credible, and financial institutions have to take the total loss (Garnaut, 1998). Second, the credit contracts are based on a crony relationship emanating from the belief that "privilege leads to excess profit", and not on risk. If this privilege is challenged by political instability, expected profit will turn into excess loss. Hence, under the condition of financial dualism, financial intermediaries have to face an asymmetric risk-sharing mechanism. On the one hand, depositors endow them with hard-budget constraints. On the other hand, they offer soft-budget constraints to debtors. Undoubtedly, this kind of financial system is vulnerable.

Structural Crisis: An Inevitable Result of Risk Accumulation

Recent Crisis Models and Critiques

What is the nature of the East Asian crisis? Recent studies generate quite different answers. One viewpoint believes that the crisis was a

currency crisis since "inconsistent policies before the attack push(ed) the economy into a crisis" (Flood and Marion, 1998, p. 13) and is an extension of the first-generation crisis model (Salant and Henderson, 1978; Krugman, 1979; Flood and Garber, 1984; Agenor *et al.*, 1992). A second proposition views the crisis as a being one of market confidence (Goldfajn and Valdés, 1997), which is an application of the second-generation model (Obstfeld, 1994, 1995). "The logic of crisis arises from the fact that defending a parity is more expensive if the market believes that defense will ultimately fail" (Krugman, 1998a, p. 5). The third hypothesis believes that the nature of the crisis was a demand shock plus contagion effect (Baig and Goldfajn, 1998; Masson, 1998). The crisis broke in Thailand because its fundamentals were shocked by several demand-side factors, and then spread into other countries because of the cross-country correlations within East Asia. In a word, the crisis was an economic crisis.

However, none of these hypotheses can cover the whole story of the crisis. First, the economic fundamentals did not show sufficient signs that Asian economies were on a turning point. For instance, from 1991 to 1995, Thailand, Korea, Indonesia and Malaysia had maintained moderately high growth; the annual average growth rates were 8.6%, 7.5%, 7.8% and 8.7%, respectively. Even in 1996, on the eve of crisis, their growth rates were 5.5%, 7.1%, 8.0% and 8.6%. Their inflation rates were quite low, 5.9%, 4.9%, 7.9% and 3.5% in 1996. The growth of real exports remained strong in Korea (13.0%), Indonesia (5.5%) and Malaysia (7.2%), except Thailand (-1.8%) in 1996 (Kochhar *et al.*, 1998). Therefore, the "policy push" or weakness of fundamentals hypothesis is not applicable to the Asian crisis. Second, the "demand-side shock and market contagion" theory also fails to offer a reasonable explanation for the following two observations. One is that those shocks (e.g. movements in the yen-dollar rate and terms-of-trade deterioration; Kochhar *et al.*, 1998; Garnaut, 1998) should have affected all economies with the same export structure in the region, but no severe crisis occurred in Taiwan and Singapore. The other observation is that Hong Kong and Singapore, the two regional financial centres, which should have the closest relations with other economies, have proved to be immune to infection (Chan-Lau and Chen, 1998). Finally, the confidence or expectation model fails to explain the reason for the confidence crisis and why it occurred in certain areas. Why did

investors in Thailand, Korea and Indonesia lose their confidence? Why has confidence of Hong Kong, Singapore and Taiwan remained strong? There must be some difference between the latter economies and the countries in crisis.

Risk Accumulation: The Structural Root of the Asian Crisis

Krugman's (1998a) "third-generation" crisis model and Chan-Lau and Chen's (1998) "inefficient financial intermediation" model grasp the nature of the Asian crisis most completely. The former model emphasises the level of financial institutions' behaviour, and concludes that the implicit government guarantees and deregulation led to a moral hazard over-investment problem (Krugman, 1998a). The latter takes the "costly loan monitoring", resulting from a lack of transparency in the corporate sector, as the cause of crisis (Chan-Lau and Chen, 1998, p. 5). Their approaches are based on two levels of information asymmetry: the regulator and financial institutions, and the financial institutions and firms. On the one hand, they are right because implicit government guarantees and inefficient finance have been the causes of the Asian crisis. On the other hand, they are not entirely right because there is no evidence that the asymmetric information structure really exists. In fact, central banks know what happens in financial institutions, and financial institutions also know the actual operation of firms. Private investors cannot know each credit or investment project well, but they know the whole investment channel. In Korea, the close credit relationship between banks and *chaebols* was not a secret. In Indonesia, investors knew the financial privilege of the Suharto family and its related enterprises. In Thailand, depositors were clear that their funds are put into the real estate market.

Therefore, the root of the Asian crisis is not the information structure but the financial structure and the risk-sharing mechanism. First, depositors believe their deposits are safe enough based on their hard-budget constraints on financial institutions. Second, financial institutions have no incentive to assess investment risk due to "credible" government guarantee and "profitable" crony relationship. To sum up, the true story of the Asian crisis is the following: financial dualism concentrates risk into financial intermediaries who are over-convinced of government guarantees and the profitability of privilege; the distorted financial activities

lead to structural crisis when risk is accumulated beyond a critical point.

The structural crisis hypothesis can explain the following facts. The first has to do with the "confidence puzzle". Investors did not lose their confidence in fundamentals but in financial structures, i.e. Korea's Bank-*Chaebol* structure and Indonesia's crony capitalist structure. The second is the "contagion puzzle". The crisis only infected those countries that had a dual financial structure. Therefore, Singapore, Taiwan and Hong Kong escaped from the crisis due to their better-developed capital market, i.e. investors took symmetric risks and returns by direct investment (Chan-Lau and Chen, 1998). Third is the "crisis duration puzzle". Since the cause of crisis is not a boom cycle or currency overvaluation, Asian afflicted economies will experience a painful mid-term structural adjustment, and any short-run recovery expectation is over idealistic.

2 Collective Action Versus Isolating Development: What Should Asia Do in the Global Financial System?

The previous section analysed the costs and benefits of Asian economies in the global financial system, and suggested that the root of the crisis is institutional or structural weakness rather than *unfair* competition. To achieve long-run regional development, Asia's attitude should be on the side of collective rationality, i.e. consistent action would be beneficial for both advanced countries such as Japan and less developed economies in Asia.

A Negative Case: Yen's Depreciation

As mentioned above, IFI encourages intra-regional competition. However, over-intensive competition without coordination results in losses. The table below shows that an isolated depreciation of the Japanese yen attacks the regional benefit including Japan itself.

The Research Department of the People's Bank of China (2002) empirically studied the effects of yen fluctuation during 1990-2001 on the trade of six Asian neighbouring economies. Conclusions are significant (see Table 1). First, the depreciation of the yen imposes a significant negative shock on its neighbours' exports: when the yen depreciates 1 percent, the region's exports to Japan and the rest of

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Table 1 The Effects of a 1 Percent Depreciation of Yen

	Bilateral Trade		Multilateral Trade (excluding Japan)	
	Export	Import	Export	Import
Six Asian Neighbour Countries	-0.43	Current period : -0.44 1 period lag : -0.53 2 periods lag :0.03	-0.15	-0.13
China	-0.13	0.19	-0.03	-0.04
Hong Kong	-0.2	Current period : -0.29 1 period lag : -0.07 2 periods lag : 0.04	-0.14	-0.12
Korea	Current period : -0.04 1 period lag :-0.25	0.18	1 period lag : -0.01 2 periods lag : -0.03	2 periods lag : -0.12
Malaysia	-0.07	Current period : -0.02 1 period lag : -0.02 2 periods lag : 0.3	-0.03	-0.12
Thailand	1 period lag : -0.1	0.11	-0.007	1 period lag : -0.09
Indonesia	1 period lag : -0.07	0.29	-0.005	2 periods lag : -0.02

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the world drop 0.43 percent and 0.15 percent, respectively. However, Japan is also hurt by the currency depreciation: the neighbours' imports from Japan decline by 0.44 percent, while the stimulation effect on Japan's export to the rest world is insignificant! The possible explanation is competing depreciation among Asian economies, though there is no persuasive empirical evidence.

This case suggests that individual action by one country may mean losses for all countries, so collective action to build up a sounder global financial system through increasing Asia's status is a feasible solution.

Collective Action to Reform the International Financial Architecture

In the post-Mexican and post-Asian crisis era, reform of the "international financial architecture" to prevent crisis has become a popular topic. Soros (1998) calls for the formation of an international deposit insurance corporation. Fischer (1999) suggests the introduction of a multilateral lender of last resort, while Sachs (1995) advocates the formation of international bankruptcy court. Krugman (1998a, b) believes in the effectiveness of capital outflow control, whereas Eichengreen (1999) prefers Chilean-style capital inflow control. Kaufman (1998) recommends constructing a single global super-regulator of financial market and institutions. Unfortunately, as Rogoff (1999, p. 39) observes, the above remedies can be classified "into three categories: those that are politically infeasible given the absence of a supranational legal authority; those that would raise costs to lenders or add protections for borrowers, and thus would lead to a sharp contradiction of capital flows to developing countries; and those that would shift risks or costs away from creditors" which introduces more moral hazard problems.

Winners and Losers in the Global Financial System

It is obvious that the US and the EU are winners in the global financial system given their market efficiency, innovation and competition. But the situation is very different in the developing world, especially during the capital flight period in crises. Thus, the benefits of international capital market integration seem overrated. However, though some economists and politicians believe that

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countries such as China and India with capital control are risk free, liberalisation is an inevitable trend, because continued tight control brings a long-run efficiency loss to those economies. Hence, in Asia, the feasible way is a two-step reform scheme. First, cooperation must be sought in the foreign exchange system, and second, there must be a formation of a regional risk manager.

Foreign Exchange System Cooperation

Currently, economists have doubts about the usefulness of an intermediate exchange rate system, and instead favour one of the corner solutions: a completely fixed or a freely floating system. As Fischer (2001) noted, an intermediate foreign exchange system lost much of its appeal in the 1990s. In 1991, 62 percent of the countries reporting to the IMF had an intermediate system, but in 2000, this figure dropped to 34 percent. There are three causes for this trend. First, political pressures force central banks to abandon their independence, especially under external shocks. Second, there are only a few freely floating currencies, such as the US dollar, euro and yen, thus limiting the floating space for other currencies (Meltzer, 2002). Third, considering the *impossible trinity*, few central banks prefer a floating system to domestic monetary targets, e.g. the Taylor or McCallum rule. Within the Asian region, a fixed foreign exchange system is an optimal choice. First, the geographic factors make for similar industrial structures in Asian economies, or at least, even though they are in different stages of development, they are on the same path; for example, Japan, Korea, ASEAN countries and China have similar growth strategies. Second, a floating system means risk and requires sufficient risk-management measures, and most Asian countries lack such measures. Third, a fixed rate is the first step toward closer cooperation, just as the former European currency unit (ECU) was a step towards the euro. Only if Asian financial integration would *not* be a target, a fixed system might be ignored. Finally, a fixed system can be a remedy for competing depreciation.

Practically, a fixed system requires a key currency. Most Asian economies chose the US dollar. However, ASEAN+3 currencies, or yen and RMB in particular (as the currencies of the two largest economies) should be a better choice since there is no significant correlation between the Asian real business cycle and that of the US.

Regional Financial Crisis Manager

The debate on the need for an international financial crisis manager is whether the IMF can fulfil this role satisfactorily. At the 1998 G-7 meetings, the "Clinton Proposal" suggested that the IMF would offer a new emergency credit line (Contingency Credit Line) for which countries would have to pre-qualify by meeting certain macroeconomic or regulatory standards. Actually, the financial resource is insufficient for regional risk management, and to reform the IMF based on Asia's needs is an impossible mission. Thus initiatives have emerged in Asia such as the establishment of an Asian Monetary Fund. The major problems facing this initiative are shares-allocation and control right, which are political economy issues. However, it is expected that economic and financial cooperation at the micro level will remove these obstacles, as the EU gives a sound example. First, Asian economies should encourage cross-border financial institutions' entry. Second, common debt issues and stock markets may be co-constructed by major economies in the region. After these two steps, the formation of a regional financial crisis manager is not a possibility, but a demand of all countries.

3 Currency Stability Versus Financial Deepening: Which Goal is to Advance in the First 10 years of the 21st Century?

In the first section of this chapter, we have shown that the banking-based financial system dominance in Asia and structural weaknesses led to the crisis. As a logical inference, under such internal conditions, currency instability is inevitable. There are two sources of bias under the current global financial system towards banking-based economies (Rogoff, 1999). The first is explicit (Korea) or implicit (China) deposit insurance schemes, which expand the banking system through taxpayers' subsidy. If we consider the international fund flow, such schemes may result in taxpayers in debtor countries subsidising the creditor countries! Equity finance, however, is free from such guarantees. Second, the international legal system does far more to protect the debt holders than the providers of equity finance. These evidences partially explain China's narrow escape from the Asian crisis since FDI is the

major part of its foreign capital inflow, while Korea takes more debt.

It is true that currency stability and financial deepening are two sides of the same coin. However, financial deepening is the only way to achieve long-run currency stability, even though the region has constructed risk-management regimes. From this analysis, a sequencing agenda is put forward as follows. Under the structural hypothesis, the optimal policy arrangement is clear: First, structural adjustment is necessary in order to integrate dual financial transactions accompanied by moderate price (interest rate and exchange rate) controls. When structural adjustment is accomplished, domestic financial liberalisation should be implemented. Inter-regional free capital flow is the final step.

Step 1. Structural Adjustment Under Financial Repression

The Asian crisis shows that under structural weaknesses, the market mechanism cannot allocate resources optimally. The crisis also demonstrates that financial reform is not a *laissez-faire approach* (Long and Vittas, 1991; Hossain and Chowdhury, 1996). Financial regulation is not equal to government, while financial liberalisation is not synonymous with so-called deregulation.

Undoubtedly, structural reform should not be delayed; i.e. implicit financial transaction must be eliminated. Since risk is concentrated in financial intermediaries, moderate financial repression is a reasonable method for redefining the risk-sharing structure. Relatively low deposit rates may reduce the financing cost of financial intermediaries and make it less costly to solve the problem of accumulative non-performing loans. The Asian crisis shows that the main element of the establishment of a strong financial system is not whether the price is determined by markets. The deeper factor is whether the financial institutions and firms adhere to market rules, i.e. whether the allocation of funds is by market competition. Hence, the most urgent structural adjustments should concentrate on two tasks. One is establishing a competitive financial mechanism. The other is strictly distinguishing regulation and intervention. The basic role of government is not intervention, but risk-based regulation.

