The ADBI-ASEAN Economic Forum on Current Asian Financial Developments

12 February 1998, Manila

Executive Summary

This forum was held by the ADB Institute,in collaboration with the ASEAN Economic Forum, at the University of Asia and the Pacific, Manila, on 12 February 1998. Participants from ASEAN countries, Japan, and the Asian Development Bank met to try to arrive at consensus on at least a few, key, common causes of the financial crisis as it affected ASEAN economies. The forum also discussed the validity of the IMF's prescriptions for Thailand and Indonesia, and what the range of alternatives that could be reasonably and realistically considered.

I. Diagnosis and Outlook

Macroeconomic and financial environment A combination of liberal capital flows and fixed exchange rates encouraged capital inflows during a period when foreign interest rates were low. However, the financial sector was too unsophisticated to absorb these flows, leading to imprudent lending and an asset bubble. Lending problems were compounded by an underdeveloped accounting system, and the lack of a money laundering law. In addition, the lack of a long-term debt market encouraged the holding of short term paper. Competitiveness was also eroded by a combination of a fixed exchange rate regime with domestic inflation that was higher than foreign inflation. Conditions made currencies and financial markets vulnerable to shocks, such as the devaluation of the Chinese yuan in 1994, which resulted in a loss of competitiveness for ASEAN economies. There was concern that in spite of Chinese reassurances, China would find itself unable to maintain its peg by 1999, possibly triggering further rounds of competitive devaluations. In short, financial liberalization and integration accentuated booms, but there was a symmetrical effect contributing to busts. In the view of one participant, this led to a crisis that was not predictable, but explainable. This crisis involved a private (rather than public) sector deficit, and involved the capital account rather than the current account. Questions were raised on how to interpret the crisis in Indonesia. Was the problem wrong sequencing---the capital account was opened before the domestic financial market sector was fully developed? Or was the pace of reform slower than the speed of global liberalization? Some say that the issue was not sequencing, but the fact that an open capital account was maintained at the same time as interest rates and the exchange rate were controlled. Others observed that an open capital account was not a problem when foreigners did not want to acquire domestic assets, but became a problem after they did. Institutional and political issues. One participant stated that in Thailand there was a need for greater coordination among government agencies in a time of crisis. The Bank of Thailand was too independent, and did not inform the Cabinet of its actions, such as the true condition of its foreign currency reserves, in a timely fashion. There was also a lack of unity of command, as the bureaucracy did not consider coalition governments formed under Thailand's parliamentary system to be very strong and cabinet members were seen as being only temporarily in office. Another participant suggested that too much democracy is not good. For example, it is inconceivable for Singapore banks to short the Singapore dollar, as the MAS could easily revoke licenses. This is in contrast to Indonesia where local banks reportedly participated in the shorting of the rupiah. Contagion. In the 1990s, institutions engaging in portfolio investments are the major source of international funds. This is in contrast to the 1970s and 1980s, when commercial banks were dominant. In contrast to commercial banks, portfolio investors have access to a lot of information, but have very little stake in the countries they invest in. Investments in individual countries are also relatively small and can easily be withdrawn. Country analysis is generally superficial, based on typical ratios. This implies that a country like the Philippines, for example, cannot differentiate itself from the rest of ASEAN. The covariance in Asian risk is high, i.e., risk or volatility in one Asian market is statistically closely related to risk in another. In view of this, individual countries should try to put their respective houses in order to accentuate differentiation. The high covariance also implies that a response involving all of ASEAN may be called for. Some reasons why Singapore has largely escaped contagion effects were mentioned, including the fact that foreign currency debt tends to be long term rather than short term, a floating and more flexible exchange rate was used to regulate capital flows, and banks were less affected by currency fluctuations because they avoided or hedged any foreign currency exposure. The virtues of Asian policies. One participant reminded the group that Asian economic policy has accomplished a lot, including rapid growth and better standards of living. While some policies have also gone awry, it is important not to lose sight of the successes. The elements for economic recovery are still there, such as high saving rates, human resources, relative distribution of income and export-led growth. It was also noted that the crisis should give many opportunities for import substitution. However, the use of exchange rates for trade policy proved to be two-edged. Allowing the exchange rates to float during periods of surging capital inflows would have caused currency appreciation and worsened the current account. On the other hand, the sustainability of fixed exchange rates became more and more suspect as current account deficits widened.

