CHAPTER 7

The Asian Financial Crisis – **A Turning Point?**

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THE ASIAN FINANCIAL CRISIS – A TURNING POINT?

One of the important functions of the Pacific Economic Cooperation Council (PECC) is to make policy recommendations not only to Asia Pacific Economic Cooperation (APEC) but also to the governments of the member economies. In order to fulfil this function, PECC currently relies heavily on its three major forums: (1) the Trade Forum; (2) the Finance Forum; and (3) the Community Building Forum. Given the current active involvement of PECC in the area of financial policy issues, one might think that the Finance Forum has a long history within the organisational structure of PECC. But that is not the case.

PECC's Finance Forum came into existence only in 2001. The idea of launching a forum specializing in financial policy issues within PECC had been agreed to at the Standing Committee meeting held in Dalian, China, in April 2000. A year later, at the Standing Committee meeting in Kyoto, Japan, Dr Soogil Young from Korea was confirmed as forum coordinator. For reasons that will become clear later in this chapter, however, it took quite some time before Dr Young was able to undertake an effective program of studies and make important policy recommendations to the APEC Finance Ministers Meeting and other forums.

Obviously, all of this took place well after the 1997–98 Asian financial crisis. Thus, several questions readily come to mind. (1) Why did PECC take so long to focus effectively on financial issues? (2) In the area of financial policy, what did PECC do before the financial crisis and after? (3) What was the impact of the financial crisis on PECC and its work program? (4) What important activities has PECC been carrying out through its Finance Forum since the forum came into being and what impact has it had? And (5) what other activities has the forum yet to carry out to accelerate progress towards an Asia Pacific Community? The purpose of this chapter is to shed light on these questions.

Why Did It Take So Long for PECC to Create a Financial Forum?

It is significant to note that in their early years, both PECC and APEC paid relatively little attention to the issues of financial policy in the Asia Pacific region. In those years, these two organisations concentrated almost exclusively on trade. Why was this the case? One answer might be that as far as the majority of the nations in the region were concerned, there was no urgent need to worry about how to finance their economic development. Before the 1997–98 Asian financial crisis, only a handful of countries in Latin America had experienced any serious problems due to instabilities in the international flow of capital. Most of the developing nations in Asia, on the other hand, had experienced no such problems.

In the years before the Asian financial crisis, most of the East Asian countries had succeeded with their export-led development strategies far beyond anyone's expectations. Their success was widely acclaimed as the "East Asian miracle". In those years, the East Asian countries were typically growing at 7–8 per cent per annum, and this high growth rate was expected to continue. As long as these expectations lasted, countries had no problems attracting large amounts of foreign capital, particularly in the form of direct foreign investment. Their problems were rather to choose between suppliers of funds. Besides multilateral institutions, private financial institutions and funds of all types from Japan, North America and Europe literally lined up to provide capital to Asian countries in expectation of high earnings. This was particularly true in the late 1980s and in the 1990s up to the financial crisis. In the years following the Plaza Accord of 1985, the Japanese yen was strong and appreciating. With the appreciating yen, Japanese investors found investing overseas, particularly in East Asian countries, highly attractive because they were able to buy assets more cheaply overseas than at home.

In the years immediately preceding the financial crisis, American investors not only experienced what their Japanese counterparts had experienced several years earlier but also did the same thing. In 1995, the Clinton administration began to pursue a strong dollar policy rather effectively. With the dollar appreciating, many American investors – both institutional and individual – were eager to invest in East Asia. Put simply, they were very anxious to have a share in the growing pie made possible by the "East Asian miracle". They thought it would last for quite some time, if not forever. For this reason, capital was rushing into all parts of East Asia for virtually all types of investment.

What Did PECC Do Before and After the Financial Crisis?

All this is not to say that within PECC there was no interest whatsoever in the financial policy issues of the Asia Pacific region before the Asian crisis. In 1994, with the blessing of PECC's Standing Committee, former US Senator Adlai E. Stevenson launched the Financial Market Development (FMD) Task Force. He was soon joined by Mr Yuichiro Nagatomi, former Vice Finance Minister of Japan. They served as co-chairs of the task force. The stated mission of the task force was "to contribute to the development of financial and capital markets in the Asia Pacific region"[1] by supporting the efforts of each member economy to achieve financial reforms, providing guidelines for step-by-step reforms tailored to different stages of economic development of individual economies, and supporting voluntary, competitive adoption of liberalization measures.