Step 2. Domestic Financial Liberalisation Under Moderate Capital Control

The elimination of implicit financial transactions establishes the base for a competitive financial market; domestic financial liberalisation is necessary for creating an undistorted price system. However, capital control is still necessary at this stage. First, structural adjustment can only solve the problem of new financial transactions, not the financial "stock". To absorb cumulative bad loans, long-run operations are needed. Therefore, the quality of the domestic financial sector will remain lower than that of foreign financial institutions for many years. Premature capital account convertibility will lead to capital flight, inadequate domestic saving mobilisation and economic instability. Second, due to the "natural" imperfect competition of financial markets (Sussman, 1993; Berthélemy and Varoudakis, 1996), an early opening of financial markets will result in the monopoly of transnational financial institutions that damage efficiency and stability. As McKinnon (1973, 1982) and Dornbusch (1983, 1984) suggest, any early opening of the capital account may result in large destabilising capital flows under the condition of imperfect domestic financial markets.

Step 3. Free Capital Flow

If the economy has sufficient market condition and regulating techniques, capital account convertibility enables the economy to mobilise international capital, and offers to domestic funds profitable foreign investment opportunities.

4 Conclusion

We draw the following conclusions. First, given the competition nature of the global financial market, improvement of the institutional structure is the only way to choose winners and losers. Thus the major lesson drawn from the Asian crisis is to reform the internal structure. Second, Asia achieves benefits and costs simultaneously from the current global financial system, and the trend of openness is inevitable. Third, collective actions in the

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regional foreign exchange system and the risk-management regime are feasible. Finally, the sequencing of reform is necessary for long-run currency stability in Asia.

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12

'Neo-Financial Dualism' Hypothesis and Regional Cooperation in East Asia: Comment on Xie Ping

Zdeněk Drábek[1]

It is very encouraging to see that China currently contributes to the global economy not only as a major emerging economic power but also in terms of economic ideas. One of such contributions is the recent paper by Xie Ping, Director General of the Research Bureau in the Peoples Bank of China. Mr. Xie has adopted a highly innovative approach to the assessment of the financial sector of China which he calls 'neo-financial dualism'. The approach allows him to analyse the operations and performance of state-owned banks in China and explain the emergence and persistence of non-performing loans, strong demand of state industrial enterprises for bank credit, the trend towards 'over-investment' as well as the liquidity positions of banks. Mr. Xie takes the liberty of even suggesting that the main building blocks of the hypothesis are not necessarily China-specific and that they can be

1 The author benefited from interesting discussions at the conference as well as of other contributions, all very relevant for this paper. I would especially like to thank Jan Joost Teunissen, Yung Chul Park, Masaru Yoshitomi, Barbara Stallings and other participants for their insights. Despite having sometimes different perspectives, they helped me a great deal with this paper. All shortcomings that may remain are, of course, my own responsibility. The views expressed in this paper are personal and should not be attributed to the WTO members or the Secretariat.

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also applied to other countries in the region. Even though he diplomatically avoids naming any countries, one can deduce that he could think of countries such as, for example, Japan or Indonesia.

The idea of neo-financial dualism is brought in his paper in the context of the debate about China's role in fostering financial stability in the Asian region and in the global economy. He suggests that governments have a choice between financial stability and financial deepening, which has become a frequently used argument of opponents of capital account liberalisation.[2] He recognises the standard explanations of financial fragility and instability – first, the so-called 'structuralist' view which claims that the instability is due to the absence of deep financial markets to provide a wide range of financial instruments and to dilute the spread of 'shock waves' generated by financial failures, external shocks, moral hazard etc. Second, the so-called 'financial repression' view which argues that the problem of financial instability is due to government policies leading to disequilibrium interest rates and exchange rates. Mr. Xie believes that these 'theories' do not adequately explain the financial instability and fragility of the Chinese financial sector, especially those of state banks. In his view, the instability is due to neo-financial dualism.

The purpose of this paper is to evaluate the main features of the *neo-financial dualism hypothesis* and to asses its implications for regional cooperation in East Asia. In order to clarify the link between the neo-financial dualism and regional cooperation I shall try to answer the following questions. What are the main features of the neo-financial dualism hypothesis? What are the implications for international cooperation? What are the main issues for discussion and, potentially, for negotiations for the Chinese authorities with foreign partners? What form of international cooperation should the Chinese authorities pursue under the circumstances – regional or global?

It is clear that the idea of neo-financial dualism leads to a novel approach to the analysis of problems of the Chinese financial sector. The idea will undoubtedly raise interest among scholars and observers of the Chinese reform. Since the approach is rather unconventional, I shall provide my own interpretation of the hypothesis with the view of perhaps putting it into a more familiar

2 See, for example, the contribution of Yoshitomi in this volume.

terminology. This, together with a brief assessment of the hypothesis will be the subject of the next section. Section 2 will provide a discussion of the implications of neo-dualism for international cooperation. Discussion of issues for international cooperation will be in Section 3. Finally, the choice between regional and global cooperation from the point of view of Chinese policymakers will be discussed in Section 4.

1 Neo-Financial Dualism – What Is It and Is It Plausible?

The hypothesis of neo-financial dualism starts from the idea that financial intermediation plays the most critical role in the present context of Chinese development. Chinese banks act as the conduit for domestic household savings which are then transformed by banks into loans. Alternative investment opportunities for Chinese households are still extremely limited.[3] *Pari passu*, alternative sources of financing other than bank credit are also very limited for Chinese firms. Thus, the operations of the financial sector are limited to fairly simple financial intermediation rather than or in addition to more sophisticated operations of capital and money markets. This is only a short step away from arguing that financial stability is a function of the performance of bank intermediation.

In theory, the neo-financial dualism hypothesis is based on the critical distinction between two types of contracts in the banking sector. The first type is represented by *formal contracts* which are strictly enforceable. They cannot be manipulated, by-passed, or avoided, and they represent as formal arrangements as legal contracts do in well functioning legal systems. These must be contrasted with the second type of contracts which, too, may be based on legal documents but they can also be in the form of *informal arrangements*.

In the Chinese banking sector the deposit arrangements between households and banks are subject to formal contracts. The deposits made with banks are believed to be (fully?) guaranteed by the state. This means that the liability part of the banks' balance sheets is given; it cannot be manipulated and is subject to strict rules of

[3] According to Goldman Sachs, only about 4% of Chinese savings are held in stocks. See "China's Big Year?", In *Global Finance*, March 2002, p. 27.

surveillance, use and control. In contrast, the banks' lending operations are heavily influenced by informal arrangements. Perhaps the most important among these arrangements are those arising from the influence and interference of political authorities into the lending operations of banks. Since banks' lending is heavily oriented towards lending to state-owned enterprises (SOEs) – currently about 70-80 percent of bank credit is allocated to SOEs – the political authorities (i.e. read the Party) are clearly concerned about any shifts in the structure of bank lending away from SOEs.[4] The lending transactions of banks can also be subject to formal contracts. But what makes them different from the formal contracts with the depositors is the lack of enforceability and discipline. The state may and often does direct the credit to SOEs irrespective of the high risk of non-repayment. In other words, the state takes over, in a way, a great deal of the commercial risk that is normally carried on the banks' books.

Thus, according to the hypothesis, the operations of Chinese banks can be divided into two groups – those that are subject to deposit contracts and those that are subject to lending transactions. Correspondingly, the banks' balance sheets have two separate circuits – those subject to formal contracts between depositors and the banks and those subject to informal arrangements between the banks, SOEs and the political authorities. The banks face a strict and enforceable obligation to return depositors' deposits. They do not face the same pressure of returning profit to their investors as would be the case in a properly functioning market economy. The reader with background in central planning will undoubtedly already recognise that the hypothesis is built on the well known idea of "hard" and "soft" budget constraints invented and developed by Janos Kornai.

The consequences of informal lending arrangements is the emergence of asymmetric risk sharing – banks (with the state) take a full risk for managing household deposits but the state takes over, partially or fully, the lending risk. Since banks do not take a full responsibility for lending risks, this may lead to moral hazard. Moreover, lax enforcement of credit contracts can only encourage SOEs to further borrow and thus provide additional incentives to

[4] According to Oxford Analytica, the numbers may be even higher – 80-90%. See *China–Banks at Risk as WTO Opens Door to Foreign Rivals*, Oxford, June 2002.

'over-invest'. Most importantly, the loose lending practices lead to the emergence of an excessive share of non-performing loans (NPLs). According to Wing Thye Woo, NPLs of the four large state banks represented 35 percent of GDP in the beginning of 2002, and the corresponding number was 15.5 percent in other ten joint-stock banks.[5]

Intuitively, too, the hypothesis seems quite plausible. As already noted above, deposits of Chinese depositors are guaranteed by the state. This should make deposit contracts enforceable. The banks' responsibility to mobilise domestic savings is further increased by the fact that there is hardly any competition for household savings since the bulk of savings is concentrated in only four banks. Moreover, since financial markets are 'thin' and the choice of alternative instruments is very limited, households are highly dependent on banks as their main and, sometimes the only savings outlet. Nevertheless, it is not entirely clear how 'hard' the deposit contracts really are. In particular, are deposit rates based on market conditions? That is, are they related to costs of capital, costs of banks' borrowing, costs of provisions?

The 'soft-budget' constraint of credit transactions is also quite plausible. The symptoms of this are non-performing loans, excessive debt, non-transparent accounts. While there has so far been no direct and comprehensive evidence of 'neo-financial dualism', the evidence of poor credit control, most likely originating in informal arrangements between banks and their clients is widespread and powerful. In discussing the origins of East Asian financial crisis, for example, the proclivity towards 'over-investment' in South Korea and other East Asian countries under conditions of lax credit controls has been well documented by Krugman (1998) and further discussed, for example, by Wade (1998). The World Bank has reached similar conclusions for Indonesia in, for example, its Country Economic Memorandum. The problem of non-performing loans has been widely discussed in the context of banking crises in countries as geographically wide apart as Argentina, Japan, the

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[5] See Wing Thye Woo (2003), Table 4. There is a dispute among economists about the size of NPL. However, there is an agreement that the problem of NPL is large and persistent. The Chinese already transferred about $170 billion of NPLs (about 18% of total loans) to asset management companies. See Guonan Ma and Ben S.C. Fung (2002).

United States (the S&L crisis), Sweden, Mexico and other. 'Over-investment' was one of the standard features of firms under central planning which China has been trying to reform for the past 20 years or so. And similar deficiencies in credit control (and bank supervision) have been found in other transition countries.[6]

2 Implications for International Cooperation

The implications of neo-financial dualism for policy making are quite important and serious. The 'soft-budget' constraint can be characterised as being equivalent to a subsidy. If banks can lend without (much) regard to the credit risk and to the chances of having their loans repaid they can either do so by assuming that the credit will be financially covered by the investors or, as in the case of Chinese banks, by the state. In other words, the financial operations of Chinese banks would have to be seen as supported and subsidised by the state.

The presence of 'subsidy' will, in turn, have three effects, two of which are international consequences. First, and arguably most importantly, the origin of neo-financial dualism is domestic. This means that the first-order policy measure which has to be taken to address the problem of poor credit discipline will involve changes in domestic policy to make the credit contracts 'hard'. The policy measures may include such steps as changes in property rights, measures to improve the enforcement of contracts, ownership changes in the banking sector, measures to improve credit appraisal, increasing competition and, first and foremost, liberalising the interest rate policy.

Second, the serious implication of the 'subsidy' element of financial credit is its effect on international competition. It is evident that subsidised credit distorts international competition in the 'traded goods' sector. This will be particularly the case of commodities produced by the state enterprise sector. The size of subsidy and its specific use may not be consistent with the country's commitment to the subsidy agreement in the WTO. This means that the trading practices of China could be contested by the WTO members as being illegal or they can be countervailed.

6 See, for example, Griffith-Jones and Drábek (1995).

Third, even if the bank subsidy is found in conformity with the WTO agreement, it may still create tensions in the country's relations with its trading partners. Under such a scenario, an international solution to the problem will be desirable. China could, for example, pursue a subsidy policy that would optimise its trade benefits by changing its terms of trade. It could obviously do that because China is a big country and many of its trading partners are small. This is what is known as the 'optimal tariff argument' and the solution to which is – for small countries – to seek a cooperative solution.[7] Thus, it would make a great deal of sense for the small East Asian and other countries to negotiate an appropriate arrangement that would address the subsidy question.

3 Issues for International Cooperation

The next question that needs to be asked is what kind of issues should be addressed through international cooperation? These issues could be grouped under the three following headings: credibility of government policies, exchange rate management and crisis prevention. Let me turn to each in turn.

One of the greatest contributions of international agreements is, in my view, the stamp of approval they give to governments' commitments. In other words, international agreements normally greatly enhance the *credibility of countries' policies*. Consider, for example, that China agrees to a reduction of subsidies to the state enterprise sector. Appropriate legislation is adopted and policy measures introduced. Foreign partners may accept these changes but may not have much recourse to counter-measures if the subsidy policy turns out to be different than what is acceptable to foreign countries. Now, compare that scenario with the alternative whereby China agrees and signs an agreement with foreign countries. An international agreement should in principle carry a much greater weight, because the Chinese commitments will be made as a part of *pro quid quo* and their power will be that much stronger if these agreements are enforced with penalties such as sanctions.

[7] The literature was reviewed and the argument of 'optimal tariff' elaborated in Staiger (1995).

The second major issue concerns *exchange rate management*. "Dualism" refers, by definition, to two segments in the economy – one functioning subject to formal rules of contracts, the other operating under the influence of informal contracts. To repeat, the two segments operate subject to different rules of business, one that is subject to "hard-budget constraint", the other to rules under "soft-budget constraint". It is very likely that under those conditions, the economy will also operate in two separate circuits which will perform differently. The savings mobilisation and discipline in China appears to be induced by strong and enforceable rules on deposits. On the other hand, credit operations, which are subject to "softer" rules will not be subject to strict commercial discipline. Moreover, state-owned enterprises clearly operate under different – softer – rules than firms in the private sector. One could, therefore, argue that under these circumstances China continues to operate a "dual exchange rate mechanism". An exchange rate that is appropriate for the "formal" sector and another exchange rate that is appropriate for the less formal sector.

