EADN WORKING PAPERS

No. 7
November 2001

Regulatory Reform in the Asia-Pacific Region: A Preliminary Study*

Tracy Yang Su-Chin

*Previously published as ISEAS Working Paper, Visiting Researchers Series No. 12(2000)

ISSN 0219-6417

Published by
INSTITUTE OF SOUTHEAST ASIAN STUDIES
for the EAST ASIAN DEVELOPMENT NETWORK (EADN)

REGULATORY REFORMS IN THE ASIA-PACIFIC REGION: A PRELIMINARY STUDY

Abstract

Even though East Asia has been the region of "miracles," recent events have raised concerns about the quality of its financial systems. A key message emerging from this study is that it is a need for further closer regional co-operation. In this regard, it seems desirable to have a regional financial facility. This paper begins with a brief discussion on the East Asian financial crisis and draws attention to the need for regulatory reform in the region. This then provides the context within which an initiative for regional co-operation is designed. The objectives and fundamental premises of such a regional facility are highlighted and justified. This paper also explores various sectors in which practices and principles seem to be desirable and feasible, given the existing international arrangements.

I. Introduction

After three decades of remarkable expansion, the once booming economies of the Asia-Pacific region went into turmoil in 1997. This regional decline was a combination of currency and banking crises that led to regional financial panic. In retrospect, it is suggested that inconsistent reforms and inappropriate sequencing of liberalization caused the build-up of vulnerabilities. Studies (e.g. Corsetti, Pesenti and Roubini, 1998 and Radelet and Sachs, 1998) show that problems in the Asia-Pacific region also emerged in domestic financial markets, particularly in the banking systems. Consequently, it is believed that the regulations necessary to manage the integration of global finance had not kept pace with capital inflows to the Asia-Pacific countries.

Now that the financial crisis has occurred, a more urgent agenda lies ahead. It is imperative that the possible changes required to achieve financial stability are identified, and the potential economic effects of such changes are evaluated carefully and the required measures are adopted. These include possible regional institutional arrangements where gaps exist for implementing such measures. This paper is the first part of an on-going study of regulatory reforms in the Asia-Pacific region as the first step toward financial stability. The following section briefly highlights the causes of the regional financial crisis and draws attention to the need for regulatory reforms in the region. Section 3 discusses the need for regional co-operation in the light of the crisis. Section 4 draws up the objectives and fundamental premises for a regional financial authority. It also sketches the practices and principles for such a regional arrangement. The final section concludes the paper.

II. The East Asian Financial Crisis: the lessons

Macroeconomic imbalance and financial sector weaknesses were most conspicuous in the case of the East Asian financial crisis. This section briefly highlights some of the issues that appear, to many observers, to be important in explaining the crisis in East Asian.

1) Twin Liberalization

Deregulation and liberalization of the financial system have swept through almost all East Asian countries in recent years. Although liberalization is a highly desirable objective, it can also be disastrous if the process is not managed properly. It is believed that countries in the region which had undertaken the so called "twin liberalization" – both the liberalization of domestic financial systems and opening capital accounts – have created conditions for the financial crisis in the region. Having said that, the East Asian experience shows that the "twin liberalization" often induce more funds to flow into the banking system, which increases opportunities for bank lending. Hence, it leads to a lending boom. In fact, the lending boom often outstrips the available information resources in the financial system, and when it burst a financial collapse is unavoidable.

Consequently, the East Asian Financial Crisis has brought liberalization into question. First, on the relaxation of capital control: a surge in capital inflows,[1] (see Table 1) as the result of financial liberalization, have financed much investment in East Asian countries, but they have also proved to be unreliable and at times severely destabilizing. The massive capital inflows made the region vulnerable to financial panic. It is believed that over-borrowing and over-investment behaviors in the region rendered economies vulnerable to a sudden withdrawal of international confidence. Second, on the sequence of liberalization: the East Asian financial crisis also highlights the fact that ill-sequenced liberalization does magnify the effects of the moral hazard problem (Sakong, 1999).[2] Third, on the theory of financial liberalization: financial liberalization has relied upon market forces to explicitly keep financial systems on the right track. However, since the onset of the East Asian financial crisis, market forces including risk assessments and risk premiums, have been ineffective in preventing either excessive lending or borrowing, or even to send early warning signals that risks are rising (Arndt and Hill, 1999).

2) Banking systems

As in many other developing countries, East Asian countries had some weaknesses in their banking systems.[3] Banks were not fully equipped to manage the risks (see Table 2) associated with the resultant asset price volatility, and this contributed to a boom-bust cycle (see Table 3). Additionally, weak governance of banks (see Table 4) often influenced directly or indirectly by government policies, added to poor performance.

Furthermore, Bank plays a particularly important role in the financial system, and thus problems in the banking sector are particularly important sources of financial instability. Indeed, the relatively small domestic bond and long-term capital markets in East Asian countries implies a dominant role for the banking system as the main intermediary for the high level of savings. The dominant role of the banking system has in turn places considerable pressure on the financial intermediation process. As the result, the deterioration in banks' balance sheets is an important precursor of financial crises, especially in East Asian countries. Problems in the banking sector can make a foreign exchange crisis more likely, which in turn leads to a full blown financial crisis.

