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Building Strong Banks and Bond Markets in the ASEAN+3 Countries

Anwar Nasution[1]

1. Introduction

The recent sub-prime mortgage crisis originated in the United States that has caused global economic recession has steeply contracted both the exports and imports of the export-oriented ASEAN+3 economies[2] and slowed down their economic growth. Global demand contraction has also caused the collapse of intra-Asian manufacturing trade. This is because the demand for imported intermediate goods is derived from demand for final goods in export markets. At present, this region has neither sufficiently robust domestic demand, nor large-intra-regional trade to offset the falling exports to the US and Europe, the principal export destinations of this region.

The financial systems of the ASEAN+3 economies have not been greatly affected by the recent global financial crisis. This is because of a combination of substantial build up of domestic savings and liquidity in their banking systems, a lack of significant investments in the US sub-prime mortgages and the underdeveloped state of local bond and securities markets. Thanks to massive injections of sovereign bonds, banks are now better capitalized. There have also been improvements in banking supervision. Equipped with huge amounts of foreign exchange reserves, the ASEAN+3 countries can shield themselves from speculative attacks. Extra financing is provided through bilateral currency-swap facilities, both from the US Federal Reserve Bank and under the Chiang Mai Initiative (CMI). Domestic liquidity is provided though reducing the minimum reserve requirement ratio and provision of emergency credit lines for viable systemic banks. Non-viable and non-systemic ones are allowed to go bankrupt. Japan continues to apply the quantitative easing that has been in place since the 1990s. As in many other countries, the capital markets in this region have been stabilized, partly by banning the short selling of equity shares of financial institutions.

Meanwhile, the distorted economic policies of the past have been corrected following the Asian financial crisis in 1997. An explicit inflation target, a more flexible exchange-rate policy and a stable government debt to GDP ratio are now the three main pillars of macroeconomic stabilization frameworks in many of the ASEAN+3 countries. Because of these policies, there were no deep exchange rate devaluations and no steep rises in interest rates that would have caused devastating impacts on the balance sheets of banks and non-financial firms, particularly those with large foreign currency debts, unlike what happened in the crisis-hit countries in 1997.

In terms of assets and branch networks, the banking industry at present remains at the core of the financial systems in the ASEAN+3 countries. The financial systems in this region are in the process of transition from the previous policies of repression to a market based environment. They are moving in the direction of long-term financing from non-bank financial institutions, rather than heavy dependence on short-term financing from the banking

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[1] Professor Dr. Anwar Nasution teaches economics at the University of Indonesia. His e-mail addresses are: nasution_a42@yahoo.com and anwar_n42@pacific.net.id.

[2] The ASEAN+3 countries comprise the 10 members of the Association of South East Asian Nations (ASEAN) plus the People's Republic of China, Japan and the Republic of Korea. ASEAN is made up of Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.

industry. The region's banking systems are still weak and inefficient because large portions of their portfolios consist of paper issued by the public sector, including both governments and central banks. Moving forward, building strong and efficient banking systems with deep liquidity, and developing efficient domestic securities and bond markets that are consistent with global supervisory and regulatory frameworks are the keys to sustainable growth in Asia. This will require major changes in economic policies, the corporatization and privatization of state-owned enterprises, overhauling of private business structures and the upgrading of regulatory and supervisory frameworks.

I concur with the proposal made by Eichengreen (2004) to enlarge the coverage of financial cooperation in this region to include financial policy, particularly as regards the banking system. Such regional financial cooperation would have four purposes. First, to continue the ongoing program of developing and modernizing financial systems, such as developing the bond and securitization markets. Second, to share experiences during the transitional adjustment from the financial repression of the past to market-based systems. This would include issues such as how to deal with state-owned enterprises, and the program-based and related lending of the private banks. Third, to share experiences on how to fix the fundamental causes of the financial crisis in 1997, such as supervisory failures and excessive risk-taking by banks and their corporate clients. Fourth, to adopt common stands on various issues involving the international financial architecture.

The rest of this paper is organized as follows. The next section presents the stylized facts of the ASEAN+3's export-oriented economic strategy and financial systems: mixed economic system, long history of financial repression, leading role of banking industry, dominant role of public sector banks (PSB), weak corporate structure, weak market infrastructure, deposit insurance scheme. Section 3 briefly discusses macroeconomic stabilization and adjustment policies under the IMF programs after the financial crisis of 1997-98. Section 4 describes policies to develop the local bond and securitization markets. Section 5 presents proposals for regional cooperation in the financial sector.