The implication of dual exchange rates for regional cooperation would be quite serious. The 'softer' exchange rate could be seen by China's trade partners as a disguised subsidy to the Chinese sector producing tradables, which would be hardly acceptable. Depending on the design of foreign currency restrictions and on the way the banks are linked to the budget, however, the outcome may be even the opposite. In that case, a dual exchange rate would act as an instrument of transferring resources from exporters to importers.[8] The solution to the problem of dual exchange rates is, of course, unification of exchange rates, which would require measures to "harden" the budget constraints of banks by, presumably, privatising banks, allowing foreign entry, increasing competition, strengthening supervision etc., as I have already noted above. While these are measures of domestic nature, some of them could become subject of negotiations with China's foreign partners, such as measures affecting market entry.

The third important area of issues for international cooperation concerns *crisis prevention*. Would a dual exchange rate system be

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[8] For a review of multiple exchange rate systems, see IMF (1995). For a recent case study of the effects of multiple exchange rate systems, see, for example, Rosenberg and de Zeeuw (2000).

intrinsically more unstable than one in which exchange rates are unified? There are two kinds of answers possible, I believe. First, the dual exchange rate system is operating in the Chinese context under rather specific conditions. The government maintains restrictions on capital movements which basically eliminate the external financial instability originating in capital surges and capital flights. Second, other sources of financial instability still exist and some of these may be due to the specifics of the dual exchange rate system. The system creates various forms of allocative distortions which lead to inefficiencies and distributional changes, which, in turn, may undermine economic growth and also lead to external imbalances as documented by the experience of countries which have practiced the policy of multiple exchange rate systems. Thus, financial crises can arise even under conditions of closed capital accounts.

4 Regional or Multilateral Cooperation?

To conclude, which path should be pursued by China and its regional partners? Should they seek a closer regional cooperation to address the issues that I have raised above or should they continue to work within the multilateral trading and financial framework? As we know all too well, there are strong feelings in the region that there is too little of East Asian cooperation.[9] This is despite the growing body of evidence which suggest that the East Asian markets are becoming increasingly more integrated.[10] These are critical questions for the region today as evidenced from various contributions to this subject.

The answers to these questions are quite straightforward on three grounds. The first issue that the countries in the region should address in any type of arrangements – regional or global/multilateral

[9] See, for example, Sakakibara (2003) and Yung Chul Park (2003). However, see also Yin-Wong Cheung *et al.* (2003) who argue that China, Taiwan and Hong Kong are already closely integrated. They show that real interest parity, uncovered interest parity, and relative purchasing power parity all hold over longer periods. The study confirms the earlier findings of Gros and Thygesen (1998) for European currencies.

[10] McCauley and his colleagues, for example, have found that bond markets and syndicated loan markets are already fairly highly integrated. See McCauley *et al.* (2002).

ones – is the extent to which these arrangements will provide credibility to policy reforms. This, in turn, greatly depends on the degree of enforceability of mutually agreed conditions and concessions. For example, if market access to the Chinese banking sector is the big issue for foreign investors, it is more likely that a Chinese commitment can be more effectively enforced through a multilateral agreement in which more countries' interests are at stake and which have an enforcement mechanism already in place.

The second factor which also would tend to favour a global/multilateral solution is the relative size of countries in the region. Given the enormous size of China relative to the countries in the region, perhaps with the exception of Japan, it must be in the interest of the small countries to seek a global solution to their problems. Surely, the interests of countries such as Thailand, Malaysia and even Korea and Taiwan will be better protected in global for than in a regional one.

These are quite standard arguments that one usually makes in favour of the multilateral system. But there may be another, more fundamental reason which is closely related to the existing norms of the international financial architecture and of the WTO agreements. The best answer to the question which of the "cooperative solutions" is preferable depends on answers to the following additional questions:

(i) Liberalisation of capital account. Suppose that, for some reason, a regional approach to financial integration was pursued giving regional banks priority market access in the Chinese banking sector – rather an unlikely scenario considering the violation of the MFN principle in this scenario. Would, say, Japanese banks be less destabilising investors than banks from other countries? Moreover, are not the financial markets already integrated to a very large extent?[11]

(ii) Surveillance. It is clear to me that whatever lender of last resort would eventually be put on the table, the lender will have to address the question of surveillance and conditionality. These were arguably the most sensitive issues created by the intervention of the IMF in the region during the financial crisis in 1997 and thereafter. The question is then: would a regional surveillance mechanism be

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[11] See the study of Yin Wong Cheun *et al.* (2003) and footnote 9 above. The existing degree of financial integration makes capital controls less effective.

more acceptable – politically or on substantive grounds – than the one operating under the IMF? Moreover, given the IMF Articles and their treatment of multiple exchange rates, would this not make alternative regional arrangement about Chinese dual exchange rates redundant?

(iii) Liquidity. One of the major justifications for the idea of a regional lender of last resort was the existence of large international reserves in the region. In theory, these reserves could be made available during liquidity crises in the region. The question is then: Would a regional arrangement make sufficient resources available for this purpose?

(iv) Exchange rate regimes. The countries in the region have become increasingly integrated, as noted above. The trade linkages have already become quite deep. Moreover, the countries pursue different policies towards fully opening their foreign currency markets. This makes the stability of intra-regional trade flows particularly important and, for that reason, so will be the stability of exchange rates. Even though there has been some increase in the use of local regional currencies to promote mutual trade, this shift has been relatively minor indicating the continued strong links of local currencies to the US dollar.[12] The question is then: Would the stability of intra-regional exchange rates be more likely achieved by tying the local currencies to, say, the yen or renmimbi (RMB).

This takes us back to the main subject of this paper – the question of neo-financial dualism. The dualism and the existence of multiple exchange rates could enormously complicate China's integration into world markets – global or regional. There are good reasons to believe that these problems could become particularly evident in the regional context in which the commercial interests are relatively more concentrated and less dispersed than in global arrangements. A classical example from recent history was COMECON – the trade arrangement of centrally planned economies which was abolished in 1990. The arrangement was extremely inefficient and eventually collapsed primarily because of the existence of multiple exchange rates which each member country maintained. The effect of that system was the emergence of markets

[12] Kerney and Mukcley found that 1 percent appreciation of the US dollar has been linked with a mean of 1.27 percent appreciation of Asian currencies against the yen. See Kerney and Mukcley (2003).

that did not clear with persistent excess demand in some markets and with a persistent excess supply in others. The solutions to "market clearing" were a strict bilateralism in payments settlements.

These were extreme solutions to extreme distortions. However, since multiple exchange rates lead to distortions of incentives and, hence to trade distortions, they will be also perceived by China's trading partners as providing an unfair advantage to Chinese exporters in some sectors while providing an additional protection to other Chinese producers. This would call for measures that unify the multiple exchange rate system as the origin of the distortion before any further measures could be taken. The WTO rules have very little to say about multiple exchange rates. But China will have the obligation to do so under the IMF agreement – which is China's multilateral obligation. Thus, the whole new idea introduced by Mr. Xie Ping is not only interesting but also has very serious economic policy implications – for domestic policy making as well as for regional and multilateral cooperation.

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13

The Role of the Financial Sector in Creating Growth and Stability: Lessons for China from Emerging Market Economies?

Barbara Stallings

There is overwhelming consensus that the financial sector is an essential component of the modern capitalist economy, in developing countries as well as the industrial world.[1]

Without a robust financial sector, households and firms cannot spend beyond their own means, and resources are inefficiently allocated, so that growth is substantially constrained.[2] At the same time, there is also widespread agreement that the financial sector is a fragile institution, which must be protected and nourished if it is to perform its functions in an adequate way. This includes prudential regulation and supervision, but also the creation and maintenance of a stable macroeconomic environment. A financial crisis can damage economic prospects and harm the most vulnerable groups in ways that take a very long time to repair. Here the consensus ends. What are the main causes of financial crises, how best to deal with them,

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2 Despite agreement about the correlation between finance and growth, disagreement persists on the nature and direction of causality between the two.

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and how to structure a financial sector that can promote growth for all – these are issues that are heatedly debated.

This paper aims to contribute to some of these debates in the context of reflecting on the challenges facing China's financial system and possible lessons that can be learned from the experiences of other emerging market economies. The paper begins with a brief look at the characteristics of the Chinese financial sector at the beginning of the twenty-first century. It then reviews selected country experiences from two emerging regions: Latin America and East Asia (excluding China). Major topics of interest are financial liberalisation, crisis and response; the evolving structure and performance of the financial markets; their contribution to investment and growth; and the problems of access to finance for vulnerable groups. Finally, it concludes with some lessons that China might draw from its Asian neighbours and Latin America. This is a broad and complex agenda, and only a few highlights can be presented here. The paper focuses on issues that are most relevant for the new authorities who have recently taken office in China. Of course, the size of China's economy makes it difficult to extract useful lessons from the experience of others, but many of the issues are common to all emerging markets.

1 Characteristics of the Chinese Financial Sector

While China has been undergoing economic reforms for over two decades now, a new turning point was reached when the country joined the World Trade Organisation (WTO) in December 2001. Among other obligations, accession to the WTO required much more extensive liberalisation of China's financial markets, especially its banking sector.[3] By 2005, geographical and numerical restrictions on foreign banks will be lifted, and the scope of foreign banking activities will be gradually expanded. Five years after accession, foreign banks will enjoy full national treatment. Their aim, of course, is to gain access to the domestic currency market, both for deposits and loans. Just as foreign merchants have hungered for centuries for access to the 'China market' (McCormick, 1967), so

[3] Other financial services are also to be liberalised to a lesser extent, e.g., insurance, securities, and fund management.

banks and other financial service providers dream of participating in the intermediation of China's one trillion dollars pool of household savings. For its part, China's government believes that the resulting rise in competition will increase the efficiency and productivity of the financial sector itself and that it will have positive spillover effects on the production system, in both the state and private spheres of the economy. Thus, the considerable sacrifices that will be required are considered an acceptable price to pay for the expected long-term reward of maintaining a growth rate sufficient to deal with employment and other social needs. (On China and the WTO, see Lardy, 2002; Panitchpakdi and Clifford, 2002.)

China's financial sector has changed dramatically over the last 25 years. For the first three decades after the 1949 revolution, China had only a single bank, the People's Bank of China (PBOC), which allocated credit according to central planning criteria. Starting in 1978, however, with the general initiation of economic reforms, financial diversification also began. Four state commercial banks were set up to assume the commercial banking functions of the PBOC: the Bank of China, the Agricultural Bank, the Construction Bank, and the Industrial and Commercial Bank. The PBOC, in turn, assumed the normal functions of a central bank. Later, publicly-listed commercial banks were established, and many non-bank financial institutions appeared, notably the thousands of rural and urban cooperatives. In the mid-1990s, three new 'policy banks' – the State Development Bank, the Export-Import Bank of China, and the Agricultural Development Bank – took over the role of providing subsidised credit to the government's priority projects. As a consequence, the four state-owned commercial banks evolved further in the direction of their western counterparts and are the dominant institutions of the financial sector today. Beyond banking, China has two stock markets, in Shanghai and Shenzhen, where the number of listed companies rose from zero in 1990 to around 1200 in 2002; market capitalisation at some $500 billion exceeds that of all Asian exchanges except Japan.[4] A much smaller bond market, predominantly featuring issues of government paper, completes the

[4] This figure exaggerates market capitalisation in the sense that some 60 percent of shares are not traded; these are held by the central or local governments or "legal persons". Thus, a complementary statistic is the so-called negotiable capitalisation (Shirai, 2002a, p. 17). Both statistics are given in Table 1.

current design of the financial sector, as shown in Table 1. (For a more detailed look at China's financial sector, see Lardy, 1998, chapters 3 and 4; Chen, Dietrich, and Fang, 2000; Shirai, 2002a and 2002b.)

The financial sector just described is embedded in a larger macroeconomic and structural context, which must be taken into account in order to understand the characteristics of the financial sector itself. Just as central planning requirements led to a single bank that served as a funnel for government funds in the early revolutionary period, so the partially liberalised, but still state-controlled, economy shapes financial sector operations today. In macroeconomic terms, the most important characteristics are the closed capital account and the non-convertibility of the renmimbi (RMB), together with the power of the authorities to set interest rates. These characteristics limit the volatility to which the financial sector is subject, but they also limit its ability to allocate resources

Table 1 China: Domestic Credit, Bonds, and Stock Market Capitalisation, 1992-2000
(percentage of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Domestic credit	94.7	103.6	92.3	91.1	97.2	106.2	119.5	130.4	132.7
Bonds	8.4	7.2	6.6	9.6	11.0	13.0	17.2	21.7	24.5
Government	4.8	4.6	4.9	5.6	6.4	7.4	9.9	12.9	15.3
Corporate*	3.6	2.6	1.7	4.0	4.6	5.6	7.3	8.8	9.2
Total stock market capitalisation	3.9	10.2	7.9	5.9	14.5	23.4	24.5	32.3	53.8
A Shares		9.6	7.5	5.7	13.9	22.9	24.3	31.9	53.1
B Shares		0.6	0.4	0.3	0.6	0.5	0.3	0.4	0.7
Negotiable market capitalisation	n.a.	2.5	2.1	1.6	4.2	7.0	7.2	10.0	18.0
A Shares		2.0	1.7	1.4	3.7	6.5	7.0	9.7	17.4
B Shares		0.5	0.3	0.3	0.5	0.5	0.3	0.3	0.6
Total (1)**	107.0	121.0	106.8	106.6	122.7	142.6	161.2	184.4	211.0
Total (2)***	n.a.	113.3	101.0	102.3	112.4	126.2	143.9	162.1	175.2

Notes:
* Includes bonds issued by financial institutions.
** Total based on total market capitalisation.
*** Total based on negotiable market capitalisation.
Source: Calculated from Shirai (2002a), p. 13.

