Asia Pacific
Financial Deregulation

Recent events in East Asia have highlighted the risks of volatility and contagion in a financially integrated world. Countries in the region had been at the forefront of the movement towards increased integration but the crisis that struck Thailand in July 1997, and the rapidity with which it spread to other East Asian nations, suggested that all was not well. Weaknesses in domestic financial intermediation, poor corporate governance and deficient government responses to large capital inflows all played a role in the build-up of vulnerability. *Asia Pacific Financial Deregulation* provides an insight into financial liberalisation and structural reform in the region generally and as illustrated by a number of countries.

This volume is edited by Gordon de Brouwer, Reserve Bank of Australia, with Wisarn Pupphavesa, National Institute of Development Administration, Thailand, and is based on the papers presented at the Twenty-fourth Pacific Trade and Development (PAFTAD) conference held in Chiangmai, Thailand in May 1998.
Asia Pacific Financial Deregulation

Edited by Gordon de Brouwer
with Wisarn Pupphavesa
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Contributors

Gordon de Brouwer, Chief Manager, International Markets and Relations, International Department, Reserve Bank of Australia

Pedro Alba, Principal Economist, Economic Policy Unit of the Poverty Reduction and Economic Management Network, World Bank

Amar Bhattacharya, Senior Advisor in the Development Economics Vice Presidency, World Bank

Stijn Claessens, Principal Economist, Financial Economics Group of the Financial Sector Practice, World Bank

Kevin Davis, Colonial Professor of Finance and Head of the Department of Accounting and Finance, University of Melbourne

Matthew Field, Goldman Sachs, Hong Kong

Farid Harianto, Deputy Chairman, The Indonesian Bank Restructuring Agency

Swati Ghosh, Senior Economist, East Asia region, World Bank

Don Hanna, Director of Non-Japan Asia Economic Research, Goldman Sachs (Asia) LLC

Leonardo Hernandez, Senior Economist, Research Department, Central Bank of Chile

Akiyoshi Horiuchi, Professor of Economics, University of Tokyo

Masahiro Kawai, Chief Economist, East Asia and the Pacific, World Bank

Manuel F. Montes, Senior Fellow, East-West Center, Honolulu

Mari E. Pangestu, Executive Director, Centre for Strategic and International Studies, Jakarta

Sang Yong Park, Professor of Finance, College of Business and Economics, Yonsei University, Seoul

Wisarn Pupphavesa, Dean, Graduate School of Development Economics, National Institute of Development Administration, Thailand

Chaipat Sahasakul, First Bangkok City Bank

Jia-Dong Shea, Research Fellow, Institute of Economics, Academia Sinica; Professor, Department of Economics, National Taiwan University; Deputy Governor, Central Bank of China; President, Taiwan Economic Association

David C.Y. Sun, Assistant Director General, Central Bank of China, Taiwan

Weiyung Zhang, China Centre for Economic Research, Peking University
### Abbreviations