3) Regional contagion

One aspect of the East Asian crisis is the virulence of the contagion effect. Studies, such as Masson (1998) and Rajan (2000), also emphasize that economic policy slumps are likely to be transmitted from one country to another and this contagion effect is largely a regional phenomenon. Recent IMF studies shed some light on the sources of the contagion in the East Asian crisis (IMF 1998). Crises may stem from a common cause. For example, financial linkages in the region, including through foreign direct investment, bank lending, and capital market activities, meant that a crisis in one country triggered a jump to a "bad" equilibrium in a "neighboring" country. A second reason why crises may be clustered is that a crisis in one country may affect the macroeconomic fundamentals in another country (Goldfajn and Valdes, 1997). A third reason is that a crisis in one country may lead creditors to re-evaluate the fundamentals of other countries even if these have not actually changed, or to reduce the riskiness of their portfolio. Contagion is one of the reasons why public authorities are concerned with the health and survival of individual financial institutions. Confidence in the financial system benefits individual participants without imposing costs on others. If the failure of one institution causes a contagious loss of confidence elsewhere, the adverse consequences to the system as a whole may be much greater than those resulting from the initial disruption.

Despite the complexity of the factors that have triggered the East Asian financial crisis, and the severity of the subsequent economic effect, there are lessons to be learnt from the crisis. One important lesson that emerges from the East Asian financial crisis is that the interaction between highly liquid global capital markets and poorly supervised financial systems can lead to financial disaster. This trade-off in financial deregulation and liberalization does not mean that countries should not pursue a liberalization strategy. On the contrary, financial deregulation and liberalization need to be actively pursued, but have to be managed carefully. Financial liberalization is critical to the efficient functioning of financial markets so that they can channel funds to those with the most productive investment opportunities. Such channelling is especially critical to emerging market countries because these investments can have especially high returns, thereby stimulating rapid economic growth. Policymakers may also need to pursue financial liberalization at a measured pace in order to keep a lending boom from getting out of hand. This in turn stretches the capabilities of both bank management and bank supervisions. The East Asian financial crisis also led us to realize that institutional development needs to be emphasized early in the liberalization process. In countries where the institutional environment is weak, achieving macroeconomic stabilization before or during liberalization would certainly bring an important independent source of financial instability under control. Having said that, a transparent financial system, in which investors can judge the soundness of banks and corporations on the basis of objective and reliable data, would have been much less vulnerable to such a contagion. Hence, improvements in standards for data dissemination and steps to increase the transparency of policies could help markets to improve their pricing of risk, inhibit the buildup of imbalances, and also spur policymakers to take timely action to address vulnerabilities. Furthermore, strengthened regional surveillance with closer monitoring of the financial sector and a focus on standards may also help alert policymakers to upcoming problems. Such regional surveillance should provide warnings of impending regional contagion of the kind that spread the East Asian crisis.

All of the above, in turn reflects clearly one major issue, which is an unavoidable aspect of the process of reform – prudential regulation and supervision. Indeed, more effort should be focused on the design and implementation of prudential regulations and supervision. A strong institutional environment, characterized by effective law enforcement can curb the adverse effects of liberalization on the financial system. Of crucial importance to this study is to identify and put in place policies to help markets work properly and to provide the public goods necessary to achieve the objective. Therefore considerable effort should be devoted to the enhancement of regional co-operation and the possible arrangement for a regional financial facility.

III. The Need for Regional Cooperation

In view of the fact that the financial crisis can spread contagiously within the regional scope, the Asia-Pacific countries have a common interest in seeing that all active parties on the financial markets adopt minimally acceptable arrangements in relevant areas. It is in this context that this section aims to access the rationale for regional cooperation.

For many years before the 1990s, the pace of regional co-operation in East Asia was very slow. There are several reasons why early attempts at regional co-operation was not very successful. First, during this period, the co-operative arrangements were based on regional import substitution and bureaucratic negotiation rather than on trade and financial liberalization and the operation of market forces. Second, there was little incentive for East Asia to form its own bloc since the majority of its trade was with countries outside the region. Third, the diversity of economic systems and the strong protectionist sentiment in the region in those days made it difficult to harmonize the activities in the region. Finally, East Asian countries have very different political system; hence, sovereignty issues and short-term conflicts of interest overshadowed the medium-term benefits of the region (Fukasaku, 1995).

However, in the 1990s, although the diversity of political system remained, the economic situation and attitude towards regional co-operation have changed in East Asia. In fact, a number of co-operative arrangements already exist in the region and several others are under consideration. What are the underlying reasons for this enthusiasm for regional co-operation in Asia? To answer this question, both external pressures and internal factors can be examined.

On the internal front, in light of the East Asian financial crisis, many East Asian countries still have institutionally quite underdeveloped financial sectors. Financial systems in East Asian countries are poorly equipped to deal with the demands being placed on them by rapid changes in corporate governance, global integration, economic and industrial structure, and the formalization of business. In terms of actual openness, East Asian countries, with the exception of Singapore and Hong Kong, rank low among averaging markets. In essence, East Asian countries have relatively closed financial systems. The combination of the spectacular growth of East Asian economies and the recent progress in trade and investment liberalization has become an important driving force for economic co-operation in the region. Consequently, given the increasing globalization of finance and financial institutions, in which the financial problems in one country may spill over into others, it is understandable that countries within the region work together to exchange information, coordinate regulation and supervision, and harmonize rules. The increased interest in regional economic co-operation among East Asian countries may hedge against a possible deterioration in the international financial environment as a result of the crisis.

On the external front, East Asian countries are increasingly concerned about uncertainties of market access, created by moves towards regional integration in

Europe and in the North America. It is suggested that being an outsider to these two most important regional arrangements, could severely hurt the export growth and economic performance of East Asia. Second, the reform and opening up of the centrally planned economies in East Asia have vastly expanded the scope of regional economic co-operation. Third, many countries in the region should strengthen the supervisory and regulatory framework for financial conglomerates and improve financial intermediaries' internal risk management. Requiring better disclosure and reducing the role of the state will also be necessary to create more robust and agile financial systems.