2. Unique ASEAN+3 Developmental Experiences

The ASEAN+3 region is unique because the countries of the region shared the same experience of an export-led development strategy to become a shining light of economic growth since the 1960s. The outward-oriented development strategy of this region has been supported by distorted industrial policies. For a long period in the past, the region's nations repressed their financial systems through directly allocated bank credits, while setting ceilings on both deposit and lending rates, with government taking over credit risks. Moreover, this region adopted a relative fixed exchange rate system to encourage overseas borrowings and protect domestic markets from import competition, and to promote exports. This, however, discouraged the reallocation of resources in the domestic economy from the relatively low productivity non-traded sector of the economy to the more productive traded sector. The outward looking export strategy was also supported by distorted foreign and domestic trade regimes, favorable tax incentives and monopolistic licensing systems, particularly as regards the exploitation of natural resources. Domestic markets were highly protected from imports through either high tariffs or non-tariff barriers. Various forms of fiscal incentives were made available to encourage new investment and exports.

The distorted credit, trade, tax and licensing systems gave rise to rent-seeking activities that encouraged collusion, nepotism and corruption. Such policies were used to nurture the emergence of large, politically well-connected business groups, conglomerates or chaebols that controlled many companies operating in a wide variety of economic sectors. In addition to public sector banks and foreign banks, there were also private banks controlled by industrial groups in many ASEAN+3 countries. The banks and non-bank corporates with industrial groups were closely interlocked, not only because of cross-ownership but also cross-management.

2.1 Mixed economic system

At present, the economies of many ASEAN+3 countries are mixed economies rather than fully fledged market-based economies. Government plays an important role in these economies, either as a regulator or as a direct player through vast networks of state-owned enterprises (SOEs). The roles of the SOEs are still dominants not only in the socialist countries such as the PRC, Vietnam, Cambodia and Laos, but also in Indonesia and Singapore. The operations of SOEs in many countries, except in Singapore, are tightly controlled by the state and they operate like arms-length extensions of the government bureaucracy. In the past, nearly all the ASEAN+3 countries applied industrial policies and export-led development strategies.

Both central and local governments in many ASEAN+3 countries own a wide range of public companies covering many sectors of the economy, including banks. The PSBs, both owned by the central and provincial governments, have a monopoly on taking deposits of government institutions/agencies and state-owned enterprises. There is also a general perception that deposits at PSBs are implicitly guaranteed by the government. When facing financial difficulties, the PSBs will at least receive more deposits from state agencies and state-owned enterprises. But, on the other hand, they are required to administer government-directed lending programs and extend loans at subsidized interest rates under credit-granting policies that are not suitable for underwriting commercial loans. The state-owned banks operate as arms-length extensions of government, and the disequilibrium they cause in the financial markets encourages rent-seeking. These regulatory distortions create both segmentation in the funding market in favor of PSBs at the expense of the private-sector banks, with different standards being applied to private-sector banks.

2.2 Leading role of banking industry

Table 1 shows that the banking industries in the major ASEAN+3 countries are at the core of financial systems in this region. Except in Hong Kong and Japan, the role of non-bank financial institutions (NBFI) is relatively small as insurance companies and pension funds are still underdeveloped. Because of the availability of cheap and low-risk credit from the banks under the past policy of financial repression, there was no incentive for economic agents to raise funds from the stock and bond markets. Market capitalizations are particularly high in Hong Kong and Singapore, the main financial centers of the region. During the Cold War, it was relatively easy for the government to finance its budget deficit from highly politicized foreign aid.

In terms of assets and branch networks, PSBs play a prominent role in the banking systems of most of ASEAN+3 countries. The role of state-owned banks is dominant in some countries such as China, Indonesia and Vietnam. Both central governments and provincial governments have their own deposit-taking banks and many lower layers of government own rural credit institutions that compete with money lenders. At present, the systems have been recapitalized and restructured following the crisis in 1997. To strengthen their capital bases, which were sharply eroded by the crisis, the authorities have injected a massive amount of recapitalization bonds. Meanwhile, their non-performing loans (NPL) were transferred to other agencies. Their number has been reduced because of consolidation. Changes in the culture of PSBs has been encouraged through the promotion of a more competitive credit market and partial privatization.

Table 1. Size and Composition of Financial System (% of GDP)

Country	Financial Sector Assets[1]				Market Capitalization[2]		Total Bonds Outstanding	
	Deposit-taking Financial Institutions		Non-bank Financial Institutions					
	2000	2008	2000	2008	2000	2008	2000	2008
China	168.8	204.5	8.8	33.9	27.1	32.3	16.9	50.3
Hong Kong	505.5	640.7	196.4	573.8	363.9	610.9	35.8	42.9
India[3]	61.6	91.6	15.4	32.8	33.3	59.7	24.6	35.3
Indonesia	63.6	48.6	8.8	13.7	18.7	21.7	31.9	13.4
Korea	147.9	192.7	44.1	62.6	31.2	56.3	66.5	86.2
Malaysia	154.2	190.3	16.5	20.2	124.7	89.6	74.8	73.5
Philippines	99.2	78.8	22.4	18.5	76.8	54.3	27.6	33.7
Singapore	683.8	707.9	39.1	47.1	243.7	148.0	48.0	70.8
Taipei, China	259.9	289.6	29.8	80.6	81.7	94.7	7.7	7.7
Thailand	132.3	137.7	10.7	33.0	26.0	39.2	25.3	51.6
Average[4]	227.7	258.2	39.2	91.6	102.7	120.7	35.9	46.5
Median	151.1	191.5	19.5	33.4	55.1	58.0	29.8	46.6
Eurozone	230.0	315.8	142.1	169.3	-	-	124.2	69.4
Japan	227.5	230.9	118.5	132.1	71.7	55.8	97.4	193.4
United States	78.3	104.8	283.2	306.1	117.5	64.6	41.8	55.3

