

Preliminary Draft  
January, 2001  
Welcome Comments

**A Post Crisis Paradigm of Development for East Asia:  
Governance, Markets, and Institutions\***

Yung Chul Park  
Korea University

---

\* This paper was prepared as a background study for the paradigm project of the ADBI.

*Table of Contents*

I. Introduction

Part One: Accomplishments and Failures of the East Asian Development Model

II. Accomplishments and Characteristics of the East Asian Development Paradigm

II-1. Fundamentally Sound Development Policies

II-2. Interventionist Policies

II-3. The Governance System

III. Causes of the East Asian Crisis and Structural Weaknesses of the East Asian Model

III-1. Overview

III-2. Structural Weakness or Financial Panic

III-3. Failures of the East Asian Development Model

IV. Democratization and Economic Liberalization: The Breakdown of the Consultative Politics

V. Financial Sector Fragility: Financial Repression and Crony Capitalism

VI. Weaknesses of the Corporate Sector

Part Two: Reform Agenda for a New East Asian Paradigm of Post Crisis Development

VII. A Critique of the IMF Program

VII-1. An Overview: The Background for Rethinking the East Asian Miracle

VII-2. Structural Reform and Recovery

VII-3. What Went Wrong with the IMF Restructuring Programs?

VIII. In Search of a New East Asian Paradigm for Development

VIII-1. A New Paradigm Sketch

VIII-2. Reform Agenda for a New Paradigm: Overview

IX. The Role of the Government and Governance Mechanisms

IX-1. The Role of the Government

IX-2. Governance

IX-3. East Asia and the Emergence of the New Economy: New Industrial Policy

IX-4. Democratization and Labor Participation

X. Reform of the Financial Sector

XI. Reform of the Corporate Sector

XII. Exchange Rate System and Regional Cooperation

XII-1. Exchange Rate System and Capital Controls in East Asia

XII-2. Globalization and Regional Integration

XIII. Concluding Remarks

Figures

References

## *I. Introduction*

Commenting on the relative success of the different models of development, Frankel and Roubini (2000) contend that when thinking of the 20<sup>th</sup> century as a competition of economic models, “capitalism beat communism in the semi-finals of the 1980’s and the American brand of capitalism beat the Japanese brand of capitalism in the finals of the 1990’s.” They also point out that “the financial system in many Asian countries has had much in common with that in Japan,” which “is today much vilified.” Furthermore, “the Anglo-American style financial structure apparently works better after all, as compared to the Japanese-Asian model.”

Diametrically opposed to Frankel and Roubini (2000), Stiglitz (1998) argues that despite the financial crisis that devastated East Asia, many of the alleged institutional weaknesses blamed for the collapse may well have only played a minute role. East Asia was not any more vulnerable to the crisis than other regions, and East Asia may remain the best model of development the world has seen to date. He adds that the East Asian miracle was real and was based on a set of sound fundamentals and public policies.

Were the crisis-affected countries in East Asia suffering from a short-term liquidity problem or from an insolvency problem? The IMF and World Bank invariably point to the structural problems in the public, financial and corporate sector as major causes of the crisis and assert that only a decisive and fast structural reform will ensure recovery and medium-term, durable growth (World Bank, 2000b, Fisher, 1999, and Lane *et al.*, 1999). A number of recent studies on the East Asian crisis put the blame on panic and herding of international financial market participants. To many advocates of the liquidity-panic view of the crisis, the rapid pace of recovery underway in East Asia is hardly surprising and that the region did not, in fact, need the IMF reform to restore its access to international capital markets.

Following Frankel and Roubini, one would not hesitate to entirely forgo and replace the pre-crisis East Asian model of development with an Anglo-American system

of capitalism. On the other hand, if one is inclined to subscribe to Stiglitz's verdict on superiority of the East Asian model, he would probably recommend the East Asian countries not to deviate too much from the model and at best reform it at the margin.

The purpose of this paper is to search for a development paradigm that will help the East Asian crisis countries regain their pre-crisis vitality and competitiveness for durable growth, at the same time facilitating their integration into the global economy. In this search, this paper will not be biased either to the Anglo-American model of free market or the East Asian development model. Instead, this paper attempts to analyze whether the East Asian development model as it was described by the World Bank study in 1993 is so outdated and out of touch with the realities of a new global economy that it should be repudiated in favor of an alternative model, such as Anglo-American capitalism, or whether it can be reformed in a way that will make the system as viable for post crisis development in East Asia as it was in the past. For this purpose, this paper delineates some of the basic characteristics of the East Asian development model as well as its weaknesses, as it surfaced in the wake of the East Asian crisis in Part One, sections II to VII.

In Part Two, this paper sketches a broad outline of a new development paradigm for East Asia and proposes a reform for the financial, corporate, and public sectors. The agenda also includes the labor market and the exchange rate system. The discussion of the reform is found in Part One, sections VIII to XI. Concluding remarks are in a final sections.

## Part One: Accomplishments and Failures of the East Asian Development Model

### *II. Accomplishments and Characteristics of the East Asian Development Paradigm<sup>1</sup>*

East Asia is often referred to as a sub-region of Asia that includes the ASEAN

---

<sup>1</sup> This section draws heavily on Stiglitz (1996) and the World Bank (1993).

member states: China, Japan, South Korea, Taiwan, and Hong Kong. In this study, the original five ASEAN members and the other northeastern countries are covered primarily for the reasons that they were the subset of the Asian countries the World Bank miracle study focused on, and that ASEAN 10 + 3 have been active in recent years in promoting financial cooperation and integration in East Asia. At the outset, it should also be noted that while one could talk about a single set of broad characteristics of the East Asian development model, in reality, there may be as many East Asian models as there are East Asian countries, each with different cultural and historical backgrounds and at different stages of development. However, the East Asian countries analyzed in this study share some economic characteristics that separate them from many other developing economies.

Among the many economic successes of East Asia before the crisis, the following achievements stand out. One was rapid growth. From 1960 onward to the early 1990's, the East Asian countries grew three times as fast as Latin America and South Asia. Between 1960 and 1985, real income per capita more than quadrupled in Japan, Taiwan, Hong Kong, Singapore, and South Korea. Another accomplishment was declining inequality: the rewards of the rapid growth were evenly spread throughout the populations. A third notable achievement was the quick reduction of the technology gap via massive investment in human capital, importation of foreign technology, export orientation, and the opening of markets for foreign direct investment as a means of introducing advanced technology.

What factors may have contributed to East Asia's rapid growth with equity? And, what led to the dramatic reduction in poverty rates? Even before the publication of the World Bank miracle study, characteristics of the East Asian economies, especially regarding the phenomenal increases achieved in promoting savings, investment, and exports had been extensively documented-different analysts emphasizing different aspects of East Asia. Of these contributions, the miracle study was the most rigorous and comprehensive analysis of the East Asia's development experience. It delineates the East Asian model as a functional framework of growth in which macroeconomic

stability, superior accumulation of physical and human capital, efficient allocation, and catching up with advanced foreign technology were important elements supporting rapid growth with equity. How did the East Asian countries accomplish economic stability and the three prerequisites of growth? In large measure, they did so by pursuing successfully a set of policies that included fundamentals and interventions and by developing a governance mechanism that made the policies credible to the polity.

### *II-1. Fundamentally Sound Development Policies*

Overviewing the economic progress achieved by East Asia over the last three decades before the crisis, the miracle study concludes that East Asia's rise can attribute a large part to their success to getting the basics right. Fundamentals included responsible and disciplined fiscal and monetary policies which helped maintain moderate rates of inflation. The relative price stability in turn contributed to providing a stable economic environment conducive for private investment and financial savings. In order to promote rapid growth in human capital, the East Asian countries ensured high investments in education. Educational policies were primarily directed to improving and expanding primary and secondary education. This together with post secondary education focusing on vocational and technical skill training developed a better educated labor force suited for rapid economic development.

Although some of the East Asian countries could be classified as interventionist regimes, in general the East Asian policymakers exercised restraint in intervening in areas where markets can be relied upon. This basic strategy of espousing a market friendly approach should be credited with the success in keeping price distortions within reasonable bounds. For example, agricultural policies were geared to improving productivity rather than protecting or taxing farmers. With the belief that labor markets would perform their allocational role if left to themselves, the East Asian policymakers resisted organized labor's demand to legislate a minimum wage and suppressed the formation of industry and economy-wide unions. They also

limited their intervention in the labor markets so that wages and employment were determined largely by demand and supply factors.

To secure a foundation for high and rising saving rates, the East Asian governments developed relatively sound and stable financial systems by strengthening prudential regulations and supervision of financial institutions and setting limits on competition. They also expanded the financial system network by promoting postal savings systems to increase successfully the accessibility of financial savings instruments to non-traditional savers. Finally, the fundamentally sound development policies included actively seeking foreign technology through foreign licensing, capital good imports, and liberalization of foreign direct investment.

## *II-2. Interventionist Policies*

A careful examination of the East Asian model reveals that it is fundamentally a traditional model of a mixed economy in which the government plays an important role. In this sense there is little that is unique about the East Asian development model. According to Stiglitz (1996) and the World Bank (1993), East Asian policymakers realized the severity of the numerous market failures associated with the inefficiency of existing markets, non-existence of several markets, technological and marketing spillovers, coordination problems in the market economy, and increasing returns to scale. What set East Asian policymakers apart from their counterparts elsewhere was that unlike communist state planners, they were intent on complementing markets, rather than replacing them. What is interesting about the East Asian experience is that its development strategy of combining fundamentals and interventions had worked well in sustaining rapid growth with equity up until the mid-1990s, before the crisis. It is instructive to note in this regard that many developing countries emulating similar strategies were not able to replicate the East Asian success.

While espousing a market friendly strategy, the East Asian policymakers intervened in various markets in a systemic fashion and through multiple channels to



encourage savings, promote exports, and to achieve the desired allocation of resources. Interventions were not confined to traditional areas that dictated government intervention, such as developing technological capabilities by building service centers and industrial parks and supporting all levels of education. In reality, East Asian governments were actively engaged in import substitution of a wide range of intermediate products, the promotion of heavy and chemical industries in Korea, for example and in setting export targets at the firm and industry levels. They targeted and provided subsidized credit to select industries for their development and, in many cases, subsidized declining as well as import substitution industries. Financial policies were repressive in that they kept deposit rates below a market clearing level and ceilings on lending rates. The East Asian governments also subsidized heavily government-owned financial institutions and introduced mechanisms for mandatory savings and socialization of risks associated with business investment and exports.

Contrary to conventional wisdom, these market interventions were not inefficient. In fact, they were associated with high rates of investment and productivity growth in many cases. Nor, did they increase the incidence of rent seeking and corruptive behavior, at least during the earlier periods of development. What factors explain the relative efficiency of the market intervention in East Asia? The interventionist policies were working largely because domestic financial and product markets were regulated and largely closed to foreign competition. In many instances, the interventions may have accomplished the intended objectives, because the East Asian policymakers were following a clear and relatively well defined performance criteria for, and monitor the consequences of, their activities. They also did not hesitate to refrain from market intervention whenever the intervention became excessively costly or when it was threatening macroeconomic stability.

The East Asian countries were also fortunate in that they had a high level of institutional capacity backed by strong bureaucracies to administer and implement interventionist policies. As discussed below, they were able to obtain the cooperation of the private sector. More than anything else, however, East Asian governments,

some of which were authoritarian, were “strong” in that they had the ability to seriously commit themselves to long-term development goals and choose those policies that would enable them to attain those goals. Finally, export push, which has been the most conspicuous feature of East Asia, was a winning combination of fundamentals and interventions. There is a large amount of literature that focuses on the contribution of the export-led development strategy to growth and technological advances in East Asia. As Stiglitz notes (1996), four activities were important in promoting export growth: the provision of infrastructure, preferential access to capital and foreign exchange, developing new export markets, and licensing and other regulations designed to enhance the reputation of the country’s exports. Stiglitz also argues that these mechanisms worked primarily because of the close and long-term relationships that were continually nurtured between exporters and governments.

### *II-3. The Governance System*

Most of the East Asian countries that escaped from third world poverty through rapid growth with declining inequality were authoritarian or even dictatorial. Like any other non-democratic governments, they had to establish legitimacy of their regimes and also limit government discretion over economic policies to remain in power. The need for legitimacy and enlisting support from a wider private sector created governance systems that are different from the western democratic system based on written constitutions, elected legislatures, and formal institutions of checks and balances. The East Asian systems were consultative polities rather than representative regimes (Campos and Root, 1996).

As their legitimizing principle, the East Asian regimes were committed to shared growth and developed a secure political foundation for granting economic rights to economic agents in the private sector. In order to achieve their objective, they had to obtain the support and participation of the business community to build a dynamic industrial base by institutionalizing the information flow between the private and public

sectors. This strategy was complemented by many wealth-sharing mechanisms, such as land reform, rural infrastructure development, promotion of small and medium sized enterprises, and public housing programs. To be successful, redistributive reforms must secure a broad support from the private sector, including business elites. Without such support, the complex coordination problems that the principle of shared growth entails could easily derail the reform programs.

In their efforts to draw as many groups into the decision-making system as possible, East Asian countries, Japan and Korea in particular, established a legal and regulatory structure that was supportive of private investment and instituted various mechanisms and practices of cooperation not only between governments and businesses but also between workers and employers, small and large businesses, and businesses and banks. One such institutional device was known as deliberation councils which were active and critical in the formation of policies, rules, and regulations that govern a sector, industry, and, in some cases, the entire economy. The councils were therefore able to overcome the private sector's reservations of the East Asian leaders' commitment to shared growth.

A successful management of the councils requires a reputable and efficient economic bureaucracy to impose discipline among the private sector members. The East Asian countries were able to create competent, honest, and well organized bureaucracies which were insulated from day to day political interference and wielded substantial power in setting and implementing policies.

Various formal and informal deliberation councils as a means of exchanging information between different firms and industries, as well as between governments and businesses, were working because they provided to businesses an excellent arena in which to learn about governmental policy direction and changes, not to mention the fact that they were also rewarded in various ways by simply cooperating and that the process of legislation was transparent.

To enhance cooperation between government and business in Japan, the Japanese government attempted to reduce bankruptcies, encouraged mergers to improve

cooperation when there were a large number of firms, and even approved the formation of recession cartels as a means of improving cooperation (Stiglitz, 1996). Although other East Asian countries did not necessarily copy the Japanese pattern of coordination, one could argue that a small number of large, family-owned industrial groups which dominated manufacturing and exports in Korea facilitated the government-business cooperation.

Stiglitz also argues that the pattern of lifetime employment facilitated cooperative behavior in the Japanese labor market. Together with the steady increase in wages that came with age and experience, lifetime employment helped develop long-term relationships between workers and employers. Paying wages on the basis of group performance rather than individual performance also helped induce cooperative behavior from workers. The Japanese version of a productivity council, which compressed the wage structure and limited the salaries of top managers, induced greater overall effort from workers and lower labor turnover. These labor market practices instilled into labor the conviction that the interests of the labor were the same as those of the firm and elicited cooperation for adapting to technological changes.

In East Asia, each firm, especially a large one, establishes a long-term relationship with a single bank, which is known as the firm's main bank. As will be shown in section IV, the main banking system could help reduce information asymmetry problems between lenders and borrowers. Therefore, the long-term relationships can increase the availability of long-term credits to, and allow the main banks to play a large role in determining the investments and other decisions of, its client firms.

Cooperation and coordination can easily be turned into collusion, and discretionary powers exercised by authoritarian governments can provide a fertile ground for rent seeking and regulatory capture. Competition is therefore needed to reduce the abuse of discretionary powers and to enhance efficiency. In order to strengthen competitive discipline, the East Asian countries established various types of contests among firms managed through deliberation councils. Most of the contests in East Asia were related to non-market allocation rules, but in Korea and Japan the

contest schemes were also utilized to promote the coordination of private investment.

The key feature of the contests was to increase competition by rewarding firms showing good performance and behavior relative to the others. For example, in the export industry, exporters with good performance records were given access to subsidized credit, foreign exchange, and other benefits. This contest scheme, according to many studies, provided strong incentives for domestic producers to develop new export products and to cultivate foreign markets. Stiglitz also argues that contests could reduce the scope for corruption by clearly establishing the judging criteria, stating the specific rewards, and disclosing all information concerning the evaluation process.<sup>2</sup> In this respect, licensing requirements did enhance, rather than restrict, competition.

### *III. Causes of the East Asian Crisis and Structural Weaknesses of the East Asian Model*

#### *III- 1. Overview*

The publication of the World Bank miracle study provoked a heated debate on whether the East Asian miracle was real and universally applicable. Many people claimed that the East Asian model, however defined, did not have universal validity and hence should be rejected on the ground that similar experiences could not be replicated in countries that also emulated the East Asian paradigm. A more serious challenge followed, however, with the publication of a number of total factor productivity (TFP) studies on the East Asian economies. To the surprise of many, the estimated sizes of TFP for a number of East Asian countries were very small. These results led to Krugman's conclusion (1996) that the East Asian success was explained by perspiration,

---

<sup>2</sup> Other contest examples in the labor market include the Japanese practice in which firms may hire a cohort of workers, which advances together. Since the mobility of labor is limited, workers are forced to work hard—signaling that they are committed to their firm. In other words, they remain in contest (Stiglitz, 1996).

not by inspiration: the contribution of technological advances to growth was relatively small and much of the growth was attributed to factor (capital) accumulation. The TFP studies had two negative implications for the universal applicability of the East Asian model. Since it was not likely for the East Asian economies to maintain their high rates of investment as in the past, East Asia's growth was bound to slow down. Initially, the miracle was perceived to be the result of a production function that was not accounted for by increases in capital and labor, that is, the TFP. Since the TFP was so small, it is reasonable to argue that there was no miracle.

Immediately after the 1997 financial crisis, critics of the miracle and many experts from international financial institutions were quick to blame structural weaknesses with misguided macroeconomic policy as the main causes of the crisis, although they did acknowledge, rather grudgingly, that sudden changes in market sentiment played a role as well. A typical characterization of the crisis is provided, for example, by Lane and Schulze-Ghattas (1999): the East Asian crises were rooted mainly in financial sector frailties, stemming in part from the weaknesses in the corporate, financial and the government sectors, which made these economies increasingly vulnerable to changes in market sentiment, a deteriorating external situation and contagion.

Other frailties included large, unhedged, short-term foreign currency debts of highly leveraged private corporations; inadequate of economic and financial data which made foreign lenders difficult to form informed decisions, and their inadequate risk assessment. The inflexibility of the nominal exchange rate also added to the accumulation of such a debt build up. The implication of the structural weakness view of the crisis is that the East Asian model has outgrown its usefulness as a development paradigm and that the crisis has conclusively proved its non-universal applicability.

There is a vast and ever growing literature on the causes and consequences of the East Asian crisis. At the risk of repetition, this paper reviews some of the alleged or actual causes of the crisis, because such a review could provide clues as to whether the East Asian model can survive the changes taking place in and around East Asia.

### *III-2. Structural Weakness or Financial Panic*

In the early 1990's, a large volume of foreign capital began to flow into East Asia, much of which was induced by East Asia's success and the low interest rates in advanced economies. The inflow of capital led to a massive increase in investment, much of which took place in the real estate sector, which resulted in a cyclical upswing. The demand expansion resulted in a higher rate of inflation, notably that of non-tradables. Financial institutions in Thailand went along with financing real estate investment rather than restraining it because real estate lending restrictions were lifted in the process of financial liberalization. Foreign creditors also favored investment in real estate in their lending, because their loans were collateralized with physical assets which increased in value with the onset of the investment boom. In Korea, capital inflows were mostly channeled to financing fixed investments in the manufacturing sector.

The current account deficit started to balloon and exchange rates, which were pegged to the dollar, suddenly began to change erratically. A subsequent real appreciation further undermined the competitiveness of East Asian exports, unfortunately at a time when the Japanese Yen was depreciating *vis-à-vis* the dollar, which caused a further increase in the current account deficit. Foreign reserve holdings of these countries were obviously not able to pay for the growing deficit. Therefore, in order to attract more foreign capital, the policymakers of these countries had to tighten up the supply of credit, thereby pushing up interest rates, particularly those in the short-term money market. Because of this market development, and perceived stability of nominal exchange rates and government monetary reserve, unhedged, short-term foreign debt held by financial institutions (in Korea) and corporations (in Indonesia), in proportion to their total foreign debt, soared beyond prudent levels.

