Policy Prescriptions for East Asia

Masaru Yoshitomi*

At the Asian Development Bank Institute in Tokyo, we recently produced policy recommendations about how to avoid another financial crisis and, if we should have a crisis, how to mitigate that crisis. These policy recommendations were disseminated at the time of the Asian Development Bank's annual meeting in Chiang Mai, Thailand, early this May.

Understanding the nature of crises should provide us with new policy prescriptions. If the International Monetary Fund (IMF) finds evidence of a new type of crisis, I am sure it will develop a new policy prescription. So, the identification of the nature of each crisis becomes very important.

The Capital Account Crisis

We call the East Asian crisis a "capital account crisis," as distinct from the conventional "current account crisis." The conventional current account crisis often is caused by poor macroeconomic fundamentals, according to conventional measures: inflation, a budget deficit, and low domestic savings rates. But in the case of Asia, as you know, such fundamentals were near perfect and yet we faced large current account deficits. However, the current account balance was driven by the capital account, rather than the other way around. Even before the crisis, when capital was flowing in, the current account deficits of East Asian emerging economies tended to widen, because of the absorption effect of the domestic monetary and credit expansion resulting from the massive

*Dean, Asian Development Bank Institute in Tokyo.

capital inflows. It is so clear now, after the crisis, that when the capital flows reversed, then the current account had to change from deficit to surplus quickly.

A major feature of the capital account crisis is, first of all, massive capital inflows, dominated by short-term loans and followed by a sudden reversal of such capital flows. And, in a sense, we can say that the “secret corrupter” in the 1990s, in most of those Asian economies, was the use of short-term, foreign-currency-denominated loans as a source of financing, which resulted in both a maturity mismatch and a currency mismatch. This had an enormously large balance sheet effect, as compared with the case of a conventional current account crisis. Therefore, an exchange rate depreciation did not help the Asian economies, but only worsened the balance sheet. The nature of the crisis required quite different policy prescriptions.

Foreign Exchange Rates and Capital Markets

So, what sort of policy recommendations do we make? First of all, we focus upon two features of this capital account crisis: the massive capital inflows and then the sudden reversals. What would be the appropriate foreign exchange rate regime? A fixed regime is considered unworkable in this dysfunctional and globalized financial market, yet at the same time we cannot advocate drastic solutions. Hong Kong has a currency board, but Hong Kong is an exception in Asia. In the case of the currency board in Argentina, the national currency first experienced the loss of a domestic anchor, that is, Argentina experienced high inflation at home. Therefore, the currency board provides the country with an international anchor for fighting its domestic inflation. There was not a similar need in other Asian economies because, as I said, conventional macroeconomic fundamentals remained quite excellent.

On the other hand, the free-floating exchange rate regime, exercised by advanced economies, may not fit the emerging economies well. Short-term volatility of the exchange rate tends to cause very high volatility in domestic assets as well. Therefore, under capital account convertibility, residents tend to make investments abroad, where they can find stable, less volatile financial assets. So, when talking about the developmental issues of an emerging economy, short-run volatility of the exchange rate and, hence, volatility in domestic markets make it difficult for emerging economies to establish and promote a strong and sound capital market.

By the way, when we say capital market, the bond market and the equity market are two totally different animals. In the Asian economies, because of the good macroeconomic performance, there have been no budget deficits and hence no need to issue government bonds. Only over the past few years have we been talking about how to establish a yardstick for the yield curve by issuing national bonds; the maturity of a national bond in East Asia now is less than five years. We are just starting in the government bond market. The corporate bond market is even more difficult to establish. Even in the United States, 94 percent of the outstanding corporate bonds are traded only once a year. So liquidity tends to be very shallow, even in the U.S. markets. No wonder emerging economies have such shallow corporate bond markets.

At any rate, because of the double mismatch of currency and maturity, the balance sheet factor worsens the crisis. Then, how to establish a sound capital market? A floating exchange rate regime may not promote a sound capital market. Also, over the medium run, a capital market's soundness will depend upon the extent to which capital flows are endogenously or exogenously determined, in emerging economies. If capital persistently flows into the emerging economies, it is possible that the exchange rate will become misaligned over the medium run, resulting in misallocation of domestic resources between tradables and nontradables, as happened in many countries. For those reasons, we propose an exchange rate policy that lies between the currency board and the pure floating regime.