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<tr>
<td>ACU</td>
<td>Asian currency unit</td>
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<td>ADB</td>
<td>Asian Development Bank</td>
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<td>ADM</td>
<td>Asian dollar market</td>
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<td>AFIC</td>
<td>Australian Financial Institutions Commission</td>
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<td>AFTA</td>
<td>ASEAN Free Trade Agreement</td>
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<td>AGPS</td>
<td>Australian Government Publishing Service</td>
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<td>APRA</td>
<td>Australian Prudential Regulatory Authority</td>
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<td>ASC</td>
<td>Australian Securities Commission</td>
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<td>ASEAN</td>
<td>Association of South East Asian Nations</td>
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<td>ASEAN-4</td>
<td>Indonesia, Malaysia, the Philippines and Thailand</td>
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<td>ASIC</td>
<td>Australian Securities and Investment Commission</td>
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<tr>
<td>BAPEPAM</td>
<td>Badan Pelaksana Pasar Modal</td>
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<tr>
<td>BIBF</td>
<td>Bangkok International Banking Facility</td>
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<td>BIS</td>
<td>Bank for International Settlements</td>
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<td>BOT</td>
<td>Bank of Thailand</td>
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<tr>
<td>CAR</td>
<td>capital adequacy ratio</td>
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<td>CARSEL</td>
<td>Capital adequacy, Asset quality, Regulatory compliance, Strategies and stability, Earnings and Liquidity</td>
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<tr>
<td>CBC</td>
<td>Central Bank of China</td>
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<td>CD</td>
<td>certificate of deposit</td>
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<td>CDIC</td>
<td>Central Deposit Insurance Corporation</td>
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<td>CEO</td>
<td>chief executive officer</td>
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<td>CPI</td>
<td>consumer price index</td>
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<td>EEF</td>
<td>exchange equalisation fund</td>
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<td>EU</td>
<td>European Union</td>
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<td>FDI</td>
<td>foreign direct investment</td>
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<td>FY</td>
<td>financial year</td>
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<td>GDP</td>
<td>gross domestic product</td>
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<td>GNP</td>
<td>gross national product</td>
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<td>Abbreviation</td>
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<tr>
<td>HK</td>
<td>Hong Kong</td>
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<td>ICBC</td>
<td>Industrial and Commercial Bank of China</td>
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<td>ICOR</td>
<td>incremental capital output ratio</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>IPO</td>
<td>initial public offer</td>
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<tr>
<td>ISC</td>
<td>Insurance and Superannuation Commission</td>
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<tr>
<td>JKSE</td>
<td>Jakarta stock exchange</td>
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<td>KLSE</td>
<td>Kuala Lumpur stock exchange</td>
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<td>KSE</td>
<td>Korean stock exchange</td>
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<td>LGS</td>
<td>liquid and government securities</td>
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<td>LIBOR</td>
<td>London interbank offered rate</td>
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<td>MOF</td>
<td>Ministry of Finance</td>
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<td>MSE</td>
<td>Manila stock exchange</td>
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<td>NBFI</td>
<td>non-bank financial institution</td>
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<td>NIE</td>
<td>newly industrialising economy</td>
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<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
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<tr>
<td>OTC</td>
<td>over-the-counter</td>
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<tr>
<td>PPP</td>
<td>purchasing power parity</td>
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<td>PTA</td>
<td>policy target agreement</td>
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<td>RBA</td>
<td>Reserve Bank of Australia</td>
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<td>RBNZ</td>
<td>Reserve Bank of New Zealand</td>
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<tr>
<td>R&amp;D</td>
<td>research and development</td>
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<tr>
<td>RM</td>
<td>ringgit</td>
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<tr>
<td>Rp</td>
<td>rupiah</td>
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<tr>
<td>RRP</td>
<td>reverse repurchase facility</td>
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<td>SBI</td>
<td>Bank Indonesia certificate of deposit</td>
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<td>SEHK</td>
<td>Stock Exchange of Hong Kong</td>
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<td>SES</td>
<td>Stock Exchange of Singapore</td>
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<tr>
<td>SET</td>
<td>Stock Exchange of Thailand</td>
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<tr>
<td>SOE</td>
<td>state-owned enterprise</td>
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<tr>
<td>SRD</td>
<td>statutory reserve deposit</td>
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<tr>
<td>TBTF</td>
<td>‘too big to fail’</td>
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<tr>
<td>TSE</td>
<td>Taiwan stock exchange</td>
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<tr>
<td>US</td>
<td>United States</td>
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<tr>
<td>WPI</td>
<td>wholesale price index</td>
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<tr>
<td>WTO</td>
<td>World Trade Organisation</td>
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<td>yoy</td>
<td>year on year</td>
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Preface

This book is a compilation of papers presented at the 24th Pacific Trade and Development (PAFTAD) conference on Asia Pacific Financial Liberalisation and Reform, held in Chiangmai, Thailand, on 20 to 22 May 1998. The conference was hosted by the School of Development Economics at the National Institute of Development Administration (NIDA), Bangkok, in cooperation with the PAFTAD International Steering Committee.