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efficiently. In structural terms, the centrality of state-owned enterprises, which are generally in a very weak financial position, and which continue to be the main borrowers from the banks, has a strong negative impact on the latter's balance sheets.

China's performance during the recent Asian financial crisis both provided satisfaction to authorities and served as a wake-up call about what could happen in the future. While GDP growth slowed by about three percentage points between 1995-96 and 1998-99, output nonetheless expanded by nearly eight percent in 1998, a year in which most economies in the region contracted. (For a comparison, see Fernald and Babson, 2000.) Moreover, the external accounts continued strong, and the RMB maintained its nominal value and even appreciated in real terms against the dollar. No banks collapsed or had to be taken over by the government, as happened elsewhere in the region. On the surface, then, it appeared that the Chinese economy was operating from a position of strength.

At the same time, no one – including Chinese officials – doubts that China's financial sector also suffers from serious underlying problems. We have already seen the extent to which banks dominate the financial sector. More important is the dominance within the banking industry of the four state-owned commercial banks. Table 2 shows the extreme level of concentration among deposit-taking institutions; the four hold 78 percent of total assets and 88 percent of foreign assets. Foreign banks play an extremely marginal role. While more than 150 foreign banks have branches in China, they are limited to foreign currency transactions and represent a mere 1.3 percent of total loans outstanding. Indeed, loans outstanding from foreign banks have actually fallen in absolute amounts since 1997 as the regional economic environment deteriorated (Lardy, 2001, p. 272). Taking a more aggressive stance, a few foreign institutions have recently purchased small stakes in some of the publicly-listed (but still state-controlled) banks: Citibank bought five percent of Shanghai Pudong Development Bank; HSBC acquired eight percent of Bank of Shanghai; and Newbridge Capital is seeking a 20 percent share in Shenzhen Development Bank (*The Economist*, March 8, 2003).

An examination of the traditional indicators of financial performance reveals significant problems, especially among the four state-owned banks. Return on assets (ROA) is low in international terms, between 0.1 and 0.2 in recent years. This was substantially

Table 2 China: Concentration among Deposit-Taking Financial Institutions, mid-1990s
(RMB billions and percentages)

Type of institution	Total assets	Foreign assets	Reserve assets
State-owned commercial banks	4,310.51	327.79	643.64
	(78.2%)	(87.7%)	(74.1%)
Publicly-listed commercial banks	361.35	46.10	75.48
	(6.6%)	(12.3%)	(8.7%)
Rural credit cooperatives	571.25	0	99.24
	(10.4%)	(0.0%)	(11.4%)
Urban credit cooperatives	229.16	0	47.24
	(4.2%)	(0.0%)	(5.4%)
Finance companies	41.04	0.01	3.15
	(0.7%)	(0.0%)	(0.4%)
Total	5,513.31	373.90	868.75
	(100.0%)	(100.0%)	(100.0%)

Source: Calculated from Chen, Dietrich, and Fang (2000), p. 11.

lower than returns on the publicly-listed banks in China, which had ROA ratios of nearly two in the mid-1990s, but have themselves fallen to around 0.5 (Shirai, 2002a, p. 14). Capital adequacy ratios are also generally below the BIS-mandated eight percent, according to a recent statement by the Governor of the PBOC.

Most attention by experts, however, has been directed to the non-performing loans (NPLs) in the banking system. A recent BIS study (Ma and Fung, 2002) reported that NPLs amount to 42 percent of loans outstanding of the four state-owned banks, including both those turned over to the asset management companies established to deal with the bad loans and those still held by the banks themselves. The total amounts to 35 percent of GDP in 2001. The BIS economists also raised concerns about the funding amounts and sources for the asset management firms. Other experts believe the NPL problem is even greater than the BIS estimate. Nicholas Lardy (2001) cites three reasons, based on information from the Governor of the PBOC. First, the NPLs are still continuing to emerge, so the problem is one of flows rather than stocks. Second, China has only recently begun using a more stringent loan classification system, which greatly increases the NPL statistics. The figure reported by the Governor (45 percent of loans outstanding) could thus be nearer to 65 percent by the new criteria;

this would be 60 percent of GDP. Third, the figures cited refer only to the four state-owned banks, but the publicly-listed banks are also under state control, and they have NPLs as well.

The main reason for the large stock of NPLs is the weak condition of the state-owned enterprises, which are the main clients of the banks; reportedly 80 percent of the four banks' loans go to state-owned firms (*The Economist*, February 8, 2003). Until these firms at least begin to break even, there is no way the banks can really improve their performance without changing their client base. A recent study by the Asian Development Bank Institute, which examines the banks and their clients after the reform process (Shirai, 2002a), tries to determine whether such a change is taking place. The conclusion is that, during the 1994-2000 period, banks had a lending bias toward large and less profitable firms and firms with greater state ownership. A parallel study (Shirai, 2002b) looks at China's equity markets and finds that less profitable, large, and old firms prefer bank lending despite rising stock prices that lower the cost of equity finance. This suggests that they must be getting favourable financing conditions. The other side of the picture is that newer firms, including exporters and the private sector in general, cannot get credit and have to rely on retained earnings, foreign direct investment, or informal (and thus more expensive) credit.

Despite these criticisms, experts nonetheless agree that substantial progress has been made toward improving the banking system and the equity markets. Better prudential regulations have been established, banks are learning about risk management, and the asset management firms have at last begun to tackle the NPLs. Government officials clearly believe that a greater foreign bank presence will help push the reforms further, as will recent changes in the political hierarchy. Among them, the new prime minister was in charge of financial reforms in his previous post.

2 Financial Crisis and Government Response in Emerging Markets

Since the Mexican crisis of the mid-1990s, there has been an outpouring of literature on financial crises.[5] A central point has been

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[5] It is impossible to do justice to this literature in terms of citations. Suffice it

the argument that there is a new model behind the breakdowns in comparison with earlier financial crises in developing countries. In addition, much time (perhaps too much) has been devoted to debating two other points: whether external or internal factors were primarily responsible for the crises, and whether the international financial institutions (especially the International Monetary Fund) played a helpful role or further exacerbated the crises. This literature has made valuable contributions to both theory and practice, but it has focused too narrowly on one particular type of crisis. Here we suggest three models, or patterns, of crisis and associate them with government responses: (i) full-blown crisis and (possible) government clean-up, (ii) low-grade crisis and government paralysis, and (iii) government destruction of the financial sector. As will be indicated below, there is some overlap among the three.

Full-Blown Crisis with Government Clean-Up

The sudden large-scale disruptions that hit the Asian countries in 1997-98 are the prototype for this first model, but they are quite similar to several earlier crises in Latin America, especially Mexico in 1994-95 and Chile in 1981-83. All began with a mismanaged financial liberalisation process, both internal and external. On the internal front, the freeing of interest rates, the end of directed credit, and the privatisation of state-owned banks were accompanied by a disregard for prudential regulation and supervision and sometimes by outright illegal activities. The combination resulted in inordinately rapid increases in credit, large loans to 'related' clients, and inadequate provisioning for potential losses. Eventually, these elements set the stage for a crisis.

The above situation was made much worse by a simultaneous external financial liberalisation, usually referred to as opening the capital account. The external liberalisation process was also

here to indicate that Fondad itself has made important contributions (see especially Teunissen, 1998, 2000a, 2000b, and 2001). International and regional institutions that have been major participants in research and debates include the Asian Development Bank Institute, the Bank for International Settlements, the Economic Commission for Latin America and the Caribbean, the International Monetary Fund, and the World Bank.

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frequently mismanaged. Typical aspects included a fixed exchange rate, which led to massive capital inflows and exchange rate misalignment, and improper sequencing, which favoured short-term over long-term inflows. A very rapid liberalisation exacerbated both problems. In addition, domestic firms (financial and non-financial) were allowed to enter the international markets to seek finance, creating currency mismatches, over-leveraging themselves, and endangering their future if/when the exchange rate had to be devalued. Not infrequently, the result was a systemic crisis, affecting both real and financial sectors. While, as mentioned above, much of the recent literature has concentrated on whether external or internal forces were to blame for these crises, the real danger lies in the combination of weakened domestic institutions and a sudden opening to external markets.

Following such a crisis, even the most laissez-faire oriented governments had to step in to stop the haemorrhaging. A typical package of measures for crisis management can be identified. A first set includes the take-over of non-performing loans, the recapitalisation of the banks, and liquidations or mergers, usually involving foreign institutions. Later, in an attempt to prevent future crises, regulation and supervision are stepped up, greater information and transparency are required, and better corporate governance is introduced. The main question becomes whether governments have both the will and capacity to intervene quickly and extensively enough to really clean up the financial sector and set it on the path of better performance for the future. This is largely a political economy question, and the answer varies from case to case. (For a political economy analysis of the Asian cases, see Pempel, 1999; Haggard, 2000.)

In the Asian context of the late 1990s, Korea provides the best example of a decisive approach that has largely, if not completely, dealt with the problems of both banks and corporations.[6] Korea appeared to be an unlikely candidate for a financial crisis, as it had been one of the world's most successful economies in the postwar period. Until the 1990s, however, the bank-dominated financial sector had had little autonomy, since the banks were heavily influenced by the country's economic authorities in the pursuit of

[6] Malaysia used a more "heterodox" approach, which has also been quite successful, although the crisis itself was not as deep in that country.

their policy goals. An important shift occurred in 1993, when financial liberalisation was stepped up. Although the government had intended to move slowly, the process accelerated, partially in response to Korea's application to join the OECD. In that context, both external and internal debt grew very rapidly, and insufficient attention was paid to the sequencing of reforms, leading to a shift toward short-term debt.

After the Thai crisis of July 1997, foreign creditors reconsidered their loans to Korean entities and began to withdraw. At the same time, many of the corporate conglomerates (*chaebol*) failed, resulting in a systemic crisis, as mentioned earlier. The government initially tried to handle the situation on its own, announcing deposit guarantees and providing liquidity to financial institutions. The size and speed of the crisis, however, drove it to an agreement with the IMF, which influenced but did not totally determine later steps. In a first phase of restructuring, in early 1998, public monies were used to close or reorganise troubled banks, with the government taking control of several, and to dispose of non-performing loans through the asset management company, KAMCO. This process had to be repeated in late 2000 as a result of the worsening of corporate problems. Once the immediate crisis was under control, the government began to reprivatise the banks it had taken over, and foreign investment laws were changed to allow foreign participation. The number of banks and other financial institutions was reduced, and foreign ownership increased substantially.

Another set of reforms involved strengthening prudential regulations, including accounting, auditing, and disclosure requirements. The definition of NPLs was tightened, coming closer to international standards, and the capital adequacy ratios were brought up to BIS levels. Corporate governance was also improved, with outside directors as well as checks and balances between management and board members.

The outcome of the restructuring process has been positive from the point of view of economic growth and of traditional financial performance indicators (see Table 3). Profitability has returned, capital adequacy ratios have increased, and NPLs have been reduced. In addition, there has been a significant shift in bank portfolios toward more consumer lending and fewer corporate loans. Interestingly, among corporate loans, a larger share is going to small and medium-sized firms, which bring in higher interest

Table 3 Korea: Financial Indicators of Commercial Banks, 1994-2001
(in percentages)

Indicator	1994	1995	1996	1997	1998	1999	2000	2001.9
BIS ratio	10.6	9.3	9.1	7.0	8.2	10.8	10.8	10.7
NPL ratio	5.8	5.2	4.1	6.0	7.4	13.6	8.8	5.1
ROA	0.4	0.3	0.3	-0.9	-3.3	-1.3	-0.6	0.7
ROE	6.1	4.2	3.8	-14.2	-52.5	-23.1	-11.9	14.1

Source: Cho (2002), p. 73.

rates and also has important social benefits. (On the Korean financial crisis, see Kim *et al.*, 2000; Ahn, 2001; Cho, 2002; Kang, 2002; Park and Lee, 2002).[7]

In the Latin American context in an earlier period, Chile provides another positive example of response to crisis. Of course, the Chilean economy in the early 1980s was far less sophisticated than its Korean counterpart in the late 1990s. Moreover, Chile's record of economic growth was quite poor, especially in comparison with Korea. Nonetheless, the problems they suffered and the outcomes produced were surprisingly similar.

In 1981, a severe financial crisis erupted in Chile. As in Korea, it was the result of a mismanaged financial liberalisation, but of a more extreme kind – in Chile, the military government set out to eliminate virtually all regulations. The following year, the situation was complicated by a balance-of-payments crisis, as the fixed exchange rate was devalued. The financial crisis was marked by the insolvency of the majority of the private national banks and finance houses, which were taken over or liquidated by the Banking Superintendent. By mid-1982, the crisis had become a systemic one, extending to many of the largest corporations, which also ended up in government hands.

Resolution of the crisis involved various measures to assist banks and debtors as well as the reprivatisation of the institutions that the

[7] Recently, Korean banks have gotten into additional difficulties through their consumer loans, especially their credit card operations. The problems of one of the major conglomerates have also put pressure on the banks, as has the exacerbation of the North Korean nuclear stand-off. Nonetheless, virtually no one expects a repeat of the 1997-98 crisis.

government had intervened. The overall operation is estimated to have cost more than 35 percent of GDP. In the aftermath of the crisis a new attitude emerged with respect to regulation and supervision of the banking sector. The Banking Law of 1986, which became an example for the region, reinforced the powers of the Superintendent. Expanding on initiatives that began earlier in the decade, it required that portfolios be ranked by risk categories and that provisioning be made for higher risk credits. It also increased the transparency of the process and tightened policies with respect to credits to 'related' parties. Capital adequacy requirements were left at the previous levels, but definitions were tightened. Deposit insurance was eliminated for term deposits, so as to make depositors more vigilant, but all sight deposits were covered, as were accounts of small depositors.

In 1997, the Banking Law was modified to bring it up to date with international and domestic trends that emerged over the preceding decade. At this time, Chile adhered to the BIS capital adequacy ratio of eight percent; BIS risk categories were also adopted. Banks were permitted to increase their international activities: setting up subsidiaries abroad as well as engaging in new activities such as administering mutual funds, leasing, factoring, and financial advising. They were also allowed to provide guarantees to clients in the international market. Finally, conditions were created for more banks to enter the Chilean market, both national and foreign, after a decade of closure.