II. Policy Responses and IMF prescriptions

Macroeconomic policies A number of views were offered on appropriate fiscal and monetary policy responses and IMF prescriptions. On the one hand, IMF programs are very severe, requiring very tight monetary and fiscal policies. There was concern that IMF prescriptions were in some respects misplaced and could have adverse effects. ASEAN has no record of excessive fiscal profligacy, so the IMF emphasis on this was questioned by some participants. In Indonesia, tight liquidity reportedly accelerated the collapse of banks because interest rates were raised too soon. One participant suggested that the rupiah should have been allowed to devalue first and seek its equilibrium level before interest rates were increased. The extent interest rates should rise should be determined on a case by case basis. On the other hand, while a Keynesian-style expansionary policy appears to be right if banks are failing, from a political economy point of view it may be desirable to call for fiscal prudence, so IMF policies might not be entirely misplaced. However, the IMF should allow fiscal and monetary policies to ease once confidence is restored. One participant observed that Malaysia avoided coming under IMF control by taking preemptive measures (fiscal and monetary prudence) that resembled IMF prescriptions. This also suggests that there may be some validity to these prescriptions. Capital Flows. There was no clear consensus on how to deal with capital flows. On the one hand, some participants called for controls on short term capital flows, and raised questions about the appropriateness of an open capital account when domestic financial markets are still underdeveloped and unprepared to absorb foreign flows. On the other hand, one participant asked what signal policymakers wanted to send foreign investors and global financial markets. Did they want foreign financing or not? Another participant said that many economies have learned to live with floating exchange rates and capital mobility and stressed the importance of identifying policies that will allow markets to operate while creating the right incentives for risk management. Exchange rate policies. Questions were raised about the appropriate exchange rate, how it can be stabilized during times of crisis, and what to do after stabilizing it. As far as stabilizing the exchange rate is concerned, one suggestion was to focus on what financial markets are concerned with. In some cases exchange rate instability may be due to worries about excessive money growth. In other cases, instability may reflect concerns about weaknesses in the financial sector. The proposed currency board in Indonesia was also discussed. While a currency board is seen as a quick way of restoring confidence, there was general pessimism about its chances for success in Indonesia. One participant observed that strong monetary and financial institutions and fiscal discipline are needed to have a currency board, but if these conditions are met, a currency board is no longer needed. Singapore has a (unique) currency board system, with a floating exchange rate adjusted to curb inflation. It was also suggested that a basket peg would be appropriate for ASEAN currencies. (More details on the rationale for a basket peg are given in the Executive Summary for the Tokyo Workshop of February 2, 1998, available on this web site.) Banking sector. Some participants thought that IMF packages focus largely on macroeconomic issues and are unable to address the key financial sector problems, such as adverse selection and moral hazard in the financial sector. Policies should address inappropriate exchange rate policy, private sector over-borrowing, and inadequate banking supervision. A leaked IMF memo on how the IMF-prescribed closure of a number of financial institutions backfired in Indonesia - by causing runs on institutions that remained open - was cited. One participant argued that weak banks should have been merged instead of being closed down, as this would have been better for depositors. ASEAN countries have no previous experience with crises of this sort, and are in a quandary as to how to respond. What instruments should they use? Should they guarantee all deposits? Singapore responded to the crisis by disclosing the standing of banks.

This had the effect of calming the market. However, differences in legal structures imply different approaches to dealing with a number of questions, such as foreclosure. For example, in Indonesia, the approach is to let lenders and borrowers come out from problems on their own. It was also noted that the reluctance of international lenders to supply credit is paralyzing trade, e.g. , letters of credit are not accepted in Indonesia, and it is not clear how this is to be addressed in the context of a tight IMF package. The financial disruption also raises questions about how to handle huge unemployment and provide a social safety net. Financial sector development ASEAN countries need to develop a number of financial sector markets and institutions, including forward markets, and a market for long-term debt that can help price long-term funds. Rating agencies need to develop the capability to evaluate ASEAN paper. National stock markets also need to be deepened. Ways also need to be found to penalize disaster myopia. Economic reforms One participant suggested that the current crisis, as well as the IMF presence, would help accelerate certain needed reforms, such as financial sector restructuring or trade liberalization. However, while a good reform package was put in place in Indonesia, the political will to implement it remains unclear. Thailand is considered to be in a better position to implement reforms, although it was noted that pressures to reverse liberalization measures exist.