In view of the above, regional co-operation has become one of the most distinctively needed development in the East Asian economies, especially after the East Asian financial crisis. The financial crisis, particularly those involving the banking sector, typically requires immediate steps to restore financial stability and an extended reform effort to improve financial robustness over the longer term. A possible regional financial facility, can be justified for both the purposes of early warning and expedite rescue operations. Hence, the setting up of a regional financial facility apart from, or supplement to, the existing international organizations is clearly a very necessary, positive first step towards improving the coordination and cooperation of the various national and international institutions.

IV. A Regional Financial Authority

Financial crises can have serious repercussions for the economies in terms of heightened macroeconomic instability, reduced economic growth and a less efficient allocation of resources. Time and circumstances now call for an arrangement that promotes competition; while relying on a combination of prompt corrective action, elimination of the time lags remaining in the financial systems, and implementation of constructive ways of harnessing market forces and market-like devices to both prevent and contain financial misfortunes. In this regard, this section is devoted to develop a possible regional financial facility – Asia-Pacific Financial Authority (APFA).[4] The discussion begins with the objectives and criteria for a regional financial authority. It also delineates the sound practices and principles by drawing from the existing institutional standards. This will then provide the foundation for the framework of a regional financial authority.

A. Objectives

The key task of the APFA should be the development of policies to manage systemic risk. It would also be the task of APFA to develop rules, which would enhance the regional externalities, and to oversee the development of a credible and effective guarantor and lender of last resort function. It should aim to devise a set of arrangements geared to the maintenance of financial stability, and supportive of high levels of growth. The APFA should be able to modernize the regulatory framework by putting in place clearer regulatory objectives and strengthened supervisory and investigative powers. It should further enhance market infrastructure by setting up a clearing arrangement for securities, stock options, and futures transactions; enhancing the financial technology architecture to facilitate direct processing of transactions across the financial markets; and moving towards a secure, scriptless securities market through the use of robust networks. The APFA should also aim at enhancing responsiveness to market forces, bringing about economies of scale in terms of operational efficiency and infrastructure investment, facilitating risk management, and boosting regional competitive position against other international markets.

However, it is important to note that no single step or narrow group of steps can be sufficient to ensure a robust financial system. Robustness is a function not only of the individual factors themselves but of their interaction as well; thus improvements in one area typically require complementary measures in other areas if their benefits are to be fully realized. Hence, the APFA should also be a forum in which the rules of regional financial co-operation are developed and implemented. The APFA needs to ensure robustness will change as markets and the economic environment evolve; thus the ability of the financial system, including regulatory and supervisory arrangements, to adapt to economic change is essential for maintaining financial robustness.

The APFA can therefore be expected to maintain appropriate incentives for all those involved in the financial markets, to generate the available information bearing on financial decisions and to provide the necessary capabilities for institutions and individuals to respond effectively to market incentives and utilize information.

B. Fundamental Premises

An effective regional financial authority should be autonomous, with the power and resources to conduct its duty on a consolidated basis. Hence, the Asia-Pacific financial authority should have at least five attributes.

First, independence/autonomy: An effective regional financial authority needs sufficient independence from the political process in order that it is not encouraged to sweep problems under the rug and engage in regulatory forbearance. Hence, the degree of APFA's autonomy is very important. It should permit the authority to perform its responsibilities without undue political interference and to allow the authority to acquire and allocate its financial and staff resources. In short, the APFA must enjoy an independent statute and be backed up by institutional and legal support to help to enforce regulations and apply corrective measures.

Second, power/authority: A regional financial authority needs to be provided with adequate powers to do its job effectively. It is suggested that the APFA should have at least the following powers: (a) to issue prudential regulations and standards; (b) to obtain periodic reports in the format and periodicity stipulated by the authority itself; (c) to take corrective actions; and (d) to take emergency action. With these powers, the APFA will be able to use its facility sufficiently. For example, it can ensure that banks will have the appropriate management expertise and controls to manage risk and have sufficient capital so that moral hazard incentives to take on excessive risk are kept in check.

Third, human and financial resources: Without sufficiently qualified staff, the regional financial authority cannot fulfill its mandate. Hence, the issue of excessive differentials between remuneration for bank inspectors and commercial bankers should be considered carefully since it can lead to excessive turnover of qualified staff and conflicts of interest. It is also essential that the APFA be seen to be free from conflict of interest, financial connections to any bank, and obvious political or business affiliations.

Fourth, information: information is a crucial ingredient for investor confidence and participation. Therefore, the APFA should be able to develop and enhance standards and share information. It should also be able to verify information on risk management and internal control systems and on asset quality through regular examinations or external audits. However, without appropriate and timely information, the authority will not be able to use its monitoring facility sufficiently to deter excessive risk taking.

Fifth, interaction and coordination: Financial robustness is a function not only of the individual institutions themselves but also of their interaction; thus processes in one institution may require corresponding actions in other institutions if benefits are to be fully realized. Coordination is needed to make the best possible use of the resources when support is being provided by a number of different institutions. Because the roles and responsibilities of the APFA and the national authority may overlap in many respects, it is suggested that close coordination between them is essential with respect to their assessment of financial systems, program design and technical assistance.

C. Developing of practices and principles

A corpus of sound principles and practices is useful when action is taken to strengthen financial systems. Clearly, for any specific area or activity relevant for robust financial systems, there should be a set of principles developed through a broad regional consultative process involving national experts with extensive experience in the area concerned. In this regard, the APFA can be of assistance by developing a corpus of sound principles and practices bearing on financial system robustness.