With the benefit of hindsight, it is highly interesting to note that such issues as the weaknesses of the international financial architecture, the volatility of exchange rates, the need for regional cooperation, the need for capacity building by East Asian financial institutions, particularly with respect to risk management – the kinds of issues that were to become very prominent after the Asian financial crisis – had not yet attracted attention. In any case, between 1994 and 1997, the FMD Task Force was able to make three presentations to the APEC Finance Ministers Meetings. These presentations covered such subjects as the standardization of requirements for disclosure of financial information, diversification of finance mechanisms for infrastructure development, and further liberalization of cross-border capital flows.

The PECC FMD Task Force failed to anticipate the 1997–98 financial crisis. In all fairness, the blame for this failure should not be placed only at the door of the FMD Task Force. Few other organisations with considerably more resources for research, or for that matter individual experts with a global reputation, had foreseen the crisis. After the crisis broke out, the FMD held

[1] See PECC (1997: 9).

many workshops and conferences aimed at addressing key issues related to the crisis. Some were held independently; others were held jointly with organisations such as the Asian Development Bank Institute and the World Bank. Issues covered in these workshops and conferences included: (1) enhanced monitoring and surveillance of finance systems, particularly in East Asia; (2) bank supervision with special emphasis on the inter-relationship among regulators, banks and the industries that banks lend to; (3) the development of a framework for cooperation and coordination among different financial systems; (4) the need for capital market development, particularly bond market development, for securing long and medium-term sources of finance; (5) the need for developing an East Asian currency index on which to create futures for hedging against fluctuations and to reduce the region's dependence on the US dollar; and (6) the urgent need for international financial institutions to take the lead in setting up a working capital loans fund for small and medium enterprises in countries hit by the crisis.

As if this list had not been long enough, the FMD Task Force also paid attention to the need to achieve regional financial integration in East Asia, currency stability, robust financial markets and institutions, restructuring of domestic banking systems, restructuring of domestic corporate sectors, prudent and considered removal of existing legislative and regulatory barriers to market development, reform and expansion of pension funds, and development of the securities market. In the course of discussing these issues, it was suggested that the topic of finance become a major pillar of APEC in addition to its traditional trade-based pillars of Trade and Investment Liberalization and Facilitation (TILF) and Economic and Technical Cooperation (ECOTECH).[2]

All in all, in the years immediately following the Asian financial crisis, the FMD did an excellent job in identifying many key issues for reform necessary to avoid another financial crisis. One must note, however, that the FMD still tended to frame policy issues from the perspectives of developed economies. Moreover, the FMD seemed to have difficulty formulating an effective and manageable work program for itself. Perhaps this was not an accident. In designing its research project as well as choosing issues for public discussion in the pre-crisis years, the FMD Task Force had tended to give undue emphasis to the interest and perspectives of developed economies in the region. Put differently, it had seemed that they defined policy issues largely from the perspective of the suppliers of capital rather than the users of capital.

Disappointed with the lack of attention paid to the perspectives of developing economies, the Standing Committee eventually decided to shift the coordination of the task force to an economy that could reflect the views of both developed and developing economies in a more balanced way. In the Standing Committee's opinion, the economy that best fitted such a description was Korea. As a result, at the Standing Committee meeting held in Dalian, China, Korea was approached to take over the FMD Task Force and merge it into a new Finance Forum.

[2] KOPEC was the first member committee to highlight the urgency to make finance the most important pillar of APEC. See PECC International Secretariat, Minutes of the PECC Standing Committee Meeting held in Kuala Lumpur, Malaysia, on 12–13 November 1998.

The Korea National Committee for Pacific Economic Cooperation (KOPEC) responded to the wish of the Standing Committee and looked for an effective coordinator. KOPEC was fortunate to find such a coordinator in the person of Dr Young, who had just returned to Seoul after completing a successful tour of duty as Korea's ambassador to the Organisation for Economic Cooperation and Development (OECD). At the Kyoto meeting in the spring of 2001, KOPEC recommended him for the position.