III. International Responses

International organizations. The main objective of the IMF is to restore confidence and end capital flight. The idea of large IMF-led assistance programs was not to spend the entire amount but to restore confidence. One participant said that the IMF's presence in Asia has a positive and stabilizing effect, for example in Thailand. Another positive contribution of the IMF is to accelerate reforms, as noted above, but the lack of political will to implement reforms in some cases poses a dilemma for the IMF. Should funds be disbursed when the package won't work because of lack of political will? The IMF has taken the lead among international organizations, however, this system has a number of shortcomings. First, it is not clear that IMF information systems are entirely effective in predicting crises. Some participants indicated the need to develop indicators of financial sector soundness. Second, there is a coordination problem, as international organizations do not share information among themselves, and there are also too many sources of conflicting advice. One participant nevertheless thought that the global financial system needs improvement and that a new financial institution is needed that would enshrine the memory of the current crisis, in the same way that the Bretton Woods institutions enshrined the memory of the Great Depression. Japan and United States Participants stressed the need for Japan and the United States to open up their markets. There was also a discussion of whether more bilateral aid would have been desirable. However, one participant suggested that the bilateral aid package to Mexico after 1994 was very expensive. Burden Sharing. Some participants felt that international creditors should take responsibility for the consequences of their lending decisions, as they are just as guilty as borrowers. One participant complained that only foreign investors are bailed out, while the country suffers all the hardship from an IMF program. It was also suggested that some creditors profited from currency depreciation. Another participant proposed that banks should take a haircut, as they did in the Brady plan, and that no free riders (banks that exit whole) should be allowed. The pressure for early repayment made it even more difficult to repay debt and rescheduling the debt would have had a less serious result.

IV. Regional Responses

Regional economic monitoring or surveillance. There is a perceived need for a regional consultation mechanism within ASEAN on macroeconomic or financial sector issues. A regional economic monitoring or surveillance mechanism would support this. In this connection, the following points were raised or discussed: What should be monitored? Financial markets and governments, as well as international organizations, are already engaged in extensive economic monitoring or surveillance. Financial market participants do it to identify profit opportunities or manage risk; governments and international organizations do it to maintain economic stability. One potential difficulty is that expectations of financial market participants may trigger financial market panics or crashes, and one objective of monitoring by governments is to avoid this. The variables monitored should be based on our understanding of sources of risk, based on economic theory and empirical findings. This requires very capable (and expensive) research. At one level, traditional variables such as indicators of the macroeconomic outlook or central bank balance sheets are monitored. However, research on the vulnerability of economies to shocks (such as yen dollar fluctuations, or changes in world interest rates), and the monitoring of such shocks is also important. Research on the characteristics of banking crises in emerging markets also suggests a list of early warning indicators. Typically, economies that have been subject to crises lack incentives for suitable risk management, become increasingly vulnerable to shocks (due to growing maturity or currency mismatches, for example), and experience a crisis following a well defined shock (such as an economic slowdown or a decline in asset prices). Indicators can be developed according to these known patterns. It was also noted that in order to respond to a speculative attack, information should be timely, and at the regional level countries should have a common information set, with consistently defined variables. Information may be generated by the supervision of international banks, and a Central Bank could share information with its counterparts about the behavior of international banks in its jurisdiction. Economic monitoring and the private sector: One issue that needs to be addressed is the extent to which the government will share information gleaned from economic monitoring with the private sector. This is the case in the most developed financial markets, and would appear to be desirable to ensure that business decisions are made correctly and resources allocated efficiently. Transparency may also stabilize expectations formation. Coordination of Monitoring Efforts. As a considerable amount of economic monitoring is already being done, there is a need to determine how these efforts can be coordinated and what indicators need to be looked at to avoid duplication at the regional level. For example, credit rating agencies already do a lot of monitoring, and these results can be used. One participant indicated that very little is needed to supplement IMF surveillance. However, the World Bank and ADB can play a role in addressing microeconomic issues. Some initiatives for economic monitoring at the levels of ASEAN are already in progress, and it is foreseen that the IMF would play a secretariat role. Finance ministers are to work out details at a meeting at the end of February, 1998. It was also suggested that the usual practice of central bank governors to share information among themselves can be institutionalized. A desk in each central bank can focus on studying developments in other Asian countries using methods for identifying suitable indicators suggested above. However, another participant expressed doubts about the extent of information sharing, as there is certain information that simply cannot be shared. Peer pressure and policy coordination. One key question is what leverage, if any, exists to ensure that warning signals triggered by economic monitoring are heeded? In this regard, one potential benefit of a regional monitoring and consultation process would be ASEAN peer pressure as countries could encourage their neighbors to correct policies that could adversely affect the region through contagion. For example, it was suggested that ASEAN should try to persuade Indonesia not to go ahead with a currency board. However, there is a cultural problem, as Asians are reluctant to criticize their neighbors. In addition, ASEAN is a low priority among regional governments, in good times and bad. Politics focuses on the present and immediate future, while ASEAN is long term. A number of participants believe that while information sharing and a frank exchange of views among ASEAN countries is desirable, policy coordination is not likely. Another expected benefit of regional monitoring and consultation is that it may lead to an ASEAN view on financial issues, in the same way as ASEAN has a view on trade. ASEAN cooperation can be used to push forward its trade agenda, and highlight the need for market access for ASEAN. ASEAN currency clearinghouse. Prime Minister Mahathir's proposal for a mechanism to use ASEAN currencies in intra-regional trade was discussed. Under such an arrangement, the Philippines and Malaysia could minimize their hard currency needs by netting out their bilateral trade with each other in their own currencies, and settling the difference in U.S. dollars. However, one participant remarked that banks could perform this service. Also, the exchange rates used to value transactions are crucial. If the exchange rates are not right, excess holdings of one ASEAN currency or the other may result. Under these circumstances, it may be more advantageous to use a liquid currency like the U.S. dollar in valuing and netting out transactions. Internationalization of the Yen. Many countries, and also some Japanese officials, want the yen to play a greater role in international transactions, supplementing the U.S. dollar. However, the lack of yen-denominated assets appears to inhibit internationalization. It was noted that even Japanese investors seemed unwilling to hold yen-denominated assets, preferring to hold U.S. dollar assets.