Notes:

1. Financial asset data for People's Rep of China (PRC) for 2002 and 2007; Hong Kong, China, for 2000 and 2007; Indonesia for 2001 and 2007; Malaysia for 2000 and 2007; and Japan for 2001 and 2004.
2. Market capitalization as percentage of gross domestic product (GDP) in local currency.
3. Financial sector assets data for India in 2000 refers to FY ending March 2000; and for 2008 ending March 2008.
4. Simple average

Source:
Chee Sung Lee and Cyn-Young Park. 2009. Beyond the Crisis: Financial Regulatory Reform in Emerging Asia. ADB Working Paper Series on Regional Economic Integration No.34. September, Table1 Page 12.

The Chinese banking system consists of 4 state-owned commercial banks, 11 joint stock commercial banks (JSCB), 3 policy banks to finance government policies, about 100 city-owned commercial banks and hundreds of rural credit cooperatives closely linked to the state financial system. The state-owned banks of China control over half of the banking industry's assets, the JSCB nearly 15 percent, the city banks 5 percent and the rural cooperatives and foreign banks the other 26 percent. The state-controlled banks in Indonesia (comprising 5 state banks and 26 regional development banks owned by 33 provinces) controlled about forty-two percent of both the deposit and credit markets in 2008. After the Asian financial crisis of 1997, state-owned banks, such as those in Indonesia, were consolidated and privatized. However, the government retains ‘golden shares’ to maintain control over these privatized institutions.

All domestic privately owned banks in many ASEAN+3 countries in the past belonged to politically well connected business groups. These groups usually started their businesses in the non-financial sector. Thanks to privileges from the state, including exchange rate power, access to cheap financing at low risk from state banks, and foreign borrowing, these privileged business groups rapidly expanded to become giant conglomerates, or chaebols in the case of Korea. The business lines of these huge conglomerates included banking and other financial services. Like the universal banks in Germany and Japan, private banks in Indonesia were not only engaged in retail and wholesale commercial and investment banking, but in addition held equity in commercial entities, to which they also extended loans. As in Germany and Japan, the privately owned banks in Indonesia had close relationships with affiliated commercial concerns, as characterized by cross-shareholding and shared directorships.

Healthier market competition from foreign banks only increased after the Asian financial crisis. After gaining greater branching power, foreign institutions are now legally allowed to penetrate domestic markets. Foreign banks also entered the domestic markets of ASEAN+3 by acquiring domestic banks through privatization, and mergers and acquisitions. Following rulings by the WTO on the financial services industry, foreigners can now control nearly one hundred percent of the equity shares of domestic banks in many ASEAN+3 countries. At present, foreign banks and joint venture banks account for less than two percent of the assets of the banking industry in China, and control 12 percent of bank deposits and over 14 percent of commercial lending in Indonesia. Foreign banks bring in more advanced technology in terms of credit operations and risk evaluations, which help reduce bank spreads and improve efficiency and soundness. Meanwhile, distorted access to foreign borrowing has been rationalized by linking it to bank capitalization. Implicit subsidies on foreign borrowing were removed with the shift from fixed to flexible systems of exchange-rate management.

2.3 Long history of financial repression

The ASEAN+3 countries have had a long history of financial repression as it was one of the key policy instruments of their industrialization policies and export-led development strategies. In the past, governments applied selective credit policies and subsidized interest rates. The savings rate was lower than it should have been as governments set nominal interest rates lower than inflation rates, and allocations of total savings was inefficient. As the allocation of financial resources was based on non-market and non-economic considerations, there was no incentive to improve information systems, including accounting systems and disclosure and transparency requirements. Corporate culture and the quality of bank supervision sharply eroded as the system encouraged rent-seeking that eventually affected all segments of the economy.

One can argue that against a background of weak market infrastructure, related lending to affiliated companies helps improve credit efficiency as bankers have more information on affiliates compared with non-affiliates. Banks can also use internal information to assess the ex-ante risks of investment projects or persuade the borrowers to abandon risky projects. As shown by the Asian experiences during the financial crisis of 1997, related lending is prone to insider trading and principal-agency problems. The recent Bank Century scandal in Indonesia indicates that the bank lent money under favorable terms to affiliated companied controlled by the bank's principal owners and family members. These companies were shells that siphoned cash to the personal offshore accounts of the owners. Their related lending to affiliated companies was also used to loot the deposit insurance fund.