The original FMD group informed the Standing Committee of its desire to continue as a separate PECC project, if not a task force. Under PECC rules, a PECC project could continue its activities without financial aid from the Central Fund, whereas a task force could draw on the Central Fund's financial resources. At the Standing Committee meeting held in Kuala Lumpur in October 2001, the committee asked the incoming PECC chair to write a formal letter to the FMD Task Force co-chairs to inform them of the discussions that had taken place and of the criteria a PECC project had to fulfil. The committee also requested that member committees restructure their participation in financial market development discussions to reflect the new policy of PECC, which was to have the Finance Forum serve as the main channel for the discussion of financial policy issues.[3]

In spite of the transitional difficulties just noted, PECC did make a major contribution during this period. In 1988, Mr Roberto Romulo, then International Chair of PECC, asked Dr Jesus Estanislao, former Vice Minister of Finance of the Philippines, to contribute PECC's work in this sector. Dr Estanislao organized, then provided outstanding leadership for the PECC Peer Assistance and Review Network (PARNet). The group worked very hard for two years and drew up an excellent set of guidelines for good corporate governance practices for East Asian economies. Dr Estanislao presented the gist and significance of these guidelines before the APEC finance ministers in 1999 and 2000. He succeeded in persuading the ministers to endorse them. At their meeting in Shanghai in October 2001, the ministers formally endorsed the guidelines for implementation by APEC economies on a voluntary basis.[4]

Impact of the Asian Financial Crisis on PECC and APEC

Apart from Dr Estanislao's excellent work, the Asian financial crisis had an enormous impact not only on the nature of PECC itself but also on its work program.

As is well known, the immediate cause of the 1997–98 Asian financial crisis was what has been the "double mismatch" between foreign currencies borrowed short-term and lent long-term in domestic currencies. It is still not clear what exactly caused the "double mismatch" to lead to a full-blown crisis. In any event, the Asian financial crisis was fundamentally different from the crises that had hit Latin American countries earlier.

The Asian crisis was basically a liquidity crisis whereas the Latin American crises were crises

3 PECC International Secretariat, Minutes of the Formal Standing Committee Meeting at Kuala Lumpur, 5 April 2002.

4 For detailed information on the content as well as the background of the guidelines, see PECC (2001).

due to excessive debts. Or, as Professor Hugh Patrick puts it elsewhere in this volume, the Asian crisis was not a balance of payments crisis based on trade; it was rather a liquidity crisis based on a mismanagement of the capital account.[5] Nonetheless, the policy prescriptions put forward by the International Monetary Fund (IMF) and others to deal with the Asian crisis were based largely on earlier Latin American experiences. This caused a sharp drop in the growth rates of East Asian countries, to a degree that was altogether unnecessary. This in turn caused crisis-hit East Asian countries to have a great many misgivings and much ill feeling about the actions of the United States, which in their opinion had played a major role in the formulation of the IMF prescriptions.

There was also another problem. The United States at best was very slow in helping countries hit by the crisis. In addition, it was partial in its help. For example, when the crisis broke out in Thailand, the United States left the job of helping the country largely to the IMF. Even when Indonesia was hit by the crisis, the US response was fairly similar. Only when Korea was hit by the crisis did the United States move decisively in view of the close security ties with Korea. Watching this kind of slow and partial response by the United States, countries like Malaysia decided to solve difficulties entirely on their own in their own way. In short, the ways in which the crisis was addressed by the IMF and the United States did much damage to the sense of unity and solidarity among APEC and PECC economies.

Right or wrong, the policy prescriptions rendered by the IMF and the analyses of the causes of the crisis had enormous impact on the financial reform agenda in East Asia. Many in East Asia believed that if there had been greater financial cooperation among economies in the region, they could have avoided going to the IMF and other international financial institutions whose conditionalities for their loans were, in their view, far too severe and not always appropriate. This led to an emphasis on promoting sub-regional financial cooperation within East Asia. Many were also of the opinion that, especially in today's rapidly globalizing world, East Asian economies could not isolate themselves from the ill effects stemming from the weakness of the global financial architecture. This gave rise to an emphasis on remedying weaknesses in the global financial architecture.

