INTRODUCTION: THE EVOLUTION OF EAST ASIA'S FINANCIAL SYSTEMS

Seiichi Masuyama
Nomura Research Institute, Tokyo

Similarities in Development Patterns. Financial systems in East Asia typically used such tools of financial repression as interest rate controls and obligatory lending to policy-preferred sectors and projects in the early stage of economic development. Under financial repression, informal financial sectors tended to develop to complement the inflexibility of the formal sectors. These financial systems, with gradual modification, comprised the economies that achieved the East Asian development 'miracle.' Their adverse consequences, such as misallocation of resources and vulnerability of financial institutions, began to explode as the repression was wound down.

Banking dominates the financial systems in the region, although direct finance through money and capital markets has recently begun to develop. Information asymmetry between lenders and borrowers explains banks' dominance in the early stage of financial development. However, bank dominance has not diminished even more mature economies, such as Japan and Korea, due to excessive regulation to maintain government control and to protect vested interests.

East Asian financial systems enjoyed generally high saving rates, which were bolstered by rapid income growth. Pragmatic policies to maintain positive interest rates also contributed to financial deepening in many East Asian economies even under financial repression. Some countries used compulsory savings strategically to promote financial sector development. Financial liberalization sometimes stimulated by outside pressure and accompanied by foreign exchange liberalization, accelerated since the 1980s. Lifting foreign exchange controls linked domestic financial systems to foreign savings and accelerated capital inflows.

Capital flows into East Asia, particularly Southeast Asia, were biased to foreign direct investment, which favors investment and economic growth because of the accompanying transfer of technology and management skills. However, in recent years, financial and capital liberalization shifted the composition of capital inflows more towards short-term capital and portfolio investment. Liberalization and the existence of two financial centers (Hong Kong and Singapore) facilitated the regional integration of financial systems. The two traditional regional financial centers and new offshore centers in Thailand and Malaysia also facilitated the inflow of short-tern capital and portfolio investment. Prudential regulation and the supervision of financial institutions lagged behind financial liberalization and was insufficient to prevent the recent financial crisis.

Shortcomings. Financial systems in East Asia tend to suffer from weak governance. Lack of discipline in resolving past financial crises and preferential lending generated a moral hazard problem. Corruption among supervisors has been serious, perhaps because the prevailing business culture emphasizes *guanxi* (relationship). Transparency has been lacking. The underdevelopment of equity and bond markets has prevented generating useful financial information from governments and corporations. The lack of long-term finance facilities has led to term mismatches in the balance sheets of financial institutions and corporations. Poor sequencing of liberalization heightened the vulnerability of financial systems. Financial and foreign exchange liberalization was often undertaken before addressing domestic financial problems such as poor governance, bad debt, and lack of competition. In particular, short-term capital movement was liberalized prematurely.

The Currency Crisis and Financial Systems. A regional financial crisis developed since the middle of 1997 as currencies plunged precipitously one after another in response to sudden capital outflows and financial instability spread. Thus, this is not a typical currency crisis brought on by current account imbalance, but an *asset crisis* centered on foreign exchange.[i] During the 1990s several East Asian countries enjoyed asset price booms in property and stock markets. These countries had currencies pegged closely to the U.S. dollar and vulnerable financial systems. As they liberalized exchange controls and financial sectors, they experienced excessive inflows of foreign capital prompted by expectation of limited exchange risk. Poorly supervised financial and non-financial institutions became over-exposed to foreign currency-denominated debt and to debt repayment risk due to foreign exchange fluctuations. Inefficient financial systems allocated capital inflows to such unproductive sectors as real estate and durable consumer goods, inviting economic bubbles. The end of the boom coupled with the sudden reversal of capital flows and the resultant plunge in currencies caused a steep decline of asset prices and a sharp increase in foreign currency obligations of domestic corporations and financial institutions, damaged the financial system, and ignited a cross-border chain reaction.

Herd behavior of international portfolio managers and inadequate supervision of financial institutions in advanced countries contributed to the spread of the crisis. But each country's susceptibility to the contagion depended on its economic fundamentals and financial system, on its foreign exchange convertibility, and on the flexibility of its exchange rate, monetary policy, and factor markets.

IMF rescue programs for Thailand, Indonesia, and Korea will affect their financial systems directly by forcing reforms to resolve bad debt problems, restructure the financial sector, and improve transparency, and indirectly by affecting underlying economic policy. However, there is growing suspicion that the program's mixture of short-term demand control (the traditional remedy for balance of payments crises, not asset price crises) and long-term structural reforms may have aggravated already severe deflationary conditions. It may also have created a moral hazard problem for financial institutions in advanced countries. These issues are behind a growing call for reform of the international financial architecture.

Agenda for Future Development. Resolving non-performing loan problems is the top short-term priority for reform of East Asian financial systems and it is the precondition for their long-term development. Japan has a serious bad-debt problem, as do most East Asian economies as a result of the currency crisis. China's transition to a market economy is creating a bad-debt problem among state-owned banks there. The solution is to create a credible financial system by separating failing financial institutions and non-performing loans from the healthy part. Public funds, in some cases from the IMF, may be needed to protect individual investors and maintain liquidity during restructuring. These painful operations require overcoming the resistance of vested interests and garnering political support.

The current crisis highlighted the importance of strong governance and of properly sequencing liberalization. Prudential regulation and supervision of financial institutions should be strengthened and competition should be enhanced by lowering entry barriers, at least domestically and probably also internationally, to prepare for financial and foreign exchange liberalization. Protected institutions lack the culture to pursue technological innovation and their managers lack skills needed in a competitive environment. Prudential control is enhanced by allowing regulatory institutions greater independence and by integrating informal sectors into the formal sector

Expanding securities markets is a necessary step to overcome the inflexibility and term-mismatch problems of financial systems dominated by banks and to increase the supply of financial information. A growing equity market could absorb the privatization of East Asia's state-owned enterprises, particularly in China's transitional economy. Bond markets are needed to mobilize domestic savings for infrastructure development without over-dependence on foreign funds; to provide vehicles for investing the growing pools of funds from mandatory saving systems; and to adjust demand and supply imbalances in individual markets.

While adequate attention should be paid to avoiding financial instability as a result of financial and capital liberalization, prolonging the process of financial liberalization also creates a financial system with undesirable characteristics, as evidenced by the experience of Japan.

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[i] See Manuel F. Montes. Banking on Contagion: The Southeast Asian Currency Crisis. In *Coping with Capital Flows in East Asia*, ed. C.H. Kwan, D. Vandenbrink, and S.Y. Chia, NRI and ISEAS. 1998.