PAFTAD is an international forum of senior academic economists in the Asia Pacific region. Its steering committee, chaired by Professor Hugh Patrick of Columbia University, comprises Narongchai Akranasee and Florian Alburo (University of the Philippines), Mohamed Arif (Malaysian Institute of Economic Research), Chia Siow Yue (Institute of Southeast Asian Studies), Wendy Dobson (University of Toronto), Peter Drysdale and Ross Garnaut (Australian National University), Ralph Hueneman (University of Victoria, Canada), Wisarn Pupphavesa (National Institute of Development Administration), Rong-I Wu (Taiwan Institute of Economic Research), and Ippei Yamazawa (Hitotsubashi University). The committee organises an international conference every eighteen months. The PAFTAD internet site provides a comprehensive overview of PAFTAD’s objectives and history, conference information and a list of publications < http://sunsite.anu.edu.au/paftad >.

The staff of the National Institute of Development Administration in Bangkok organised an excellent conference, with particular thanks to the host committee of PAFTAD 24: Thammanum Pongsrikul, Klin-Keo Chintakananda, Suchitra Chamnivickorn, Komain Jiranykul, Nada Chunsom, Chanika Charoenwong, Somporn Silpuwon and the staff at NIDA. Matthew Terpstra, from the PAFTAD secretariat at the Australian National University, also provided valuable assistance. We also thank the Westin Hotel, Chiangmai, for their service and support, and the Ford Foundation (USA), the Institute for Southeast Asian Studies (Singapore), the University of Toronto, the Australian National University, the Taiwan Institute for Economic Research, the Korea Member Committee of the Pacific Basin Economic Council, the National Centre for Development Administration (Thailand), the Centre for Strategic and International Studies (Indonesia), the Foundation for Advanced Information Research (Japan), the Japan Federation of Economic Organisations
(Keidanren), the Kansai Economic Federation (Kankeiren), the Rockefeller Brothers Fund (USA), the Korea Development Institute, the Ministry of Foreign Affairs (Japan), the Asia Foundation (USA) and the Chinese Taipei PECC Secretariat for generous financial support.

This book reflects the work of many people, for which the PAFTAD International Steering Committee and the editor wish to express their deepest appreciation. We would especially like to thank Denise Ryan for her excellent supervision of the publication process, and Raylee Singh for superb editorial work.

Gordon de Brouwer and Wisam Pupphavesa
November 1998
1 Introduction

Gordon de Brouwer

THE ISSUES

The East Asian financial crisis is one of the defining economic events of the last quarter of the twentieth century. The crisis was sparked by a currency adjustment in Thailand in June 1997, but extended its reach to most of Asia and, indeed, from the second half of 1998, to the world.

The crisis was the result of the interaction of a number of factors. New opportunities to access international finance, combined with weak bank and corporate governance and the expectation of rising regional exchange rates, led to widespread unhedged and short-term foreign currency borrowing by both banks and businesses in East Asia. Access to foreign capital was unprecedented, driven by the steady winding back of capital controls in emerging East Asia and an unparalleled willingness of foreign financial institutions to lend to the rapidly growing economies in the region. While capital flowed to a range of productive sources, expanding the capacity of the economy, there was also excess investment in some of these sectors (like motor vehicles) and in less productive, more speculative sectors (like property). Funds had also been directed—sometimes by government and sometimes by private commercial connections—to projects which did not necessarily have the highest risk-adjusted returns.