The Asian financial crisis in 1997-98 showed that credit risks had accumulated both in the heavily regulated banking industry and in unregulated affiliated firms in the financial and non-financial industries. The crisis came about because of a combination of a general lack of disclosure and violations of legal lending limits to affiliates, shareholders and managers. In addition, violating the regulations on net open positions, banks and non-bank corporations borrowed heavily in the short-term from the international markets, with loans denominated in foreign currencies, to finance long-term loans denominated in rupiah, mainly to their affiliates. Part of the external borrowings was used to finance long-term investment projects in the non-traded sector of the economy, such as real estate. Such practices resulted in maturity and currency mismatches. The experiences gained from the 1997 crisis indicate that the poor quality of bank assets was partly due to conflicts of interest between different businesses within the same conglomerates. As a result of this situation, banks tended to evaluate loan applications from affiliates less rigorously than would have been the case with unaffiliated firms. These practices gave rise to principal-agency and insider trading problems.

Responsibility for risk was assumed by the government under the financial repression policy of the past. As a result, there was no incentive for bank managers to monitor and manage risks, to upgrade transparency in corporate reporting or to provide economically relevant information. The required information includes disclosure of asset quality to assess financial positions of borrowers and therefore the loan portfolios of banks. As credits were allocated based on non-economic considerations, the supervisors classified loans based on repayment of the credit rather than on the creditworthiness of borrowers or the market value of the collateral they pledged. Such inefficient allocation of financial resources resulted in poor asset quality and a high level of non-performing loans. Without reliable up-to-date and comprehensive information, the markets cannot work effectively and efficiently.

2.4 Weak market infrastructure and heavy reliance on recapitalization bonds

In general, the basic ingredients of market infrastructure are still in the making in many emerging ASEAN+3 countries, including (i) protection of property rights at least cost, and (ii) the availability of high-quality information to minimize market asymmetries. The legal system continues to be underdeveloped as regards the proper application of the laws and regulations, enforcement of contracts, and the sanctioning of defaulting borrowers. At present, the bankruptcy process in many ASEAN+3 takes too long and creditors are hardly ever properly compensated. Creditors' agreements are rigid and inflexible and the judicial system does not support informal means of recovery. As a result, it is still impossible to mitigate banking risks as it is difficult to enforce the seizure of the collateral pledged by defaulters to preserve value and provide a fast reallocation of resources in the economy.

The core capital of the recapitalized banks in a country such as Indonesia mainly consists of recapitalized bonds, some of them non-traded papers. Government is regarded as a default-free institution as it has the monopoly power to print money and collect taxes. Because of this, sovereign bonds are classified in the Basel I framework as zero-risk assets in the Tier 2 capital category. At the same time, the recapitalized bonds generate significant portions of bank income. The central banks of Malaysia, Indonesia, Taiwan, China, Thailand and Korea issue interest bearing short-term papers to mop up excess liquidity of the banking system. These central bank interest bearing papers are competing with short-term Treasury bills and sovereign bonds. While banks may profit from investing in risk-free government and central bank papers, important challenges remain because of the inefficiency and imperfections that still persist, as evidenced by large bank spreads (between borrowing and lending rates) and low credit volumes made available to the private sector. The high level of bank spreads is partly due to the inefficiency of bankruptcy procedures in ensuring recovery of pledged collateral.

2.5 Double standards of bank regulation and supervision (?)

During the course of the IMF programs in the late 1990s and early 2000s, the financial and banking sector regulatory and supervisory systems in crisis-hit emerging ASEAN+3 countries were overhauled to bring them more into line with the Basel Core Principles and Recommendations. The adoption of the Basel II framework based on the principles of risk-focused supervision is highly relevant to the emerging economies of ASEAN+3 so as to prevent crises and avoid wasting resources, cost overruns and excessive spending on their development efforts. Because of their unique corporate structure, history and culture, the application of that market-based supervisory framework by the ASEAN+3 countries will take considerable time and require major structural policy reforms. As pointed out by Calomiris (2007), financial policy reforms will include overhauling the legal structure as it affects financial intermediaries, the rules governing firms' access to public market funds, the rules governing international capital flows, and foreign exchange systems. Corporatization and/or privatization of SOEs and the elimination of distorted policies and their replacement with effective and efficient market institutions are part of the structural reforms that will be needed to improve the efficiency of resource allocation and raise the productive capacity of the economy.