The Work of the Finance Forum

It was against this background that Dr Young assumed his responsibilities as the coordinator of the Finance Forum. He and his colleagues agreed to focus on three areas: (1) strengthening domestic financial systems in emerging markets; (2) promoting regional financial cooperation in East Asia; and (3) improving the international financial architecture. The study on domestic financial systems emphasized the monitoring of progress with reforms with special reference to risk management and corporate governance. The study on regional financial cooperation gave special attention to assessing the steps already taken by governments in East Asia, particularly the Chiang Mai and Asian Bond Market initiatives. The review of the international financial architecture stressed the need to provide the perspectives of the emerging economies.[6]

5 See Hugh Patrick, Chapter 9 of this volume.

6 See Soogil Young (2005: 2).

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Based on the three Finance Forum studies PECC made two principal recommendations for strengthening domestic financial systems and regional financial cooperation. The first was that APEC consider launching a process for the peer review of reform efforts being made by individual governments. PECC itself has already launched its own peer review program on corporate governance reforms. The second was that, in view of the continuing weaknesses in the global financial architecture, APEC should appreciate the importance of supporting the efforts of its Asian members to build a regional financial architecture in their sub-region. This should include a short-term liquidity finance mechanism, an effective regional surveillance mechanism, an exchange rate policy coordination mechanism, and the development of an Asian Bond Market.

Consensus within PECC on the Asian Bond Market is that an Asian Bond Market must be part of the global market rather than a segmented and isolated market. In addition, PECC takes the view that Asian economies must develop domestic markets before the creation of an Asian Bond Market. These views are somewhat at variance with the position taken by ASEAN+3 finance ministers, who want to promote an Asian Bond Market through various credit enhancement schemes even before individual countries involved have sufficiently developed their domestic markets. Nonetheless, these recommendations by PECC reflect the judgment of the Finance Forum that the process of promoting the emergence of an Asian Bond Market not only is difficult and complex, but also involves risks that need to be managed. The foremost among these are risks arising from cross-border capital flows as a result of capital account opening.[7]

PECC's position on the international financial architecture is rather pessimistic. There are currently two views on the subject. On the one hand, there are many who argue that the progress in strengthening the international financial architecture has been slow and far from complete. On the other hand, there are experts who argue to the contrary. In their view, one reason why there is no sign of crisis, despite the existence of all the conditions for a classic emerging market crisis, such as rising US interest rates, rising oil prices, the persistence of US twin deficits and the lingering fear of a hard landing of the Chinese economy, is that the architecture has already been greatly strengthened thanks to many reforms that have been implemented. With regard to these positions, PECC calls attention to the fact that financial reforms in emerging market economies have slowed down considerably, and the efforts addressing the supply side of the international capital markets still leave much to be desired. As a consequence, international capital flows continue to be volatile and small open economies remain vulnerable to financial instability even if they have a reasonably sound domestic financial system and good policies in place.[8]

PECC's position on the current problems of the trans-Pacific imbalance is also worth noting. The trans-Pacific imbalance refers to the growing surpluses on current accounts being accumulated by East Asia on the one hand and

7 For a full exposition on these points, see S. Ghon Rhee (2004: 3).

8 For a full exposition on these points, see PECC (2004: 1–7).

the growing deficits on the current accounts being run by the United States on the other. PECC believes that this imbalance is neither sustainable nor desirable from the global point of view.

Viewed from the East Asian perspective, this imbalance represents a situation somewhat tolerable in the short run, but not in the long run. The growing current account surplus has generated a massive accumulation of foreign exchange reserves. This serves as a safeguard against financial uncertainty for the East Asian economy, but it will soon create intolerable inflationary pressure in these economies. Viewed from the US perspective, the imbalance causes many problems. For one thing, the imbalance will result in growing US debt, much of which is held by East Asia. For another, with growing US debt, US interest rates will have to rise to the detriment of its economic recovery. In short, neither the United States nor East Asia will want to tolerate such a situation for very long. As a remedy, PECC recommends that all APEC governments work together to reduce the imbalance without delay.[9]

In preparing these and other recommendations, Dr Young has done his best to make full use of expertise available not only in the PECC member committees but also in several international financial institutions (IFIs) including the IMF, the World Bank, the Asian Development Bank, the OECD and the Bank for International Settlements. Dr Young also has taken care to collaborate with such organisations as the APEC Business Advisory Council (ABAC) and the Asian Bankers Association (ABA). Since 2002, he has managed to organize three annual conferences jointly with ABAC. He recently launched an Advisory Group on APEC Financial System Capacity Building jointly with ABAC. Last year he held a workshop jointly with the ABA and this year in Seoul he will hold a Forum Session jointly with the ABA.