The trigger for the collapse happened to be an exchange rate realignment in Thailand which had pegged its currency at a value that was moderately out of line with fundamentals that had deteriorated following the global excess supply in semiconductors and the rise in the US dollar against Japan and Europe. But the trigger itself could have been almost anything. The event spread to other markets, as lenders re-evaluated their financial investments, and other currencies depreciated. Again, foreign borrowing was short-term and currency exposures were not generally hedged, and domestic financial institutions were fundamentally weak. The scramble to reverse exposures, as currencies started to drop, in turn exacerbated the fall. Financial markets responded as a herd, exiting the markets en masse and pumping up the risk premium on lending to the region without regard to the actual circumstances
in particular countries. Political uncertainties, especially in Indonesia in early 1998, compounded the problem. Initial international policy responses were also misguided, interpreting events as a classic balance of payments problem driven by government profligacy, rather than a financial crisis, and focusing on reforms which were not directly relevant to the problems at hand.

The crisis was contained within East Asia until August 1998, when the Russian government defaulted on its debt. Markets again overreacted, losing their appetite for risk and failing to distinguish the very different circumstances of particular countries and borrowers. With this, the Asian financial crisis became a fully fledged emerging market crisis (although the situation in East Asia itself improved at this time).

The next step was for the crisis to spread to the industrialised economies of the world. The loss of appetite for risk was one element by which events in East Asia had spread to industrialised countries, with the risk premium on lower grade corporate borrowing rising substantially. But the more potent force was through the financial institutions of Europe and the United States. The first leg was the exposure of the banks—and Swiss, French and German banks in particular—to emerging markets in Asia, eastern Europe (including Russia) and Latin America. These exposures involved loan write-downs, lower profits and falling share prices, which undermined world share markets (widely thought to be overvalued and vulnerable to a fall), and adversely affected consumer sentiment (especially in the United States). The second leg was bank lending, especially of US banks, to hedge funds, which had taken huge leveraged speculative positions in financial markets around the world and suffered large losses when these positions turned against them. European and, especially, US banks had also taken what turned out to be unprofitable proprietary positions in asset markets. This led to major disorder in world financial markets in October 1998, as market liquidity dried up, bank earnings fell substantially and fears of a credit crunch and weakness in consumer and business sentiment became widespread. The US Federal Reserve responded by lowering interest rates several times. The financial crisis triggered by the baht depreciation in July 1997 became a world financial crisis.

**THIS BOOK**

This book goes back to analyse the start of it all: Asia Pacific financial deregulation. The argument is set out in five parts in a collection of twelve essays by experts in their field.

**Part I: The changing architecture of financial regulation**

The first part examines the changing architecture of financial deregulation in East Asia. Chapter 2, written by Pedro Alba, Amar Bhattacharya, Stijn Claessens, Swati Ghosh and Leonardo Hernandez, sets the scene by explaining what happened in East Asia and why. In ‘Volatility and Contagion in a Financially Integrated World’, Alba and his colleagues provide a detailed analysis of the
origin of the East Asian financial crisis. Relying on extensive analysis of the data, the authors argue that the crisis was largely the result of weaknesses in domestic financial intermediation, poor corporate governance and inadequate government policies in dealing with large capital inflows. Weak due diligence by external creditors and ample global liquidity obscured these fundamental weaknesses in the financial system and were more a trigger for the crisis, rather than its cause. The authors also argue that the financial crisis was not inevitable and, for most countries, was triggered by spill-over effects from Thailand’s exchange rate crisis. It also sets out some implications of the crisis for dealing with volatile capital flows and the structure of the financial system.

Chapter 3, written by Jia-Dong Shea and David C.Y.Sun, assesses the conditions for the successful prudential regulation of financial institutions in the Asia Pacific region. The authors argue that what happened in East Asia was a failure of the financial system, markets and superintendence. They make the point that maintaining macroeconomic stability, particularly in monetary policy, is generally important for maintaining financial stability. But, more broadly, the preconditions for financial stability also include well-developed banking supervision, effective market discipline, the efficient resolution of problem loans in banks and mechanisms to secure stability of the financial system as a whole. They argue that this task has been complicated by financial innovation and globalisation. They focus their discussion on the experiences of Taiwan.