Except for a few large, state-owned enterprises, most East Asian corporations

and financial institutions had little access to international capital markets because they were not able to obtain an investment grade rating from credit rating agencies. Therefore, they had to borrow from the short-end of the market where the cost of borrowing was lower than that of long-term borrowing. At East Asian commercial banks, short-term foreign currency loans from the interbank loan market also rose sharply. Apparently, foreign lenders believed that since the government would not let these institutions fail, their loans were guaranteed. On their part, the domestic banks, long accustomed to relationship banking, had the wrong expectation that their loans from the interbank market would be rolled over continuously. It is also plausible that foreign lenders curtailed the maturity of their loans as a means of reducing the risk involved in their lending, stemming in part from non-transparency and poor governance, both at corporations and banks (Rajan and Zingalis, 1998).

On the banking front, the higher interest rates were cutting into profits and deteriorating the quality of the assets held by a growing number of financial institutions, as many of their clients were unable to meet their debt service obligations. In the absence of an efficient system of prudential supervision and regulation, and with the implicit bailout guarantee, these financial institutions began adding more and more risky assets to their portfolios to bolster their sagging profits and thereby increase their franchise values. The situation was getting untenable, and faced with the growing number of business bankruptcies, the monetary authorities in East Asian had to increase the liquidity in their economy. At that point, speculators wasted no time in attacking the currencies. Once a couple of countries failed to defend their currencies, foreign portfolio investors and lenders moved out of other East Asian countries with the expectation that they would also come under attack, since they were similar in many respects. Soon after, the Thai crisis created a contagion, engulfing all of East Asia.

The East Asian experience raises an important question as to whether the East Asian governments could have mounted a credible defense of their currencies had they pursued a different set of macroeconomic policies, including their exchange rate policies. Here again, the economic profession is sharply divided. Eichengreen (1998),



Corsetti *et al.* (1998), and many industry analysts argue that pegging their currencies to the dollar was a serious mistake, and that the lax in financial regulation and supervision allowed the build-up of unhedged short-term foreign currency loans. This was critical in triggering the massive exodus of foreign investors and lenders from East Asia at a time when a host of structural weaknesses had made these economies highly vulnerable to a crisis.

Opposed to this structural weakness and macroeconomic policy mismanagement view, Furman-Stiglitz (1998), Feldstein (1998), Radlet-Sachs (1998), and Chang and Velasco (1998) put more emphasis on panic and the herding of international financial market participants as the more serious cause of the crisis and suggest that one of the major shocks that initiated the crisis in East Asia was the sudden change in the supply function of short-term foreign capital. This was triggered by an equally sudden change in the market's perception of risk, partly a result of certain pronouncements made by western governments and international bodies which stated that East Asian countries had profound problems. Although these problems were known before, this new emphasis led to the general belief that the region was much vulnerable than originally thought. Without a doubt, the probability of this kind of external shock being translated into a crisis increases when financial institutions are weak, corruption is widespread, and corporate behavior is non-transparent.

As Furman-Stiglitz (1998) puts it, none of the alleged causes of the crisis was as critical as originally thought. By definition, a cause is a factor that leads to a given consequence. Since causes can be factors that increase the probability of a crisis, it can be said that many of the structural problems that existed before the crisis increased the vulnerability of East Asian countries to a crisis situation. In other words, the structural weaknesses contributed to an increase in the probability of translating internal and external shocks into a crisis in East Asia. Therefore, from the perspective of reexamining the viability of the East Asian paradigm, it is important to identify those central factors that are large enough to have led to such a high probability of disaster.

Should the East Asian policymakers have responded to the crisis situation

precipitated by the halt in capital inflows by floating and tightening monetary and fiscal policies? Pure floating would most likely have exacerbated the situation because while the boom was gathering momentum, increasing pressure was placed on the exchange rate to appreciate. Monetary policy was immobilized in this setting, where the degree of variability of the exchange rate was limited. And, given the rigidities of fiscal policy, it could have hardly been an effective means of defending the currency.

According to the liquidity-panic view, a more plausible explanation of the cause of the crisis can be found in the misguided financial market opening in the absence of an effective system of prudential regulation and supervision of financial institutions, which allowed, among other things, the expansion of unhedged short-term foreign currency debt at financial institutions and corporations. To complicate the crisis situation, the bulk of the foreign currency short-term loans were lent to finance long-term investments, exacerbating both the maturity and currency mismatches at banks and corporations. However, even this explanation is not satisfactory.

East Asian emerging market economies are small in size, so once their capital accounts are deregulated, they can not easily deal with a large capital inflow because it can easily overwhelm them. They simply cannot accommodate large amounts of foreign capital in the short run without disrupting domestic financial markets. Given this constraint, even if a well-functioning system of supervision and regulation were in place, the system would not have been able to minimize the disastrous consequences of the large capital inflow, although such a system would have made the crisis less painful. For instance, if banks were more cautious in their real estate lending, domestic borrowers could have gone directly to international financial markets as they did in Indonesia.

### *III-3. Failures of the East Asian Development Model*

Even if structural problems were not the direct causes of the crisis, they deserve a careful examination, because they may have greatly undermined the viability

of the East Asian development model in the 21<sup>st</sup> century to the extent that they became factors that increase the probability of a crisis. The structural weaknesses may not necessarily result in the end of the system, but at the least, they may signal that the system is in need of repair, if not a complete overhaul. Needless to say, the East Asian model has evolved over time and adapted to political, societal and economic changes taking place in both East Asian and the rest of the world. The fundamental question is whether the model can adapt to some of the most significant developments that will change East Asia's economic landscape: democratization and domestic economic liberalization, globalization in parallel with regionalization, and the emergence of a new economy driven by information technology.

More advanced East Asian economies, such as South Korea and Taiwan, phased out their industrial policies of the 1960s and 1970s years ago. Other less developed countries in the region have seen little room for government-managed industrial policy within the framework of the WTO. Trade liberalization has replaced export promotion throughout East Asia. More importantly, "the conditions that produced a consensus for growth gave away to a more affluent, complex, and diverse body politic" (Campos and Root, 1996, P. 177). By the mid-1990's, many of the East Asian countries had migrated toward a Washington consensus model of Anglo-American capitalism and away from the mixed economy models of fundamentals and interventions. The shift did not help countries like Thailand and Korea forestall the currency crisis; on the contrary, the deregulation of capital account transactions and the opening of financial intermediation industries made them more vulnerable to speculative attacks than before. What did go wrong with the East Asian system?

As noted earlier, most of the major structural problems of the East Asian countries that surfaced after the crisis originate in the financial and corporate sectors and are related to the failure of the system of governance at various levels of the economy. Therefore, the controversy over the viability of the East Asian model essentially hinges on the extent to which these structural problems, including the failures of the government arising from regulatory capture and rent seeking behavior,

were hidden by rapid growth and, more importantly, on whether and how seriously they will act on development in the 21<sup>st</sup> century as constraints. Finding a resolution for the controversy will not be easy, but it will have to begin with searching for those failures in the model that drove some of the East Asian countries to the brink of total collapse and that bode ill for post crisis development in East Asia. This paper will show that they are all related to institutional weaknesses and rigidities that were imbedded in the model over the three decades of rapid growth, and which impeded the adjustment of the economy to political democratization, economic liberalization, and globalization of the world economy.

One of the critical failures of the East Asian model was the inherent conflicts in its governance mechanism between democratic polity and market liberalization. East Asia was slow and ineffective in instituting a democratic governance mechanism in place of the system characterized by consultative polities with the onset of political democratization that had started late in the 1980's. By the early 1990's, it was clear, at least in some of the East Asian countries, that the consultative mechanisms of coordination and cooperation between the government and the private sector and between the different groups in the private sector were crumbling down and degenerating into collusion, political cronyism, and corruption. With this collapse, serious coordination problems were cropping up at the national, industry, and enterprise level. Many of the East Asian governments literally did not care to know what the large family-owned enterprises and their main banks were doing. They acted as if they should not be involved in monitoring the behavior of the banks and corporations, lest it could be misunderstood as unnecessary interventions in a market economy. Governments could not mediate disputes between labor and management. And, banks did not know what their client firms were doing.

Most of the East Asian regimes repressed the formation and activities of the labor union in an effort to maintain flexibility in the labor markets. Political democratization has greatly increased the labor's demand for participation in economic and social policy choices. Reflecting this new trend, a variety of new trade unions and

federations have been established. This new growing demand has not been met, because East Asia has been lagging behind in developing the proper mechanisms for conflict management that will include labor. As a result, labor movements have increasingly deviated from guarding the right to freedom of association and collective bargaining to playing a political role in the national decision making process.

The politicization of labor union activities has weakened considerably the traditional mechanism of cooperation between labor and management. East Asia will therefore have to meet the challenge of maintaining a balance between accommodating the rising demand by labor for political participation on the one hand and keeping labor market flexibility on the other. That is, the region will have to manage a smooth transition to a democratic governance system of relations at both the national and enterprise level from the legacy of overt repression of trade unionism without sacrificing labor market flexibility.

A second failure of the East Asian model arose from the rigid financial and exchange rate system that did not adjust well when faced with global products and financial markets. East Asian policymakers backed the financial systems dominated by banks for far too long, neglecting and delaying the development of capital markets. Ensnared in a closed and regulated market environment, banks, which were placed under the direct control of the government, did not have the incentives to develop modern techniques of risk management, observe the requirements for soundness -- capital adequacy, loan classification, loan-loss provisioning, and lending restrictions including those on investments in stocks and bonds -- or to monitor their client firms. The "control syndrome" meant that the government did not realize either the need or the urgency for developing an effective regulatory system, although the banks were exposed to greater risks than before.

In a relationship banking system, banks were supposed to play an important role in governing corporations, but it was unclear who was to monitor the banks. In retrospect, the East Asian banking industry was a traditional infant industry. Once deregulated and opened to foreign competition, the East Asian banks were no match for

western banks with better risk management, a larger network, and a secure capital base. They simply lost out in the international financial markets competition. The implicit government bail out guarantee induced them to venture into risky asset management and establish them as easy targets of speculative attack. When they were denied access to the interbank loan market, many of the East Asian banks with maturity and currency mismatches in their balance sheets simply could not manage the mounting losses stemming from their bad investments and lending. At that point, the banks were no longer able to provide even short-term loans to their clients experiencing liquidity shortages, not to mention long-term financing. In relationship banking, when the banks closed their doors, so did many of their client firms, both small and large, simply because these borrowers did not have access to other sources of financing.

One of the lessons of the East Asian crisis is that in a bank-oriented open financial system, a banking crisis can quickly become an economy-wide crisis because the failed banks are likely to drag the entire real sector of the economy into insolvency. However, one must hasten to add that the East Asian experience does not prove that the Anglo-American style financial system, where securities markets serve as a major source of corporate financing and monitoring, is superior to the East Asian system. Instead, it simply underscores some of the potential risks and dangers emerging market economies are likely to encounter in deregulating and opening an inefficient and unregulated bank-oriented system.

While most of the East Asian economies chose a managed floating system for the exchange rate management, in many cases, nominal exchange rates were grossly overvalued. Beginning in the early 1990's, despite the apparent structural weaknesses, the East Asian economies were forced to open their financial intermediation industries and to liberalize capital account transactions to disastrous consequences. Here again, the managed floating system itself should not be faulted so much for the crisis as it was mismanagement, keeping the nominal exchange rate out of line with market developments.

A third failure of the system could be found in the closed non-transparent

corporate sector that did not fare well with market liberalization and opening. Over a long period of pursuing an export-oriented development strategy, the East Asian economies had become open to trade, foreign direct investment, and foreign technology. Many of the major corporations from East Asia were borrowing heavily from international financial markets and expanding direct investment throughout the world as part of their globalization strategy. Although they were becoming more active on the global scene, they were not changing themselves to meet the global norms and practices in the areas of accounting, disclosure, and corporate governance. Western investors were attracted to the growing economies of East Asia and, in particular, owning a stake in these large corporations that looked invincible with a global reach. Up close, however, these corporations were riddled with poor accounting and auditing irregularities, non-transparent management, and practices of expropriating minority stockholders. Once again, East Asian economies failed to build a corporate sector that was credible and transparent to foreign investors. In the subsequent sections, this paper will analyze the failures of the East Asian model in more detail at the sectoral level, beginning with the financial system to be followed by the corporate sector and governance system.

#### *IV. Democratization and Economic Liberalization: The Breakdown of the Consultative Polities*

As noted in section II, the East Asian governance of consultative polities was often hailed as a successful institutional device for resolving coordination problems that had supported East Asia's rise. However, it has not survived political as well as economic liberalization and is becoming a relic of the past authoritarian regimes in East Asia largely because it was a system tailored to the political needs of authoritarian regimes. In retrospect, the effectiveness of deliberation councils as a coordination and cooperation mechanism appears to have been vastly exaggerated. The ubiquitous

councils were, in many cases, designed to serve an advisory role and to inform and persuade private sector council members of the different backgrounds and interests the rationale of government policies. Only in rare cases did policymakers take discussion of and recommendations made by the councils seriously, and they seldom withdrew or changed their policies because of councils' objections.

Before the democratization process got underway toward the later part of the 1980s, a delicate system of checks and balances had been maintained among the government and private sector members of the council. By that time, however, it was clear the consultative governance was no longer working as a mechanism of conflict management, because many underprivileged groups, such as urban labor, small and medium-sized firms, farmers, and various professionals groups were increasingly being left out of the decision-making process; and, it had become too unresponsive and rigid to resolve the conflicts of interest arising from rapid growth or to accommodate the growing popular demand for direct political participation. As their relative position in society elevated in rapidly growing economies, large family-owned enterprises and industrial groups began to exercise more political influence than before. They were not discreet about colluding with the economic bureaucracy to pursue their own interests. This shift in power structure undermined the credibility and effectiveness of the deliberation councils.

At the same time the government pulled itself out of the deliberation councils which were to be replaced by incipient democratic institutions and processes. Since the late 1980s, many of the deliberation councils have been dissolved and the remaining ones have lost much of their influence. In their place, the legislature and political parties have assumed a greater role in the decision-making process. However, the political parties are fractured, lack policy expertise, and often support similar policy platforms that are ideologically undistinguishable. On the other hand, the economic bureaucracy transformed itself into a powerful pressure group bent on protecting its own interests and resisting adaptation to the changing internal political and external economic environment. It often blocked or delayed the inevitable market deregulation



and opening and resisted the transfer of their policy role to the elected representatives. A new democratic system capable of building consensus and accountability has yet to be developed after a decade of democratization efforts, creating a vacuum in the coordination process. In the meantime, labor unions and other interest groups have mounted an increasingly serious challenge to the government for greater participation in the policy making process.

Rodrik (2000) argues that in democratic societies, labor, business, and other social groups are more willing to cooperate and compromise in the political sphere, generating greater stability as a result, because liberal democracies entail constitutional rules and the separation of power, and also espouse the rule of law and protection of minorities. In contrast, one might argue that in East Asian countries, democracy has, in many instances, created paralysis and status quo bias in policy making as a result of the veto power exercised social groups, including labor.

In the East Asian context, development policies could not have been carried out effectively and various coordinating mechanisms would not have worked in the absence of a reputable and efficient economic bureaucracy capable of imposing discipline on the private sector members of the deliberation councils and to deflect external pressures from the power elites and powerful interest groups. The contribution of a high quality bureaucracy to economic development is also supported empirically. Radelet, Sachs, and Lee (1997) provide evidence that the quality of institutions, such as bureaucracies, is one of the most critical factors that determine long-term growth performance across regions and economies. A recent study by Rodrik (1996) also links differences in the economic performance of East Asian economies with differences in the quality of their institutions.

Like many others, including Campos and Root (1996), Bardhan (1996) also stresses the importance of efficient economic bureaucracies in East Asia and argues that a strong government usually supports a high quality bureaucracy. A strong government is one that has the ability to credibly commit itself to long-term development goals and choose appropriate policies. The governments in Japan, Korea,

and Taiwan were and still are perceived to possess these abilities. One must then ask why and how these countries were able to support such strong governments. In general, history, culture, tradition, and path-dependence were all likely factors that contributed to the emergence of strong, efficient governments in East Asia. Other important factors are distributive equality and homogeneity in East Asian societies. According to Bardhan, these factors helped create and sustain communal institutions, which in turn were able to provide local public goods and to enforce social rules and regulations and property rights. Effective communal institutions can then help maintain a high quality bureaucracy since these institutions do not allow interest groups to easily control local politics.<sup>3</sup>

The 1997 financial crisis has seriously eroded the public's confidence in East Asian governments. Yusuf (2000) argues that the biggest lesson learned from the East Asian crisis is that contrary to the widely held belief, "East Asian planners did not know what they were doing." As was the case for other structural weaknesses, rapid growth masked much of the government's ineffectiveness in policy management and coordination, their overzealousness in market interventions, and corruption. To many skeptics of the East Asian miracle, the crisis has brought to light the many failures of the public sector institutions. In fact, the crisis has provided the prima facie evidence justifying their long-standing critique of East Asia's strong regimes.

During the pre-democracy period, the legislative branches were nominally involved in making policies and implementing them in the East Asian authoritarian or dictatorial regimes. As a result, bureaucracies were exercising much more power than otherwise. They were no longer playing an efficient functional role. Instead, the technical elite was turning itself into a politically powerful group. In a growing number of instances, policymakers were abusing their power, while there was no effective mechanism that could limit their discretion in place. The democratic reform

---

<sup>3</sup> Since so many factors are involved in establishing an efficient, relatively independent, and corruption-free bureaucracy, it is not clear how developing countries should go about building one. Following Bardhan, it appears that redistributive reforms may help lay a social foundation conducive to the emergence of a strong government. However, the effective implementation of economic reforms often requires the existence of a strong government, taking us back to square one.

has increased power and legislature's sphere of influence, but elected representatives in many East Asian countries still are not able to control the bureaucracies.

Bureaucratic entrenchment has been a serious roadblock to institutional reform in East Asia. Even after the crisis, leadership in economic policy did not change. In fact, those same policymakers and bureaucracies, long accustomed to an interventionist regime, were in fact entrusted with the task of restructuring and reforming financial and corporate sectors and liberalizing and opening domestic markets, instead of being held responsible for the crisis. Therefore, it is not surprising that they did not fully understand either the need or the urgency of the overall reform. The technocratic elite was not as well insulated from political pressures as it was perceived to be, often succumbing to pressures from those asking for intervention on their behalf. Government officials also forged close ties with private entrepreneurs to ensure their influence. These ties made them highly susceptible to corruption.

In some of the East Asian countries, relationships between politicians and business constituents, as in the case of Indonesia, were too close to be free of corruption and collusion and may have been directly responsible for the crisis. What is surprising is that corruption has increased in all four crisis countries and in the Philippines even after the 1997 crisis (according to a recent survey of the trend of corruption in Asia by Political and Economic Risk Consultancy, Ltd., 2000). In view of these new pieces of evidence, Yusuf (2000) claims that "the heyday of the technocratic bureaucracy, at the helm of a developmental state, pursuing long-term goals through industrial policies and the tightly calibrated opening of the economy may be past."

How serious was the deterioration in the quality and effectiveness of the East Asian bureaucracies? A World Bank measure of governance, which combines perceptions of voice and accountability, political instability and violence, government effectiveness, regulatory burden, rule of law, and corruption shows that the governance ratings of East Asian countries are more or less average by international standards. World Bank governance indicators suggest that a country's institutional quality is highly correlated with its level of development. It concludes "unqualified praise for East

Asian government institutions is surely overstated” (P.103). The same report also shows that the argument that “crony capitalism is more pernicious in East Asia than in other regions of comparable income is no less misguided” (P.103).

The trend toward greater democratization and the building of legal institutions that will support the democratic polities is in all likelihood irreversible in East Asia. Even in the former communist states, like China and Vietnam, some political liberalization has occurred. This development may be seen as a normal accompaniment to the increasingly open and growing role of the market economy (Yusuf, 2000). What does this development, then, portend for the future reform of the public sector as well as the evolution of the East Asian governance?