In addition to regular periodic supervision, in-site supervision has also been instituted by the IMF programs so as to ensure tighter oversight of problem banks. Supervisory officers, however, have received little training in the field of credit analysis and risk management in banking sector organizations. The risks specific to the banking industry are divided into eight categories, namely: capital or gearing risks, credit risks, counterparty risks, liquidity or funding risks, market or price risks (which include currency and interest rate risks), operational risks, and sovereign and political risks. As shown by the recent case of Bank Century, a tiny bank in Indonesia, long standing bad habits have proven difficult to erase. Banking supervisors continue to be unable to detect violations of prudential rules and regulations, and to be disinclined to take prompt corrective action. Bank Century collapsed due to a long history of arms-length transactions between the bank and its affiliates, violation of the legal lending limits, outright theft by the controlling shareholders, and fictitious transfers and transactions. Two of the principal shareholders of Bank Century are foreigners with bad track records. As a result, relevant, accurate, comprehensive and timely information is frequently unavailable. Despite repeated warnings from field supervisors, no firm corrective measures were taken by Bank Indonesia.

Transparency and accountability are not sufficient on their own to establish public trust. Beside suffering from inadequate technical knowledge and funding, personal integrity in the banking supervisory system is also lacking in many countries with the result that the prevailing laws and regulations are frequently not enforced. It is the banking supervisors who are responsible for the application of the laws, rules, regulations, concepts, structures, procedures and best practices. The inherent weaknesses in the regulatory and supervisory system afford little incentive to banks to provide key relevant information or to adhere strictly to prudential rules and regulations. The personal integrity of bank regulators and supervisors is also important as they are the enforcers of the laws and regulations. Court cases in 2008-2009 showed that senior officials of Bank Indonesia deliberately manipulated book records of the central bank and its training foundation and violated both the know-your-customer and money-laundering regulations to raise money for unspecified uses. The obscure KONSTAN news magazine devoted its February 2008 issue (Vol. III/Edisi 60) to publishing classified internal memoranda and minutes of meetings of the Board of Governors of Bank Indonesia on this scandal. The personal integrity of bank regulators and supervisors has again been called into question over the handling of the politically well-connected Bank Century. The decision to take over the tiny bank was made in September 2008 only a few days after the G-20 Summit Meeting in Pittsburgh called for the upholding of integrity by banks and their supervisors.

The focus of bank supervision today is totally different from the financial repression of the past. At that time the focus was on the delivery of credits according to the intended purposes as set in the selective credit program. Credit analysis and risk management was not important as the risk was assumed by the government. Under the market-based system of today, credit analysis and risk management are the main focus of bank supervision. This requires supervisory officers with adequate training in these fields.

The Basel Core Principles are intended to apply to all commercial banks regardless of ownership. In reality, however, this is not the case. Because of their government affiliation and susceptibility to political pressures, Public Sector Banks (PSB) may not be subjected to market discipline and compliance with prudential rules and regulations. This is because their missions, restrictions and operational modalities are not clear cut. In reality, regional development banks in Indonesia are operating as fiscal agents of their owners, namely, local governments. They are required to administer government-directed lending programs and make loans according to government criteria that may not be suitable for underwriting commercial loans. Moreover, the CEOs and senior managers of PSBs are often selected by ministries from among civil servants who do not have adequate technical knowledge of banking.

As mentioned earlier, the deposits held by state-owned banks are perceived as being implicitly guaranteed by the government. This creates segmentation in the funding markets, which in turn allows the PSBs to gain market share and profits. Part of this profit is then used to subsidize program lending. The unequal treatment between the deposits held by PSBs and those held by private banks results in prudential standards differing as between the two categories of bank ownership.

In some cases, the PSBs have been used to acquire failed institutions. Acquisitions that do not meet the Basel Core Principles only transfer the problems from the failed institutions to healthy ones.

Modeled after the FSA (Financial Services Authority) of the United Kingdom, Japan and China, Korea has established a separate and centralized financial regulator and supervisor for all financial institutions under one umbrella. The independent Chinese version of the FSA, called the Bank Regulatory Commission (CBRC), was established in April 2003 following China’s admission to the WTO. The Bank Indonesia Law of 2004 envisaged the establishment of such an institution by not later than 2010. Some argue that transferring such powers from the central bank — while maintaining its role as the lender of last resort— will reduce the ability of the monetary authority to oversee financial vulnerability in specific institutions and systemic risks that threaten the entire system. The key is proper coordination and exchange of information between the FSA and the central bank. Due to a shortage of experts and inadequate funding, some of the emerging economies of ASEAN+3 cannot afford the luxury of an overlapping and fragmented regulatory system involving various central and local institutions, such as is the case in the United States. In Singapore, the Monetary Authority of Singapore supervises all financial institutions operating in that country.

2. 5 Deposit insurance

To protect depositors, the ASEAN+3 countries have introduced deposit insurance companies to replace the blanket guarantees introduced during the crisis in 1997. This was followed by the establishment of financial stability forums (FSF) to handle distressed banks and other financial institutions. These FSFs are chaired either by the Minister of Finance or the Head of Government. In many countries, such as Indonesia, these institutions still lack the necessary procedures and early warning systems needed to respond to problematic financial institutions. As shown by the current Bank Century debacle, both the central bank and deposit insurance company relied solely on stress tests based on incomplete and outdated data, and unrealistic scenarios. Neither the deposit insurance company nor FSF has direct access to the computer systems of insured banks or the detailed structures of their deposits (Nasution, 2009). So, if something goes wrong, they cannot act rapidly in transferring insured deposits to bridge banks or to other institutions. As mentioned earlier, through related lending to their affiliated companies, bank owners can easily loot deposit insurance funds.