As a consequence of the processes just discussed – the thorough clean-up of the banking industry and the improved system of regulation and supervision – the Chilean financial system functioned very well in the 1990s (see Table 4). It is essential to point out, however, that this good performance also depended on the context in which it took place. On the one hand, macroeconomic policy contributed to a stable and growing economy, which had a strong positive interaction with the financial sector. On the other hand, the capital account of the balance of payments was managed so as to limit volatility from the international economy. All of these were necessary elements for the positive outcome. (On the Chilean crisis, see De la Cuadra and Valdes, 1992; Sanhueza, 1999; Ffrench-Davis and Tapia, 2001; Held and Jimenez, 2001).

Of course, these two positive examples are not the only possible outcomes of full-blown crises. Two alternatives are more common

Table 4 Chile: Financial Indicators of Commercial Banks, 1996-2001
(in percentages)

Indicator	1996	1997	1998	1999	2000	2001
BIS ratio	n.a.	n.a.	12.48	13.53	13.34	12.73
NPL ratio	0.95	0.96	1.45	1.67	1.73	1.62
ROA	1.14	1.01	0.90	0.73	1.00	1.32
ROE	15.50	13.67	11.54	9.36	12.70	17.70

Source: IMF.

occurrences. One is when a government cannot or will not make headway with respect to the crisis, and it continues to fester. In Asia, Thailand and especially Indonesia have suffered this unhappy trajectory up till now. Another possibility is that the crises appear to be under control, but not enough progress is made, or new problems appear, and the countries fall into one of the other types of crisis discussed below. Mexico and Argentina can be seen in this light, as will be explained later.

Low-Grade Crisis and Government Paralysis

While attention has focused on the full-blown crises for obvious reasons, another type has received insufficient notice. These are crises where the financial sector is loaded with non-performing loans, and is highly inefficient, but it is kept afloat by government aid of various sorts. Typical government support includes public money to recapitalise banks, permission to roll over delinquent loans or capitalise interest payments, and lenient supervision. All of this is to avoid an open crisis that would bankrupt large corporations if their loans were called and create major political and social problems. It is hoped that, in the long run, the problems will be dealt with 'automatically' by higher growth. The downside, however, is a credit crunch, where viable – or potentially viable – firms cannot get access to credit and thus the hoped-for growth remedy cannot take place. Japan and Taiwan are examples of this type of crisis in the Asian region. Although Mexico was a clear example of the first type of crisis in the mid to late 1990s, it may now have lapsed into this second type.

Japan's economic crisis is 'homemade'. Unlike the crises

discussed in the previous section, foreign capital flows were not a factor. Indeed, Japan has imported very little foreign capital and has the world's largest foreign currency reserves. Financial liberalisation, which took place in Japan in the 1980s, did create problems for the banks since it took away many of their traditional clients among the largest corporations. After the liberalisation, they could find cheaper financing alternatives through the stock market, the bond market, and commercial paper. The main source of Japan's financial crisis, however, was the asset bubble of the 1980s, especially the stock market and real estate prices. The Nikkei index went from less than 7,000 points in 1980 to almost 39,000 in 1989; now it is back to near 1980 levels. Real estate prices have followed a similar, if less dramatic, trajectory.

The bursting of the asset bubble has been important to Japanese banks in at least two ways. First, they themselves own stocks and real estate. While these are not valued at market prices, the 'unrealised gains' between book and market value can be counted as capital for determining capital adequacy ratios. Second, they have loans outstanding to other owners of both assets, especially in the construction and real estate sectors, who are then unable to keep up with their debt payments.

Two sets of indicators provide evidence of Japan's financial problems (see Table 5). One is the falling, and now negative, value of return on assets (ROA) and return on equity (ROE). The other is the rising volume of NPLs, compounded by the fact that Japan uses more lenient standards than other countries to determine whether loans are non-performing. In absolute terms, according to a recent study of NPLs in Asia by the accounting firm, Ernst and Young,

Table 5 Japan: Financial Indicators of Commercial Banks, 1998-2000
(in percentages)

Indicator	1998	1999	2000	2001	2002
BIS ratio[a]	9.6	12.1	12.3	11.7	11.0
NPL ratio	5.4	5.8	6.1	6.6	8.9
ROA	-0.6	-0.9	0.3	0.1	-0.7
ROE	-20.0	-25.1	6.8	1.2	-19.5

Note:
[a] Seven internationally active banks only.
Source: IMF (2003c), Supplementary Information, pp. 8-10.

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Japan has about 1.2 trillion dollars of such loans or 60 percent of the nine-country total. While Japan has disposed of $300 billion since 1997, a similar amount has come onto the books, so that the total has not changed (*Asian Wall Street Journal*, July 11, 2002).

Like many of its Asian neighbours, Japan has established an agency – the Resolution and Collection Corporation (RCC) – to deal with bad loans. Set up in 1999 and modeled after the US Resolution Trust Corporation, the RCC has made little headway, both because it lacks resources and any firm date to complete its tasks and because of political foot-dragging by important politicians from the ruling Liberal Democratic Party. The latter do not want any radical steps to clean up bad loans because of the negative impact for major contributors and for fear of making Japan's long-lasting recession and deflation even worse. (On Japan's financial crisis, see Hoshi and Kashyap, 2000; Hosni and Patrick, 2000; Kanaya and Woo, 2000; Montgomery, 2002; Callen and Ostry, 2003.)

Taiwan shares many characteristics with Japan, but they are not yet as serious. The most important similarity is that an asset bubble, also involving the stock market and real estate, was the dominant factor leading to financial problems. Indeed, Taiwan was notable for having avoided the Asian financial crisis of 1997-98.[8] Growth dropped slightly, but nothing like in its neighbours. There are several reasons for the differences. Taiwan has virtually no foreign debt and the third highest level of foreign reserves after Japan and China; in per capita terms, Taiwan's reserves are obviously much higher than the other two. Although it underwent financial liberalisation in the late 1980s and early 1990s, including semi-privatisation of state-owned banks, Taiwan nonetheless maintains important economic controls. Perhaps most important, the currency is not fully convertible.

The indicators of financial difficulties are also similar between Japan and Taiwan. As Table 6 shows, profits have fallen, while NPLs have risen. (Like Japan, Taiwan's definition of NPLs is less stringent than international standards.) While no banks have failed, there

[8] Agosin (2001) has compared Korea and Taiwan in their economic performance during the Asian crisis. He favours the latter, but he was looking at an earlier period and concentrating on international factors, while Taiwan's problems were domestic.

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Table 6 Taiwan: Financial Indicators of Commercial Banks, 1994-2000
(in percentages)

Indicator	1994	1995	1996	1997	1998	1999	2000
NPL ratio[a]	2.58	3.75	4.94	4.82	4.80	5.15	5.17
NPL ratio[b]	2.27	2.74	3.36	3.74	3.98	5.15	6.68
Return on assets (ROA)[a]	0.69	0.49	0.57	0.69	0.67	0.44	0.38
Return on assets (ROA)[b]	0.91	0.67	0.73	0.91	0.27	0.27	-0.12

Notes:
[a] Old banks
[b] New banks
Source: Montgomery (2002), p. 19.

were serious problems in 2002 among rural cooperatives. The government initially planned to close some of them down, but then backed off in response to farmers' protests. The finance minister resigned as a consequence, leading observers to conclude that the government will do nothing dramatic about the problem (*Far Eastern Economic Review*, December 5, 2002).

What the government has done is to intervene actively in the real estate and stock markets to help keep prices up. It also established a six-month rollover for company loans and mortgages when economic problems arose in 2000. Later, taxes were lowered on banks in order to give them resources to write off NPLs, and mergers or acquisitions have been encouraged. Most of all, the strategy is to hope that the economy will grow fast enough to eliminate the NPLs without causing extensive bankruptcies and unemployment. But without a sound financial system, this is unlikely to happen. (On the Taiwanese crisis, see Shea and Shih, 1999; Yang and Shea, 1999; Chow and Gill, 2000; Montgomery, 2002.)

Government Destruction of the Financial Sector

Although Argentina is the only recent case of this third crisis pattern, it is important to mention it because it is always a possible response to very severe economic problems. Banks tend to be unpopular institutions, so the temptation exists to make them scapegoats in a political sense and to look to them for resources to

full gaping holes in fiscal and/or international accounts. The consequence, however, is a long-term drag on the economy since credibility as well as assets must be recovered before the financial sector can again play a positive role in economic growth.

Ironically, Argentina in the mid-1990s seemed to be a clear example of a crisis that was overcome by prompt and effective government action. Caught in the tidal wave of the Mexican collapse, and exacerbated because its currency board system prevented the central bank from functioning as a lender of last resort, the country suffered a run on its banks, which lost 18 percent of total deposits in four months. The run was stopped by a large loan from the IMF and World Bank, together with a local 'patriotic bond' purchased by the banks and large corporations. As a consequence of this experience, the authorities implemented several new policies to prevent future crises: (i) a fund to promote restructuring of the banking sector, which led to a smaller number of stronger institutions, including the entry of many foreign banks; (ii) a deposit insurance scheme, financed by the private sector; (iii) a new system of reserve requirements that covered more types of deposits; and (iv) contingent credit lines with foreign banks, which constituted a proxy lender of last resort. As a result, after a five percent decline in GDP in 1995, growth resumed and the banks more than regained the deposits they had lost. In terms of capital adequacy ratios, Argentine banks were among the most solid in the world, although other indicators were less positive (see Table 7).

By the end of the 1990s, the picture turned bleak again, due to a combination of international shocks and internal political and

Table 7 Argentina: Financial Indicators of Commercial Banks, 1996-2002
(in percentages)

Indicator	1996	1997	1998	1999	2000	2002
BIS ratio	23.8	20.8	20.3	21.0	20.1	n.a.
NPL ratio	13.6	11.6	10.3	11.5	12.7	34.4[a]
ROA	0.8	1.2	0.7	0.5	0.4	"Hefty losses"
ROE	5.1	7.8	4.9	4.0	3.2	"Hefty losses"

Note:
[a] Average of three largest private banks only.
Sources: IMF (2003a), p. 45 (for 1996-2002); Fitch Ratings (2003), pp. 3-4 (for 2002).

economic factors. Notwithstanding a brief respite due to the election of a new president and another IMF package, conditions deteriorated sharply in 2001. A ‘voluntary’ debt restructuring was carried out to help relieve fiscal pressures, but by the end of the year the government froze all bank deposits to avoid devaluing the currency. In part because of opposition to this move, months of political chaos resulted, including five presidents in a brief period. By early 2002, there was a large devaluation and the end of the currency board, together with a default on the country’s foreign debt obligations.

The main problem for the banks was that their assets and liabilities were converted to local currency at different rates. To protect debtors and depositors, bank loans were converted at 1:1, while their deposits were converted at 1:1.4. Thus, the banks were to pay much of the cost of the crisis, although the government promised some (unspecified) kind compensation. The banks were closed for some time, and several foreign banks exited the market, unwilling to recapitalise their branches. To make matters worse for the banks, the public tended to blame them for the fact that they could not get access to their deposits and, when the latter were unfrozen, they could only get their money back in devalued pesos rather than dollars. The foreign banks were singled out for particular attack since they were seen as having betrayed the expectation that they would bring in as much additional capital as necessary to keep their operations solvent.

This situation has continued for nearly two years, with no agreement on compensation for the banks and virtually no loans being made, although deposits have been returning to the system. Few statistics are available on the sector, and it is unclear when any resolution will be achieved. Bankers expect it will take years to regain their credibility, even after ‘normality’ returns. (On Argentina, see Kiguel, 2001; de la Torre, Levy, and Schmukler, 2003; Fanelli, 2003; Todesca and Acosta Ormaechea, 2003).

3 Beyond Crises: Finance for Development in Emerging Markets

Preventing crises and overseeing recovery efforts are fundamental tasks for governments of emerging market economies, but there is

also a more positive agenda to be addressed. In particular, governments need to construct a financial sector that will be able to promote development, including both higher growth and greater equity. With respect to growth, much attention has been devoted to the issue of bank-based systems versus capital markets (see, for example, Allen and Gale, 2000; Demirgüç-Kunt *et al.*, 2001). This is a chimera for two reasons. First, banks and capital markets are complements, not substitutes. Second, banks will continue to dominate the financial sector in emerging market economies for some time, so it is necessary to find ways to make them work better, while, at the same time, promoting bond and stock markets. With respect to equity, the discussion is primarily on whether public or private, national or foreign, institutions are more likely to expand access to finance (see, for example, Holden and Prokopenko, 2001; Westley, 2001; World Bank, 2001). Again, there is some evidence that these various types of institutions are complementary.

This section of the paper will contribute to this agenda by reflecting on the relative merits of two types of banking systems: Chile, which has a private-sector dominated system with an important foreign presence, and Korea, which maintains a strong public-sector presence, despite the reprivatisation trend that we have already mentioned. Both also have large securities markets. In each case, we will look at questions of finance and growth as well as finance for smaller enterprises.[9]

A Privatised Banking Sector

The Chilean commercial banking sector has been nearly completely privatised since the 1980s. The single public-sector institution (*Banco del Estado*) holds only about 13 percent of the banking system assets. During the 1990s, the foreign presence rose substantially to 53 percent of assets in 2000. Both the banking sector and the securities markets performed impressively in the 1990s, and they were very supportive of the growth process witnessed during the decade. The banking sector was marked by rapid growth, increased efficiency, and stability. In dollar terms, total lending of the system increased steadily from $15 billion in 1991 to around $40 billion in 2000. This

[9] For a more detailed comparison of the financial sector in these two countries, see Stallings (2003).

trend was also reflected in the rise of lending as a percentage of GDP (see Table 8). Almost all of this credit went to the private sector, as budget surpluses meant that the government no longer required finance. This fact was important since the private sector had access to bank credit without competition. Not surprisingly, then, growth of credit and investment were closely linked.