Democratic changes sweeping through East Asia raise three fundamental questions concerning the proper role of government. One issue is to ascertain whether a strong government, or a strong but limited government, can survive democratization or, more fundamentally, is compatible with democratic political regimes. A second in the question of whether East Asian countries will be able to establish corruption-free governments is whether they will be strong or strong but limited. A third issue is to identify and build those legal and regulatory institutions that could strengthen the market and remedy some of the market failures in the absence of direct government intervention. The second issue is particularly relevant to the more advanced East Asian countries, such as Taiwan and South Korea, which have moved to a greater market liberalization and opening than other East Asian countries through a series of liberalization measures in trade and finance since the early 1990s. To these economies, restoring a strong government may not be either possible or desirable.

In charting a new development strategy for the 21st century, East Asian countries may find it unavoidable to operate in a framework of a mixed economy in which the market and government complement each other, although policies and reforms in East Asian took a decisive swing towards the markets. As Stiglitz (1998) points out, the issue is not whether the government should intervene in the market, but to what extent can the government make the markets work better, correct market

failures, and assume a catalytic role. Stiglitz may be right, but the question still remains: how can the East Asian countries avoid or minimize the problems of government failures, including corruption?

#### *V. Financial Sector Fragility: Financial Repression and Crony Capitalism<sup>4</sup>*

For more than three decades preceding the crisis, the East Asian countries had relied on the banking system as an instrument of industrial policy -- as the means of mobilizing savings and allocating them to strategic industries and favored projects. This strategy was successful for it had sustained rapid growth and industrialization for almost three decades before the crisis in 1997. According to critics of the East Asian system, such a policy exacted a heavy toll; it resulted in a very weak and inefficient financial system, deficient in many respects (Eichengreen, 1999).

One weakness was that banks became "too big to fail". The moral hazard syndrome associated with this implicit government guarantee led to poor risk management, which in turn caused a massive deterioration in the quality of the assets held by the banks. Another weakness was that direct government control over the management of and credit allocation at banks and other financial institutions left little room and few incentives for the regulatory authorities to develop and improve their capacity for prudential supervision and regulations. Failure to require banks to follow rigorous auditing and accounting practices made bank balance sheets non-transparent. A lack of transparency and disclosure created a fertile ground for corruption, the cumulative effect of which manifested in poor economic performance.

A third problem was that the dominant position of banks interfered with and delayed the diversification of financial assets, institutions, and markets. In particular, the bank intermediary dominance impeded the development of capital markets. Developing capital markets requires detailed information on the financial position

---

<sup>4</sup> This section draws on Park (2000).

and legal structures of firms, so as to protect minority stockholders. Financing through capital markets rather than banks, including the greater use of financial derivatives, and liberalizing the capital account all demand a reliable disclosure system. Insofar as they were relying on banks for financial intermediation, the East Asian countries were less inclined to improve accounting, auditing and disclosure standards. Finally, the government control of banks created opportunities for crony capitalism, since bank owners and managers could easily collide with politicians to further their interests.

During the early period of economic development, Eichengreen argues when high-return investments were abundant in East Asia, the industrial policy of using banks as instruments of resource allocation did not pose any serious efficiency problems. Once these opportunities were exhausted, sustaining rapid growth required a more efficient allocation of resources which, in turn, dictated the liberalizing and opening of domestic financial markets. The East Asian governments, however, stuck to the old strategy of bank-dominated control. The government directed credit allocation in a way that disregarded market signals. Eventually, non-performing loans began to pile up at banks and brought the solvency of these institutions to risky levels.

Krugman (1994) was the first to point out that East Asia was running into diminishing returns and that rapid growth was only being sustained by a massive infusion of capital, much of which came from abroad in the form of short-term credit. Supporting this line of argument, Eichengreen also claims that the East Asian governments decided to liberalize the capital account to facilitate borrowing from abroad, not to improve the efficiency of the economy. Unfortunately, he argues, they did it backward by deregulating short-term borrowing first.

In what follows, it is argued that the financial weakness was not necessarily one of the main causes of the East Asian crisis, although it exacerbated financial instability and economic contraction once the East Asian countries came under

speculative attack.<sup>5</sup> Eichengreen's view is open to question because there is no clear evidence that by the mid-1990s the East Asian policy regime was crumbling under the inefficiencies of crony capitalism, bringing the period of rapid growth to an end. For example, a recent World Bank (2000) report suggests that the East Asian countries managed to invest their savings productively, so that the return on capital investment remained higher than in most other developing countries, at least until the mid-1990s. Even before capital account transactions were liberalized and increasing volumes of foreign capital began to flow into East Asia, most East Asian countries were already growing at rates much higher than the rest of the world. In fact, it is this success and the potential for future success that had attracted foreign capital into the region. Not only had there been both rapid growth and domestic stability, but the rates of return on capital had been high before the crisis.

In most East Asian countries, the national budget was balanced or generating a surplus. Since the mid-1980s, all of the countries in the region had pursued policies of trade and financial liberalization. Given these sound fundamentals and the region's commitment to liberalization, foreign investors saw enormous opportunities for profit and moved vast sums of money into the region. Because of this massive inflow, investment as a proportion of the GDP in all of these countries was significantly higher than it had been in the 1980s. At the same time, savings rates were stable, resulting in large increases in the current account deficits.

Therefore, it may not be correct to argue that East Asian countries were intent on borrowing heavily from abroad to meet the ever-increasing volume of capital needed to compensate for the losses in efficiency that were slowing economic growth. Certainly, the assertion that these countries began liberalizing the capital account to facilitate capital inflows is at variance with the facts. To the contrary, East Asian countries were very reluctant to liberalize the capital account and trade in the financial services in the early 1990s, although they were committed to doing so in the long run for a number of reasons.

---

<sup>5</sup> See Furman and Stiglitz (1998) for a detailed analysis on this issue.

First, none of these countries had enjoyed any comparative advantage in exporting financial services. East Asian economies were understandably concerned that Anglo-American financial institutions could easily dominate their domestic markets for financial services once they were allowed free market access. By the mid-1990s, for instance, American and European financial institutions had already established a dominant position in international investment banking in Asia (Park, 1999).

Second, it was feared that the deregulation of capital account transactions could destabilize domestic financial markets. The shallowness of financial markets together with weak financial institutions was likely to increase the volatility of capital movements and the exchange rate, complicating macroeconomic management.

Third, East Asian countries were cautious in opening money and capital markets, because their regulatory and supervisory systems were hardly comparable to those of advanced countries in terms of standardization and effectiveness. Few of the East Asian countries were able to meet the necessary information and disclosure requirements for capital account liberalization. Despite this weak capacity in prudential supervision and regulation, western governments were increasing pressure to secure their financial firms' rights of access in East Asia (Park, 1996).

Although the same governments knew that accounting practices and disclosure requirements in East Asia did not conform to their standards and that financial supervisory authorities were not capable of enforcing rules and regulations, few western governments demanded the necessary reforms to financial supervision before entering the East Asian financial markets. Instead, they were persistent in their demand for equal access and the outright opening of domestic capital markets. Their justification for the persistence and impatience was that unless financial opening and liberalization were carried out quickly, the inertia would become too great and these countries would never pursue liberalization. As a result, they did not choose to address the possibility that pell-mell liberalization could invite speculative



a t t a c k s a n d f i n a n c i a l  
crisis, particularly in small East Asian emerging market economies .

Western governments did not realize that once capital accounts were deregulated, small East Asian economies could not deal with a large capital inflow because their financial markets were shallow. They simply cannot accommodate large amounts of foreign capital in the short run without disrupting domestic financial markets. For this reason, even if a well-functioning system of supervision and regulation of financial institutions were in place, the system would not have been able to minimize the disastrous consequences of the capital inflow, although such a system would have made the crisis less painful. For instance, if banks were more cautious in their real estate lending, domestic borrowers could have gone directly to international financial markets as they did in Indonesia.<sup>6</sup>

Prior to the crisis, foreign lenders had access to much of the information needed for investment decisions, including information that the balance sheets of banks and corporations in East Asia were not reliable. Foreign market participants either ignored or were not able to process the available information. If the lack of transparency and the inadequate disclosure of information made East Asia vulnerable to financial crises, how serious was the problem? Furman and Stiglitz (1998) show that increased transparency in the form of disclosure requirements is not needed, since markets can and do provide optimal incentives for disclosure. They also argue that under certain circumstances, information disclosure could exacerbate fluctuations in the financial markets and precipitate financial crisis (you do not cry fire in a full theater).

The seriousness of crony capitalism, or widespread corruption in East Asia, was also well known among foreign investors, but according to several measures of corruption, the risk of corruption had declined or remained unchanged before the crisis in East Asia (Furman and Stiglitz, 1998).<sup>7</sup> It is also instructive to note that the Nor

---

<sup>6</sup> For further discussion on this issue, see Radlet and Sachs (1998), Furman and Stiglitz (1998), and Hellmann, Murdock, and Stiglitz (2000).

<sup>7</sup> A recent measure of corruption in Asia by Political and Economic Risk consultancy, Ltd. (2000) shows

dic like Sweden, Norway, Finland countries, which did not suffer from the non-transparency problem nearly as much as the East Asian countries, could not fend off crisis in the early 1990s (Rodrik, 1999).

Foreign investors knew quite well that East Asian firms, both small and large, relied almost exclusively on banks for financing their investments and their working capital requirements. In such a bank-oriented financial system, it is only natural to expect that the debt-equity ratios of these firms are likely to be much higher than those firms operating in economies where capital markets are well developed. Apparently before the crisis, foreign lenders did not consider that the balance sheet's weaknesses would pose serious default and liquidity risks or that the weaknesses did not seem serious enough to discourage their lending to those highly leveraged firms. Once the crisis erupted, however, the lending problem was suddenly brought up as one of the major vulnerabilities of the East Asian economies.

#### *VI. Weaknesses of the Corporate Sector*

Two of the most distinctive characteristics of East Asian corporations are that ownership is concentrated among a few large families and many corporations are affiliated with an industrial group. Such affiliations occur because an individual, a family, or a coalition of families, controls a number of firms or because firms have extensive interlocking ownership (Claessens, Djankov, and Lang, 2000). The diversified conglomerates, or the chaebol in Korea and the tycoons in China, are closely held, controlled, and managed by families who dominate East Asian business and exert great influence on the policy making in many East Asian countries.

The diversified conglomerate form of organization has a number of advantages when compared to other forms, particularly in developing economies. As Khanna and Palepu (1999) point out, business groups provide important institutional services such

---

that the trend of corruption in all four crisis countries has been rising.

as those of investment banks, accounting firms, and business schools. Those services are often absent or poor in quality in many emerging market economies. East Asian industrial groups are also able to pool internal resources and information to create internal capital (including venture) and labor markets and develop a common group brand that stands for world-class quality and customer service, a trait valuable in export-oriented economies. That is, at an early stage of development, when institutional and legal Foundations are underdeveloped and capital markets are moribund, industrial groups or large family owned corporations could economize transactions costs. Before the crisis, these advantages were considered at least some of the reasons for the success of East Asian corporations.

The family-based corporate governance was combined with the coordination system of deliberation councils involving government, banks, and corporations to provide strong incentives for East Asian firms to maintain a high rate of investment, upgrade technology and to remain competitive in the global markets. In a bank oriented financial system, these conglomerates had to rely on bank financing for much of their investments with the consequence of higher leverage. The debt-equity ratios of these groups rose gradually and then shot up during the first half of the 1990s, making them highly susceptible to cyclical fluctuations.

However, the high levels of debt at these groups were buffered by the long-term relationship they maintained with banks, as the government stood ready to provide support to both these groups and the banks in the event of systemic shocks (Veneroso and Wade, 1998). The high debt strategy, according to a World Bank report (1998), propelled East Asia through a meteoric rise in technology, productivity, and a standard of living that surpassed virtually all other countries. Wade (1990) makes the same point and argues that the high leverage was an important component of the East Asian success.

The East Asian crisis has dramatically changed this positive assessment of the role and contribution to economic development of East Asia's corporations. The crisis exposed a number of serious structural and managerial problems in the East Asian

corporate sector. Many of these East Asian industrial groups were poorly managed, made unwarranted investment decisions, taking excessive risks, and expropriating small stockholders and stakeholders. Principal owners' emphasis on personal objectives rather than profits meant that these groups were also prone to serious agency problems.

Claessens *et al.* (1999) find that higher cash flow rights (dividend rights) are associated with a higher market valuation of corporations whereas higher ownership rights (voting rights) with a lower market valuation in East Asia. This finding suggests that family control leads to a lower valuation and expropriation of small stockholders.

Together with the high leverage, the pervasiveness of cross debt guarantees among affiliates of a group created a systemic risk in which the failure of a member firm could easily cause the collapse of other firms-risking the downfall of the entire group. Contrary to popular belief, the groups were not ideal places where a professional class of managers could be trained. Most of the senior managerial positions were held by the members of the controlling families and eventually passed on to their offspring. Since these members wielded so much power, they were able to resist and often bloc those reforms that were not in their interests.

With the rapid expansion and diversification of their business operations, the conglomerates emerged as the dominant member of the consultative system of coordination, and numerous cases in which they were colluding with government officials and politicians were uncovered. Even when they were barred from owning a controlling stake in financial institutions, they were able to control a large number of banks and non-bank intermediaries through cross ownership arrangements. They could also exercise a great deal of influence on the management and lending decisions of banks and other financial institutions without owning these institutions, largely because these groups were the much courted customers and the most creditworthy. Unlike Germany and to some extent Japan, the main banks in the other emerging market economies in East Asia had become accommodative to the financial needs and wishes of large, family-owned industrial groups before the crisis, thereby perpetrating the soft budget constraint.

The increase in the number of bankruptcies and excess capacities and the growing debt burden and non-transparency of these industrial conglomerates during and immediately after the crisis epitomized the ills of the East Asian industrial groups. Such factors provoked an uproar, demanding their breakup, particularly by multilateral financial institutions and academics in the west.

What are the factors, then, responsible for the dramatic fall of the East Asian corporations, in particular that of large groups such as Daewoo in Korea? How did these industrial groups allow themselves to be so reckless in diversifying their businesses with borrowed funds, taking greater risks than warranted, and being liable for corruption? How did their internal control become so weak, financial reports unreliable, disclosures inadequate, and audits so poor?

A simple answer to this question is that the old system of governing the behavior of banks and corporations -- the consultative mechanism of cooperation and competition -- broke down in the process of democratization and market deregulation and opening, thereby creating a vacuum in the external monitoring of investment and funding behavior of corporations, including large industrial groups. In particular, the long-term relationship between banks and corporations supported by the government did not create any incentives for corporations to strengthen their accounting standards, disclosure requirements, and corporate governance. The East Asian system of cooperation and competition effectively shielded banks, other non-bank financial institutions, and corporations from market discipline, unlike their counterparts in the west.

Institutional investors such as insurance companies, mutual funds, pension funds, and investment banks in advanced economies provide market incentives for adopting good corporate governance practices. In many of the East Asian countries, these institutions were, and still are, scarce and underdeveloped. Since the management of most of the major banks in East Asia was controlled either by governments or large industrial groups, in the absence of government intervention, these banks could not be expected to be a reliable monitor of corporations. Although the

presence of foreign banks has been extensive in terms of their branch operations in East Asia, they seldom impose international standards of accounting, disclosure, and auditing on their clients; instead, they often assimilate into local markets, adopting local norms and practices.

With the opening of domestic financial markets, a growing number of foreign institutional investors have invested in a growing variety of East Asian stocks and bonds to diversify their portfolios. However, they do not demand the same high standards of accounting, disclosure, and auditing for East Asian corporations as they do in their home countries. In order to minimize the credit risks of their investments, foreign investors tend to diversify their East Asian portfolios to the point where their holdings of different East Asian assets become almost perfect substitutes of each other. There is also little evidence indicating that foreign subsidiaries or joint ventures abide by the international rules and norms that govern the corporate behavior in advanced countries.

While development of western rules, norms, and organizations that govern corporate behavior and protect the rights of shareholders was lagging behind, East Asian countries were engulfed in forces of democratic change and market liberalization. Beginning in the early 1990s, East Asian governments embarked on an extensive program for market liberalization and opening, fully embraced the WTO agreements and participated in a number of regional arrangements for trade liberalization and integration. In this milieu of the Washington consensus, many East Asian governments had to pullout from, and in so doing literally dismantled, the cooperative system of deliberation councils; hence, they let loose much of their control over large corporations and industrial groups. In the lack of monitoring and supervising by the government or banks, large industrial groups were free to pursue whatever they believed was in their interest.<sup>8</sup> With so many foreign loans available at reasonable prices, it was not surprising that an investment binge ensued. To exacerbate the adjustment problems during the transition period, many corporations in East Asia borrowed heavily from the short end of the market to make up for the losses they incurred, raising their leverage

---

<sup>8</sup> This argument does not suggest that government monitoring through the deliberation council was desirable or needed after the democratization process got underway.

above an acceptable level. In particular a large amount of short-term foreign currency dominated debt created a serious balance sheet problem which later dealt a deadly blow when the exchange rate collapsed.

## Part Two: Reform Agenda for a New East Asian Paradigm for Post Crisis Development

### *VII. A Critique of the IMF Program*

#### *VII-1. An Overview: The Background for Rethinking the East Asian Miracle*

Before the 1997 financial crisis, East Asia was often praised effusively for its economic achievements as an economic miracle. Five years later the region was left in ruins. Many pundits in the west wasted little time in debunking the miracle: to them, the miracle turned out to be a debacle. A region that had been proud of rapid growth with declining inequality and macroeconomic stability was suddenly reduced to a haven of reckless investors, insolvent financial institutions, and cronyism.

Over a three-year period since the collapse of the Thai financial markets, extensive theoretical and empirical literature for the rethinking the East Asian development model has emerged. This ever growing literature extensively analyzes the structural problems plaguing the financial markets, labor markets, corporate sector, and the governance system of East Asia as the major causes of the crisis. After the dust settled down and the initial shock from the crisis wore off, however, more serious analyses of the crises appeared, disputing the conclusions of the earlier studies. Also, the recent recovery in the region, which was much faster than expected, renewed interest in the reexamination of the East Asian development system from positive perspectives. As a result of these developments, there appears to be an emerging consensus that most of the alleged causes of the crisis have little theoretical or empirical

grounds for repudiating the model.

The crisis, however, exposed many of the structural weaknesses of East Asia: over-intrusive governments, lack of transparency, and corruption; inadequate corporate governance, financial systems without a proper framework of supervision and prudential regulation; and inefficient and excessive investment, mismanaged macroeconomic policy, including exchange rates pegged to the dollar, and the growing current account deficit that was continuously financed by short-term, unhedged foreign debts. This list is hardly exhaustive.

The reform programs developed by the IMF for the crisis affected countries were based on the premise that resolving these structural weaknesses is key to the recovery of East Asian. Many analysts have challenged this dogmatic view by arguing that the IMF structural reform programs were so misguided and unknowing of the institutional constraints the crisis countries were subject to that they would not work. In view of this continuing controversy and to develop a more realistic reform program, this paper will first turn to what went wrong with the IMF reform program in this section before proposing an alternative reform program in the subsequent chapters.

#### *VII-2. Structural Reform and Recovery*

The experiences of financial crises in other countries suggest that it takes an average of two to three years for an emerging market economy to return to the pre-crisis trend rate of growth. Thereafter, the GDP growth rates do not rise above the pre-crisis level, so that the level of the GDP remains permanently below the pre-crisis trend (Lee and Rhee, 2000). As shown in Figure1, the East Asian crisis countries have been able to bounce back in a V pattern adjustment, which was much faster than expected, after a year and a half of severe recession. In particular, the Korean recovery stands in sharp contrast to the stylized patterns of adjustment in that the initial GDP contraction and the subsequent recovery from it has been far larger than expected and what the cross-country evidence predicts.



<<Insert Figure 1>>

At the beginning of the crisis, there was widespread belief that the crisis countries' commitment to structural reforms would be critical to the recovery in East Asia. The reforms were expected to help East Asia emerge from the crisis with a more stable, transparent and efficient financial and corporate sectors. This expectation of reform espousing a market-oriented system would then improve long-term growth prospects and, at the same time, restore market confidence, thereby inducing the return of foreign lenders and investors to the region.