3. Macroeconomic Policies

Under the IMF programs following the Asian financial crisis in 1997, the crisis-hit countries have corrected the distorted policies that they previously applied. The IMF programs typically consisted of a short-run economic stabilization plan and longer term structural adjustment program. The objective of medium- and long-term adjustment programs was to improve the efficiency of resource use and thereby increase the productive capacity of the economy. The IMF structural adjustment programs following the Asian financial crisis in 1997 were aimed at removing distorted policy instruments that had been used to pursue government industrial policies, nurturing a handful of politically well-connected business groups and export-led development strategy. The structural adjustment policies included the elimination of rent-seeking activities, undervalued exchange rates, and financial repression, bank and corporate restructuring, the removal of distorted licensing systems and trade policy regimes, and encouraging transparency and disclosure. The IMF and the World Bank recommended that the crisis-hit countries develop deep, liquid, and efficient domestic securities markets so as to reduce heavy reliance on the banking sector.

At present, the ASEAN+3 economies adopt a variety of exchange rate management systems (Table 2). In reality, all of the economies in this region remain in the “dollar zone” as they continue to closely peg their exchange rates to the dollar. Prior to the crisis in 1997, Indonesia and Korea formally adopted managed floating exchange rate management, but, in reality they still restricted the movement in the external values of their currencies vis-a-vis the dollar. Thailand maintained strict pegging. Under the IMF programs, exchange rate policies in Thailand, Indonesia and Korea shifted to independent floating in 1997, supported by inflation targeting as a monetary policy operating strategy. This means that an exchange rate target is no longer used as a nominal anchor for monetary policy. Along with the control of short-term capital movements, Malaysia moved in 1997 from managed floating to strict pegging. Cambodia and Singapore maintain the managed floating system. Myanmar, Vietnam and China preserve strict pegging while Brunei and Hong Kong continue to adopt the currency board system. As pointed out by Eichengreen (2004), the economies of hard US dollar peg currencies are subject to the vagaries of dollar-yen fluctuation. As the peg system rules out adjustments in relative prices, maintaining it requires strict fiscal discipline and a high degree of wage and price flexibility.

The relatively stable fixed exchange rate system serves three objectives. First, by eliminating currency risks it provides incentives for overseas borrowing, particularly when international interest rates are lower than domestic interest rates. Second, an overvalued exchange rate provides extra protection against import competition. And third, an overvalued exchange rate policy provides additional incentives for exports. On the other hand, such an overvalued exchange policy provides disincentives for the reallocation of resources from the less productive non-traded sector of the economy to the more productive traded sector.

The maintenance of inflation targeting as an operating strategy of monetary policy in Indonesia, Korea, Philippines and Thailand long after the end of the IMF programs indicates their firm commitment to price stability, disclosure, transparency, central bank independence and refraining from printing money to finance budget deficits. An explicit inflation target, along with a more flexible exchange rate regime and a mechanism that ensures a stable government debt-to-GDP ratio are now the three main pillars of macroeconomic stabilization frameworks in these countries. A combination of these policies protects these countries from the deep devaluations and steep increases in interest rates that devastated the balance sheets of their banks and non-financial firms, particularly those with large foreign currency debts, in 1997. Central bank accountability under the inflation targeting framework imposes costs on incompetent and opportunistic central banks.

In reality, however, not all countries in ASEAN+3 practice strict inflation targeting, with some having adopted more flexible policies. Aside from inflation, the policy objectives of the central banks of many countries also include exchange rate stability but no more setting of exchange-rate targets (Filardo and Genberg, 2009). As pointed out by Calvo and Reinhart (2002), because of the 'fear of floating', avoiding large exchange rate fluctuations continues to play a significant role in the monetary policy of emerging economies so as to avoid adverse impacts on their economies. There are four factors that drive this fear of floating, namely: (i) the fear of increases in foreign liabilities denominated in domestic currencies, (ii) the fear of output costs associated with exchange rate fluctuations, (iii) the fear of inelastic supply of funds during times of crisis; and (iv) the fear of losing credibility and access on the international capital markets.

As pointed out earlier, ASEAN+3 countries have introduced a number of policy measures to protect their financial systems from the global turmoil. In line with the policies adopted elsewhere, the authorities of this region temporarily banned short selling of equity shares of financial institutions. Non-viable and non-systemic banks have been allowed to go bankrupt. The supply of liquidity in domestic currencies has been augmented by reducing the minimum reserve ratio requirements and introducing emergency credit facilities. Japan continues to apply monetary easing by supplying liquidity to the market and reducing nominal interest rates to close to zero. The quantitative easing monetary policy in Japan has been in place since the instability in its financial system in the 1990s.