This section therefore looks at various sectors in which practices and principles seem to be desirable and feasible, given the existing international arrangements. The principles and practices drawn in this section are intended to assist the APFA in reviewing existing so-called international standards and in developing its own standards for the region. Hence, it draws heavily on existing works, particularly that of Basle Committee on Banking Supervision and the International Organization of Securities Commission, which have greatly contributed to the promotion of internationally accepted standards and practices for financial regulation and supervision. It also identifies international official and private sector groupings which have the expertise and experience to develop the practices and principles. However, the principles should be applied in the light of the circumstances of each country.

1 Accounting and auditing

The related major international organizations are **The International Accounting Standards committee (IASC); International Federation of Accountants (IAC); Basle Committee on Banking and Supervision (BCBS); and International Federation of Accountants (IFAC).**

Building long-term investor participation depends on transparent financial information based on clear accounting rules and full disclosure of material information. Since the preparation of accounting standards involves considerable cost and the magnitude of cross-border financing transaction, securities trading, and direct foreign investment is enormous, it would not be economical for each country to have a separate process. The need of a single set of rules by which assets, liabilities, and income are recognized and measured is urgent. Hence, international institutions are working to develop a set of high-quality accounting standards. The accounting system which was proposed by those international institutions embody four basic quality standards. First, the information provided is numerically and factually accurate. Second, it is relevant and transparent in that individual items correspond correctly to the underlying condition being reported. Third, the information is comprehensive in covering all material activities and aspects of an enterprise's operations that bear on its present and future financial condition. Fourth, the information needs to be sufficiently timely and regularly provided to be of use when decisions are made.

This study suggests that the Asia-Pacific Financial Authority should first review and study the difference in the accounting procedure among its member countries and existing International Accounting Standards. It should then seek to reduce the number of alternative accounting procedures in order to achieve the best practice in the presentation of financial statement. If this is successful, it will contribute to ensuring that information contained in the financial statements is accurate, timely and comprehensive.

2 Banking supervision

The related major international organization is **The Basle Committee on Banking and Supervision (BCBS).**

In response to the need for a comprehensive and an internationally endorsed set of principles and practices that could be applied to the entire banking system in a variety of different counties, the BCBS has developed both a set of core principles and an exhaustive compendium of rules and recommendations on banking supervision. They cover: preconditions for effective banking supervision; licensing and structure of banks; prudential regulations and requirements; methods of ongoing supervision; information requirements; formal powers of supervisors; and cross-border banking supervision. However, it should be noted that the BCBS has no legal force – members are simply expected to put their best efforts to see that its rules and recommendations are followed nationally.

Recognizing that sound-banking supervision is important in ensuring financial stability, this study suggests that the Asia-Pacific Financial Authority should aim to identify gaps or shortcomings in the supervisory framework of its member countries. It could then form the basis for designing future training programs to ensure a core of well qualified bank supervisors, which is essential to the maintenance of a strong and well-supervised banking system. This study also suggests that the Asia-Pacific Financial Authority should aim to assist supervisors in employing the practices and tools that will allow them to enhance their ability to adopt changes in their countries and tackle more ambitious goals. The APFA should also provide supervisors with the latest information on market products, practices, and techniques to help them adapt to rapid innovation in risk management, finance and regulation. The APFA will focus on identifying supervisory measures that facilitate the successful implementation and enforcement of these principles across the region.

3 Securities market supervision

The related major international organization is **The International Organization of Securities Commissions (IOSCO).**

The (IOSCO) is working to establish universal principles for securities regulation. The aim is to ensure that markets are fair, efficient and sound. A consultative approach is used that leads to the voluntary adoption of these principles by country authorities. The dissemination of its principles and guidelines among its members contributes to market transparency, investor protection and financial stability. Thirty principles of securities regulation are set out based upon three objectives of securities regulation: to protect investors; to ensure that markets are fair, efficient and transparent; and to reduce systemic risk. The principles give practical effect to the objectives and are divided into eight categories: the responsibilities of the regulator; self-regulation; enforcement of securities regulation; cooperation in regulation; issuers; collective investment schemes; market intermediaries; and, the secondary market. The IOSCO provides securities regulators with a yardstick against which progress toward effective regulation can be measured. It provides examples of current practices, but recognizes that these practices should change as market evolves and as technology and improved coordination among regulators make other strategies available.

The APFA should therefore collect relevant materials from member countries and international organizations on the practical measures for implementing sound securities market supervision. It also needs to draft concrete analysis on the issues which require priority.

4 Insurance supervision

The related major international organization is **The International Association of Insurance Supervisors (IAIS).**

The IAIS issued the Insurance Supervisory Principles, a compendium of principles, standards and guidelines. The IAIS consists of insurance supervisors. It is charged with developing internationally endorsed principles and standards on insurance supervision, and with assisting insurance supervisors in implementing those principles and standards through cooperation programs and training. The IAIS is currently focusing its work on licensing, use of derivatives and on-site inspections. The IAIS recommendations are advisory, rather than binding, on the membership.

This study suggests that the APFA should have the power to: (i) license insurance companies; (ii) apply prudential regulation; (iii) conduct consolidated supervision; (iv) obtain and independently verify relevant information; (v) engage in remedial action and execute portfolio transfer and (vi) apply sanctions against insurance companies which do not follow the recommendations and injunctions of the supervisory authorities.