Three years into the reform process, the crisis countries have accomplished a great deal in improving the soundness and profitability of financial institutions and alleviating corporate distress. The World Bank (2000b) argues that "assertive structural adjustment helped restore credit flows and boosted consumer and investor confidence" (P.7). Yet, it is not clear whether and to what extent financial and corporate restructuring has contributed to the ongoing recovery. Most of the serious structural problems that were identified as the major causes of the crisis in Indonesia, Korea, Malaysia, and Thailand could not have been resolved over a span of two years. In fact, banks are still holding in their balance sheets a large volume of non-performing loans and remain undercapitalized in all four countries. Many corporations in the region are still unable to service their debts. As for institutional reform, new banking and accounting standards, disclosure requirements, and rules for corporate governance have been introduced, but they are not rigorously enforced. It will take many years for the new system to take root.

Since the crisis countries are not even half-way there in restructuring their financial institutions and corporations, it would be presumptuous to argue that the reform efforts have established a foundation for sustainable growth in East Asia. Nor, would it be correct to assert that the gain in efficiency through the restructuring, which is difficult to measure at this stage, has been one of the principal factors driving the

recovery. The improvement in efficiency is likely to be realized and translated into high growth over a longer period of time, certainly longer than two years.

The available pieces of evidence also do not support the contention that the market-oriented reform has contributed to restoring market confidence in the East Asian crisis countries; it certainly did not appear to have during the first two years of the crisis. International credit rating agencies report that the reforms in the banking sector in the crisis countries have not gone through enough to ensure that these economies would be able to forestall another financial crisis. Only toward the end of 1999, Moody's and S&P upgraded the sovereign credit ratings of Korea and Malaysia to the lowest investment grade from the speculation grade. By that time, the recovery was in full swing in East Asia. Journalistic accounts have been abound with similar concerns and continued to raise doubts to the effectiveness of the reform in the crisis countries. Numerous publications put out by the World Bank and the IMF seldom fail to stress the need to step up the pace of financial and corporate restructuring in the crisis countries. Under these circumstances, most foreign investors would find it too risky to return to the crisis countries, but they have. Many of the foreign investors appear to have been lured back by the rapid recovery and substantial improvements in external liquidity resulting from large surpluses on the current account.

Reflecting recovery rather than ratings improvement, capital inflows in East Asia have been rising, but still modestly and certainly below the pre-crisis level. Since policy changes and structural reforms are subject to many uncertainties and require a long period of time to take effect, international banks and global institutional lenders do not seem to have either the patience or ability to monitor and assess the effects of structural reforms. This is particularly true when they are preoccupied with the short-term performance of their portfolios.

### *VII-3. What Went Wrong with the IMF Restructuring Programs?*

As the IMF report (Lane *et al.*, 1999) admits, from the outset, the reform

programs for the crisis countries did not have a road map to guide the formulation and implementation of financial and corporate restructuring and institutional reforms, except perhaps the general policies of the Washington consensus. The IMF should not be criticized for the failure of developing a comprehensive framework *ex post facto*, however. After all, the IMF did not have the luxury of spending many months in designing a coherent program while the crisis was deepening every day, threatening the total collapse of the crisis countries. The program packages, therefore, had to bring in various reform measures that were presumed to help restore market confidence, reduce the likelihood of a recurrence, and improve the long-term economic performance of these countries without thinking much about possible conflicts between the different measures for different reform objectives.

Even with a well laid out plan, a complicated program, such as the IMF conditionality, which included a wide range of different measures of short-run operational restructuring as well as medium-term institutional reform, was bound to run into a host of implementation problems. The programs did not have a coherent plan. Therefore, it is not surprising that it has suffered from confusion in setting appropriate targets for restructuring, inconsistencies between different reform measures, and a wrong sequencing of financial and corporate restructuring. In the end, these problems have weakened the effectiveness of the IMF programs. This section discusses some of the problems created by a blurred road map of the IMF programs.

- Setting Operational Reform Targets ( underline might be better )

Since the IMF programs did not anticipate the sharp downturn of the economy, a massive currency depreciation, and the full extent of the financial and corporate sector problems, the reform had to be implemented in a reactive manner. Modifications had to be made as new information about the effects of the initial measures and the depth of the financial institutions' unsoundness and corporate distress became available (Lane *et al.*, 1999).

With this reactive process of implementation, the required strategy and operational targets for restructuring and institutional reforms could not be clearly

defined, or could have easily obtained consensus beforehand, and had to be adjusted repeatedly. Therefore, the reactive process raised the fundamental question of what would constitute realistic targets for operational restructuring and institutional reforms that would be sufficient to reduce the vulnerabilities of the crisis countries in terms of bank capital adequacy, the size of NPLs, and loan provisioning. Financial reformers, for instance, could not reach agreement on whether the operational definition of NPLs should be inclusive to all the loans overdue for more than three-month or longer or if they should eschew the old mechanical classification in favor of a set of new forward looking criteria. In the end, the crisis countries adopted the international best practice of forward looking criteria, though the new loan classification has not made it any easier to determine a reasonable level of NPLs, and hence, the amount of public funds needed for resolution.

The rationale behind the reform mandate in the crisis countries in which banks were required to raise their BIS ratios to over 10 percent, and in Korea large corporations to lower their leverage below 200 percent, before the end of 1999 was never made clear. Immediately after the crisis broke out, there emerged a consensus that insolvent financial institutions must be closed, and in fact, many were suspended or liquidated. The programs, however, did not have any clear picture as to whether it was desirable to close all of the money losing institutions at once or in some sequence. The programs did not indicate which types of institutions, new or old, should replace those liquidated institutions so that the stability of the payment system and credit flow were maintained and that the existing customers could be served, not to mention reemployment of a large number of skilled professionals shed by the failed financial institutions.

Confusion and dissension on setting the targets, which in turn have dictated frequent changes in implementation strategies, have provoked strong resistance by the affected groups and created uncertainties in the domestic financial markets on the pace and the extent of reform that is required. To many foreign market participants these changes have been viewed as evidence of backtracking on the part of domestic

policymakers.

- Conflicts between Reform Objectives

By following the reactive process of implementation, the authorities of the crisis countries may not have given due consideration to the question of whether the prescribed reforms were appropriate or consistent to one another. That is, the IMF programs did not fully appreciate possible conflicts between different reform measures and objectives as the following cases demonstrate.

- The reform programs were initially designed to restore market confidence and to develop a strong institutional foundation requisite for durable growth in the medium term. However, completion of operational restructuring (resolution and recapitalization of financial institutions and corporate debt workout) and institutional reforms does not automatically guarantee recovery and resumption of growth. As the experiences of the crisis countries elsewhere suggest, the restructuring and reforms could deepen the economic downturn in the short-run, unless they are complemented by expansionary macroeconomic policies. In all crisis countries, policy makers were indecisive as to when reflation of the economy should begin and what instruments--monetary and fiscal--should be employed.
- The IMF reform programs appear to have underestimated the seriousness of the possible conflicts between the operational restructuring of financial institutions and corporations on the one hand and institutional reform on the other. For example, the programs for all three countries saw the need to upgrade loan classification, loan loss provisioning and capital adequacy at banks, but they did not carefully examine whether the planned regulatory upgrading could be completed within a three-year period and the extent to which it could disrupt the recovery process. In many cases, banks were trying hard to reduce their exposure to those weak but viable borrowers, while the policy authorities were busy providing special credit facilities and credit guarantees to the same borrowers.
- The injection of public funds into banks for recapitalization led to government ownership of a growing share of corporate assets, banks, and other non-bank

financial institutions. Whether intended or not, this was clearly against the spirit of the IMF programs, which essentially espouse a market-led approach in financial and corporate restructuring. By mid-1999, the state had amassed a large share of banking assets, ranging from 18 percent in Malaysia to 78 percent in Indonesia (World Bank, 2000b). No one thought about how to deal with this nationalization problem and no one knows how, to whom and at what prices, these assets will be sold in the future. Since the privatization of financial institutions is often a lengthy process, the pervasiveness of the government in restructuring has raised the concern that the crisis countries may return to their old dirigisme regimes.

- In the IMF programs, many of the institutional reforms, including the reform of government bureaucracy and the legal system, were prescribed as medium-term priorities. At the beginning of the crisis, however, the institutional reforms were perceived to be critical to win back the confidence of foreign lenders in the crisis economies and thereby to stabilize domestic financial markets rather than to address, over a longer period, the underlying structural weaknesses of the economy. From the beginning, therefore, operational restructuring and institutional reform have been carried out simultaneously without making distinctions between the short-run priority of liquidity management and the medium-term priority of building a strong foundation for the prevention of future crises. This strategy has interfered with the implementation of institutional reforms in two ways.

As discussed in section III, the rush to introduce new corporate governance, a new regulatory and supervisory structure, and new accounting standards, and even to initiate legal and judicial reform in disregard of the difficulty of assimilating a set of alien institutions, has resulted in many cases with cosmetic reform. Worse yet, once the recovery got under way, it has become difficult to maintain the momentum of reform, because the recovery has diminished the need to improve foreign investors' confidence in the crisis countries. On their part, foreign investors and lenders have been losing interest in monitoring whether these countries are moving in the right direction in carrying out the planned reforms. There has been little

market pressure on these economies to stay on course with the initial reform program. In adjusting the sovereign ratings of the crisis countries, for example, the rating agencies appear to attach more weight to improvement in the external liquidity position and macroeconomic variables than restructuring progress. This lack of foreign pressure has given a false impression to the crisis countries that the international community is satisfied with their economic reform progress.

- Fallacy of Banking Reform Prior to Corporate Restructuring

As far as financial restructuring is concerned, the IMF and the policymakers of the crisis countries knew at least what should be done, drawing on the experiences of other countries that had suffered a similar crisis. However, there was no known “best practice” for corporate restructuring when practically all of the corporations in manufacturing were perceived to suffer from liquidity problems, as in Korea, and when all of the real estate, construction, and infrastructure sectors were lying in ruins, as in Southeast Asia. Debtors and creditors did not understand why such an alien approach as the London Rules had to be chosen for the workout of corporate debt, and why reducing the debt/equity ratio so drastically in the short-run was critical to the success of the IMF programs. Opinions were also divided, and remained so to this day, on the advantages and disadvantages of government-owned, centralized AMC versus privately-owned, decentralized AMCs in the management and disposal of NPLs at banks.<sup>9</sup>

The adoption of the London Rules, which are the procedures for voluntary, out-of-court settlements for corporate restructuring, was to some degree dictated by the absence of necessary market and government institutions for market-led restructuring, such as merger and acquisition, and a well functioning court-based resolution procedure.

---

<sup>9</sup> In order to deal more effectively with the management of non-performing assets, Korea, Malaysia, and more recently Indonesia have established centralized AMCs while Thailand has chosen a decentralized process in which each commercial bank is encouraged to establish its own AMC. AMCs could be effective in resolving insolvent financial institutions and selling their assets, although they are not expedient vehicles for corporate debt workouts, in particular for those in manufacturing (Klingebiel, 1999).

A centralized AMF is often more effective in forcing the operational restructuring of insolvent financial institutions and has the advantage of centralizing scarce skilled personnel. It could, however, become a place where NPLs and collateral are parked for a long period instead of liquidation (Baliño, 1999).

In this framework of out-of court workouts, the government was supposed to play the role of mediator, facilitating an orderly debt-resolution, and banks as creditors managing the workout of corporate debt. But, in most cases, the government ended up dictating the process.

In retrospect, corporate structuring should have been treated as an integral part of financial restructuring. However, it was not banks were to be restructured first by cleaning up their balance sheets and building up their equity base, and then to varying degrees letting them take charge of restructuring ailing corporations. The rationale for this approach was that after the rehabilitation, the structure of governance and prudential framework of banks would provide powerful levers to bring about corporate restructuring (Baliño, 1999). Contrary to expectations, this strategy has not been effective largely because many of the state-owned banks, which now dominate the banking industry, have been afflicted with the moral hazard syndrome of public enterprises and because they have not been able to resume normal lending operations. These problems have been holding up the recovery as well as the structuring process. The bank-first strategy could, therefore, pose a serious danger of necessitating repeated bank recapitalizations as evidenced by the recent experiences of Thailand and Korea.

When a bank was recapitalized through the injection of public funds, its management was invariably installed by the government. As often is the case with public enterprises, the state appointed bank management has been unwilling to change the status quo. It has certainly had little incentive to either to collect overdue loans or to engage in the workouts of weak, but potentially viable, corporations to which the bank lent money.

Since it is difficult to identify potentially non-viable firms and to forecast accurately how many of the restructured firms would be able to survive the current difficulties, corporate restructuring does not necessarily restore the soundness of the balance sheets of those recapitalized banks; the success of corporate reconstruction very much depends, among other things, on the speed of economic recovery. Given the difficulties of forecasting cyclical developments with little experience in investment



banking and the unreliability of corporate financial statements, distinguishing non-viable corporations from viable ones have been difficult, contentious, and time consuming. Under these circumstances, the restructured banks have taken an easy way out: they have avoided corporate workout as much as it could so as not to increase their holdings of NPLs or to lower their profits. As a result of this reluctance, the banks have kept many weak or near bankrupt corporations, which should have been either liquidated or subjected to workout, on their loan portfolios longer than necessary. Supporting many of their non-viable loan customers has meant that they have not had a sufficient amount of lendable resources to cater to the credit needs of healthy borrowers. The moral hazard problem has therefore delayed corporate restructuring and resulted in a deterioration of asset quality of the banks which has in turn undermined their long-term viability.

As noted before, the banks in the crisis countries were obligated to comply with the new, more rigorous regulatory requirements including a CAR over 8 percent. Since most of the banks were unable to raise equity capital, and still are, they had to either reduce their holdings of risky assets (mostly loans) or to issue high cost subordinated bonds to replenish their capital. Whichever option was chosen, a higher capital adequacy requirement has been costly and undermined their earning prospects. Lower profits have lowered the franchise values of these banks, limiting further their access to the capital market. Hellmann, Murdock, and Stiglitz (2000) suggest that the lower franchise value could lower incentives for making good loans, increasing the moral hazard problem. There is no evidence that East Asian banks have resorted to gambling in the face of the declining franchise values. On the contrary, they have become more averse in taking lending risks. Once public funds, or the tax payers' money, are injected into insolvent banks, the authorities of the crisis countries set a higher standard of performance for these institutions than others in terms of net profits and the volume of NPLs. Knowing that the government will hardly tolerate any further losses or deterioration in the quality of assets, bank management has withdrawn more from lending, in particular to small and medium sized firms.

The new CAR, together with strict loan loss provisioning and risk management, has taken a heavy toll as it has reduced the capacity of banks to supply fresh loans. This contraction, in particular in Malaysia and Thailand, has been severe and subsequently slowed down recovery as well as corporate restructuring. In Thailand, for example, the regulation and supervision tightening brought about a downward spiral as it made banks more reluctant to lend. This in turn led to a credit crunch--a decrease in the real supply of credit--and more business failures, thereby deepening the recession (Pakorn, 1999).<sup>10</sup>

The problems related to the regulatory upgrading were further complicated by foreign accounting firms and investment banks hired to conduct due diligence of banks and other non-bank financial institutions. In order to assure the credibility for reform, the crisis countries sought at the beginning of the crisis the services of the U.S. and Europe-based accounting firms, consulting agencies, and investment banks for estimation of NPLs and restructuring financial institutions, simply because there were no credible and reliable domestic counterparts. Understandably, these foreign organizations followed Anglo-American standards in due diligence and restructuring, which were unfamiliar to and more stringent than those of the crisis countries. Furthermore, given the pessimistic outlook of the economy, they were inclined to overstate the size of their NPLs at the banks. They were also concerned about their potential liability in case they overvalued assets (Baliño, 1999). As a result, in many instances, foreign accounting firms and investment banks magnified the bad loan problems at banks beyond a manageable level, thereby deepening the credit crunch.

Once subject to these new and tougher criteria for loan evaluation and due diligence, the lead or main creditor banks and debtors found it difficult to reach agreement on the modality of their debt workout. The insolvent corporations objected to what they perceived to be the fire sale of their assets. On their part, commercial

---

<sup>10</sup> At the same time, Thailand's stock exchange stipulated the prerequisites for new entrants, stringent minimum profits for several consecutive years, and a minimum number of shareholders, among other things. Most small-and medium-sized enterprises were hardly able to meet these requirements, while their access to commercial banks and finance companies was drastically reduced (Pakorn, 1999).

banks did not have the staff experienced in managing corporate debt workouts. Instead of evaluating project viability and the debt service capability of workout candidates, banks in Thailand, for example, were more inclined to recover their loans as much as they could by foreclosure on their assets if the candidate clients had pledged enough collateral or guarantees from reliable entities. If they did not, then banks would keep them on their books and continue to provide short-term emergency financing in order not to incur any further losses (Pakorn, 1999).

### *VIII. In search of a New East Asian Paradigm of Development*

#### *VIII-1. A Sketch of a New Paradigm*

Many of the structural problems in East Asia analyzed in section III may not have been any worse than those faced by other countries (including advanced countries) and may not have caused the crisis. Nevertheless, the crisis itself, and the subsequent revelation of the weaknesses in the crisis-hit countries, provide good reason to think about whether East Asian countries should stay with the old regime, reform it while keeping its major elements intact or eschew it altogether in favor of an Anglo-American model of free capitalism. While it may be premature to reach any definite conclusions at this stage of recovery, the discussion of the failures of the model in section III-3 leaves little doubt that it will have to undergo an extensive overhaul to be useful as a development paradigm, not because it was susceptible to crises, but because it may be a model too outdated to cope with the changes taking place in both domestic and global economies. For example, many of the policies that worked well at the earliest stages of development may no longer be effective, and the old governance system has become irrelevant to democratic regimes.

The East Asian development model is not a static concept, but rather path-dependent in the sense that its formation has been greatly influenced by cultural,

historic and political factors. The system will and, in fact, should evolve over time with societal, political and economic changes taking place in East Asia and throughout the global economy.

One clear conclusion that can be drawn from the analysts of Part One is that although the model is outdated in many respects, neither the crisis itself nor the structural failures have rendered the East Asian model dysfunctional. Certainly, the structural weaknesses do not lead to the conclusion that East Asia should emulate Anglo-American free capitalism, and that institutions and policies should be likewise developed to support the indegenization of such a model. The real challenges in thinking about a new East Asian paradigm for post crisis development would therefore lie in reforming the existing system to make it better suited for and more flexible to adjust to the new realities of East Asia and the rest of the world.

At the outset, it should be emphasized that East Asia covers a huge territory, is home to almost 2 billion people and accounts for 30 percent of the total world GDP. It would indeed be presumptuous to talk about a new paradigm for all of East Asia, just as it would be to define the East Asian development model as if it applied to all East Asian countries. In what follows, this paper will analyze whether the general features of the model are as appropriate to East Asia now as they were in the 1970's and 1980's. If not, what reforms are necessary in the financial, corporate and public sectors to rejuvenate it as a new paradigm for post crisis development in East Asia.

Over the last two years, the rapid recovery has renewed a reevaluation of the East Asian miracle and searches for the kinds of institutional reforms East Asia must undertake to regain its pre-crisis dynamism and strength. The rethinking centers on the question of whether the East Asian model still provides a better framework for development than an American, free capitalism model for an emerging market and developing economies. While the liberal policies of the Washington consensus still find many proponents, the virtues of the mixed economy are better appreciated than before (Rodrik, 2000). The East Asian model is one of a large variety of mixed economy models. Therefore, it is not surprising that one of the major conclusions one

can infer from the discussion in the preceding sections is that a new paradigm must be a mixed economy model that combines the state and market (laissez faire and intervention as was the old system). As in other developing and emerging market economies, therefore the major challenge facing East Asian economies in the coming decades is to evolve their own specific models of a mixed economy. In this evolutionary process, East Asian policymakers will have to realize that democratization has imposed a different participatory mechanism for consensus building, whereas market liberalization has reduced the scope of industrial policies and other types of market intervention. Markets will also have to be supported by a new set of institutions for financial regulation and supervision, corporate governance, and the management of industrial relations.

East Asia may not have to embrace Anglo-American capitalism. But, the global realities leave the region no choice but to conform to international standards of transparency, disclosure, corporate governance, and banking, all established by the advanced countries in Europe and North America. Compatibility between the new system and global standards and codes is important, because most of the East Asian countries will continue to rely on North America and European markets for their exports and to integrate themselves into a new global economy, which is likely to be dominated by the United States and EU. These two economies will dictate the rules governing international trade, foreign direct investment, and international financial transactions. At the same time, to be viable, the new system must be consistent with the rules of WTO and capable of accommodating the global activities of MNCs. It must also be flexible enough to adjust to the ongoing revolution in IT and the quality of government and to the other institutional constraints from the emerging markets and developing economies of East Asia.