I should stress that this in-between exchange rate regime is going to work alone, but that our recommendations should be taken as a comprehensive policy package. So we also suggest that, if necessary, Chilean-type capital controls over short-term loans and short-term flows also be introduced. Many researchers suggest that the composition of capital flows could be influenced by such Chilean capital controls, but this would not necessarily influence total volume of capital inflows.The composition could be changed toward longer maturities, which certainly would help to at least mitigate a crisis caused by massive short-term capital inflow.

Maturity Mismatch

The third policy recommendation concerns how to mitigate the maturity mismatch. The currency mismatch, that is, the exposure of domestic intermediaries to foreign-currency-denominated liabilities, was not their only problem. In many cases, their excessive lending to the real estate sector using short-term lending was an important cause of the crises, too. So, a cap on lending to such areas should be introduced to avoid serious maturity mismatch. Many people, even Asian economists, are saying that banks are no longer functional because of the overreliance on short-term borrowing to finance long-term projects of investment and, therefore, capital markets should be utilized more. But these markets are not there yet in emerging countries, as I have said. A sound and deep capital market is very difficult to establish, in the short term.

Corporate Governance

We also need to consider corporate governance. When talking about corporate governance in Asia after the crisis, in particular bank-based corporate governance, one should note that the banks in Asia are very different from the banks in Germany or even banks in Japan. And we should talk not about the governance of corporations featured by dispersed ownership in Asia, but instead about the corporate governance of family businesses, featured by concentrated ownership. Also, the powers of banks in Asia are very different from those in Japan or Germany. Most of the banks in the Asian economies are located in a lower position in the control chain of the overall industrial organization, whereas they are in a higher position in Japan and Germany. Therefore, when we address the issues of how prudential regulation and the strengthening of the banking system would improve these economies, we should not forget the feature of family businesses. Given these considerations, we did reach the conclusion that banks should be strengthened.

Currency Restrictions

On the sudden reversal of capital flows, we have another set of recommendations. One is related to the currency attack on the Malaysian ringgit in the first half of 1998, which resulted in the introduction of capital controls by Malaysian authorities on September first of that year. It was interesting to observe that such a currency attack took place a year after the Thai crisis in July 1997. We wondered whether such different timing of the crisis might reflect the different nature of the crisis from those in Thailand, Korea, and Indonesia. In the Malaysian case, nonresidents accumulated Malaysian ringgits in the Singapore offshore market, resulting in a very high interest rate on the ringgit in that offshore market, about 35 percent from April to July. This compared to about 12 percent or so on the onshore home market in Malaysia. This was a pure currency attack on the Malaysian ringgit through selling the accumulated Malaysian currency by nonresidents in the offshore market. Therefore, why not restrict the nonresident holdings of domestic currencies of emerging economies? Exactly that has been done by the Singapore authorities over the past three decades, in sharp contrast to the fact that Singapore has liberalized capital account convertibility. This restriction is one of the policy recommendations regarding reversal of foreign capital flows.

Lender of Last Resort

The last policy recommendation concerning sudden reversals of capital flows relates to the international and/or regional lender of last resort and the international liquidity crisis as an important aspect of capital account crisis. To take care of large currency depreciations, which tend to aggravate the problems associated with the aforementioned balance sheet mismatch, we may need an international and/or regional lender of last resort. If the IMF is ready to provide a timely and massive amount of international liquidity to economies undergoing a capital account crisis, as in the case of the East Asian economies, then we welcome such provision of international liquidity. If the IMF is not ready for that, then an Asian monetary fund-type of arrangement should be established to supplement the activity of the IMF.

I have been discussing all these policy recommendations with various financial ministers in Asia. However, we have to admit that we might be fighting the old war instead of discussing how to avoid a new crisis. My major concern today is what we should do in Asia if the U.S. stock market crashes. The nature of the next crisis may be very different, we may need a very different policy prescription in Asia. The U.S. stock market is one of the major concerns Asian policymakers now have in mind.