**Part II: Regional financial integration**

Part II shifts focus to regional financial integration. Masahiro Kawai, in Chapter 4, provides a comprehensive account of the pattern of capital flows in emerging East Asia, examining foreign direct investment, portfolio investment, banking transactions and foreign exchange transactions before and after the crisis. He analyses the differences in the forces underlying capital flows and regulation in the Asian NIES, ASEAN and China, and considers some ways to restore capital inflows, such as privatisation and guarantees from multilateral institutions. He explores the lessons of the East Asian financial crisis, concluding that it shows the need for sound economic management, financial system resilience (including the need for flexible monetary policy and possible temporary use of capital controls, at least on inflows), solid corporate governance, viable exchange rate regimes and international cooperation. He argues that the crisis does not obviate the importance of financial liberalisation, but it does show that the speed and scope of liberalisation should depend on a country’s stage of development.

In Chapter 5, ‘The Development of Asian Equity Markets’, Matthew Field and Don Hanna trace and explain the reasons behind the growth of East Asian stock markets over the past decade, including providing a handy chronology of developments in individual country share markets. They identify domestic demand and supply factors, and the role of foreign participation, as key factors
behind the growth of markets up until the mid-1990s. They analyse the financial crisis and its effects on equity markets and investment in the Asia Pacific region, arguing that recovery in regional stock markets will be slow, reform of laws and practices extensive and foreign ownership substantially expanded. They also expect private equity placements to become more common.

In Chapter 6, Manuel Montes addresses the relative positions of Hong Kong, Singapore and Tokyo as regional financial centres. He presents a taxonomy of financial centres within financial intermediation and identifies the key requirements for a financial centre: market efficiency (including taxation regime), market innovation, human infrastructure, language, concentration of financial institutions, political stability, business infrastructure and quality of life. The relative attributes of Hong Kong, Singapore and Tokyo are discussed with reference to a classification of systems and criteria. Montes argues that Hong Kong has particular advantages as a service centre for China, as Singapore has for Southeast Asia, but that Singapore has the overall advantage because it has strong government support. He believes that Tokyo will decline in relative importance.

Part III: Patterns of corporate governance, finance and reform

Weakness in the corporate governance of banks and businesses was a key factor in the East Asian financial crisis, and is an issue deserving particular focus in analysis of the crisis. Part III looks at the experiences of Indonesia, China and Korea.

Farid Harianto and Mari Pangestu examine developments and the prospects for the Indonesian corporates in Chapter 7, providing a concise insight into corporate structure and behaviour leading into the financial crisis. They trace the shift in corporate governance—or the accountability of company owners and managers to outside investors—over the past few decades, shifting from family-owned enterprises to ones which are professionally managed and have to compete internationally. State-owned enterprises have also been subject to the same forces of change, albeit at a slower pace. Harianto and Pangestu identify the key features of, and differences between, corporate governance and market discipline for state-owned enterprises, Chinese-owned businesses and pribumi (indigenous) businesses. The market in Indonesia is characterised by myriad imperfections and government involvement. The authors describe how Chinese businesses, which are family based, have generally used their own commercial networks to supplant imperfections and internalise transactions (including the provision of funds), as well as developing close ties with government in order to protect their vulnerable social position. Pribumi businesses, by way of contrast, have lacked effective networks, even though they have had close links with government, and would use alliances with Chinese groups to develop expertise and gain access to capital. Disclosure has typically been poor, and regulation and enforcement weak, although the authors argue that recent changes
to bank disclosure and structure and to bankruptcy proceedings should impose more discipline on corporates.

In Chapter 8, Zhang Weiying assesses recent developments in Chinese corporate finance, one of the many interesting dimensions of change in China. In the post-reform period, from 1978 to the present, there has been a substantial shift in the distribution of national income, with households surpassing the state as the main source of finance for investment capital. But while corporate finance has changed, corporate governance has not, with state-owned enterprises still owned by governments which lack sufficient incentive to make these firms efficient. Moreover, households have weak incentives to monitor banks which in turn have weak incentives to monitor firms. Zhang argues that the financial crisis has placed particular stresses on state-owned enterprises and the banks which lend to them. But the crisis has also shown that the problem, and the issue of corporate governance of both firms and banks, have to be addressed by the government.