Table 2. Elements of Monetary Policy in ASEAN + 3 Countries following the Asia Financial Crisis of 1997

Country	Exchange Rate Arrangement	Year of Adopting Inflation Targeting	Goal Autonomy	Target Autonomy		Instrument Autonomy		Bank Restructruring 2/
			Legislated Goal	Target Specification 1/	Government Override	Credit to Gov't	Gov't participation in Policymaking	
Brunei Darussalam	Currency board arrangement	-	-	-	-	-	-	-
Cambodia	Managed floating	-	-	-	-	-	-	Yes
China	Pegged to USD	-	-	-	-	-	-	Yes
Hong Kong	Currency board arrangement	-	-	-	-	-	-	-
Indonesia	Independent floating	January 2007	Currency stability	G + CB	No	No	No	Yes
Japan	Independent floating	-	-	-	-	-	-	Yes
Korea	Independent floating	April 1998	Price stability	G + CB	No	Yes	Non-voting	Yes
Laos	Managed floating	-	-	-	-	-	-	Yes
Malaysia	Pegged	-	-	-	-	-	-	Yes
Myanmar	Pegged	-	-	-	-	-	-	Yes
Philippines	Independent floating	December 1989	Price stability	G + CB	No	Yes, limited	Voting member	-
Singapore	Managed floating	-	-	-	-	-	-	-
Thailand	Independent floating	May 2000	Price stability	CB	No	Yes	No	Yes
Vietnam	Pegged	-	-	-	-	-	-	Yes

Notes: 1/G = Government; CB = Central Bank; 2/Finance Minister may delay implementation of decision for two weeks.

Sources: IMF. 2009. Annual Report on Exchange Arrangements and Exchange Restrictions 2008. Washington DC: IMF.
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4. Bond markets

Both the government and the central bank in six ASEAN+3 countries issue competing interest bearing bonds and securities. The six countries are Indonesia, Korea, Malaysia, Taiwan, Thailand and the PRC (the People's Republic of China) The papers are used by the central banks as instruments for open market operations and to sterilize accumulations of foreign exchange reserves. Bank Indonesia has issued interest-bearing SBI certificates of deposit (Sertifikat Bank Indonesia) since 1974 in the absence of both short-term Treasury bills and government bonds. Some countries, such as the PRC, recently issued interest bearing bills as it ran out of government papers to sell to sterilize purchases of foreign exchange. Particularly during the Cold War, budget deficits in the public sector in some ASEAN+3 member countries were also financed by official development aid based on long-term maturities and low interest rates.

Because of the availability of cheap and low-risk credit from the banks during the past policies of financial repression, there was no incentive for the corporate sector to raise funds from the capital and securities markets. On top of this, tax policies, such as stamp duty on transfers of bond ownership, impeded the development of the secondary bond markets. On the demand side, institutional investors, such as insurance companies and pension funds, were not yet developed. As a result, both the private sector and public sector were heavily reliant on short-term borrowing from the banking system. Bond market and securitization started to grow in ASEAN+3 after the credit crunch following the bankruptcy of major banks in 1997.

After the financial crisis in 1997, the ASEAN+3 and EMEAP[3] countries adopted a combination of a market-led and government-led strategies to develop domestic and regional bond markets. To create and improve the working of domestic bond markets and promote their regional integration, both the central banks of EMEAP and the Ministers of Finance of ASEAN+3 have taken measures to improve and harmonize market infrastructure. The governments have also helped establish rating agencies, introduce credit guarantee schemes, and enhance securitization. The menus offered by regional bond markets have been diversified through the issuance of large amounts and greater diversity of government bonds.

Table 3 shows the rapid growth of Asian bond markets between 1997 and 2004. Government bonds play a dominant role in the structure of the bond markets in China, Indonesia, Korea, Singapore and Thailand. The rapid growth in the issuance of government bonds following the financial crisis in 1997 in Indonesia, Thailand and Korea was mainly for the purpose of financing bank recapitalization and the restructuring of bank clients in the corporate sector. In 1998-1999, Indonesia issued government bonds for its bank recapitalization program amounting to Rp 640 trillion, or roughly equivalent to 50 percent of her annual GDP in 1999. The rapid growth of the bond market in Malaysia has been mainly due to the government's initiative to promote the issuance of corporate sector bonds. The sovereign bond markets in Singapore and Hong Kong are relatively small due to the balanced budget policy applied by these countries. By contrast, Indonesia changed its debt strategy after the Asian crisis to one of financing its budget deficit with government bonds issued both on the domestic and overseas markets.