What type of a model could satisfy all these old and new conditions and specifications? There would be little disagreement that fundamentally sound development policies will survive political as well as economic liberalization. In fact, East Asian countries should continue to adhere to these policies they benefited from

during the rapid growth period and every emerging market economy should be advised to do so. Despite the structural problems that crippled the functioning of the financial system when it fell victim to a speculative attack, East Asia may have to depend on a bank oriented financial system for an extended period of time in the future, until a legal and regulatory structure that provides adequate protection to outside investors as a foundation for efficient securities markets is established. As for the corporate sector reform, the East Asian countries will gain little by dismantling large family-owned businesses. What is needed at this stage of development is the strengthening of a bank-based corporate governance and other legal and judiciary reform that will improve the transparency and accountability of these enterprises and better protection of minority stock holders.

In the aftermath of the East Asian crisis, emerging market economies have been given two alternative choices for managing of the exchange rate: a free floating or currency board system. The experiences of East Asian and other emerging market economies do not support such corner solutions; instead, they suggest that other arrangements such as a crawling band system with capital control should be considered as viable options (Williamson, 2000).

Perhaps the most serious challenge East Asia will face with is managing a smooth transition to a democratic mechanism of coordination and cooperation. East Asia will have to ask and find a solution to the question of why democracies in the region have not been as effective as they could in moderating social conflict and inducing compromise and cooperation. The region will have to find ways of accommodating the growing demand of labor for political participation. In managing industrial relations, East Asian countries should weigh the relative advantages of the Anglo-American system favoring labor market flexibility and the European corporatist approach, which places more emphasis on labor's participation in economic and social choices. After many years of suppressive labor policies, the East Asian countries will have no choice but to make room for political participation of labor without compromising labor market flexibility. As far as the labor participation is concerned,

unlike other areas of economic management, there can not be a single approach acceptable to all of East Asia. Each country will have to fashion its own mechanism of participation and bargaining with labor compatible with its political system.

#### *VIII-2. Reform Agendas for a New Paradigm: Overview*

The preceding discussion on the East Asian development leads us to the conclusion that conceptualization of a new paradigm must begin with reform of East Asian institutions. There is indeed extensive theoretical and empirical literature on the importance of institutions in economic growth: the consensus emerging from this literature is that institutions matter for growth.<sup>11</sup> As Rodrik (2000) puts it, the question is no longer whether institutions matter but which institutions matter and how to develop them. A recent World Bank study (2000b) shows that “a 20% improvement in macroeconomic, trade, financial, and public institutions can add 1.2-2.0 percentage points to a country’s per capita growth” (P.144).

To be effective, a democratic regime with free markets will have to be supported by a set of new market supporting institutions, rules, and norms. Institution building is not easy, and it is a long-term process. As a result, although the old system of governance is being dismantled, a new system is nowhere in sight, thrusting East Asia into a long period of transition marked by uncertainties and confusion.

In charting a new development strategy after the crisis, many East Asian countries have accelerated their plans for building democratic, market institutions and at the same time improving the capabilities of their governments to manage the difficult transition period. As for the main thrust of institutional reform, the East Asian countries may have to focus on the following five areas:

- (i) Establishing and enforcing democratic rules of governance to replace the East Asian system of coordination and cooperation over time;
- (ii) Improving the quality, effectiveness, and efficiency of the delivery of public

---

<sup>11</sup> See Mauro (1994), Knack and Keefer (1995), Temple and Johnson (1995), World Bank (2000b), and Rodrik (1995 and 2000).

services;

- (iii) Reducing the incidence of corruption that has become systemic and, in recent years, more pervasive in the government, businesses, and financial institutions;
- (iv) Enhancing the effectiveness of the judiciary system; and
- (v) Developing an effective system of regulations

Corruption is too large an issue to be adequately covered in this paper.<sup>12</sup> Combating corruption is such a difficult and politically sensitive issue that fighting it goes beyond implementing liberal economic policies and enacting better laws and that many East Asian political leaders, while supporting such efforts, have been reluctant to undertake them. Many of the anti corruption measures and campaigns have invariably ended in failure in many parts of East Asia mostly because of the lack of political will or capacity, such as proper strategies and structures.

Klitgaard (1998) suggests that international cooperation could assist individual countries to develop the necessary will and capacities. In this regard East Asian countries could join forces to develop regional schemes for combating corruption, such as sponsoring private sector studies of corruption in many areas throughout East Asia. These studies will then be used to devise measures that will help reduce the incidence of corruption. The regional cooperation could also assemble and disseminate examples of best practices for corruption fighting.

Greater reliance on the market system for economic management, of course, does not mean that East Asian governments do not have any important roles to play and must blindly move toward being a minimalist state. Instead, the challenges facing many East Asian countries, in particular less developed ones such as Cambodia, Laos, Myanma, and Vietnam, would be to develop a strong but limited government.<sup>13</sup> And, within this framework of government, these countries may have a better chance of managing the needed industrial policies, acceptable within the WTO framework, to facilitate technology transfers and to manage limited intervention in the market when

---

<sup>12</sup> For a review on corruption and development, see Bardhan (1997).

<sup>13</sup> A strong but limited state is strong enough to resist political pressures for market intervention, but unlike a strong state, it is willing to accept market-led growth (Bardhan, 1996).



market failures dictate stronger action. This means that the priorities for reforms include developing rules and norms that will provide government officials with incentives to act in the collective interests while controlling corruption and arbitrary actions.

At the sectoral level, two areas of reform deserve our attention. One area concerns reform of the financial sector. Theory and experience do not prove that a market oriented financial system is more effective in promoting economic development and financial market stability in emerging market economies. In fact, many East Asian countries, particularly those at earlier stages of development, may have to improve efficiency and stability of the banking system before entertaining the idea of developing money and capital markets, because their priority is on the institution of an efficient and stable payment system. However, in a world with increasingly globalized financial markets, other East Asian economies may find it desirable to reduce gradually indirect financing by financial intermediaries in favor of direct capital market financing.

If there is one lesson to be learned from the crisis, it is that East Asian corporations will not be able to maintain robust growth unless they reduce their leverage by going directly to capital markets rather than to banks for their investment financing. In this regard, the backwardness of capital markets could serve as one of the major constraints on growth in East Asia. Therefore, more developed East Asian countries may attempt to develop simultaneously both market-based and bank-based financial systems. Both require a set of prudential regulation, supervision, and administrative rules, although the development of capital markets requires a more elaborate system of regulations and legal infrastructure. Development of the regulatory and legal infrastructure may in turn require a medium-term strategy in which reforms involving capital adequacy, loan classification, loan-loss provisioning, and risk management and corporate governance are implemented on the basis of international codes and standards.

The second area of reform is related to corporate restructuring. Despite their problems of inefficiency, non-transparency, and inadequate governance, at this stage of development, the dismantling of East Asian family industrial groups may not be

desirable. The experiences of western economies suggest that the building of market institutions, better governance, transparency, and the protection of minority stockholders over time strengthen market discipline to which the East Asian industrial groups will be subjected to and which weed out the inefficient groups. Increased competition from domestic market liberalization and integration into the global system will also weaken the traditional advantages of a large, family-owned group. In particular, the growth of knowledge-based industries could accelerate the breakup of these groups (World Bank, 2000b). It is also worth noting that East Asian industrial groups are not so much products of Asian values, as they are of a certain stage of economic development. Some of today's industrial icons, such as Ford, Thyssens, and Siemens, started out as family businesses. Over time, they have become modern, transparent, and shareholder friendly corporations (*Economist* 4/29-5/15, 2000).

Finally, in promoting the institutional reforms and institution building as suggested in this section, the East Asian countries will be well advised if they appreciate the local constraints and rely more on the local knowledge than the so-called best practice model of West and foreign advisors (Rodrik, 2000). Without proper indigenization and assimilation of western reforms, there is the danger that new institutions can be ignored or circumvented. More serious problem is that the crisis countries may not benefit from the signaling function of western reform. Serious efforts at institutional reform in emerging market economies may often serve as a signal to foreign market participants that the crisis countries are indeed transforming themselves to develop institutions compatible with those of western societies. During the normal period, the market participants will most likely be indifferent to the quality of institutions. However, once the emerging markets' economies are perceived to be vulnerable to a crisis, they seize the opportunity to scrutinize institutional quality and the ability of these countries to implement reform. If foreign investors discover that the reform is rather superficial, they withdraw their investments, precipitating a crisis. Then the reforming countries lose the signaling function of and past investments in institutional reform (Pistor, 2000).

## *IX. The Role of the Government and Governance Mechanism*

### *IX-1. The Role of the Government*

In view of a long history of development led by strong states, it may be surprising to find that most countries in East Asia have, to varying degrees, embraced so readily the policies of the Washington consensus: macroeconomic stability, privatization and market deregulation (including the labor market), flexible exchange rates, institution building, and increased education spending (Williamson, 1996). The main message of the Washington consensus is that with the absence of government intervention, private markets will be able to ensure the efficient allocation of resources and generate robust growth (Stiglitz, 1998). This liberal ideology has reached the corners of East Asia's least developed countries: Cambodia, Laos, Myanmar, Vietnam, and the inner regions of China. Policymakers, and even the old socialist style planners in these economies, do not have an East Asian development model in mind when charting future development strategies, more so after the East Asian crisis.

Democratization and market liberalization have brought about significant changes in the role of government in East Asia, the changes that were not expected only a few years before. The general public is demanding more active participation in political processes and government management, government accountability, and the eradication of corruption. Compared to the 1960's and 1970's, East Asian governments now have a limited role in allocating resources through planning and the provision of incentives and subsidies. They are instead under strong pressure to provide a variety of social services, such as health care and pension, the protection of workers, low-income groups and the elderly, the protection of the environment, education, and the establishment of an appropriate legal and regulatory system; all which were relegated to a category of secondary importance before (World Bank, 2000).

The growing demand for welfare services has put severe strains on a government's fiscal management, as their ability to mobilize additional resources required for the provision of these services is limited and has also required the building of a consensus, often a long and acrimonious process.

For the next several years, East Asian governments will have to manage reform of their financial systems, corporations, and public sectors. Now that the revolution in IT technology threatens to leave many East Asian countries more technologically disconnected, the governments of these countries must engage more actively in building human capital and acquiring new technology. Globalization and the integration of financial markets have increased the frequency of financial market failures, such as panic and herding, and have complicated further coordination difficulties. In a world of free capital mobility, capital account liberalization has weakened the effectiveness of traditional instruments of monetary and fiscal policy. Globalization has created serious social tension in small open economies, as it has exposed a deep fault line between groups who have the skills and mobility to flourish in global markets and those who do not (Rodrik, 1997). At the same time, globalization has made it exceedingly difficult for governments to provide social insurance to groups that remain internationally immobile, as a way of helping to maintain social cohesion. The increasing mobility of capital and skilled workers and professionals has reduced the effective tax base. As a result, in order to support an enlargement of social insurance, governments of developing countries are often forced to follow a contradictory policy in which they impose more tax on the group of people they are to protect. Given this inherent dilemma associated with globalization, Rodrik (1997) argues that market-opening policies should not be prioritized first, since it makes little sense to sacrifice social concerns for the sake of liberalization.

The increase in social tension is not the only problem arising from the globalization of markets. It seems that the services of a strong, or a strong but limited government are more in need than before. Although the post-war experiences of Scandinavia and Japan suggest that a strong government can flourish in democratic

regimes. East Asia as a whole is moving toward being a minimalist state which can not perform social welfare functions on a large scale. More advanced countries in East Asia, such as South Korea and Taiwan, have deviated further away from the East Asian vintage model of the 1960's and 1970's to move closer to a Washington consensus regime. For these and other more advanced countries in East Asia, it may no longer be feasible, or even desirable, to return to their old regimes of a strong state, but the same can not be said for other economies.

The macroeconomic and social welfare problems associated with economic integration would be more severe in the least developed countries -- Cambodia, Laos, Myanma, and Vietnam -- which are likely to suffer from inefficient bureaucracies with a limited capacity to formulate and implement policies. In these countries, markets do not function properly, and the number of specialists and professionals with experience are extremely small. The bureaucracies of these countries often find it difficult to bring these experienced professionals into the government to form a technocratic elite. Instead, many of them are scattered around in the private sector, and those remaining in the government seldom have influence in policymaking. East Asia's least developed countries may have to learn from the experiences of Indonesia, Chile, and Korea in the 1970's : in order to develop a strong state, qualified and experienced professionals must be attracted into government positions. Is there a risk that such a strategy may support and perpetuate authoritarian regimes? That will not depend on the commitment of political leadership to democracy. If the political leadership in these countries has an encompassing interest in the overall performance of the economy, there is no reason why it could not develop an efficient bureaucracy insulated from the pressures of political expediencies.

#### *IX-2. Governance*

As noted in section III, together with market liberalization and global integration, democratic changes have imposed a new governance system fundamentally

different from the consultative mechanism of coordination and competition involving the government, private sector groups (including corporations), and banking institutions.

Political changes in East Asia have not necessarily brought about a new system of governance consistent with democracy, however, because many institutions that traditionally support democratic governance have not yet been established. According to Yusuf (2000), democracy could promote good governance if certain procedural and constitutional rules are in place. These rules specify the division of responsibility between the central and sub-national entities and between different branches of the state. Further divisions determine representation by different groups and regions of the country on legislative bodies and the formation of parties and specific election times.

Although it has been more than a decade since East Asia turned to liberal ideology, the market system does not work as well as it was expected, because it is not supported by a system of laws, courts, and institutions that protect property rights and enforce contracts. Rodrik (1998) identifies five types of institutions essential to make markets function properly. They are: property rights; regulatory institutions; institutions such as the central bank for macroeconomic stability; institutions for social insurance; and institutions for conflict management. A new legal and regulatory framework must also include: rules for contracting, bankruptcy proceeding, and regulations and laws governing financial institutions and markets, promoting market competition, and protecting the rights of shareholders and creditors. In rethinking the East Asian miracle and considering the priorities for the region, Yusuf (2000) argues that the future mechanism of governance deserves the closest attention.

Even in the relatively more advanced countries of East Asia, building the institutions necessary to make democracy and the market work better has been a slow process because of the past legacies of a strong government. While the old regime of governance has been rendered ineffective and moribund, a new system is nowhere in sight. The slow process has left the East Asian governance in disarray. There is no denying the urgency of creating new institutions for better legal and regulatory systems. Western rules are important, and East Asian countries would be ill advised to abruptly

graft western rules on their societies. Those imported rules and practices must be filtered through local practices and needs, as Japan did in introducing a legal system based on a German model (Rodrik, 1998). Obviously this process will stretch over many years, if not decades. Important issues to consider are what type of governance is appropriate during this transition period and how it could be devised.

### *IX-3. East Asia and the Emergence of the New Economy: New Industrial Policy*

A new economy has arrived, and it is real. A new economy that is driven by information technology, in which an increasing share of trade in goods and services and various types of financial transactions, transcending national borders in cyberspace, are growing rapidly. A variety of technologies, particularly those associated with the Internet, have been disrupting and driving out many traditional industries while creating a host of new service oriented ones and opening new opportunities for exporting technology related services in East Asia. The Internet is reshaping the business landscape as it fundamentally alters those factors determining business competitiveness. Over time, the ongoing IT revolution will change East Asia's industrial structure as well as its comparative advantage. Many countries like India which have not had any measurable comparative advantage in producing and exporting manufactures may suddenly find that they can be competitive in IT based service exports such as software, telemarketing, and data transcription.

Another development is the new emphasis on improving total factor productivity (TFP) as an important source of medium-term growth in East Asia. A number of recent empirical studies on TFP show that productivity gains have been slow in East Asian economies, although they are a lot higher than similar figures for other developing countries (Yusuf, 2000). These TFP studies then suggest that East Asian countries could attain their past growth rates through productivity improvement, even if saving and investment rates fall from their pre-crisis levels.<sup>14</sup> This prospect has

---

<sup>14</sup> It should be pointed out that although returning to the pre-crisis trend growth may hinge on TFP gains in the crisis countries, TFP estimates do not necessarily indicate whether investment rates are excessive or

encouraged many East Asian countries to embark on a new strategy for developing knowledge-based and IT oriented industries. With the support of the World Bank and IMF, the crisis countries are expected to allocate more investment resources to these industries which are dynamic sectors for trade and productivity gains. Such a shift in investment will therefore help improve national productivity and the competitiveness of many other traditional industries and firms.

Except for Japan, South Korea, and Taiwan, other countries in the region have not been able to move out of their technology adopting groups. East Asian countries that do not keep up with global IT technology may collapse, rendering them incapable of even maintaining their living standards. Furthermore, information technology is less likely to converge than other forms of technology: East Asia may find it difficult to narrow the technology gap that exists between the region and advanced countries.

Yet, whether East Asian countries could create a second miracle may depend upon their ability to tap into the new economy (World Bank, 2000). Can the old East Asian model of development be capable of facilitating East Asian countries with the ability to catch up with the advanced countries in terms of technological sophistication? If not, how should the East Asian model be modified or adjusted to speed up the conversion process?

According to a recent World Bank study (2000), a development model that could take advantage of the technology and knowledge revolution requires the following components: economic and institutional policies that facilitate a quick response to technological changes; a dynamic information technology infrastructure;

---

not. That is, the findings of low TFP growth in East Asian economies by Young (1994) and others do not necessarily prove that capital investment was excessive in these countries. Furthermore, there are clearly limits to the conventional growth-accounting method because it does not clearly distinguish between different sources of growth. If capital and technology can not be clearly separated, then TFP is not a true measure of technology progress. The distinction between capital and technology is often ambiguous. If technology is embodied in imported capital good, then, it is hard to separate capital from technology. Growth-accounting is a mere mechanical calculation; it does not explain a causal relationship. For example, technology grows at an exogenously given rate of  $x$  at the steady-state. Then, capital and output will also grow at the same steady-state rate  $x$ . Growth-accounting will then attribute  $\hat{a} \cdot x$  ( $\hat{a}$ =capital share) of output growth to capital growth. Thus, although the true contribution of technology to output growth is 100%, growth-accounting underestimates it by  $(1-\hat{a})$  100% (Easterly and Levine, 2000).



and a highly skilled and creative population. Have most East Asian countries (excluding Japan) have developed these components? Would the East Asian development model help create an environment conducive to technological innovation as well as adoption?

The World Bank miracle study points to the region's ability to adopt new technologies and its well-educated population as its main strengths. In the 1970's and 1980's, many East Asian countries were highly successful in expanding their capacities to adopt new manufacturing technologies in such sectors as automobile, household electronics, ship building, and machinery. These sectors were then transformed into export-oriented industries. These experiences and the East Asian strengths suggest that East Asian countries will be able to catch up with western information technology in the 21st century if all crucial steps are successfully completed.

However, successful technological innovation requires close cooperation among the government, academia, the industries and industrial policies (Sachs, 2000). During the 1970's and 1980's, the East Asian cooperative mechanism involving government, corporations, and financial institutions facilitated the transfer of foreign technology. As Sachs puts it, "America has a sophisticated industrial policy for the uptake of IT: so should developing countries." The revolution in IT technology is one development that may restore viability to the cooperative mechanism of old East Asian model, at least in some East Asian countries.

#### *IX-4. Democratization and Labor Participation*

One of the major characteristics shared by the eight East Asian countries was flexibility in the labor market that had been sustained by rapid growth before these countries embarked on the democratization process. As long as the economy was growing at a double-digit rate, generating a strong demand for labor, there was no need to suppress wage increases. More than anything else, rapid growth fostered a highly integrated market with a compressed occupational structure of wages. But, most of the

East Asian government exercised greater control over business-labor relations, suppressed labor movements, in particular the activities of the economy- and industry-wide unions. Although the benefits of rapid growth are widely shared, labor was, by and large, excluded from the political process.

As a result, a smaller minority of the overall work force, and even that of the modern formal sector, participates in labor unions. Collective bargaining coverage is even smaller than the degree of labor representation. Democratic transformation has also generated a growing interest in developing mechanisms for greater popular participation in political and social institutions, including the institutions for labor market governance at the national and enterprise level. Reflecting this interest, an unprecedented number of tripartite initiatives involving labor, management, and government have been proposed. And, the crisis appears to have given these initiatives a new impetus.