Sang Yong Park examines financial reform and its impact on corporate governance in Korea in Chapter 9. He argues that the financial crisis and economic contraction in Korea were not accidental, and that recent events point to the need for major reform in product, labour and financial markets and in corporate governance. Park outlines the process of financial reform in Korea during the past decade and how it affected corporate organisation, practices and financing in that country. He thinks that the crisis provides Korea with a once-in-a-lifetime opportunity to reform and hence defeat the normal political tide of opposition to structural reform, but he admits that events have been hugely costly and reform generates enormous uncertainty about the rules of the game, all of which are a major challenge to politicians.

**Part IV: Case studies in financial reform**

Part IV changes tack, focusing on the experiences of a number of countries in the Asia Pacific region. Chapter 10 starts with Japan. In ‘Financial Fragility in Japan’, Akiyoshi Horiuchi explains how the broad-ranging failure of governance mechanisms worsened the effect of the banking crisis in that country. Many industrialised countries, including Japan, experienced banking crises in the late 1980s and early 1990s, but Japan’s crisis has endured longer than others. Indeed, the problem has become progressively worse. Horiuchi describes the way this crisis evolved and explains how the governance structure of banks has been systematically undermined by the operation of government, including, for example, the appointment of retired government officials into senior positions in financial institutions. He argues that the immunity of the management from market discipline has undermined Japan’s banks and delayed necessary structural adjustment.
In a more positive tone, in Chapter 11 Kevin Davis outlines the nature of the successful—but at times also eventful—financial reform undertaken by Australia and New Zealand. He starts off with a summary of the process and pressures for reform in the two countries. While the approach to domestic monetary policy largely converged in the mid-1990s, the approaches to prudential supervision are quite different, with New Zealand taking a ‘buyer-beware’ market approach and Australia taking a wholistic and active approach to supervision of its financial system. One feature of interest in the New Zealand system is that its banks are largely foreign owned, which can be regarded as an advantage in stabilising the banking system of a small open economy. It also implies that the authorities essentially refer financial supervision to the home country of their banks, which, in New Zealand’s case, is Australia.

In Chapter 12, entitled ‘Thailand’s Financial Reforms’, Chaipat Sahasakul provides an example of the depths of the difficulties in financial reform currently facing much of emerging East Asia. Chaipat summarises the process of reform in the 1990s and then explores the reasons for the foreign exchange rate crisis in 1997. He argues that the Bangkok International Banking Facility was a key conduit for volatile short-term capital inflows, with much of the excess capital inflow at this time going into unproductive investment projects. The mix of high Thai interest rates, low foreign interest and the pegged exchange rate was also an important factor underlying the acquisition of large unhedged foreign exposures which left the system highly exposed to a negative ‘shock’ and reversal of capital inflows. The author provides an assessment of the Thai financial reform package.

**Part V: Looking forward**

Part V brings the debate together, focusing on the prospects for the future and the implications from the analysis of previous chapters. Chapter 13, by Gordon de Brouwer, comprises two parts. The first considers the recovery and reform process underway in East Asia, examining the likely speed of recovery and what recent experience indicates is the appropriate speed, order and content of reform, especially given domestic political constraints. This also includes an assessment of the lessons for emerging East Asia from Japan’s experience, arguing that Japan is a poor role model for emerging economies. The second part analyses, more generally, the evolving debate about the international architecture. It starts by reviewing the reports and outcomes of the G22 (Willard Group) working groups on transparency, financial system reform and managing financial crises. Since the debate has also turned to the role or otherwise of capital controls, de Brouwer provides a summary of the arguments for and against such controls. He also assesses how the IMF position on capital controls has evolved in light of experiences with financial markets in 1998.
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