The drying up in bank lending has encouraged non-bank and non-financial institutions in this region to provide funds by securitization built around asset-backed securities supported by lease and credit receivables. Governments, such as that of Japan, have also been active in promoting the securitization markets. To replace the Fiscal Investment and Loan Program (FILP) as a provider of credit to small and medium enterprises (SMEs), the Government of Japan has established the JASME (Japan Finance Corporation for Small and

[3] EMEAP, or the Executives' Meeting of East Asia Pacific Central Banks, has 11 members, namely, the Reserve Bank of Australia, People's Bank of China, Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, the Bank of Korea, Bank Negara Malaysia, Reserve Bank of New Zealand, Banko Sentral ng Pilipinas, Monetary Authority of Singapore and Bank of Thailand.

Medium Enterprises), a specialized financial institution to provide government program loans to this class of customer. JASME receives a guaranteed lending facility through the credit guarantee corporation, and other credit enhancements (Sekine, et.al., 2009).

Table 3. Size of Asian Bond Markets

Country	1997		2004	
	Outstanding ($ million)	Percentage of GDP	Outstanding ($ million)	Percentage of GDP
China	116.4	12.9	483.3	24.9
Indonesia	4.5	1.9	57.7	22.7
Korea	130.3	25.1	568.3	83.2
Malaysia	57.0	57.0	106.6	90.0
Philippines	18.5	22.3	25.0	28.8
Thailand	10.7	7.1	66.5	41.1
Hong Kong	45.8	25.9	76.8	46.3
Singapore	23.7	24.7	78.6	73.1
Japan	4,433.6	97.6	8,866.7	197.7
USA	12,656.9	62.9	19,186.6	161.6

Source: Eiichi Sekine, Kei Kodachi, Tetsuya Kamiyama, *The Development and Future of Securitization in Asia,* Table 7.1 in Yasuyuki Fuchita (et.al) 2009, Chapter 7.

5. Regional financial cooperation

With the establishment of the bilateral currency swap arrangements (BSA) under the Chiang Mai Agreement (CMI) in 2000, the regional financial cooperation of ASEAN+3 countries has provided an extra supply of funds to member countries in need. The finance ministers of the ASEAN+3 countries made strategic decisions on the CMI during their meetings in Madrid in 2008. They agreed to multilateralize it, to enlarge the size of the currency swap facility and to increase the portion that is non-linked to an IMF program. Multi-lateralization of the CMI is a great leap forward toward greater political cohesion in the ASEAN+3 countries as they transfer some national powers to a regional institution. The multilateralized CMI will result in the pooled fund becoming self-managed under a single contract, thus reducing costly bilateral transactions and wasteful duplication of loan contracts.

I would propose that the ASEAN+3 countries minimize potential demand for crisis financing by strengthening their financial systems though regional cooperation. They could cooperate at least in three areas. The first area would be to continue the existing regional programs to develop the bond and capital markets. The second area would be to reorganize and enlarge the SEANZA[4] forum by establishing a college of regional bank supervisors to discuss common interests. The issues would cover the comparing of notes and the harmonizing of bank resolution and insolvency procedures, the transition to a market-based system, corporate governance, how to corporatize and privatize public sector banks, how to deal with related lending of private banks, and the application of the risk-based Basel II regulatory and supervisory framework to all banks regardless of ownership. Narrow banks can be established with a special mission to administer government directed lending programs. The third area of cooperation would be to discuss and adopt a common stand on the harmonization of capital rules and supervisory practices in the region, and to anticipate the implications of the recent discussions in international forums, such as the BIS and G-20, on the expansion of regulatory and supervisory perimeters to non-bank affiliates, increasing minimum capital for total and Tier 1 element risks under the Basel framework, and the introduction of minimum leverage ratios for bank capital, on their banks, corporations and developmental strategies. The invitation of some emerging economies to join BIS and the establishment of the Hong Kong Representative Office of BIS in 2002 were partly intended to incorporate regional inputs of “the Asian way” to the universal banking regulations and supervisory standards. Traditionally, the BIS standards were exclusively tailored to the needs of the well developed banking systems and matured financial markets in Europe and the United States.

The college of regional bank supervisors would not only supervise the operations of regional financial firms, it would also discuss the implications of the proposals for expansion of capital requirements and accounting standards to quasi fiscal operations, public sector companies (including banks), and affiliated companies (both shadow banks and non-financial corporations), and on off-balance sheet items. The setters of accounting standards in the region should work closely together on how to improve credit and collateral valuation standards as regards business affiliates to avoid principal-agent and insider-trading problems. Other topics of common interest would include how to avoid pro-cyclicality and minimize deposit insurance rates. Based on their historical experiences and Asian culture, the nations of this region need to contribute to the global discussions on these issues. Supervisory coordination, however, should not extend to the creation of a safety net as ASEAN+3 is not a monetary union.

January 3, 2010.

[4] Established in 1956, SEANZA (South East Asia, New Zealand and Australia Central Banks) has two subsidiaries, namely, SEACEN and SEANZA Forum for Bank Supervisors. SEACEN is a training center and research organization based in Kuala Lumpur.

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