Advocates of a more participatory approach on the part of labor claim that the absence of democratic mechanisms had a role to play in causing the crisis and that the economic advantages of participation are unobtainable in the absence of independent and representative worker organizations. What are then economic advantages for creating democratic mechanisms for labor participation? It is often argued that the tripartite procedures could improve economic performance and minimize social instability through the resolution of conflicts that otherwise impede adjustments to external shocks (Campbell, 1999). Rodrik (1999) makes a similar point that greater and improved social dialogue at the micro level through participatory political institutions that mediate conflict among social groups, including labor and business, can facilitate policy adjustments and reform.

There are other advantages of labor participation. In a globalized competitive environment, firms have to rely on the knowledge and information of employees more than before and have to acquire the ability to adopt to changes in technology and product market. These features of a competitive firm requires extensive communication exchanges between labor and management, which can be achieved

more readily at a unionized setting.

The problems of information asymmetry may also call for the creation of democratic participatory mechanisms at the enterprise level. The interests of labor and management often diverge and, hence, relevant information is not identically perceived. Social dialogue or democratic participation can be a tool solving the information problem, a mechanism through which commitment is instilled and resistance is minimized. In the end, better decisions are made, and they are better enforced. Campbell (1999) provides Korean experience with the tripartite approach that has been most extensive and influential in East Asia as evidence that better social dialogue leads to better economic performance.

The importance of social dialogue is widely recognized, but at the same time, strong unionism advocated by the ILO, for instance, may not be desirable, because together with minimum wages, it could reduce flexibility of the labor market and thus generate dual labor markets which in turn generate wait unemployment as people queue for the good jobs (Layard, 2000). While Layard believes that workers should have “some basic normal employment rights” he is also against artificial limits on working hours, and scheme to promote an early withdrawal from the work force in developing countries. Instead, he emphasizes the importance of education as a means of promoting employment and earnings of workers. With the increasing mobility of capital around the world, the earnings of the work force of a particular country would depend mainly on its skill. Education is the prime determinant of earnings and also an important factor contributing to a high level of employment.

The new Korean government that came to power in 1998 placed the creation of a tripartite commission at the top of its reform agenda to restore industrial peace and to mobilize nationwide support for the economic restructuring it was about to undertake as part of the IMF conditionality. The commission was inaugurated early in 1998 with the high hope that it would negotiate an agreement between labor and management on matters related to sharing the burden of restructuring. During the first year of its operation, the commission was successful in eliciting labor’s support for a restructuring

program that resulted in a large increase in unemployment. A year later when the economy began to recover, however, labor was becoming less cooperative, refusing to give tacit support to the government program. Two labor federations represented at the tripartite commission refused to accept any more layoffs resulting from restructuring and demanded wage hikes. When their demand was not met, one labor federation withdrew itself from the commission. Although the federation returned to the commission recently, the commission has been stalled in one dispute after another, and few in Korea believe that the commission will regain its earlier status or influence as a decision-making mechanism for economic and social decisions.

Many skeptics argue that in retrospect, the tripartite commission was able to support the restructuring because right after the crisis broke out, there emerged a national consensus on the urgency of restructuring corporations and financial institutions, not necessarily because it was an effective participatory institution for labor. They also point out that in a society where the tradition of social dialogue for consensus building does not exist, tripartite approaches would have their limits as an effective mechanism for labor participation.

One reason for this pessimistic view is often traced to the absence of political parties supported by labor. Worker organizations, which have a relatively short history in Korea, have not had the opportunities to participate and negotiate with other political groups in making economic and social policies at the national level. Partly for this lack of experience and tradition, the government and management representatives complain that they could not conduct meaningful discussions at the committee. Frustrated at labor's inability to deal with policy issues, the government and management representatives have expressed their reservations about continuing the dialogue with labor. Their earlier confidence in the tripartite machinery has been waning. On their part, unable to push through their demands, labor has often resorted to mass mobilization tactics. The fragile foundation for mutual trust among the participating members could not withstand the harsh process of restructuring. This is the second reason.

A third reason is that labor union federations participating in the tripartite committee may not truly represent the interests of labor. In Korea, only 12 percent of the total labor force belong to various unions. This percentage is smaller in other East Asian countries. While so many workers are left out of the formal process of participation, critics argue that whatever decisions the tripartite approaches may make, conflicts over labor issues with management are likely to remain unresolved. Finally, in many East Asian countries including Korea, the formation of economy- and industry-wide unions are not allowed. As a result, loosely structured federations of enterprise unions represent the voice of labor at the tripartite commission. These federations can not control easily the rank and file at the company unions because there is no multi-tiered consultation mechanism at the industry and regional level and hence are constrained in enforcing many of the policy decisions they agreed to at the commission. Their lack of ability to enforce the committee's decision has undermined the effectiveness of tripartite approaches in Korea.

What types of labor market reforms are needed at this stage of development in East Asia? On this question, labor experts as well as policy makers are divided on an Anglo-American system of flexible labor markets and a corporatist approach of labor participation favored by many European countries. The choice will be dictated in large part by the degree of labor mobility between industries and between firms and the extent to which organized labor should be brought into the policy-making process at the national level. After many decades of suppressive labor policies, and faced with the growing demand of labor for openness and political participation, East Asian governments could no longer persuade either labor or the society as a whole the rationale of discouraging union movements. They will have to find a proper place for labor in political and social institutions.

It is often argued that the tripartite mechanisms in the corporatist tradition have been successful in promoting labor participation without sacrificing the flexibility of the labor markets in a number of smaller European countries such as Denmark, Ireland, Norway, and Austria (Visser and Hemerick, 1997). Although Korea's experience with

a similar approach has been less than encouraging, it is premature and unrealistic to argue that economic and political conditions are such that East Asia could not embrace the European tripartite approach and instead should place more emphasis on the Anglo-American tradition of labor market flexibility.

#### *X. Reform of the Financial Sector*

The East Asian experience also raises the question as to why the countries in the region did not initiate financial reform earlier to loosen the control over financial institutions and markets and also to develop a more balanced financial system where capital markets compliment the banking industry. There were several reasons for their reluctance to follow a liberal reform. One reason was the problem of inertia and complacency bred over a long period of rapid growth before the crisis. As far as the East Asian economies were concerned, the bank-dominated financial system had worked very well for them in sustaining rapid growth and industrialization. There were no compelling reasons for these countries to tinker with the system until they were forced to open their fledgling capital markets to foreign competitors.

Another reason had to do with a theoretical justification for both financial restraint and reliance on a bank-dominated financial system in developing countries. Problems with incomplete information, markets and contracts tend to be more severe in the financial sector. In any economy, whether developed or underdeveloped, these deficiencies weaken and sometime break down the functions of the financial system. Failures in the financial systems can be more frequent and serious in developing economies where market incompleteness is, in general, more pronounced. Furthermore, in many developing countries, round and effective legal and regulatory systems often do not exist. Under these circumstances governments of developing economies often intervene and impose restraints on lending and other bank operations

to improve the efficiency of the financial sector.<sup>15</sup>

Stiglitz and Uy (1996) and Stiglitz (1998b) argue that financial restraints, or repressive financial policies in East Asia had their share of problems, but made an important contribution.<sup>16</sup> For example, deposit rate controls increased the franchise values of banks and, hence, discouraged them from taking excessive risks that otherwise might have destabilized the financial system. One might argue then that the economic costs resulting from financial restrictions, however, were more than offset by the gains from greater financial stability and that the removal of financial restraints was one of the causes of crisis in East Asia.

The literature on finance and development suggests that the more pronounced the information asymmetries and the higher the transactions costs are, the more preferable banking arrangements are to direct securities markets. In developing economies, where informational problems are severe because accounting and auditing systems are typically less reliable and shareholder rights are not adequately protected, banks assume a more important role than in advanced economies. In the course of development, institutions specializing in gathering, assessing, and disseminating information appear, as do regulatory agencies that can enforce greater disclosure and legal systems that protect the rights of investors and effectively enforce contracts. This institutional development makes it possible to nurture bond and stock markets. In practice, however, banks have remained the dominant source of external financing even in advanced countries.

In a recent paper, Aoki (2000) argues for the desirability of relying on a bank dominated financial system at an earlier stage of development on the grounds that much of the information that is critical for financial transactions can not be digitalized or

---

<sup>15</sup> On this question, there is the question of government failures. Government intervention can not be justified, if the legal and regulatory systems are not efficient and reliable.

<sup>16</sup> Hellmann, Murdock, and Stiglitz (2000) distinguish financial restraint from financial repression. The former is used to improve the efficiency of financial markets whereas the latter is designed as a mechanism for the government to extract rents from the private sector. In reality, however, such a distinction can not easily be made.

disclosed because it is tacit. The role of banks, in contrast to that of capital markets, is to process information regarding borrowers and their conducts that is often tacit. In providing finance to enterprises in developing countries, lenders in many cases have to deal with less standardized and unquantifiable information on the quality and reliability of entrepreneurs and managers, which is an important element of the *ex ante* monitoring of borrowers. This *ex ante* monitoring dealing with tacit information can not easily be substituted by introducing capital markets. The reliance on the banking system does not imply that the East Asian emerging market economies could ignore more specialized capital market and monitoring activities such as derivative transactions and securities underwriting and trading. Aoki argues that this line of business should be developed in parallel with the monitoring of tacit information, because they are complementary to each other. To this end, Aoki advocates the development of a universal banking system in which the holding company controls the multiple subsidiaries.

There is also the argument that bank intermediaries are more efficient than open securities markets for supplying long-term financing to industry. One reason for this is that banks could lengthen the investment horizon of firms while they monitor the activities of their borrowers. Another is that banks can also enter into repeated relationships with borrowers in order to mitigate informational distortions. This relationship banking, in turn, can facilitate the provision of long-term (or at least ongoing) credit.<sup>17</sup>

In a number of recent papers, Demirguc-Kunt and Levine (1999) and Levine (2000) show that well developed financial systems exert, independently of whether they are dominated by banks and other financial intermediaries or financial markets, positive influences on economic growth. However, their cross-country study indicates that neither intermediary-centered nor market-centered financial systems are associated with

---

<sup>17</sup> Mayer (1988) argues that competition in the financial markets can have time inconsistency costs that result in a decline in long-term financing. Yanelle (1989) shows scale economics and Bertrand oligopolistic competition that imply unfettered competition in financial intermediation are not likely to be realized and that deregulated banking may not lead to an efficient allocation of resources.



high growth in countries at different stages of economic development. That is, the financial structural characteristics pertaining to dominance, either by financial intermediaries or markets, are immaterial to promoting economic growth.

Instead, they argue that legal environment and development are more critical to financial development than financial structural characteristics. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1999) suggests that the legal environment for investor protection and contract enforcement is the most critical determinant of the level and quality of financial services, and thus to the development of both financial intermediaries and market. According to this view, a well functioning legal system could nurture economic development, as it facilitates the operation and improves the efficiency of both financial institutions and markets. Hence, they argue the debate on the relative merits of the intermediary or market-centralization of the financial systems either in advanced or developing countries is not analytically meaningful.

While the importance of the legal environment can not be denied, it should be also pointed out that the legal approach does not prove that banking arrangements are less efficient or preferable in mobilizing and allocating savings than direct securities markets are in developing economies. As shown empirically by Demirguc-Kunt and Levine (1999), national financial systems tend to become more market-oriented as countries become richer and develop a well-functioning legal system. In most developing countries, the existing legal systems hardly provide a strong protection of the shareholder and creditor rights and contract enforcement. Accounting practices and disclosure requirements do not meet international standards. Because of these institutional weaknesses, information asymmetries are more serious and transaction costs are higher.

Developing economies may therefore have to rely on bank-based financial systems because these structural problems act as a major constraint for fostering a market-based financial system, at least in the early stage of development. The bank-dominated system is a more realistic way for developing countries to grow, but to be efficient the systems should not be subject to undue state influences. Instead, they

should be exposed to more competition and be prudently regulated. East Asian countries might not have met these criteria and failed to adjust as globalization was taking place (World Bank, 1998, P.56). However, emerging market economies may not be able to sustain robust growth as long as they depend on a bank-oriented financial system.

Although East Asian economies are likely to be better off by staying with a bank-oriented financial system until the regulatory and legal infrastructure that could support a well functioning securities market is established, this does not mean that they do not have to reform their financial system. The list of reforms for stable and sound banking system is long and growing. And, the strict separation of commerce and banking tops the list: the separation should be observed so that industrial groups or large enterprises can not own controlling stakes in banks and other financial institutions. There are other reforms that deserve close attention for building a more stable and competitive banking industry. They are:

- There is little disagreement that financial reform should begin with the re-privatization of state-owned banks, non-bank financial institutions, and corporate assets. If ownership and management control of major banks and other financial institutions remains in the hands of the government as it is likely to, the government can not extricate itself from its extensive involvement in the reform process, leaving little room for the market to intervene. After three years of operational restructuring, however, the crisis countries have reached a point where they can no longer postpone the selling of state-owned financial institutions back to the private sector, for re-privatization holds the key to the successful reform of corporate governance in general and large, family-owned groups that dominate many industries in particular. Re-privatization will also help ease the growing government debt burden of restructuring and secure additional public funds needed to implement a second round of restructuring if needed.

If enforcement of the general principle of the bank-commerce separation is desirable, then a single individual or family owned conglomerate should not be

allowed to own a large stake in banks and other financial institution. In this case, the state-owned bank stocks will have to be sold to the general public for their wide dispersion. However, ownership dispersion does not necessarily prevent the large groups from exercising management control of financial institutions, because they can always command a large block of voting stock by putting together a number of small shareholders through a cross ownership arrangement. Knowing this possibility and difficulty of regulating such a collusive behavior, the government may attempt to form its own group of small shareholders (usually other institutions it controls or owns) to thwart the efforts of the groups, as Korea has in the past. The government's counter action may be justifiable, but it does not serve the purpose of re-privatization.

If a widely dispersed ownership of banks and other financial institutions is not a viable option, then an effort could be made to establish privately-owned investment funds created primarily for the takeover of these financial institutions. Another option is to create financial groups which are not subject to ownership restrictions and are not related to industrial groups or do not own any industrial or commercial entities except for their stocks for financial investment. To encourage the formation of these groups, the government could provide tax and other incentives to the large conglomerates to spin off their financial firms to establish an independent financial group or financial holding company.

- Easing restrictions on foreign entry into the domestic financial services industry

Economic forces driving the globalization of finance have been gathering speed in recent years and will continue to do so. Regardless of their policy and strategic preferences, the East Asian countries will be forced to adjust to this trend by opening their intermediation markets and providing a level playing field to foreign competitors. If the ongoing worldwide financial integration is going to be a natural and unavoidable development, the East Asian authorities should consider taking advantage of their market opening as an opportunity to exert pressure on domestic financial institutions to prepare themselves for foreign competition by

improving their balance sheets and operations and also by consolidating among themselves through mergers and acquisitions. Foreign competition will serve as a credible threat to domestic financial institutions in that unless they reform themselves voluntarily, they will not only lose their market shares but also could be driven out of the domestic intermediation market.

- Recapitalization through the stock market

The banking reform will gain more credibility and become more effective if corporations and financial institutions are able to develop a greater access to capital markets for investment financing and recapitalization. Many firms and financial institutions in Korea and Thailand were successful in raising equity capital and issuing debentures in 1999 when the stock markets in the region were booming.

A recent financial statement analysis by the Bank of Korea (2000), for example, shows that at the end of 1999 the average debt-equity ratio of 2,046 sample firms in Korean manufacturing fell by 88.3 percentage points to 214.7 percent from 303 percent a year earlier. 36.6 percentage points of the drop were accounted for by recapitalization through rights issue. A similar figure for a sample of 513 companies listed at the Korea Stock Exchange dropped to 150.6 percent in 1999 from 277.7 percent a year before. During the same period, the net profits of the listed firms as a percentage of their total sales rose to 4.4 percent compared to -7 percent of the corresponding period in 1998 largely due to a decline in market interest rates and economic recovery.

Encouraged by the booming market, a large number of Korea's financial institutions including banks, were making plans for public offerings of both common and preferred stocks in the domestic equity market and also for issuing global depository receipts to foreign investors. The rapid recovery with a recent upward adjustment in Korea's sovereign rating eased the marketing of these instruments a great deal. In Thailand, the private sector was also successful in raising capital through the issuance of new equity and debenture. It raised TB 45 billion (US\$1.2 billion) from the stock market and issued TB 120 billion in

debentures. In the first four months of 2000, Thai corporations raised TB 4.6 billion through the issuance of new shares and issued TB 52 billion in new debentures.

After a year long surge, the stock markets of all four crisis countries have floundered again in 2000 and are expected to remain depressed, reducing the scope of bank recapitalization and corporate debt workout through the equity market. A vibrant and growing capital market is likely to speed up the transition to a market-oriented reform, and for this reason sustaining the recovery underway will be more critical than otherwise.

#### *XI. Reform of the Corporate Sector*

As the end of 1996, the ten of the largest families controlled more than a half of the publicly traded companies in Indonesia, the Philippines, and Thailand. A similar figure for Hong Kong and Korea was a third. In Indonesia and the Philippines, a single family controlled 17 percent of the total market capitalization (Claessens *et al.*, 1999). Despite two years of corporate sector reforms, the predominant economic position of large, family-owned enterprises in Southeast Asia and the *chaebol* in Korea remain largely unchanged. As Khan (1999) notes, the most dominant type of Asian corporate governance, which is the family-based system, remains intact.

Most of these large corporations and business groups in Southeast Asia maintain a controlling interest in banks and a large number of non-bank financial institutions. Given this type of ownership structure, it is difficult to imagine that these banks and other financial institutions could be effective in monitoring the financial and investment activities of large family-owned businesses. There are no other groups in society, excluding the government, which can monitor the behavior of financial institutions. Since capital markets are narrow and thin, and institutional and legal infrastructure for protecting the rights of shareholders are not well established, replacing

the family-based system with an equity market-based system can, at best, be a long-term goal. What types of reform will then be able to improve the East Asian corporate governance, restrain the collusive behavior among the government, financial institutions and large enterprises, and develop a policy regime which will discipline family-owned firms and reduce agency costs?

In view of their poor performances and structural deficiencies, should the Korean chaebol and Chinese tycoons be broken into pieces? Some of the East Asian governments, notably the Korean government, are determined to lower the leverage, slim down the operations, and improve the transparency of the large industrial groups. Khanna and Palepu (1999) argue that since the East Asian industrial groups act as substitutes for the institutions that support effective markets in capital, labor, and goods and services, the rapid dismantling of the groups could weaken the competitiveness of East Asian corporations. The disjunction would only exacerbate East Asia's institutional void, due to the absence of an alternative industrial organization. Instead of taking them apart, Khanna and Palepu suggest that these countries must build the kind of institutions, such as investment banks, accounting firms, and a sound legal framework such as the SEC, that support well functioning markets for capital, labor, management, and transfer international technology in the long-run. In the short-run, however, they argue these industrial groups must be subjected to an internal restructuring that will upgrade their corporate governance, accounting methods, and disclosures to international standards.

Chile took almost a quarter of a century to build efficient capital markets, which are still far from being complete. The Chilean experience suggests that the short-term reform of business groups should be carried out in parallel with, or even before, the building of those institutions that are a requisite for the functioning of the market economy. In this regard, Khanna and Palepu suggest the following internal reforms for business groups in the short-run: investing in internal information and incentive systems; learning to exit from money losing businesses; relying more on long-term equity capital from foreign as well as domestic sources; and adopting foreign

holding company structures. In addition to these changes, the World Bank (1998) provides another list of long-term reform measures that include: improving enterprise monitoring, disclosures, and accounting practices; structuring the enforcement of corporate governance regulation; improving the corporate governance framework; facilitating equity institutions; and strengthening regulatory institutions.

At present, there is widespread belief that East Asia will have to catch up in areas such as managing for shareholder value, greater accountability and transparency and that in the future management styles around the world will be locked into an Anglo-American trajectory; hence, becoming more homogeneous. East Asian corporations operating in globalized markets may find it difficult to deviate from this trend in the long run. However, the governance reform along the line of the Anglo-American system raises a number of complex questions over the medium-term horizon, although there is little disagreement on the need to change the family based system of corporate governance in East Asia. In the long-run, the bank based system à la the Japanese main bank or German universal bank and the equity market based system are two serious candidates East Asia could adopt for its corporate governance. However, questions remain as to how these countries should transition from the family-based to either a bank or market-based system without incurring large adjustment costs.