5 Financial conglomerates

The related major international organizations are **The International Accounting Standards Committee (IASC); The Basle Committee on Banking and Supervision (BCBS); The International Organization of Securities Commissions (IOSCO); and The International Association of Insurance Supervisors (IAIS).**

It is widely accepted that the key issues of regulation and supervision of financial conglomerates are exchange of information between different specialist agencies, co-ordination of regulatory requirements and liaison of their activities, and effective mechanisms for coordinated action when problems with a regulated firm arise. The IASC is working towards agreeing on a core set of internationally acceptable accounting standards for cross-border offerings and listings that will be considered by IOSCO upon its completion. The IASC is also working closely with the BCBS on reviewing differences in supervisory approaches to loan valuation and credit loss provisioning. In addition, the three international supervisory groupings (the Basle Committee for banking, the IOSCO for securities and the IAIS for insurance) are to co-operate through the Joint Forum to ensure that conglomerates are subject to adequate supervision, particularly as they present special challenges on account of their size and complexity.

As far as the APFA is concerned, it should begin with reviewing various means to facilitate the exchange of information and investigating legal or other barriers which could impede the exchange of information between supervisors within their own sectors and between supervisors in different sectors. This study also suggests that the APFA should then establish criteria to identify and define the responsibilities of a coordinator, and work on developing principles toward a more effective supervision of regulated firms within financial conglomerates.

D. Setting for implementing sound principles and practices

In an increasingly integrated global economy, financial sector stability is most likely to be achieved when prudential standards are met and when markets operate competitively, professionally and transparently, according to sound principles and practices that generate the relevant information and appropriate incentives. However, the availability of information necessary for sound financial decisions, the ability to respond to incentives and the capacity to implement financial transactions efficiently all depend upon, particularly, the quality of the legal framework and the regulatory and supervisory arrangements that support effective market functioning. The following will provide some discussion on the framework for implementing sound principles and practices.

a. Legal and juridical framework

The legal and juridical framework necessary for supporting the Asia-Pacific Financial Authority includes adequate contract, corporate, bankruptcy and private property laws. Having said that, the basic functions of the legal and juridical framework of the APFA should be as follows: to establish clearly the rights, responsibilities and liabilities of the parties to financial transactions; to establish codes to support market forces in maintaining appropriate incentives and adequate information; and to provide means to enforce legal obligations and claims efficiently.

b. Regulation and supervision

As regulation and supervision are concerned with supporting the operation of market discipline, it is necessary to ensure that the APFA is independent from political interference in the execution of supervisory tasks, but is accountable in the use of its powers and resources to pursue clearly defined objectives. The APFA should also have the power to license institutions, to apply prudential regulations, to conduct consolidated supervision, to obtain and independently verify relevant information, and to engage in remedial action. Finally, the APFA should ensure that it has the power and resources to co-operate and exchange information with other authorities, both at the regional and international level, thereby supporting consolidated supervision.

c. Lender of last resort

The APFA, once established, should be organized to take responsibility for funding regional rescue operations when the need arises. Hence, there should be explicit consideration of how its procedures should be developed to deal with problems of liquidity, and the development of a lender of last resort function. It should be combined with stringent conditionality, clear performance criteria and reliable means of repayment. It is also suggested that the official lending facilities within APFA should be provided only as a last resort and only be made to solvent institutions.

d. Role of regional surveillance

Monitoring is meant to generate timely information useful to policy makers and market participants. For policy makers, timely information identifies harmful factors to which policy corrections can be applied. Indeed, a monitoring and surveillance mechanism without proper regulatory authority may lead to possible information distortion or moral hazard problems. Hence, the APFA could set up both regular and ad hoc surveillance committees to conduct the job of monitoring on a continuous basis and evaluate the necessity of emergency credit provision on an emergency basis. These surveillance committees could advise on necessary policy guidelines to individual member countries during non-crisis period, but they could ask for some joint actions by member countries in order to prevent the spread of contagion when a country is likely to be in or is struck by the crisis. In order for the regional surveillance system to function more efficiently, the APFA needs to ensure the sharing of data on individual financial institutions, regional financial markets, and macroeconomics indicators.

e. Enforcement and co-ordination

Both research and experience suggest that good design and strong enforcement of key prudential regulations are needed in such areas as capital requirements, valuation guidelines, regulatory accounting principles, and disclosures. To achieve efficient and resilient financial systems, the APFA must adopt a consistent set of reinforcing actions. This includes: to enforce existing standards; to follow work procedures that comply with the relevant standards; and to update the checklists to enforce the standards on on-site inspections and derivatives.

f. Technical assistance and training

The APFA is in an ideal position to be a central intermediary between organizations which provide technical assistance and users of technical assistance. The APFA should also play a coordinating role in ensuring that technical assistance provided by various institutions is complementary. Areas that need such skill development are: Banking supervision (including learning from private sector); accounting, loan valuation, provisioning; deposit insurance and structured early intervention mechanisms (to help ensure that systems that may have been designed with outside assistance can be operated with vigilance and independence); resolution of troubled or failed financial institutions; and the process of policy-making, including information sharing and accountability among official bodies.

The effectiveness of a supervisory body depends mainly on the human resources at its disposal. However, at the moment, training courses, materials and methods for supervisory staff are not arranged systematically in the region. Taking into account the shortage of qualified staff and lack of proper resource development strategies; well-organized training schemes for supervisors are crucial to the Asia-Pacific economies. Training for supervisors involve both theoretical and practical aspects as well as legislative and supervisory aspects. It should not be a single event but should be conducted continuously and be based on well-arranged programs. In designing the APFA training programs, an active role by the recipient countries should be particularly encouraged so as to ensure that the training addresses their needs.

D. Further steps

A number of further steps should be taken to adopt and implement sound principles and practices for APFA.

1. Developing steps towards a regional financial authority, which would carry out prudential regulation in a consistent way across countries and financial sectors.