Another way to study the relationship between credit and growth of output is to move to the sectoral level. The supply of credit to the productive sectors, consumers, and homeowners all rose in the 1990s, but this growth was particularly impressive for the latter two where average growth rates were above 16 percent. Even though the pace of growth varied significantly across productive sectors, credit as share of production value rose in almost all sectors. This is a good indicator that bank credit has been playing an increasing role in the financing of productive activities or, alternatively, that self-finance is becoming a less important mechanism (Stallings and Studart, forthcoming).

Table 8 Chile: Growth, Finance, and Access, 1990-2000
(in percentages)

	GDP[a]	Bank credit[b]	Bonds[b]	Credit to large firms[c]	Credit to SMEs[c]
1990	3.3	47.2	n.a.	n.a.	n.a.
1991	7.3	44.8	n.a.	n.a.	n.a.
1992	10.3	48.0	n.a.	n.a.	n.a.
1993	6.9	52.8	37.2	n.a.	n.a.
1994	5.0	52.1	43.9	68	32
1995	9.0	54.4	39.7	70	30
1996	6.8	59.8	42.6	66	34
1997	6.8	63.0	44.2	69	31
1998	3.3	64.3	42.6	69	31
1999	-0.7	67.3	45.2	70	30
2000	4.4	68.0	46.6	71	29

Notes:
[a] Annual growth rate.
[b] Amount outstanding to private sector as share of GDP.
[c] Share of total credit to corporate sector.
Sources: ECLAC, *Statistical Yearbook of Latin America and the Caribbean*, various years (growth rates); IMF, *International Financial Statistics*, various years (bank credit); IMF (2002), p. 51 (bonds); Roman (2003), p. 36 (credit to large firms and SMEs).

Trends in the securities markets were similar to those just described for the banking sector. There was significant growth in value of issues: in US dollars, they almost doubled between 1991 ($3.9 billion) and 2000 ($7.5 billion). This growth was not monotonic: the value of issues grew from 1991 to 1997 ($11.8 billion) and then fell in 1998 ($4.8). The decline had to do with the uncertainties brought by the Asian crisis, which directly affected the issues of corporate bonds and equities, and with the sharp decline of issues of Central Bank notes. Overall, however, the access of the corporate sector and households to securities markets expanded substantially.

While the private sector had more competition with the public sector in the securities than in the credit market, there was no problem of crowding out of the former in the Chilean case. Government bonds – mainly attributable to the Central Bank policy of sterilising capital flows – remained at about the same absolute level throughout the 1990s, but declined significantly in relative terms (from over 70 percent in 1991 to less than 30 percent in 2000). In both markets, then, the government's austere macroeconomic stance left plenty of space for the private sector to finance itself and thus contributed to the successful economic growth process (Stallings and Studart, forthcoming).

If Chile's financial system made an important contribution to growth rates in the 1990s, what about access to finance? The number of borrowers of bank credit more than doubled during the decade, rising from 1.6 million in 1990 to 4.5 million in 1997, before falling to 3.7 million in 2000, which is a positive sign. Nonetheless, the distribution of credit was heavily skewed. The most complete study of credit allocation provides data on debt outstanding by sise of firm over the period 1994-2000 (Roman, 2003). It shows that at the beginning of the period small and medium-sized firms accounted for 32 percent of debt outstanding and large firms for 68 percent. Between 1994 and 1996, the former increased their share somewhat, but by the year 2000, as a result of the economic shocks that hit the Chilean economy at the end of the decade, the distribution was more unequal than it had been six years earlier: SMEs' share had fallen to 29 percent, while that of large firms had risen to 71 percent (see Table 8).[10]

[10] The study referred to above also includes data on credit for microfirms, but

After the return to democratic government in 1990, the Chilean government maintained the predominantly private character of the banking system, but began to provide programs to help micro, small, and medium enterprises. Rather than subsidise interest rates or direct credit to smaller firms as in earlier times, the programs act through 'second-tier' public-sector financial institutions that subsidise transaction costs for commercial banks willing to lend to small firms. Nonetheless, these programs have not made any significant change in the distribution of credit, which continues to mirror the vast discrepancies in wealth that characterise the country (Foxley, 1998).

A Continuing Role for the Public Sector

The banking sector in Korea played a key role in the government's development strategy in the 1960s and 1970s. In particular, the nationalised banks served as the channel for allocating resources to the *chaebol* and their export-oriented subsidiaries. While contributing to Korea's successful industrialisation, the banking sector itself became highly distorted and inefficient. Already by the 1980s, the government began to make changes, reprivatising the banks in 1981-83 and giving them greater autonomy. Nonetheless, it continued to operate behind the scenes to influence the banks and propagated regulations to guide their behaviour. One of the most important was the ceiling on the share of loans that could go to the *chaebol* and the promotion of lending to SMEs. It also continued to own a number of 'specialised' or development banks that carried out particular government policies (Hahm, 1999, 2003).

In response to the restrictions, the *chaebol* turned to new sources of finance. One was the non-bank financial institutions (NBFIs), such as investment trusts, which were much less regulated than the commercial banks. Another source was the capital markets – stocks, bonds, and commercial paper – which the government was advocating as an alternative for the *chaebol.* As a share of GDP and as

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these are excluded in order to make the Chilean data comparable with those available for Korea. It is interesting to note that microfirms maintained their share of credit over the period analysed, in contrast to small and medium-sized firms. The author of the study attributes this to a government program that subsidises transaction costs for loans from commercial banks to microfirms, but not to SMEs.

From: China's Role in Asia and the World Economy - Fostering Stability and Growth, FONDAD, December 2003, www.fondad.org

Table 9 Korea: Growth, Finance, and Access, 1990-2000
(in percentages)

	GDP[a]	Bank credit[b]	Bonds[b]	Credit to large firms[c]	Credit to SMEs[c]
1990	9.5	87.8	n.a.	n.a.	n.a.
1991	9.1	87.6	n.a.	n.a.	n.a.
1992	5.1	93.2	n.a.	42.	58
1993	5.8	101.3	45.2	38	62
1994	8.6	106.5	46.0	34	66
1995	8.9	109.6	46.4	27	73
1996	7.1	117.9	45.9	27	73
1997	5.0	131.2	27.3	32	68
1998	-6.7	153.5	75.7	35	65
1999	10.9	147.6	65.4	30	70
2000	9.3	134.2	69.4	29	71

Notes:
[a] Annual growth rate.
[b] Amount outstanding to private sector as share of GDP.
[c] Share of total credit to corporate sector.
Sources: ADB, *Asian Development Outlook*, various years (growth rates); IMF, *International Financial Statistics*, various years (bank credit); IMF (2002), p. 51 (bonds); Cho (2002), p. 73 (credit to large firms and SMEs).

a share of total financial liabilities of the corporate sector, both increased dramatically. Bank credit also increased as a share of GDP, although declining as a share of corporate finance. Based on this new division of labour, the financial sector continued to support a high growth rate in Korea during the 1980s and most of the 1990s (see Table 9).

Under the surface, however, problems were building. As was explained earlier, they were exacerbated by the way in which financial liberalisation was undertaken in the 1990s. Both domestic and international financial liberalisation were unbalanced. In the former case, the NBFIs were given much more freedom than were the commercial banks. They were free to set their own interest rates, leading to a large gap in deposit rates between the two sets of institutions. Also there were no ownership restrictions on NBFIs, so the *chaebol* began to take control of them. In the latter case, short-term borrowing was liberalised before long-term borrowing, and merchant banks and commercial-bank subsidiaries undertook a surge of international activity. Ultimately, these problems set the

stage for the eruption of the 1997 crisis, when a negative shock spread from neighbouring economies. As we have already seen, however, the government moved quickly to rescue and then clean up the financial sector, which – after a slump in 1999-2000 – has resumed its dynamism within a more liberalised framework. While the government took over several commercial banks at the height of the crisis, it is now reprivatising them, and foreign ownership has increased as a consequence. Nonetheless, it shows no sign of privatising the five state-owned development banks, which together account for about 15 percent of total bank assets (IMF, 2003d, p.8).

While there are similarities in the sense that both Chilean and Korean financial sectors have supported growth in their respective countries, the picture in terms of access to finance is dramatically different. The last two columns in Tables 8 and 9 present some relevant data, which show that the two economies are mirror opposites with respect to access. In the year 2000, large firms in Korea received approximately 29 percent of all bank credit to the corporate sector, while SMEs received the remaining 71 percent. As we have seen in Chile, large firms accounted for 71 percent and SMEs 29 percent. Even if these figures substantially exaggerate the gap,[11] it is clear that SMEs have a great deal more access to credit in Korea. A number of factors help explain these differences, but variation in government policies is certainly one of them. While the Chilean government has basically left the allocation of credit to market forces (with some small compensatory programs), its Korean counterpart – although retreating from its domination of the financial sector in the earlier postwar period – has continued to intervene in favour of SMEs.

The policies favouring SMEs date from the 1980s; the new constitution of that era stipulated that protection and promotion of SMEs should be part of the government's responsibilities. Loans from the government-owned specialised banks are one instrument; special credit funds are another as are tax breaks of various sorts (Nugent and Yhee, 2001). More important, commercial banks are required to allocate 45 percent of their new loans to SMEs; for

[11] There are many problems with this kind of comparison. Among the two most important are: (i) the data for individual countries are hard to collect and the relationships difficult to measure; (ii) the different definitions across countries make comparisons only rough approximations.

From: China's Role in Asia and the World Economy - Fostering Stability and Growth, FONDAD, December 2003, www.fondad.org

regional banks, the figure is 60 percent. In addition, the Bank of Korea provides special refinancing facilities for a portion of loans extended by banks to SMEs (Fitch Ratings, 2002). It is possible to argue about the efficiency of these policies, e.g., SMEs clearly seem to be less productive than larger firms. Nonetheless, it is noteworthy that SMEs in Korea engage in substantial amounts of research and development activity, and they account for around 40 percent of total exports. At the same time, there is some evidence that the pro-SME policy has contributed to greater equality in income distribution (Nugent and Yhee, 2001).

4 Lessons for China from Emerging Market Economies

At the beginning of the twenty-first century, despite its impressive economic trajectory, China faces a number of challenges with respect to its financial sector. These are magnified by the deadlines for liberalisation accepted in the WTO accession process. The main challenges can be summarised as follows:

- The NPLs should be rapidly reduced, and a more transparent process should be established for funding them. For the future, a means should be developed to avoid incurring additional bad loans.
- Stronger prudential regulation and supervision must be put into place, together with greater transparency and better corporate governance.
- Liberalisation should be phased in an orderly manner, with respect to both the capital account and interest rates.
- Ownership should be diversified. Privatisation, including foreign ownership, can increase efficiency as well as provide new technology and resources. Nonetheless, it should be asked if public-sector banks have a useful role to play in terms of expanding access to finance.
- Over time, the stock and bond markets should be strengthened to provide alternative sources of finance for firms.

In meeting these challenges, the experience of the emerging market economies documented in the paper can provide some guidance, despite the difference in size and background. As China moves toward a western-style financial system, similarities will become more important than differences.

The typology of crisis presented in the paper is useful from the Chinese perspective. In many ways, China's situation is most similar to that of Japan and Taiwan. Low return on assets continues and NPLs continue to increase on the banks' books, constituting a drag on the economy. The government seems unable or unwilling to move the clean-up process forward. Moreover, despite the rapid growth, there is no indication of being able to grow out of the NPL problem. In this context, Chinese authorities should look to the two examples (Korea and Chile) of rapid elimination of bad loans and a stronger regulatory and supervisory regime to prevent crises from recurring. This combination returned Korea to rapid growth (unlike other Asian crisis countries) and was instrumental in putting Chile onto a growth path from the mid-1980s. Finally, the Argentine situation provides a useful lesson of what to avoid, even when conditions become very difficult. China must protect and increase the credibility and functionality of its financial sector; otherwise, its growth potential will be held back. Moreover, care must be taken with any implications extracted from Argentina's experience with foreign banks. Some observers are claiming that the withdrawal of several foreign banks and the failure of others to recapitalise their branches mean that foreign banks are not trustworthy partners. In reality, the actions of the Argentine government were so misguided as to justify bank actions.

Beyond the present, China can also learn from the historical experiences of the various countries discussed. In this vein, the most relevant examples are the countries where trouble with financial liberalisation, internal and/or external, led to full-blown crises. Mismanaged liberalisation – whether through improper sequencing, excessive speed, or extreme versions of liberalisation – can lead to crises, even in countries with stronger financial fundamentals than China currently enjoys. Since China still has a closed capital account, it can take advantage of others' experience. In particular, a gradual capital account opening, with long-term flows liberated before short-term, and some ability to take precautionary steps against capital surges, can protect the fragile financial sector against devastating volatility. Likewise, putting in place an adequate regulatory and supervisory framework before liberalisation will prevent the lending booms and failure to take adequate precautions that have preceded so many crises in the past.

In addition to dealing with problems and protecting itself from

future dangers, it is equally important for China to consider how best to structure its financial system to promote growth and to broaden access to finance for the large majority of the population. The two models presented offer differing combinations of actors and policies. The Chilean financial sector is almost completely privately owned, and foreign capital is increasingly dominant. In the context of strong regulatory rules and supervisory capacity together with a stable macroeconomy, the financial sector has proved a boon to growth, as financial deepening has progressed and diversification toward capital markets has advanced further than in any other country in the region. As expected, foreign financial institutions have brought new technology and management skills and have helped smooth Chilean firms' entry into international markets. Nonetheless, the system has not done enough to spread opportunities to sectors of the population – small and medium enterprises, microfirms, poorer households and individuals – that were left out of the growth opportunities during the 1990s. Perhaps there are ways to stimulate more equal opportunities, and some success has been attained through joint public-private venture such as second-tier banks, but the jury is still out on this crucial point.

South Korea, by contrast, is an important example of a country where the government and public-sector institutions continue to play a major role. Abandoning its *dirigiste* role of the 1960s and 1970s, the government has looked to private-sector banks, non-bank financial institutions, and the capital markets to provide the main support for economic growth in the last two decades. Nonetheless, it has remained active in promoting the interests of small and medium-sized enterprises. Key instruments have included credit from the five government-owned development banks, and the requirement that commercial banks devote a substantial share of their loans to SMEs. The interesting question, for China as well as for other emerging market countries, is whether state-owned development banks should continue to play an important role or whether a way should be sought to transfer their current functions – both social and developmental – to the more efficient private sector. A few years ago, the answer seemed to be settled in favour of privatisation, but now renewed interest is emerging for some level of public-sector involvement.