Generally speaking, corporate governance is a set of mechanisms through which outside investors protect themselves against expropriation by insiders. During the 1980s, the heyday of the Japanese economy, the bank-centered governance was regarded superior to the market based governance (Aoki and Patrick, 1993). After many years of stagnation and financial sector problems in Japan, the bank-centered governance has lost much of its luster in recent years. The Japanese relationship banking was susceptible to the soft budget constraint in that the banks kept on supporting unsound firms that required radical reorganization (Kang and Stulz, 1998). The Japanese banks are also accused of colluding with enterprise managers to deter external threats to their control and collect rents on banks.<sup>18</sup> According to Aoki (2000),

---

<sup>18</sup> See La Porta *et al.* (1998) for a further discussion and references on these issues.

a crucial feature of Japanese main banks was the expectation that the banks would determine whether financially troubled borrowers would be bailed out at their own costs or liquidated. When this expectation was not met, the role of the main banks was greatly reduced. Contrary to widely held belief, German banks did not provide effective governance.

Do these problems mean that the East Asian countries should opt for a more market-centered corporate governance system? This choice raises more complex problems than the bank-based system in emerging market economies in East Asia. To function properly, the market-based system must be supported by a set of well advanced financial infrastructures that include accounting firms, law firms, rating agencies, investment banks, and bankruptcy courts. It will take many years for these institutions to come into existence and mature, suggesting that many emerging market economies in East Asia may have no choice but to rely on a bank-based governance system in the medium-term and develop a regulatory structure that is likely to minimize the problems associated with the bank-centered system. In this regard, the control of banks by industrial and commercial firms should be strictly regulated. Regulations and supervision need to be based on well-defined, neutral rules such as capital adequacy, loan classification, and loan-loss provisioning requirements.

Citing the experience of Hong Kong, Khan (1999) shows that family-based corporate governance can thrive in such a market-oriented open economy. The family-based system can be a workable form of governance under certain conditions. In this regard, Khan points to the importance of proper monitoring capabilities of the financial system, managerial expertise and market competition. In the case of Hong Kong, the insolvency and bankruptcy procedures are transparent and accounting and auditing standards are higher than in other East Asian countries. These institutional features help reduce problems of information, corruption, and inefficiencies in Hong Kong's corporations, suggesting that the family-based system could be "an interim type of governance for some time to come," provided, of course, that the monitoring role of banks can be strengthened than it is today.



Focusing on the aspect of protecting of outside investors, La Porta *et al.* (1999) advocates a legal approach to corporate governance where shareholders and creditors are protected by laws and their enforcement. According to the legal approach, protection of investor rights is a basic determinant of the financial structure. A legal system that provides a strong protection of shareholder rights, such as the right to vote on key corporate matters, to select corporate directors or to sue the directors and the firm, encourages the development of equity markets. On the other hand, a legal system that secures creditor rights such as the right to repossess collateral or to reorganize firms, encourage lending. Depending on the structure of these rights, such a legal system could promote bank lending and hence a bank-based financial system. Given the elaborate institutional requirements for shareholder protection, many developing countries will find that protecting the rights of both banks and their depositors as creditors is relatively more expedient than shareholder rights. The legal approach therefore provides another reason why financial systems in developing countries are dominated by banks and other intermediaries.

Although East Asian business groups have resisted measures to protect minority stockholders, promote mergers and acquisitions, and improve disclosures, they are changing and their pace of transformation is accelerating for a number of reasons. They realize that institution building, though slow in progress, will strengthen market discipline and weed out inefficient groups. They are also aware of the fact that East Asia's mature legal, regulatory, and financial systems will weaken their hold over the economy. Second, the crisis has made big business groups much more reliant on equity capital and modern notions of shareholder value. Finally, the emergence of the new economy in East Asia, though the region is several years behind the U.S. and Europe in its shift into e-commerce, will produce strong market forces bearing down on the management practices of the East Asian industrial groups (Economist, 4/29-5/15, 2000).

The widespread exploitation of the Internet will greatly reduce the advantages East Asian industrial groups possess in gathering and assessing information. As the

cost of obtaining information has declined because of its abundance and instantaneous accessibility to all, it has become easier for smaller and medium-sized firms to move into knowledge-based industries and other territories traditionally dominated by the groups. Most of the internet firms, “dot coms,” are small and tend to be financed with equity capital by venture capitalists or market investors. These businesses also rely much more on stock options as compensation to employees. As a result, these investors demand more transparency. In learning to exploit the Internet, most East Asian companies either rely on alliances with western companies or on western venture capitalists, and most plan to list their ventures. More exploitations of the Internet means more equity and listings, which will eventually lead to greater transparency and faster development of the capital market.

## *XII. Exchange Rate System and Regional Cooperation*

### *XII-1. Exchange Rate System and Capital Controls in East Asia*

As part of the IMF rescue programs, the East Asian crisis countries were required to jettison a fixed or managed floating exchange rate system in favor of a free floating system. A majority of professional economists believe that greater flexibility in the nominal exchange rate helps diffuse the impact of adjustment to external shocks on domestic financial markets in emerging market economies.<sup>19</sup> Flexible exchange rates are also expected to give banks and corporations an incentive to hedge their foreign exchange exposures and, in doing so reduce the frequency of foreign exchange crises. Many studies have shown that an exchange rate fixed at an untenable level was invariably one of the major causes of financial crises as in the cases of Mexico, East Asia, and Russia. Blinder (1999) argues that floating rates should be the accepted norm in the new financial architecture. According to Dornbusch (1999), countries in

---

<sup>19</sup> An exception to this new orthodoxy is Williamson (2000) who proposes an intermediate regime called a monitoring band system for emerging market economies in East Asia.

East Asia have no option but to move to a flexible exchange rate system.

Despite the overwhelming support for the flexible exchange rate system in emerging market economies, many countries in East Asia have been reluctant to accept the advice of the IMF. Malaysia decided to adopt a fixed exchange rate system in the midst of a crisis, China continues to adhere to what they call a managed floating system, and other East Asian countries with a free floating system intervene extensively to stabilize their nominal exchange rates. An important question is why these emerging market economies in East Asia have so little confidence in the flexible exchange rate system. It is perhaps too early to assess the effects of the flexible exchange rate system on East Asia's recent recovery. However, judging from the available evidence, contrary to expectations, the free-floating system is not likely to reduce the frequency and depth of a financial crisis and has not clearly enabled East Asian countries, either, to regain their monetary autonomy or to reduce their holdings of reserves.

There are a number of structural as well as other reasons that may explain the unwillingness of many emerging market economies to allow exchange rates to move around over a wide margin. Perhaps the most common argument against a free floating system is that under flexible rates, exchange rates often move too much, and these movements are unrelated to fundamentals; hence, causing undesirable movements in real exchange rates. The high degree of volatility of exchange rates also make business more costly for firms, especially for those small and medium sized firms specialized in foreign trade.

Foreign exchange markets are relatively small in terms of the volume of transactions in emerging market economies. Therefore, even a small change in capital flows or market expectations could trigger a large change in the nominal exchange rate. At times, the high degree of volatility in exchange rate movements may become unbearably high, particularly, when traders have limited access to or have to pay high costs of hedging. In Korea, for example, only the big five chaebol have been able to hedge their foreign exchange exposures through the forward exchange market. SMEs

are required to provide collateral for a forward cover, making the cost of hedging much higher than that of large firms. Most of the SMEs do not have skilled staff who could manage complex arrangements forward market transactions require. Currency futures and options are available in some emerging market economies, but cannot be used as a means of hedging, because the markets for these instruments are not liquid and are still in an early stage of development.

A second argument for favoring stable exchange rates is related to the changing nature of the foreign exchange markets in these countries where capital movements have increasingly dominated the determination of the nominal exchange rate with deregulation of capital account transactions in recent years. Capital movements in and out of these economies have largely determined the direction and scope of fluctuations and also resulted in an overshooting of nominal exchange rates. Changes in the real exchange rate in these economies may therefore not be consistent with, or may make it difficult to maintain balance in the current account. To elaborate further on this point, consider a cyclical expansion in an emerging market economy. The country in question may experience a deterioration in its current account, which may, other things being equal, lead to a currency depreciation. The current account deficit may be a short-run cyclical development and could be sustainable. Nevertheless, foreign investors may regard it as a structural problem and decide to pull their investments out of the country. This withdrawal could cause a much sharper depreciation of the currency than otherwise. Conversely, a surplus in the current account may lead to a large appreciation of the exchange rate more than when capital account transactions are small in volume or regulated.

A third reason centers on the effects of changes in the exchange rates of the three major currencies, namely the dollar, Euro, and yen, on the currencies of emerging market economies. In most East Asian countries which trade heavily with Japan and compete against Japanese exporters in third markets, the dollar-yen exchange rate is an important variable in determining their real effective exchange rates. A high degree of volatility of the yen-dollar exchange rate is then translated into a high degree of

instability of the real effective exchange rates. For example, a depreciation of the yen against the U.S. dollar will, other things being equal, cause an appreciation of the real effective exchange rates of the East Asian economies. While these countries may experience an erosion in their export competitiveness *vis-à-vis* Japanese exporters, their exchange rates *vis-à-vis* the U.S. dollar may not change. In order to prevent real appreciation, they have to intervene in the foreign exchange markets to bring about a depreciation of their currencies against the U.S. dollar.<sup>20</sup>

A fourth reason is that stability of a flexible exchange rate system in a world of free capital mobility has not been established. The system could easily generate a cycle of boom and bust in emerging market economies, and more so in export-oriented economies as capital flows have become procyclical. For example, consider a large increase in capital inflow in an emerging market economy attracted by the prospect of a boom. The inflow initially creates pressure for currency appreciation. However, the initial appreciation may not create expectations for a depreciation of the currency and may not deter or reverse the inflow insofar as the foreign investors' perception of economic expansion does not change. The expected future exchange rate may simply appreciate also as the spot rate appreciates. The nominal exchange rate may follow a random walk, and even if it does not, the prospect of boom may lead to an appreciation of the future nominal exchange rate.

Suppose that the stock market of an emerging market economy is expected to gain continuously because of the ongoing expansion.<sup>21</sup> This expectation may make foreign investors believe that the local currency will also continue to appreciate because the bullish stock market will attract further foreign capital inflow. In the absence of central bank intervention, the inflow will lead to monetary expansion and subsequently increase the prices of assets, including real property. The asset price increase keeps the currency strong, but the booming asset markets and domestic demand expansion do

---

<sup>20</sup> One might argue that foreign investors may curtail or withdraw their investments in the East Asian countries once they observe a weakening of the yen and subsequently force a depreciation of the East Asian currencies *vis-à-vis* the dollar. However, there is no empirical evidence supporting this type of adjustment.

<sup>21</sup> For the sake of simplicity, it is assumed that the domestic bond market is underdeveloped and closed to foreign investors as it is in many emerging market economies.

not generate any expectation of depreciation, hence resulting in further inflow, which in turn feeds on speculations in the asset market. The appreciation of the currency will eventually slow down export earnings and bring about a deterioration in the current account. It may take anywhere from six to nine months to observe such the effects of appreciation on trade account.

Only when the current account begins to show signs of deterioration would currency depreciation expectation set in. Once they see an incipient current account deficit, market expectations suddenly shift and foreign portfolio investors and lenders pull out their investments all at once. Such an exodus of foreign investors could easily precipitate a major financial crisis, because capital markets are relatively small in terms of their market capitalization and foreign exchange markets are also shallow, narrow, and often brittle in emerging market economies.<sup>22</sup>

In many East Asian countries, foreign portfolio investors have become dominant forces in determining the direction of asset price movements, since these countries began opening their capital markets in the early 1990s.<sup>23</sup> Many domestic investors tend to mimic the portfolio choices of foreign investors in the belief that foreign market participants have more accurate information on and better capability of analyzing market developments. This imitative behavior of domestic investors could aggravate the instability of financial markets further.

Finally, a number of recent studies on exchange rate policies have shown that policymakers in developing and emerging market economies have been reluctant to let their exchange rates fluctuate freely for fear of a large depreciation. One of the policymakers' concern with floating is the currency mismatch effects of a large depreciation in the balance sheets of banks and corporations with a large amount of U.S. dollar denominated debts. Another is that a large depreciations may complicate

---

<sup>22</sup> For a similar argument, see Furman and Stiglitz (1998).

<sup>23</sup> There is also evidence that foreign investors have tended to augment fluctuation of asset prices in East Asian financial markets. At least, one empirical study shows that foreign investors are positive feedback traders and exhibit herd behavior. See Kim and Wei (1999).

inflation management while it could downgrade their sovereign ratings and consequently reduce their accessibility to international financial markets (Calvo and Reinhart, 2000a and b, and Hauamann *et al.*, 1999, Goldsajn and Olivares, 2000, and Mussa *et al.*, 2000).

East Asian policymakers are under constant pressure to keep both the nominal and real exchange rates stable. The monetary authorities in these countries usually attempt to sterilize some of the capital inflows. Sterilization helps achieve the policy objective, because it either increases the money supply or interest rates (when combined with an open market sale of securities). Although they are often fighting a losing battle, the monetary authorities continue to use monetary policy as the main tool for stabilizing the nominal exchange rate. As a result, these countries do not enjoy any degree of monetary autonomy and suffer from a high degree of volatility of domestic asset markets, although they are on a flexible exchange rate system.

Should East Asian countries then eschew a flexible exchange rate system in favor of other arrangements with less flexibility? Whatever its merits, East Asian countries would not find it practical or politically acceptable to move to a currency board. Other arrangements such as crawling pegs with wider bands have their share of problems, and while the experience with a flexible exchange rate system is not encouraging, it is not likely that an alternative regime appropriate to East Asian emerging market economies will emerge in the near future.

If East Asian countries are going to stay with the flexible exchange rate system, they may have to consider a number of policy and institutional reforms. The policy authorities could intervene when volatility of their nominal exchange rates is much higher than that of either the Yen or Euro and is not accounted for by market fundamentals. Even in this case, market intervention should avoid following ad hoc policy decisions, but be based on a set of conditions and criteria defining irregular market movements. If the nominal exchange rate moves in either direction out of the normal range of fluctuation in a given day, the monetary authorities may intervene.

However, if depreciation or appreciation persists for more than a few days, for example, such a change can be regarded as reflecting changes in market fundamentals and the intervention must cease.

Another institutional reform should be geared to creating a variety of tools for hedging foreign exchange rate risk. As noted earlier, the forward exchange markets in East Asia are often narrow and lack liquidity, and the markets for currency futures and options are almost non-existent. A better market infrastructure for hedging foreign exchange exposure is likely to reduce the pressure of traders to stabilize the nominal exchange rate. Finally, emerging market economies in East Asia should consider introducing a system of control over short-run capital movements to ease the burden of adjustment through exchange rate fluctuations. In this respect, the IMF, while advocating an overall liberalization of capital account transactions, points to the need to implement measures to influence the volume and characteristics of capital flows. Such measures could include taxes on short-term foreign borrowing and prudential limits on offshore borrowing.

The Chilean experience with short-term capital controls has been widely accepted as a successful case. During the 1990s, Chile imposed a 30 percent reserve requirement on all capital inflows with no interest and also required foreign direct investment to stay in the country for at least one year. These measures were effective in lengthening the average maturity of the country's foreign currency debt.

In a recent article, however, Edwards (1998) disputes Chile's successful management of capital inflows. He shows that the capital control measures did not sufficiently reduce the share of short-term to total debt, did not succeed in slowing the appreciation of Chile's currency, and did not appreciably increase the central bank's control over monetary policy. On the other hand, Chile's capital controls had the problem of raising the cost of borrowing. As expected, large firms were able to find ways to circumvent the controls.

There is another potential dilemma with the Chilean type of control: the a



diverse selection problem. Some foreign investors, including commercial and investment banks, are not always intent on speculating for short-term profits. Indeed, many international lenders often move into emerging markets in search of long-term investment opportunities and then establish long-term relationships with local financial institutions. Yet a uniform reserve requirement on all capital inflows penalizes not only short-term speculators but also those long-term investors who will help strengthen and stabilize links of emerging market economies with the international financial community. If the tax rate is very high, these desirable investors will avoid countries with capital controls. Their withdrawal will in the end lower the quality of international investors, even more so when foreign investors move together in a herd.

## *XII-2. Globalization and Regional Integration*

According to Stiglitz (1998), “small open economies are like rowboats on a wild and open sea with a high probability of being broadsided by a large wave no matter how well the boat is steered.” In the process of market deregulation and opening, many small rowboats of East Asia have been pushed out into a treacherous open sea. And to exacerbate their plight, it seems they have lost at least one oar.

As experienced by the East Asia crisis countries, the size of the domestic financial markets of emerging market economies, measured in terms of the volume of transactions, is very small compared to the pool of international capital. Foreign portfolio investors have often been a determining influence on the movements of asset prices in these countries. Since capital movements in and out of the emerging market economies are triggered by sudden changes in the sentiment of foreign investors, these countries suffer from a high degree of volatility of capital movements even when exchange rates are flexible. This has consequently resulted in the sustained instability of the domestic financial markets. As pointed out earlier, East Asia’s policymakers have been under pressure to stabilize the nominal exchange rate, and monetary policy

has been managed to serve this purpose. Given the rigidities of a fiscal policy, these countries lack effective policy tools, other than monetary policy, at their disposal and are constantly stricken by a variety of external shocks.

As the opening of the capital account progresses, problems of financial panic and herding, caused by market coordination failure and information asymmetry, have become more pronounced and have frequently threatened the stability of East Asia's financial markets. Although individual countries may not be able to cope with these problems alone, there are no global institutions, such as a global lender of last resort and a global financial supervisory authority, which could be entrusted with the task of correcting some of the international market failures. At this stage, it is also clear that a global governance mechanism is not likely to be realized because only a few countries, whether developed or developing, are prepared to accept any erosions in their sovereignty.

As a second best solution to the governance problem, the G-7 led international financial reform has developed a large number of banking, accounting, auditing, transparency, and monetary and fiscal policy standards, and recommends that these standards be adopted by all countries with the enforcement authority given to the IMF. The multitude of standards also raises a number of questions concerning legitimacy, fairness, and national sovereignty, because they constitute a quasi-governance system, one which is established by G-7 and then imposed on all the IMF member countries. As a result, such a governance system may not be legitimate in the eyes of many emerging market economies, and given the decision making structure dominated by the advanced countries at the IMF, the Fund's accountability may be in question when it assumes the responsibility of enforcing standards.

At present, there are too many standards that emerging market economies yet find difficult to comply with. Other than this "one-size-fits-all" approach, an effective enforcement mechanism is difficult to develop and few believe its standards will be effective. If a standard setting is not a viable alternative in creating global governance, what are the alternative strategies emerging market economies could consider to protect

them from the vagaries of international financial markets? As far as East Asian countries are concerned, they could, for the time being, retract from their commitment to capital account liberalization and introduce a mechanism of control over their capital movements in the short-term by adopting an intermediate exchange rate regime (Williamson, 2000).

The issues related to capital control raise the question of whether there is a need for a region-wide cooperation and coordination of policies of individual countries to stabilize short-term capital movements in East Asia.

East Asian countries, in particular those which have experienced a financial crisis, are taking measures to build up their foreign currency reserves above the level that has been regarded adequate in terms of their import requirements even when they are on a flexible exchange rate system. For instance, Korea is currently targeting a level of reserves equivalent to 17-18 percent of its GDP, largely because of an increased volume of capital account transactions. By any measure, this level is excessive, costly, and represents a clear case of resource misallocation.

To reduce the amount of reserve holdings, at least some of the East Asian economies could enter into an arrangement for precautionary lines of credit with private financial institutions. They could also rely on the IMF as a lender of last resort, which could provide an additional issue of SDRs.

There are other schemes for reducing the holdings of foreign currency reserves. For instance, East Asian countries could organize cooperative arrangements among their central banks to enlarge swap arrangements, both within the region as well as with other countries. There has been increasing support in East Asia for creating a regional mechanism of defense in the form of financial cooperative arrangements. This support has culminated in the Chiang Mai initiative of ASEAN + 3 to create currency swap arrangements among thirteen countries.<sup>24</sup> The agreement is widely perceived as a major step toward strengthening financial

---

<sup>24</sup> Asia's three economic powerhouses -- China, Japan, and Korea -- along with the 10 members of ASEAN, agreed during the ADB annual meeting in Chiang Mai, Thailand to expand an existing network

cooperation among the East Asian countries and as a forerunner for an East Asian monetary fund.