2. Advancing and perfecting the existing mechanisms to provide official liquidity, including last resort lending to countries in distress.
3. The APFA should be designed to fill the gaps that remain in areas where there are no clear assignment of roles and responsibilities for the development of understanding about best practice. It is important to ensure coordination and to avoid the emergence of conflicting norms. It is also advisable to ensure that no key area is overlooked and to establish procedures for developing consensus when several bodies are active in an area.
4. A further consideration in designing the APFA should take steps to define the respective roles and means of coordination for the APFA, both between regional countries and with other international organizations.
5. Future research should design a program to monitor the progress in implementing the principles and practices. It should also consider whether any changes to it are needed in the wake of evolving economic and other conditions.
6. In all areas, the work of APFA should respect the key premises and main principles listed above.
7. Future research should also establish timetables for the completion of the work for APFA.

IV. Concluding Remarks

Even though East Asia has been the region of "miracles," recent events have raised concerns about the quality of its financial systems. Indeed, the Asian financial crisis provoked a serious round of debate on how the financial systems could be strengthened in order to help prevent economic crises of this sort happening again in the future. A key policy message emerging from the Asian financial crisis is that it is natural to strive for closer co-operation among Asian nations to minimize the spread of contagious effects among neighbors. In this regard, it seems desirable to have a regional financial facility.

Therefore, this study provides a platform for the discussion of enhanced regional cooperation in the spheres of financial cooperation in the light of the Asian financial crisis. The study also focuses on the issues for future cooperation

— an Asia-Pacific Financial Authority should be developed. This study provides information necessary for future development of regional standards; it summarizes the current status of development of international standards; and it also indicates the relevant international standard-setting institutions. Hence, this study provides an outline for the development of the APFA, that will be able to competently service the region, play its role in an integrated financial market and ensure the stability and prosperity of the Asia-Pacific region. It will also require public authorities to provide for enhanced transparency and disclosure, improved regulation and supervision of financial institutions and markets.

NOTES

1. Studies (e.g. World Bank, 1998) show that the process of liberalization and globalization in the region were spawning new and difficult developmental problems prior to the crisis.
2. Hence, properly sequenced liberalization should be from the current account to the capital account. Capital account liberalization should be in the order of long-term investment to short-term investment. (Sakong, 1999)
3. Banking problems include low capital-adequacy ratios of banks; inadequately designed and weakly enforced legal lending limits on single borrowers or group of related borrowers; asset classification systems and provisioning rules for possible losses, that fell short of international standards; poor disclosure and transparency of bank operations; lack of provisions for an exit policy of troubled financial institutions and weak supervision. (World Bank, 1998)
4. The name, APFA, has given here is just for reference only. Issues regarding the creation of the APFA, such as membership etc., are beyond the scope of this study.

REFERENCES

Alworth, J. S. and Bhattacharya, S. (1995). “The Emerging Framework of Bank Regulation and Capital Control”, *LSE Financial Markets Group Special Paper*, no.78. London: London School of Economic, December.

Arndt, H.W., and H. Hill (1999). *Southeast Asia’s Economic Crisis: Origins, Lesson and the Way Forward*”. Institute of Southeast Asian Studies.

Baig, T., and I. Goldfjn, (1998). “Financial Market Contagion in the Asian Crisis,” *IMF Working Paper*, WP/98/155. International Monetary Fund, Washington, DC.

Berg, A., (1999). “The Asia Crisis: Causes, Policy Responses, and Outcomes,” *IMF Working Paper*, WP/99/138. International Monetary Fund, Washington, DC.

Bonte, R., (1999). “Supervisory Lessons To Be Drawn From the Asian Crisis,” *BIS Working Papers*, No.2. Basel Committee on Banking Supervision, Basel.

Bora, B., and C. Findlay (1996). *Regional Integration and the Asia-Pacific*. Oxford University Press Australia.

Buira, A., (1999). “An Alternative Approach To Financial Crises”. Essays in International Finance,

Claessens S. and T. Glaessner, (1997). “Are Financial Sector Weaknesses Undermining the East Asian Miracle?” Directions In Development, The World Bank, Washington, DC.

Claessens, S., and T. Glaessner, (1998). “Internationalization of Financial Services in Asia”. The World Bank, Washington, DC.

Corsetti, G., P. Pesenti and N. Roubini (1998). “What Caused the Asian Currency and Financial Crisis?” Mimeo, New York University.

Corsetti, G., P. Pesenti and N. Roubini (1998). “Paper Tigers? A Model of the Asian Crisis”. Mimeo, New York University.

Crockett, A., (1997). “The Theory and Practice of Financial Stability”. International Finance Section, Princeton University, New Jersey.

D’Arista, J., (1998). “Financial Regulation in a liberalized Global Environment”. *CEPA Working Paper Series* III, No.2, Center for Economic Policy Analysis, New York.

Davues, H. (1996). "Financial Regulation: Why, How and By Whom?" *Bank of England Quarterly Bulletin*, 37(1), 107-12.

Demirguc-Kunt, A., and E. Detragiache, (1998). "Financial Liberalization and Financial Fragility," *IMF Working Paper*, WP/98/83, International Monetary Fund, Washington, DC.

Dobson, W. (1998). *Fiscal Frameworks and Financial Systems in East Asia: How Much Do They Matter?" Hong Kong Bank of Canada paper on Asia*; V.4, Institute for International Business, University of Toronto.

Eatwell, J., and L. Tayler (1998). "The performance of Liberalized Capital Markets" *CEPA Working Paper Series* III, No. 8, Center for Economic Policy Analysis, New York.

_________. "International Capital Markets and the Future of Economic Policy". *CEPA Working Paper Series* III, No. 9, Center for Economic Policy Analysis, New York.