Dr Young has observed that the PECC Finance Forum "has emerged as a unique network of experts on financial and monetary policy issues in the APEC region" that is driven by East Asian PECC member committees with active contribution by leading experts not only from developed PECC economies but also from major IFIs.[10] As a consequence, Dr Young believes, the forum has been recognized by the APEC Finance Ministers Meeting as a key advisory group. Dr Young also believes that the forum offers long-term and academically disciplined perspectives and constructive criticism that complement the perspectives and approaches of government and business, which are often constrained by the limited time horizon and other practical considerations.[11] There is little question that, in less than four years, the PECC Finance Forum has achieved a great deal not only in terms of policy inputs into the APEC process, but also in terms of the network of experts the forum has been able to build, both in the region and beyond.

Where to Go From Here?

Before concluding this chapter, it is appropriate to make several observations with regard to

9 For a full exposition on these points, see PECC (2004: 7–11).

10 Soogil Young (2005: 8).

11 Ibid (2005: 8).

work the Finance Forum has yet to do. The forum needs to draw in even greater participation from the eastern side of the Pacific. The western side of the Pacific by itself can go far in addressing such issues as capacity building and reforms of financial institutions. However, when it comes to addressing such issues as the trans-Pacific imbalance, we need far greater involvement and participation from the United States in particular.

The second observation is that the Finance Forum must convince both PECC and APEC of the need to address the issues of financial policies as much as issues of trade policies. The failure to give financial issues anywhere near the attention given to trade issues has proved to be a major weakness of the two organisations. This became most clear during the 1997–98 Asian crisis. In all probability, that crisis could have been avoided if there had been intense consultations among APEC finance ministers comparable to the consultations that had occurred among APEC ministers responsible for trade. If there had been more consultation and coordination among APEC finance ministers, the United States might not have vetoed out of hand the initiative taken by Japan in 1997 to develop a complementary Asian Monetary Fund. This imbalance in the attention given to financial and trade issues is not just the fault of PECC or APEC. The imbalance reflects the unwillingness on the part of financial and trade bureaucracies in every capital to work together.[12] Thus, addressing this particular imbalance requires every PECC national committee to work hard first in its national capital.

The third observation has to do with the greater attention we have to pay to the international financial architecture, particularly currency movements and exchange rate instability. The willingness of Japanese investors to invest almost recklessly in East Asian countries in the late 1980s and the early 1990s had a great deal to do with the sharp appreciation of the yen that was then occurring. Similarly, the undisciplined willingness on the part of US investors to rush their money into East Asian economies during the years preceding the Asian financial crisis stemmed in a large measure from the strong US dollar the Clinton administration deliberately promoted. As long as such ill-considered policies are in place, any amount of effort to stabilize cross-border flows of capital will get nowhere.

Last but not least, we should continue to examine the causes of the last Asian financial crisis. Unless we succeed in pinpointing the fundamental cause or causes, our effort to prevent the next crisis will go awry. To this day, there are basically two schools of thought on the causes of the crisis. On the one hand, we have people who believe that the crisis stemmed from structural defects of East Asian economies such as the lack of flexibility in the labor market, the absence of an efficient financial sector, and excessive regulation of economic activities, all of which led to a decline in international competitiveness and profits for both industrial firms and financial institutions. The list does not stop here; it goes on to include a near total absence of supervision of financial institutions by the government, the low degree of transparency in corporate governance, and the absence of effective political leadership.

12 These points are also made by Hugh Patrick in Chapter 9 of this volume.

Some people even mention "Asian values". There is little question that each of these structural deficiencies played a role in bringing out the crisis in Asia. On the other hand, there is a different school of thought, which emphasizes such factors as excess capacity, differential movements of currencies, and wrong sequencing of capital account liberalization.[13] We need to assess, objectively, the relative validity of the two schools as well as the relative weight of all the factors mentioned by both schools before we can effectively prepare against the next crisis. Otherwise, we may fight a wrong financial war at the wrong place, at the wrong time.

13 For a summary of different explanations on the causes of the Asian financial crisis, see Kihwan Kim (1999: 1–3).

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