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Workshop Participants

Philippines

Aarne Dimanlig	*Senior Manager for Corporate Finance, Bank of Ph*
Ernest Leung	*President, Philippine Deposit Insurance Corp.*
George Manzano	*Research Director, School of Economics, UA&P*
Cayetano Pederanga	*Member of Monetary Board, Bangko Sentral ng Pili*
Ma. Cyde Tuano-Amador	*Acting Deputy Director for Economic Policy Studies Pilipinas*

Singapore

Tan Khee Giap	*Head, Public Policies Studies Unit, Nanyang Techn*
Ngiam Khee Jin	*Senior Lecturer in Economics, National University c*
Manuel Montes	*Senior Fellow, Institute of Southeast Asian Studies*
Chia Siow Yue	*Director, Institute of Southeast Asian Studies (ISEA*

Indonesia

Rino Effendi	*Head of Research, Danareksa Securities*
Hermanto Gunawan	*Research Associate, Faculty of Economics, Univer*
Mari Pangestsu	*Executive Director, Center for Strategic and Interna*

Malaysia

Mohd. Haflah Piei	*Deputy Director, Malaysian Institute of Economic R*

Thailand

Narongchai Akransanee	*Chairman, Seranee Holdings*
Wisarn Pupphavesa	*Dean, Graduate School of Development Economic*
Pakon Vichyanond	*Research Director (Financial Markets), Macroecon Development Research Institute Foundation*

Japan

Hideichiro Hamanaka	*President, of Fiscal & Monetary Policy, Ministry of F*
Hirofumi Koda	*Section Chief International Finance Division, Intern Japan*

Mitsuteru Nakayama	*Section Chief, Planning and Research Division, Mi Finance*

Investment Bankers

Lito Camacho	*Executive Vice President, Bankers Trust, Manila*
Monique Manalo	*Vice President and Head of Corporate Finance, Cit*
Vaughn Montes	*Vice President and Head of Public Sector, Citibank*

ASEAN Finance Officials

Ma. Cecilia Soriano	*Undersecretary of Finance, Philippines*
Bambang Kusumanto	*Head, Bureau of Monetary Analysis, Indonesia*
Witaya Pintong,	*Chief of Fisical and Monetary Policy, Over-all Plan*
Renato Reside, Jr.	*Consultant, Department of Finance, Philippines*

Asian Development Bank

Amb. Linda Tsao Yang	*Director for the United States*
Prasit Ujjin	*Director for Malaysia, Myanmar, Nepal, Singapore,*
Romeo Bernardo	*Alternate Director for Kazakstan, Maldives, Marsha and Philippines*
Sim Cheng Huat	*Alternate Director for Malaysia, Myanmar, Nepal, S*
Tobias Hoschka	*Investment Officer, Private Sector Group*
Soo-Nam Oh	*Economist*
Pradumna Rana	*Senior Economist*
S. Ghon Rhee	*Resident Scholar*
Yutaka Shimomoto	*Economist*
Reza Siregar	*Economist*
Ahmad Badri Mohd. Zahir	*Director's Assistant for Malaysia, Myanmar, Nepal,*

Asian Development Bank Institute

Jesus P. Estanislao	*Dean*
Gil Gonzales	*Administrative Officer*
Penelope Joy Price	*Training and Learning Methods Specialist*

Ramon Moreno	*Technical Adviser (Senior Economist, Federal Rese*

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BACK TO HOMEPAGE

The ADBI-ASEAN Economic Forum on Current Asian Financial Developments

Workshop Papers

"Diagnosis of Current ASEAN Financial Challenge and Priority Actions Confror It (Short to Medium Term)"

Narongchai Akrasanee

Serrane Holdings, Thailand

Manuel Montes

Institute of Southeast Asian Studies, Singapore

"IMF Prescriptions for Select Asean Economies: Are they Adequate and Proper?

Mari Pangestu

Center of Strategic & International Studies, Indonesia

"ASEAN Coordination & Cooperation on Financial and Monetary Issues: Surveillance, Monitoring, and consultation Mechanism"

Vaughn Montes

Citibank, Philippines

Ramon Moreno

Asian Development Bank Institute, Tokyo