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Korean and Chinese Finances: Comment on Barbara Stallings

Robert N. McCauley[1]

In this paper, Barbara Stallings has drawn lessons from Latin America and East Asia for China as it develops its financial system and opens its capital account. This is a very worthwhile enterprise; the Latin American leg of the comparison is often neglected in East Asia. Had East Asian paid more attention to the crises of 1994-95 in Latin America, 1997-98 might have gone differently. Moreover, one can only agree on the value of drawing lessons from Korea for China (Cho and McCauley, 2003), recognising that this orange still has juice to be squeezed.

These comments are organised around four themes in Professor Stallings' paper: preventing and responding to financial crisis; unifying the bond market; defining the role of foreign banks; liberalising the capital account.

Preventing and Responding to Financial Crisis

Preventing financial crisis seems to require more and more in the way of good policies (Crockett, 2001). It has become evident that low inflation is no guarantee against financial crisis. Indeed, there are aspects of the disinflationary process that seem to contribute to

[1] Views expressed are those of the author and not necessarily those of the BIS.

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financial excesses.[2] Policymakers need to look out for rapid credit growth and high asset prices (Borio and Lowe, 2002). A corollary is that, contrary to many studies that have examined cross-sectional data, more credit is not necessarily good for growth – as the time series evidence from more than one country suggests.

Korea provides an interesting case study in crisis prevention. In 2002, the Korean authorities recognised the danger of too rapid growth of household credit and surging property prices. There focus was on credit – its underwriting standards; the capital backing it; and the speed of recognising profits from it (McCauley *et al.*, 1999). In response they adopted four measures, three addressed to the credit and another to the underlying market for the asset subject to price pressure (land):[3]

- Lowered maximum mortgage loan-to-value ratios;
- Increased Basel weight on mortgages;
- Increased *ex ante* provisioning versus household loans; and
- Increased supply of land.

Note that these measures were taken in a year in which the policy interest rate was raised by only 25 basis points. We shall never know whether the strong household credit growth would have led to a full-blown crisis if left untreated (International Monetary Fund, 2003). In the event, political uncertainties, Peninsular tensions and financial strains combined to tip the Korean economy into recession in the first half of 2003. The financial strains included an accounting scandal at SK Group, which, along with rising credit card delinquencies, led to a run by Korean households on investment trust companies that held the bonds of credit card companies. The credit card companies in turn required concerted lending from the banking system and recapitalisation. Under these circumstances, it is also very difficult to know the role played by the measures above in the subsequent sharp deceleration of household credit growth at the beginning of 2003.

Crises and widespread financial distress will not always be prevented. Stallings usefully contrasts various modes of dealing with such challenges. The evidence strongly suggests that a speedy and

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2 For an examination of the role of lower nominal interest rates in giving a spurious impetus to US corporate profit growth in the late 1990s, see McCauley *et al*. (1999).

3 See Financial Supervisory Service (2002a).

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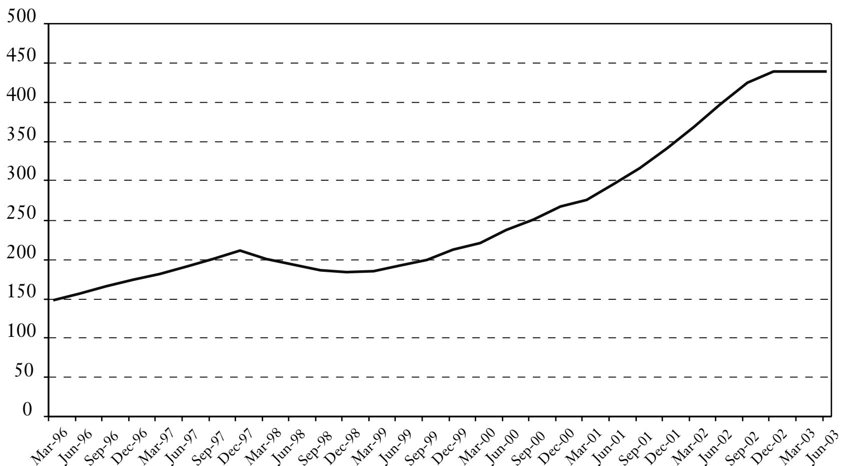
thoroughgoing response is best for growth and cheapest in long run. In particular, rough justice is better than the dead weight that drawn-out distributional trench warfare usually entails. This is by no means an emerging market lesson, as Stallings' references to Japan make clear. If the Nordic countries and Korea point to the possibility of speedy resolution, Japan and Taiwan suggest a different possibility. China, with its mix of non-performing loans to state-owned enterprises, a legacy of the early transition days, and very modern troubled real estate or equity-related loans, presents a very complicated and difficult case. But by official reckoning, the measures taken to date are half measures (Ma and Fung, 2002).

Regarding the question of what to do with the Chinese banks, Stallings stakes out a position different from the conventional one and that of Fan Gang. The conventional view holds that the big banks should be recapitalised and then privatised. Fan Gang argues that since they will not be privatised, they should not be recapitalised. Stallings argues that they should be recapitalised, but not necessarily privatised, for reasons discussed below.

Figure 1 Credit to Korean Households
(in trillions of Korean won)



Source: CEIC Database, Nanyang Technological University, Singapore.

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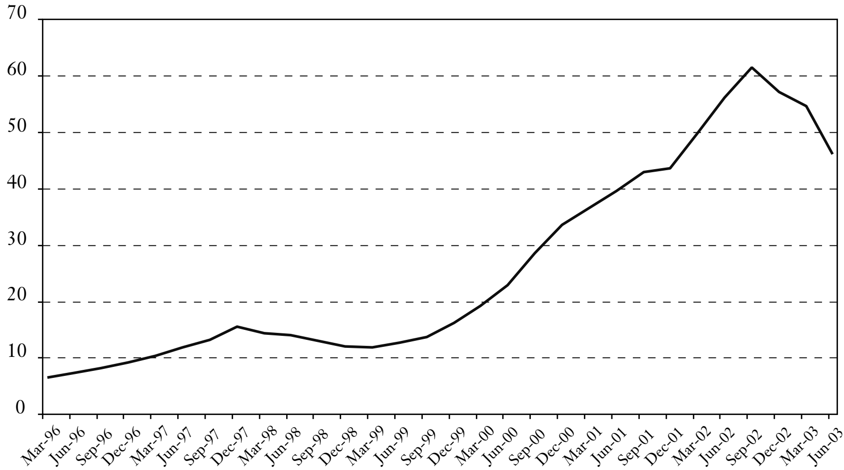
Figure 2 Household Credit Extended by Korean Non-Bank Financial Firms
(in trillions of Korean won)



Source: CEIC Database, Nanyang Technological University, Singapore.

Unifying the Bond Market

Recognising the fiscal cost of cleaning up the financial system leads to a larger government debt. The United States gave bad example in issuing FICO bonds, rather than using Treasury borrowing, to recapitalise the insurer of the deposits of savings and loans in the late 1980s. Using these bonds instead of full faith and credit bonds of the US Treasury added to the expense, because they did not enjoy an explicit government guarantee, and split the government bond market. The damage in this case was minor, however, because the cost of the savings and loan clean-up was small in relation to outstanding Treasury debt.

Unfortunately, window-dressing the fiscal costs of bank restructuring is not unusual. It is, however, costly. It often increases interest costs by introducing some ambiguity into the government's commitment to service bonds issued to restructure troubled banks. Even where outright guarantees are extended to such bonds, the government bond market ends up split. Such a fracturing of the government bond market imposes a second cost in the form of a less

liquid bond market. At the micro level, the bonds of different issuers will not trade interchangeably, even if economically they are very close substitutes. Even in the German bond market, the debt of the Federal Republic ('bunds") and the government-guaranteed financial institution KfW are quite distinct and the latter yield 15-30 basis points more than the former. Liquidity split is liquidity lost.

In this matter, Korea is in the process of setting a better example. Korea split its government bond market in the process of restructuring its banking system after the crisis. In particular, Treasury bonds, Korea Asset Management Corporation bonds and Korea Deposit Insurance Corporation bonds all trade separately in the market, even though the KAMCO and KDIC bonds are government-guaranteed. In addition are the Monetary Stabilisation bonds of the Bank of Korea. Now, however, the Korean government is in the process of refinancing most of the KAMCO and KDIC bonds in the form of outright government debt, which will save on interest expense and make for a more liquid government bond market. China, for its part, has government bonds and asset management corporation bonds. In addition are the central bank bills sold by the People's Bank of China. The liquidity of China's government bond market would benefit if "full faith and credit" obligations of the government were used to refinance the asset management corporation and central bank paper.[4]

Defining the Role of Foreign Banks

All around the world, foreign banks are increasingly involved in domestic intermediation ("global banking") instead of cross-border intermediation ("international banking"). This can be seen in the table, which focuses on the banking markets in countries that on which Stallings focuses.

Pure international banking would have sizeable amounts in the first two columns and zeros in the third column. Pure global banking would have zeros in the first columns and substantial amounts in the third column. In general, the ratio of local to cross-border claims of banks in the BIS reporting area has been rising (McCauley, Ruud and Wooldridge, 2002).

[4] See McCauley (2003).

China's low ratio of local to cross-border claims reflects not only restrictions on foreign banks operating in China, but also restrictions on foreign-invested enterprises there. Foreign-invested firms, or in other words, multinational firms, operating in China have been limited in the extent to which they can borrow renmimbi to finance their operations in China. As a result, multinationals in China rely relatively heavily on equity that enters China as direct investment. At the global level, however, these firms do depend on debt to finance a substantial share of their assets. As a result of the constraints in China, however, most of the debt that in effect finances the Chinese assets is offshore.[5] As constraints on foreign banks and companies are eased, multinationals in China will borrow more locally, and to the extent that foreign banks capture this business, local loans will rise.

Stallings has some apprehension regarding the large share of the banking market held by foreign banks in Latin America, and considers that it may be worthwhile for the government to hang on to some banks, especially to serve small and medium-sized enterprises. An important difference between Latin America and East Asia is the market share of foreign banks. Outside of Hong Kong, the share of foreign banks in Korea's total bank credit, about a tenth, is more typical of East Asia than the half to two-thirds share that foreign banks have gained in Latin America (see last column of the table).

In the Chinese context, foreign banks could widen access to credit, at least to some extent. Three groups of potential borrowers have traditionally not been well served by the state-owned commercial banks. These are firms outside of the state sector, households and foreign-invested enterprises. Judging from foreign bank strategies elsewhere and their moves so far in China elsewhere, they will target the household sector (which the big four banks have also been targeting for 3-4 years) and foreign-invested firms.

[5] In balance of payments terms, the constraints tend to raise foreign direct investment relative to other countries that allow multinationals to borrow onshore. The higher foreign direct investment has a counterpart in turn in the higher foreign currency holdings of the banking system, including the SAFE, in China.

Table 1 International and Local Banking in Selected Countries
(in billions of dollars and percentages)

	Total Cross-border Claim	Cross-border Claim on Non-Banks	Local Claims in Local Currencies	Share of Local Claims to Cross-border Claims	Share of Local Claims to Domestic Bank Credit	Share of Foreign Bank Credit in Total Bank Credit
China	54	27	5	0.09	0	2
Korea	54	23	20	0.36	5	10
Argentina	61	53	21	0.34	26	67
Brazil	72	53	66	0.91	30	45
Chile	20	19	22	1.08	48	66

Note:
Foreign bank credit is the sum of cross-border claims on non-banks and local claims (second and third columns), while total bank credit sums domestic bank credit and cross-border claims on non-banks.
Sources: IMF and BIS.

Liberalising China's Capital Account

Stallings urges a gradual opening of China's capital account. She wants "long-term flows liberated before short-term, and some ability to take precautionary steps against capital surges". This advice reflects the Chilean, and in a negative way, the Korean experience. How this applies to China may be affected by China's initial conditions.

In Chile and Korea, inflation was above the level obtaining in major countries, interest rates were accordingly higher than abroad and equity prices were relatively low. Thus, surges of capital flowing into the country was a likely consequence of liberalisation. China enjoys low inflation, relatively low interest rates and high equity prices. Although China is currently dealing with large inflows of capital attracted both by higher yields at the shortest maturities than on US dollar instruments and by the prospect of an appreciation of the renmimbi, over time incipient outflows of capital may prove a challenge (Icard, 2003).

China may have some advantages in coping with such challenges. In particular, the Chinese authorities already have experience in dealing with outflows associated with significant dollarisation of domestic banking system (Ma and McCauley, 2003).

Recent experience in Korea highlights how quickly perceived exchange rate policy can feed back into capital flows. The Korean won has tracked the yen more closely than the dollar only since late 2000. Yet by the mid-2002 a considerable sum of yen borrowing had been taken on by the Korean corporate sector to "profit" from the low interest rates on yen. Reportedly, the borrowers were mostly small and medium-sized enterprises that had not been taught a lesson, as the chaebol had, about the dangers of dollar liabilities when the won depreciated sharply in 1997-98. As the Financial Supervisory Service (2002b) put it:

> "At the end of November, the total amount of yen-denominated lending [to Korean firms] stood at $7.68 billion, up $7.1 billion … from $0.57 billion at the end of last year. The government's decision in October 2001 to allow companies to secure foreign currency-denominated loans for operational funds has brought an increased demand for yen-denominated loans. In the past, foreign currency-denominated loans could only be secured for import payments, foreign direct investments or to pay back maturing foreign currency-denominated loans. *The relatively stable won/yen exchange rate and low interest rate have contributed to the growth in yen-denominated loans as well*" *[emphasis added]*.

Conclusions

- Policymakers need to be on guard against rapid credit growth and buoyant asset prices. The recent credit measures in Korea point to alternatives to interest rate policy.
- The contrast between Korea and Japan suggest speed and thoroughness in responding to widespread financial distress best serve an economy.
- Government bond markets gain liquidity from lumping rather than splitting public bond issues. The recapitalisation of a banking system should have a silver lining in the greater size, depth, and liquidity of government bond market.
- Foreign banks might help widen access to credit, especially in Chinese context.
- China may face unusual challenge of incipient outflows in capital account liberalisation. Perceived exchange rate policy can feed back into capital flows very rapidly.