Echengreen, B. (1999). "Strengthening the International Financial Architecture: Where Do We Stand?" the East-West Center Workshop on International Monetary and Financial Reform, Honolulu.

Edwards, F.R. and Patrick, H.T. eds. (1992). *Regulating International Financial Markets: Issues and Policies*: Dordrecht: Kluwer Academic.

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

Fukasaku, K. (1995). *Regional Co-operation and Integration In Asia,* OECD.

Giannini, C., (1999). "Enemy of None But A Common Friend or All? An International Perspective On the Lender-of-Last-Resort Function". International Finance Section, Princeton University, New Jersey.

Goldfajn, I., and R. Valdes, (1997). "Capital Flows and the Twin Crisis: The Role of Liquidity". *IMF Working Paper* 97/98, International Monetary Fund, Washington DC.

Goldstein, M., and P. Turner, (1996). "Banking Crises in Emerging Economies: Origins and Policy Options". *BIS Economic Papers* No. 46, Bank for International Settlements, Basle.

Goodhart, C., Hartmann, P., Rojas-Suarez, L. and Weisbrod, S., (1998). *Financial Regulation: Why, How and Where now?* London: Roultedge.

Grenville, D. (1998). "The Asian Crisis and Regional Co-operation". Paper presented at International Seminar on East Asia Financial Crisis, Beijing, April 21.

Grunsven L. V. (1998). *Regional Change In Industrializing Asia*. The Organization of Industrial Space.

International Monetary Fund, (1997). "Financial Stability in Emerging Market Economies". International Monetary Fund, Washington, DC.

International Monetary Fund, (1998). "Toward a Framework for Financial Stability". International Monetary Fund, Washington, DC.

Ito, T. and A. Krueger, (1996). *Financial Deregulation and Integration in East Asia*. The University of Chicago Press.

JP Morgan, (1998). "Asian Financial Markets". JP Morgan.

JP Morgan, "World Financial Markets". Various Issues. JP Morgan.

Kanaya, A., and D. Woo, (2000). "The Japanese Banking Crisis of the 1990s: Sources and Lessons". *IMF Working Paper*, WP/00/7, International Monetary Fund, Washington, DC.

Kochhar, K., Loungani, P., and M. Stone, (1998). "The East Asian Crisis: Macroeconomic Developments and Policy Lessons". *IMF Working Paper,* WP/98/128, Internaitonal Monetary Fund, Washington, DC.

Kopits, G. and J. Craig (1998). "Transparency in Government Operations". *Occasional Paper* 158, International Monetary Fund, Washington, DC.

Kumar, R. and B. Debroy (1999). "The Asian Crisis: An Alternate View". *Economic Staff Paper N*o. 59, Asian Development Bank.

Krugman, P. (1998). "The Confidence Game". *New Republic*, October.

Krugman, P. (1998). "What Happened in Asia?" Mimeo., MIT, Cambridge, MA.

Large, A., (1998). "The Future of Global Financial Regulation". *Occasional Papers* No.57, Group of Thirty, Washington, DC.

Lee, E., (1998). *The Asian Financial Crisis: The Challenge for Social Policy*. International Labour Organization, Geneva.

Lindgren, C., Balino, T., Enoch, C., Gulde, A., Quintyn, M., and L. Teo, (2000). "Financial Sector Crisis and Restructuring: Lesson from Asia," *Occasional Paper* 188, International Monetary Fund, Washington, DC.

Lye, C. and R. Lazar (1991). *The Regulation of Financial and Capital Markets*. Singapore Academy of Law.

Masson, P. and M. Mussa (1997). "The Role of the IMF: Financing and its Interactions with Adjustment and Surveillance". *Pamphlet Series* No. 50, IMF.

Masson, P., (1998). "Contagion: Monsoonal Effects, Spillovers, and Jumps between Multiple Equilibria". *Working Paper* WP/98/142, International Monetary Fund, Washington, DC.

McLeod, R. and R. Garnaut, (1998). *East Asia in Crisis: From Being a Miracle to Needing One?* London: Routledge.

Radelet, S., and J. Sachs, (1998). "The Onset of the East Asian Financial Crisis". Paper presented at the Currency Crises Conference, National Bureau of Economic Research.

Rajan, K., (1999). "Financial and Macroeconomic Cooperation in ASEAN: Issues and Policy Initiatives". Paper prepared for ASEAN Roundtable 1999, Institute of Southeast Asian Studies, Singapore.

Rajan, K., (2000). "Examining the Case for an Asian Monetary Fund," *Working Paper Visiting Researchers Series* 3/2000, Institute of Southeast Asian Studies, Singapore.

Rodrik, D. (1999). "Governing the Global Economy: Does One Architectural Style Fit All?" Unpublished manuscript, Harvard University.

Sachs, J., Tornell, A., and A. Velasco, (1996). "Financial Crises in Emerging Markets: The Lesson from 1995". *Brooking Papers on Economic Activity*.

Sakong, I., (1999). "The Asian Financial Crisis: Its National, Regional and Global Policy Implications". JIIA Conference on Asia-Pacific Cooperation. The Japan Institute of International Affairs, Japan.

Sasaki, F. (1996). "Significance and Feasibility of the Asian BIS Concept". *Nomura Asia Focus Quarterly*, (Winter 1996/1997), pp. 34-9.

Tan, G., (1999). *The End of the Asian Miracle? Tracing Asia's Economic Transformation*. Time Academic Press, Singapore.

Villanueva, D., (1997). "Financial System Soundness and Risk-Based Supervision". The Eleventh SEACEN Meeting of Directors of Supervision, Malaysia.