Another possible regional cooperation could develop a scheme in which a group of countries from the region may decide to pool a certain percentage of their reserves to create new credit facilities for the participating countries. An individual country belonging to the arrangement would not have to hold as large an amount of reserves as it would otherwise if it could borrow from the credit facility in the event of a reserve draw-down.

The volume of intra-regional trade and that of intra-regional capital flows have increased a great deal as a proportion of their total trade and capital account transactions in recent years. The growing integration of East Asia has increasingly made East Asian countries difficult to pursue independent trade and macroeconomic policies. The competitive structure of trade combined with regional integration has raised the importance of policy coordination, especially in regard to exchange rate policies, among East Asian economies.

This realization has stimulated the debate on the possibilities of creating a region-wide exchange rate mechanism that could stabilize the region's currencies and its regional bond and equity markets. Excluding Japan and China, the other markets of East Asian countries are relatively small and this smallness raises the question of whether it is desirable or feasible for these countries to develop their own broadly based capital markets with depths that could withstand and absorb the impact of external shocks. The cost of establishing infrastructure that is necessary to develop capital markets with a reasonable degree of depth and width could be very high. Well-developed individual capital markets in individual countries, however, do not guarantee that the economy will be insulated from adverse external shocks because these markets will remain small. These and other considerations have also led to the discussion on

---

of arrangements designed to ward off a crisis similar to the one that rocked the region in 1997. The plan, dubbed the Chiang Mai initiative, calls for a network of bilateral currency swap-and-repurchase arrangements and implies the establishment of a system of pooled reserves that central banks could draw upon to buy time when their currencies come under speculative attack.

the possibilities of creating East Asian regional bond and equity market.

### *XIII. Concluding Remarks*

With the growing acceptance of the Washington consensus' liberal ideology throughout East Asia since the early 1990's, many countries in the region have moved to transforming themselves into deregulated and open economic regimes. This liberal trend has been accelerated by democratic changes and economic globalization. The three crisis-hit East Asian countries -- Indonesia, Korea, and Thailand -- had to seek an IMF financing rescue and with it accepted a structural reform program that saw to transplanting an Anglo-American free market capitalism in place of a development system that had served them well for three decades before the crisis. Many detractors of the IMF were critical about the reform programs, arguing that these programs were so misguided and out of touch with the realities of these countries that they would not work. Although it may be too early to judge, growing evidence suggests that the IMF directed reforms covering the financial, corporate, and public sectors have not been as successful as initially expected and in many instances have been little more than cosmetic.

The recent recovery in the region, which was much faster than expected, and the critical assessment of the IMF programs have renewed interest in the reexamination of the East Asian model as an alternative to the Anglo-American capitalism. Our review of the characteristics and evolution of the East Asian model suggests that despite its structural weaknesses and failure to fend off financial crises, some of the main features of the system remain intact and should serve well for post crisis development of East Asia, although as a whole it is in need of major structural repair. The need for reform is not surprising in view of the fact that the model, as it was outlined by the World Bank miracle study, had evolved as a development paradigm designed to serve the strategic purposes of authoritarian regimes during an era characterized by tightly

controlled and closed markets and protectionist trade practices.

One of the major failures of the model could be attributed to its rigidity which delayed its adjustment to a liberal political and economic environment. Even before the breakout of the crisis, the East Asian system had been showing many cracks around its structure. During the five year period preceding the crisis, the system had been unable to slow down or accommodate a massive increase in capital inflows. When much of East Asia came under a speculative attack, the system simply broke down.

Democratization and economic liberalization put severe strains on, and gradually incapacitated, the working of the consultative mechanism of coordination and cooperation. Nevertheless, it was not replaced or complemented by new participatory political and market supporting institutions. As a result of this failure, the East Asian countries were stumbling along with serious coordination problems. The bank-oriented financial industry, which was a typical infant industry, could not bear the strains of adjustment to competition of globalized financial markets. The collapse of the financial system caused by the crisis deprived of a large number of corporations a major source of financing in relationship banking, prompting their downfall as well and hence deepening the crisis.

Although the crisis exposed a number of structural problems and damaged the universal applicability of the model, the East Asia's experience by no means proves that the East Asian system was "beaten" by the Anglo-American model. Except for the governance mechanism, many features of the system still remain intact and are likely to serve well emerging market economies in East Asia in their quest for catching up with advanced economies. However, this conclusion does not mean that East Asia can remain content with its vintage 1960s-1970s model, laying the blame on foreign speculators for the 1997 crisis. In fact, except for the basic building blocs, all aspects of the model, in particular institutions governing the financial system, corporate sector, and the labor market will have to be repaired. How should the model then be reformed to make it as effective in a new East Asian and global environment as it was before?

Most of all, the East Asian governance system of cooperation will have to

embrace a set of new democratic institutions, rules, and norms. They should also be complemented by a host of new institutions for conflict management, social insurance, and regulation to assist the market system function better. In particular, securities, commercial, and bankruptcy laws are in need of amendment to improve investor protection and regulatory and judicial mechanisms of enforcing investor and creditor rights need to be improved. Many of these institutions are western concepts and will have to be transplanted in an inhospitable East Asian terrain. Unless this transplantation is carefully managed with due consideration of the capacity and constraints of the reforming economies, the reform will not succeed. In particular, the legal and judiciary reform will be met by strong political obstacles by bureaucracies and large, family-owned enterprises, the two principal architects of the East Asian paradigm of development. Instead of blindly introducing an ideal set of institutions and rules borrowed from the west, East Asian countries will be better off if they enact the rules they can enforce within the existing legal and judicial framework.

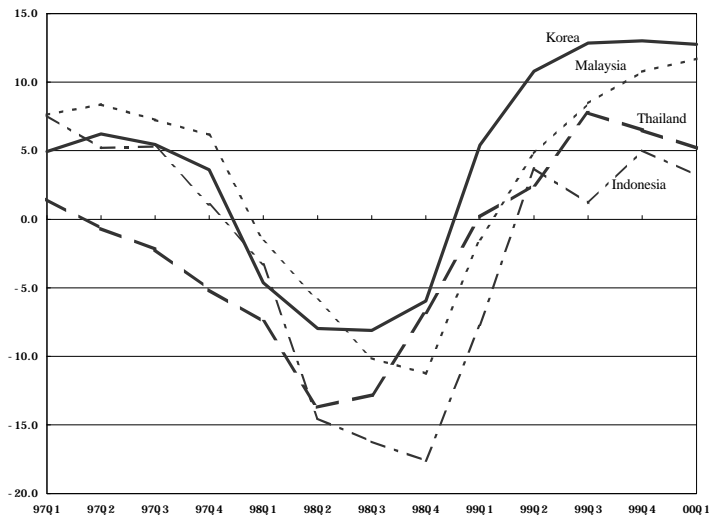
While accelerating their plan for building democratic and market institutions is critical, at the same time East Asian countries can not ignore the urgency of improving the capabilities of their governments to manage through the difficult period of transition. If they succeed in developing a strong but limited government, less developed East Asian countries may have a better chance of managing the transition: and, within this framework, these governments need industrial policies, acceptable within the WTO framework, to facilitate technology transfers and to manage the limited intervention in the market when market failures dictate stronger actions. To these countries the priorities of public sector reform must be geared to developing rules and norms that could provide government officials with incentives to act in the collective interests while controlling corruption and arbitrary actions.

As Rodrick (2000) points out, “the idea of a mixed economy is possibly the most valuable heritage the 20<sup>th</sup> century bequeaths to the 21<sup>st</sup> century in the realm of economic policy.” The East Asian system is essentially a mixed economy model, and depending on how it is reformed to meet the challenges of the 21 century, there is no

reason why it could not be a useful model for post-crisis development in East Asia.

**Figure 1**      **Quarterly GDP Growth Rates<sup>a</sup>**





<sup>1</sup> percentage and y-o-y

Source : ADB Regional Economic Monitoring Unit

ARIC - <http://aric.adb.org/indicators/ino/peia.asp> and IFS, August,

2000, International Monetary Fund

### Reference

Aoki, Masahiko (2000), "A Note on the Role of Banking in developing Economies in the Aftermath of the East Asian Crisis," Governance, Equity and Global Markets, The World Bank, Paris, 2000.

- Aoki, Masahiko and Hugh Patrick (1993), "The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies," Oxford University Press, New York.
- Baliño, Tomás J.T., Charles Enoch, Anne-Marie Gulde, Carl-Johan Lindgren, Marc Quintyn, and Leslie Teo (1999), "Financial Sector Crisis and Restructuring: Lessons From Asia," International Monetary Fund, September.
- Bank of Korea (2000), Financial Statement Analysis for 1999, Seoul, Korea
- Bardhan, Pranab (1997), "The Political Economy of Development Policy: An Asian Perspective," Economic and Social Development into the XXI Century, Inter-American Development Bank,
- Bardhan, Pranab (1997), "Corruption and Development: A review of issues," Journal of Economic Liberator, September.
- Blinder, A.S. (1999), "Eight Steps to a New Financial Order," Foreign Affairs, September/October.
- Campbell, Duncan (1999), "Globalization and Change: Social Dialogue and Labor Market Adjustment in the Crisis-Affected Countries of East Asia", mimeo.
- Campos, J. E. and Root, H.L. (1996), "The Key to the Asian Miracle: Making Shared Growth Credible," The Brookings Institution, Washington.
- Calvo, A. and C. Reinhart (2000a), "Fear of Floating," mimeo, University of Maryland.
- Calvo, A. and C. Reinhart (2000b), "Fixing for Your Life," mimeo, University of Maryland.

Chang, Roberto and Andres Velasco (1998), "Financial Crises in Emerging Markets: A Canonical Model," *NBER working paper* No.6606, June.

Claessens, Stijn, Simion Djankov, and Daniela Klingebiel (1999), "Financial Restructuring in East Asia: Halfway There?," *Financial Sector Discussion Paper* No. 3, September.

Claessens, Stijn, Simion Djankov, and Larry Lang (2000), "East Asian Corporations: Growth, Financing, and Risks," *Emerging Markets Quarterly*, Spring.

Corsetti, G., P. Pesenti, and N. Roubini (1998), "What Caused the Asian Currency and Financial Crisis," unpublished manuscript.

Demirguc-Kunt, Asli and Ross Levine (1999), "Bank-Based and Market-Based Financial Systems: Cross-Country Comparisons," a paper prepared for the conference on 'Financial Structure and Economic Development,' organized by the World Bank on February 10-11.

Dornbusch, Rudiger (1999), "The Target Zone Controversy," mimeo., February.

Easterly, Williams, and Ross Levine (2000), "It's not Factor Accumulation: Stylized Facts and Growth Models," Mimeo. World Bank

The Economist (2000), April 29 - May 15

Edwards, Sebastian (1998), "Capital Flows, Real Exchange Rates, and Capital Controls: Some Latin American Experiences," paper presented at the National Bureau of Economic Research Conference on Capital Flows to Emerging Markets, Cambridge, Massachusetts, February.

Eichengreen, Barry (1999), Toward a New International Financial Architecture, Institute for International Economics, Washington, D.C.

Eichengreen, Barry (1999), "Strengthening the International Financial Architecture: Where Do We Stand?" a paper presented for the East-West Center Workshop on International Monetary and Financial Reform, October 1-2.

Feldstein, Martin (1998), "Refocusing the IMF," *Foreign Affairs*, Vol. 77, pp. 20-33.

Fischer, Stanley (1999), "The Road to a Sustainable Recovery in Asia," IMF, October 18.

Frankel, Jeffrey and Nouriel Roubini (2000), "The Role of Industrial Country Policies in Emerging Market Crises," a paper prepared for the NBER Conference on Economic and Financial Crises in Emerging Market Economies, NBER, October 19-21.

Furman, Jason and Joseph Stiglitz (1998), "Economic Crises: Evidence and Insights from East Asia," *Brookings Papers on Economic Activity* II.

Goldsajn, I. and G. Olivares (2000), "Can Flexible Exchange Rates still Work in Financially Open Economies?" Studies on International Monetary and Financial Issues for the Group of Twenty Four.

Hausmann, R., M. Gavin, C. Pages-Serra, E. Stein (1999), "Financial Turmoil and the Choice of Exchange Rate Regime," Working Paper No. 400, Inter-American

Development Bank.

Hellmann, F. Thomas, Kevin C. Murdock, and Joseph E. Stiglitz (2000), "Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?," *The American Economic Review*, March, PP. 147-165.

Kang, Jun-Koo and René M. Stulz (1998), "Do Banking Shocks Affect Borrowing Firm Performance? An Analysis of the Japanese Experience," Manuscript, Ohio State University, Columbus.

Khan, A. Haider (1999), "Corporate Governance of Family-Based Businesses in Asia: Which Road to Take?," a paper prepared for the 2<sup>nd</sup> anniversary symposium of ADBI, Tokyo, December 10.

Khanna, Tarun, and Krishna Palepu (1999), "The Right Way to Restructure Conglomerates in Emerging Markets," *Harvard Business Review*, July-August, 1999, Vol. 77, Iss. 4, pp. 125-134.

Kim, Woochan and Shang-Jin Wei (1999), "Foreign Portfolio Investors Before and During a Crisis," *NBER Working Paper* No. 6968.

Klingebiel, Daniela (1999), "The Use of Asset Management Companies in the Resolution of Banking Crises Cross-Country Experiences," mimeo., October.

Klitgaard, R (1998), "International Cooperation against Corruption," *F&D*, March.

Knack, S. and P. Keefer(1995), "Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures," *Economics and Politics* 7(3), pp.207-227.

Krugman, Paul (1994), "The Myth of Asia's Miracle," *Foreign Affairs*, November.

Krugman, Paul (1996), "The Myth of Asia's Growth," in Pop Internationalism, MIT Press

La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (1999), "Investor Protection: Origins, Consequences, Reform," *Financial Sector Discussion Paper No. 1*, The World Bank, September.

Lane, Timothy, Atish Ghosh, Javier Hamann, Steven Phillips, Marianne Schulze-Ghattas, and Tsidi Tsikata (1999), "IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment," *Occasional Paper*, No 178, IMF.

Layard, Richard (2000), "The "Third Way" and Its Relation to the Labour Market," Governance, Equity and Global Markets, The World Bank, Paris, 2000.

Lee, Jong Wha and Changyong Rhee (2000), "Macroeconomic Impacts of the Korean Financial Crisis: Comparison with the Cross-country Patterns," a paper presented at the international forum on 'The Korean Financial Crisis,' the Center for International Development at Harvard University and the Harvard

Institute for International Development, Cambridge, MA, U.S.A., November 18-19, 1999.

Levine, Ross (2000), "Bank-Based or Market-Based Financial Systems: Which is Better?," a paper prepared for the conference on 'Financial Structure and Economic Development,' organized by the World Bank on February 10-11.

Mauro, Paula (1994), "Corruption, Country Risk, and Growth," *Quarterly Journal of Economics*, 110, October.

Mayer, Colin (1988), "New Issues in Corporate Finance," *European Economic Review* 32, pp. 1167-89.

Mussa, M, Masson, P. Swoboda, A., Jadresic, E., Mauro, P. and A. Berg (2000), *Exchange Rate Regime in Increasing Integrated World Economy*, Occasional Paper No. 193, International Monetary Fund.

Pakorn, Vichyanond (1999), "Financial Reforms in Thailand," mimeo., June.

Park, Y. C. (1996), "East Asian Liberalization, Bubbles, and the Challenge from China," Brooking's papers on Economic Activity, II.

Park, Y. C. (1998), "The Financial Crisis in Korea and Its Lessons for Reform of the International Financial System," in Regulatory and Supervisory Challenges in a New Era of Global Finance, edited by Jan Joost Teunisen, FONDAD, The Hague.

- Park, Y.C. (2000), "East Asian Dilemma: Restructuring Out or Growing out?," *Princeton Essay in International Economics*, forthcoming.
- Pistor, Katharina (2000), "The Standardization of Law and Its Effect on Developing Economies," *G-24 Discussion Paper Series*, No. 4, United Nations Conference on Trade and Development, United Nations, June.
- Political and Economic Risk Consultancy, Ltd. (2000), "The Trend of Corruption in Asia," March.
- Radelet, S. and J. Sachs (1998a), "On the Onset of the East Asian Financial Crisis," *Development Discussion Paper*, Harvard Institute for International Development.
- Radelet, S. and J. Sachs (1998b), "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects," *Brookings Papers on Economic Activity I*.
- Radelet, S., J. Sachs and Jong-Wha Lee (1997), "Growth in Asia," unpublished paper, Harvard Institute for International Development.
- Rajan, R.G. and L. Zingalis (1998), "Which Capitalism?: Lessons from the East Asian Crisis," *Journal of Applied Corporate Finance*, forthcoming.
- Rodrik, Dani (1995), "Trade and Industrial Policy Reform," in J. Behrman and T.N. Srinivasan eds. Handbook of Development Economics, Volume III, Chapter 45, pp.2925-82.



Rodrik, Dani (1999), "Governing the Global Economy: Does One Architectural Style Fit All?," a paper prepared for the Brookings Institution Trade Policy Forum conference on 'Governing in a Global Economy', April 14-16.

Rodrik, Dani (2000), "Institutions For High-Quality Growth: What They Are and How to Acquire Them," a paper prepared for the International Monetary Fund's conference on 'Second-Generation Reforms', Washington, DC, November 8-9, 1999.

Rodrik, Dani (2000), "Participatory Politics, Social Cooperation, and Economic Stability," unpublished manuscript.

Rodrik, Dani (2000), "Development Strategies for the Next Century," a paper prepared for presentation at the conference on "Developing Economies in the 21<sup>st</sup> Century," Institute for Developing Economies, Japan External Trade Organization, in Chiba, Japan, January 26-27

Sachs, Jeffrey(2000), "A New Map of the World," *Economist*, June 24.

Stiglitz, Joseph (1996), "Some Lessons from the East Asian Miracle," *World Bank Research Observer*, August.

Stiglitz, Joseph and Marilou Uy (1996), "Financial Markets, Public Policy, and the East Asian Miracle," *World Bank Research Observer* 11(2): 249-76.

Stiglitz, Joseph (1998), "More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus," *WIDER Annual Lectures 2*, UNU/WIDER.

Temple, Jonathan and Paul Johnson(1997), "Social Capability and Economic Growth," *Quarterly Journal of Economics*. 113, pp.965-990.

Veneroso, Frank and Robert Wade (1998), "The Case for an Asian Monetary Fund: Asia Should Look to its Own Resources," *The Economist*, November 7<sup>th</sup>.

Visser, J and Anton Hemerick (1997), A Dutch Miracle, Amsterdam University Press.

Wade, Robert (1990), "Governing the Market: Theory and the Role of Government in East Asian Industrialization ," Princeton University Press.

Williamson, John (2000), "Exchange-Rate Regimes for East Asia: Reviving the Intermediate Option," draft of a Policy Analysis to be published by the Institute for International Economics.

World Bank (1993), The East Asian Miracle: Economic Growth and Public Policy: Policy Research Report, Oxford University Press.

World Bank (1998), East Asia: The Road to Recovery, Washington, D.C.

World Bank (1999), "East Asia: Recovery Begins," Presentation of the Regional Quarterly Update, East Asia and Pacific Region, World Bank, September 23.

World Bank (2000a), "East Asian: From Recovery to Sustained Growth: An Update," Presentation of the East Asian and Pacific Quarterly Brief, March 22.

World Bank (2000b), East Asia: Recovery and Beyond, May.

World Bank (2000c), World Development Report 1999/2000.

World Bank (2000d), "East Asia's Recovery: Gathering Force: An Update," September 18.

Yanelle, M. O. (1989), "The Strategic Analysis of Intermediation," *European Economic Review* 33.

Young, Alwyn (1995), "The Tyranny of numbers: Confronting the Statistical Realities of East Asian Growth Experience," *Quarterly Journal of Economics*, 110, pp.641-648.

Yusuf, Shaid (2000), " Rethinking the East Asian Miracle," Chapter I of Rethinking the East Asian miracle, edited by J. Stiglitz and Shaid Yusuf, Oxford University Press, forthcoming.