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15

Floor Discussion of "Asian and Other Views on the Functioning of the Global Financial System"

The Xie Ping Paper

Yung Chul Park, of Korea University, thought that the neo-financial dualism problem might disappear if China strengthened its regulatory system, changed the ownership restrictions within the banking sector, and deregulated interest rates. "This neo-financial dualism may not cause any serious problems to reforming China's financial sector in the future if the government allows, as many other countries have done before in their process of financial liberalisation, the commercial banks to engage in different types of financial activities – insurance business, capital market activities, derivatives dealings and all those activities that would transform them into universal banks of the European style. In such a process of reform and liberalisation, this dualism problem may disappear, because the banks will have to compete in the market. When China also deregulates interest rates, the banks are likely to charge market interest rates to the borrowers so that this advantage of having implicit credit rationing may disappear to some extent, not entirely. So I think the answer to this dualism problem is financial liberalisation and a strengthening of the regulatory system."

Turning to the issue of regional cooperation, Park said he had spoken last year with Asian central bankers who were working on negotiations for free trade between the ASEAN member states. "Their main preoccupation is to maintain financial stability within

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the Asian region. Instability in Asia would affect China's bilateral relations with the Asian countries, which is obviously not in China's interest. The argument of Xie Ping's colleagues is that China's priority, as far as regional cooperation is concerned, is to engage in another round of parallel negotiations for monetary unification. Now that Asian countries are working on monetary unification among themselves, China may find it easier to join in the Asian discussion on monetary unification within the next 10 or 20 years, and China may absolutely not be interested in any kind of regional exchange rate arrangement with South Korea or Japan. However, one learns from the European experience that financial cooperation and monetary integration is a 90 percent political process. If China's new prime minister and Japan could agree to unify the currencies of the two countries, I'm sure that many other countries in the region would follow. Without the agreement between Germany and France, where would Europe have been now in terms of monetary integration? Nothing would ever have happened over the last 10 years or so."

Masaru Yoshitomi, former dean of the Asian Development Bank Institute (ADBI), wanted to reinforce Park's argument from a different angle. "This neo-financial dualism system is nothing neo, it is very traditional. Sorry to say that because we have two different kinds of non-market mechanisms. One is the no market or less-market oriented mechanism where we have state-owned enterprises and where we are talking all the time about reforming the socialist system into a market system. The other is a more complicated non-market mechanism that is family business. We should be very careful when talking about relational banking because even in the advanced economies, including the US, there is relational banking. The interaction between family businesses and their related banks and the government is the kind of triangle system that prevailed particularly before the crisis in the East Asian economies. So this neo is nothing neo, it's very traditional and we at ADBI are studying how to reform that. But don't forget that, under the miracle economies, such triangle worked quite well. That's why I asked how one could explain the fact that the miracle economies of East Asia got into financial crisis only a few years after the World Bank published its study 'The East Asian Miracle'."

Yoshitomi believed, just like Park, that China's financial system would gradually evolve into a more market-oriented system as a

result of financial liberalisation. "After WTO accession, China is engaged in more free international capital movements. Foreign financial institutions will be welcomed and financial services will be liberalised. So in 5 to 10 years time, whether you have neo-financial dualism or not, capital account convertibility will gradually become a fact. And then the independence of monetary policy, capital mobility and a fixed exchange rate cannot go together. You will have to abandon one of the three, maybe the exchange rate, which does not need to be completely free but has to become more flexible. My suggestion would be that China adopts a sort of multiple currency basket whereby the effective exchange rate in real terms could be fixed with a 10 percent band."

Xie Ping did not believe in the usefulness of a multiple currency basket. "A flexible RMB exchange rate with a multiple currency basket does not make much sense. The Chinese RMB has always been pegged to the US dollar. Over the last 20 years in the foreign exchange market, more than 95 percent of the trading has been between the RMB and the US dollar. The RMB and the Japanese yen have a very small trading value, not more than 5 percent every day. The Hong Kong dollar has always been pegged to the US dollar, and so gradually the RMB has also almost been pegged to the US dollar. This is the traditional formula."

Yoshitomi agreed that the US dollar is the dominant currency, but said a distinction should be made between the exchange rate of the RMB vis-à-vis the US dollar as the main transaction currency, and the international competitiveness of the RMB. "When I talk about a multiple currency basket, the US dollar is obviously the main vehicle currency or transaction currency. But China should also be concerned about the rate of the yen, for example. If the yen depreciates, it will affect your international competitiveness. To mitigate this kind of concern, a multiple currency basket is far better than a fixed rate."

Xie Ping still disagreed. "I am also talking about administrative convenience, bureaucratic convenience. I do not understand why China should be so concerned about a depreciation of the yen, even though it might have a small effect on our exports."

Charles Adams, of the IMF, observed that both an appreciation or depreciation of the yen could have an impact on China's exports depending on the import content of its exports. "You have to calculate the import content in China's exports to find out whether

an exchange rate depreciation or appreciation is good for China or not."

It struck Adams that there is no such thing as a single Asian view on the problems with the global financial system. "There is a multitude of different views about the problems and about the solutions. When one thinks about regional financial cooperation, for instance, we have some people advocating the Japanese chequebook model, where Japan writes the cheque and does the surveillance and China goes out and does the free trade agreements. Then there is another model where Japan is out of the picture and China pursues regional trade agreements, and, most importantly, China has an interest in regional financial stability because of the implied trade links. So we have very different conceptions of where things will go."

Asked what he thought about regional efforts at crisis management, Adams responded: "On global versus regional crisis managers, I guess I have to give the IMF party line which is that, in a globalised world, it becomes very difficult if there are a lot of regional crisis managers. It becomes difficult for reasons of coordination and consistency. From a more general perspective, the idea might be that for some of the solutions to a crisis – be that debt restructuring or be that the provision of liquidity – at least global coordination of regional crisis managers is needed. So I would think that the first-best solution would be a well functioning global crisis manager. But if the interest is there for a regional crisis manager, then maybe people are not happy with the functioning of the global crisis manager or maybe they use a different cost benefit model that favours a regional rather than a global crisis manager."

"What is your personal view?" asked Yung Chul Park.

Adams: "My personal view is that I think the party line is correct conceptually, in terms of the solutions. It seems to me that some of the interest in Asia for regional solutions is based on a view that the IMF governance voting structure is not giving adequate attention to Asian interests. I wonder whether this argument for a regional crisis manager is a second-best argument or a first-best argument, and I think that a regional crisis manager is extremely difficult."

Geng Xiao, of the University of Hong Kong, argued that financial crises should not always be prevented. "Reform of the global financial system, regional cooperation and integration, global or regional crisis management – none of these is going to eliminate financial crisis, they cannot and they should not. Financial crises can

be quite useful, for the allocation and absorption of losses and to minimise the distortions. If a financial crisis does not interrupt the real resource flows and is consistent with the long-term structural changes in the real economy, then it is healthy and necessary. Look at the US economic system, the stock market crash and the citizens of the US taking losses. The real resource flows in the US, the real growth in the US, are not distorted, they are flowing less to the high-tech sector, and that is how it should work. You have a global economy, and if China fully integrates a lot of things will change. Resource flows have to adjust and without financial shocks or fluctuations you cannot change real resource flows. We cannot eliminate financial crises, we have to live with them and the best we can do is to reduce the impact on the real sector."

Although Zdeněk Drábek of the WTO did not disagree with Xiao's view on the eventual beneficial effects of a crisis, he put the occurrence of financial crises in a different perspective. "I don't disagree with Geng Xiao that in a market economy there would be profits, losses, and occasional financial crises. But the point is that the crises we have seen over the past years have looked like the 'Great Depression', and that there has been significant collateral damage. So the work programme in terms of crisis prevention is certainly not intended to avoid all crises but to try and reduce the frequency and the amplitude of crises, and to deal with contagion and collateral damage. But certainly in a capitalist economy you are going to see financial crises and there is a role for these crises in terms of working out from past problems."

Barbara Stallings, of Brown University, wondered whether incentives in China might be such that they would lead to overinvestment. "There is a large literature on overinvestment written in the context of incentives. If the incentives are of the kind of the formal central planning mechanism, firms are pushed into spending more than they would under cost-minimisation and profit-maximisation alternatives. My guess is that incentives in China are such that they push the banks to overinvest."

Drábek followed up: "Incentives are a critical issue. The banks in China have incentives to keep spending credit for investment purposes. State enterprises are demanding more funds for investment and banks are lending the money for that purpose. Nobody is stopping them, even when the projects don't justify the lending on economic grounds."

Li-Gang Liu, of the ADBI, gave the incentive issue a different twist. “Wing Thye Woo mentioned that China was eager to join WTO because of risk issues. The other reason is that China is willing to converge its institutions to international standards so that trade transactions can be facilitated. When we talk about international financial arrangements, what are the incentives for China to enter such an arrangement, whether it is regional or global? What can a country gain by joining global or regional institutions? The IMF preached capital account convertibility and for many developing countries it turned out to be disastrous. By not converging to that incentive, China has saved itself from the Asian financial crisis. With regard to regional financial arrangements, what criteria could be developed to take care of this incentive issues and allow China to take a leadership role? Can China use a regional or international financial arrangement as a way for itself to further liberalise its domestic financial sector and make the banking sector more modern and things like that? If there would not be such a piece in a regional or global arrangement, I think China would be less interested in playing an active role.”

Wing Thye Woo, of California University, thought that China should become a prominent player on the world stage and take a more active role in leading the developing countries in efforts at reforming the international financial system. “For example, China could argue that the IMF role in a crisis should be to ensure the fast recovery of the countries rather than to collect overdue loans for the international banks. Regional cooperation is a mechanism that may help to improve the global situation and China has to be part of an Asian effort to change the international financial architecture. Regional financial institutions can also be useful instruments to complement and critically review global institutions. Two minds are better than one and a regional institution may be able to force better behaviour at the global level. China could play an important role in shaping WTO rules and it could act, together with Japan and Korea, towards changing the international financial rules.”

The Barbara Stallings Paper

Zdeněk Drábek stressed that many Central and Eastern European transition countries have made “the incredible step” of allowing the

banking sector to be taken over by foreign banks. "Virtually all Czech banks are owned by foreign banks. Hungarian banks are, with the exception of one, all foreign owned and market penetration by foreign banks in Poland is also very high. I am sure that China has the same problem in the financial sector as the Czech Republic and Hungary had, which is that there is virtually no historical experience of proper banking and, and as a result, the banking sector has remained highly fragile. For that reason, I think the foreign banks should play a major role in the reform of the financial sector in China."

Drábek did not agree with the idea that, given the initial conditions in China, capital account liberalisation would lead to a threat of capital flying from the country. "Again, look at what happened in the Czech Republic, Poland and Hungary. These three countries have liberalised their capital markets, had similar initial conditions, and there has not been any capital flight."

Yung Chul Park added: "About this sequencing of the capital account liberalisation, we have been hearing from the IMF that one of the major causes of the crisis in Korea was that Korea failed to liberalise the long-term market prior to liberalising short-term flows. I just want to know some evidence suggesting that countries, which had liberalised the long-term market first and then the short-term market later, indeed prevented the crisis or suffered less from financial crisis. In fact, one of the studies I was involved in does not suggest any kind of causality between financial crisis and the maturity structure of foreign debt in emerging market economies. Even on a theoretical basis one can argue that the maturity structure has nothing to do with the susceptibility and vulnerability of an emerging market country to a crisis. Does someone know any study or have any anecdotal evidence on this issue?"

Charles Adams endorsed Park's view and related that he had seen a study that showed that "there is no relationship, which is consistent with your view".

Barbara Stallings said there was a huge debate in Latin America on whether one can determine anything on the basis of the liberalisation of short-term capital flows. "There is an article that came out a number of years ago in one of the World Bank publications claiming that you cannot even clearly identify a short term asset from a long-term asset. The IMF has now stopped making that distinction in the accounts, so clearly this indicates they

don't think it is a relevant issue. The anecdotal evidence is that things have worked well in the Chilean case, where short-term flows were not fully liberalised, and the feeling is that if you have a lot of short term debt and suddenly people stop to roll it over, you have got an immediate problem."

Geng Xiao observed that there are likely to be "a lot of surprises" in China's financial reforms, because of political reasons and because of the presence of Hong Kong. "China has been in Hong Kong for many years and the operation of the Bank of China in Hong Kong is actually very much integrated with the domestic banking. China is very lucky with the capital market development in Hong Kong, because many experiences can be transferred quickly to China. Of course, there are problems in the financial sector in China, but those problems are more outside than inside of the financial sector. Two-thirds of the shares of the companies in China are held by the state. So that is not really a problem within the financial sector, but within the entire economy. The country has not yet substantially privatised the economy.

Let me give you an example. A lot of Chinese companies are listed in Hong Kong, and Hong Kong probably has the best legal system in Asia. The regulation in Hong Kong is very good but we cannot deal with some of the private enterprises from China because the original certificates of land or contracts are wrong. We cannot do enforcement with a faked document, that should be done in China, and the Hong Kong police cannot go to China. China should fix its property rights system, which is a basic system. So the bottleneck does not lie in the financial sector itself, but goes actually beyond the financial sector. That is the point I want to emphasise."

When Geng Xiao remarked that a lot of Chinese capital is flowing out of the country and then comes back in the form of foreign direct investment, Xie Ping stressed that China's private sector sends its capital to the capital markets because of lower taxes and better property rights. "Taxes on foreign investments are much lower than for domestic enterprises. But the most important reason for these capital flows is that China gives more protection to property rights of foreign capital."

Geng Xiao warned of a major problem with these capital flows going in and out of the country. "All this smooth trade, all these smooth financial flows are based on the important assumption that China has a stable exchange rate. The Hong Kong dollar is pegged

to the US dollar, the Chinese renmimbi is pegged to the US dollar, the dollarisation of liabilities and assets in China is so substantial that if there will be exchange rate volatility, like the volatility that happened in Japan, China would probably follow in the footsteps of Japan."