Wang, Y., (1999). "The Asian Financial Crisis and the Need for Regional Financial Cooperation". *KIEP Working Paper No.* 99-14, Korea Institute for International Economic Policy.

Williamson, J., and M. Mahar, (1998). "A Survey of Financial Liberalization". International Finance Section, Princeton University, New Jersey.

World Bank (1998). "East Asia: The Road to Recovery". The World Bank.

About the author

Tracy Yang is a Fellow of the Institute of Southeast Asian Studies, Singapore.
E-mail: tracy@iseas.edu.sg

Table 1 Net Inflows to Emerging Asia, 1977 – 1997 (US dollars in billions)

	Annual Average									
	1977-1982	1983-1989	1990	1991	1992	1993	1994	1995	1996	1997
Net Portfolio Flows	0.6	1.4	-0.4	3.1	7.4	23.9	18.5	20.1	20.1	na
Net Equity Flows	----	----	3.89	4.73	10.95	30	na	na	na	na
Net Capital Flows	----	----	----	----	----	----	106	135	150	90

Sources: World Economic Outlook data base, IMF, for net portfolio flows and net equity flows; and World Financial Markets, JP Morgan, for net capital flows.

Table 2 Banking System Exposure to Risk (% of assets at the end of 1997)

	Property	Collateral	Non-Performing Loans		Capital
	Exposure	Valuation	1997	1998	Ratio
Hong Kong	40-55%	50-70%	1.50%	3%	15-20%
Indonesia	25-30%	80-100%	11%	20.00%	8-10%
Korea	15-25%	80-100%	16%	22.50%	6-10%
Malaysia	30-40%	80-100%	7.50%	15.00%	8-14%
Philippines	15-20%	70-80%	5.50%	7.00%	15-18%
Singapore	30-40%	70-80%	2.00%	3.50%	18-22%
Thailand	30-40%	80-100%	15%	25%	6-10%

Source: JP Morgan “Asian Financial Markets,” January 1998.

Table 3 Lending Boom Measure *

	China	Hong Kong	Indonesia	Korea	Malaysia	Philippines	Singapore	Thailand
Measure	**7%**	**26%**	**10%**	**11%**	**31%**	**151%**	**17%**	**58%**

* As rate of growth between 1990 and 1996 of the ratio between the claims on the private sector of the deposit money banks and nominal GDP.

Source: Sachs, Tornell and Velasco (1996).

Table 4 Weaknesses in Banking Systems in Asian Emerging Markets

	Indonesia	Korea	Malaysia	Philippines	Taiwan	Thailand
Inadequate prudential supervision	**Y**	**Y**				**Y**
Inadequate financial reporting and audit	**Y**	**Y**	**Y**	**Y**	**Y**	**Y**
Weak credit assessment	**Y**	**Y**	**Y**	**Y**		**Y**
Limited bank reserve regulations	**Y**	**Y**	**Y**		**Y**	**Y**
Political - financial links	**Y**	**Y**	**Y**	**Y**		**Y**
Immature financial sector	**Y**			**Y**		**Y**
High percetage non-performing loans	**Y**	**Y**				**Y**
Slow to close/ write off	**Y**	**Y**	**Y**			**Y**
Limited foreign entry	**Y**	**Y**	**Y**	**Y**		**Y**
Underdeveloped portfolio of financial instruments	**Y**		**Y**	**Y**		**Y**

Source: Dobson, 1998

EADN WORKING PAPERS

EADN Working Papers
(ISSN 0219-6417)

1(2001): Thawatchai Jittrapanun, *The SIMEX Experience: Implications for Thailand's Futures Exchange*, November 2001.
[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 4 (2000).]

2(2001): Le Minh Tam, *Reforming Vietnam's Banking System: Learning from Singapore's Model*, November 2001.
[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 5 (2000).]

3(2001): Gao Haihong, *Liberalising China's Capital Account: Lessons Drawn From Thailand's Experience*, November 2001.
[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 6 (2000).]

4(2001): Liliana Halim, *Reviving the Indonesian Banking Sector? Indonesia's Economic Crisis: Impact on Financial and Corporate Sectors 1997-1999*, November 2001.
[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 7 (2000).]

5(2001): Wang Xiaomin, *Zhongguancun Science Park: A SWOT Analysis*, November 2001.
[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 10 (2000).]

6 (2001): Doan Phuong Lan, *The Asian Financial Crisis and its Implication for Vietnam's Financial System*, November 2001.
[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 11 (2000).]

7(2001): Tracy Yang Su-Chin, *Regulatory Reforms in the Asia-Pacific Region: A Preliminary Study*, November 2001.
[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 12(2000).]

8(2001): Akhmad Bayhaqi, *Education and Macroeconomic Performance in Indonesia: A Comparison with Other ASEAN Economies*, November 2001.
[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 13(2000).]

9 (2001): Tubagus Feridhanusetyawan and Haryo Aswicahyono, *Gender Assessment of the Indonesian Labour Market*, December 2001.

10 (2001): Vo Tri Thanh, Dinh Hien Minh, Do Thu Huong and Nguyen Thi Hong, *The Sustainability of the Current Account Deficit and External Debt in Vietnam*, December 2001.

11 (2001): Ari Kuncoro, *Microeconomic Determinants of Economic Growth in East Asia*, December 2001.

12 (2001): Medhi Krongkaew, *The Political Economy of Growth in Developing East Asia*, December 2001.

13 (2001): Chin Hee Hahn and Jong-il Kim, *Sources of East Asian Growth: Some Evidence from Cross-country Studies*, December 2001.

14 (2001): Ammar Siamwalla, *Markets and Economic Growth in East Asia*, December 2001.