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Recent Trends in External Debt Management Practices,
Global Governance, and the Nature of Economic Crises
—In Search of Sustainable Economic Development Policies—

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Abstract

The East Asian financial crisis of 1997-99 was essentially one of external debt problems between financial institutions in both lending and borrowing countries, while crises in other emerging market economies—such as in Russia (1998), Brazil (1999) and Argentina (2001)—were associated with external debt problems between sovereign borrowers and overseas private investors. Although both crises were triggered by a reversal of capital inflows caused by a change in investor sentiment, the conflicts of interests among creditors were more complicated in the case of Russia, Brazil, and Argentina than those in East Asia, since the presence of a large number of individual investors made it extremely difficult to undertake restructuring negotiations about the foreign debt of indebted countries in the case of bond finance. Given that both private loan and sovereign bond problems may re-emerge in the future, it is vital to examine the external debt management practices applied in each of the cases noted here. This paper examines external debt management practices with respect to sovereign bonds and private sector external financing.

Key words: East Asian Crisis, external debt, sovereign bonds, exchange rate policy, capital controls

1 Introduction

Since the East Asian financial crisis of 1997-99, strong and increasingly prevalent views have emerged in the international community that banks are no longer functional. Such views claim that the crisis was caused by firms' heavy dependence for investment on bank loans, and that Asian banks did not function as properly as those operating in some advanced countries, due to cronyism (among banks, firms and governments), the inability of banks to develop risk management skills, and a lack of proper prudential risk management. It is now widely understood that the crisis underscored the risks associated with financial structures where firms depended excessively on short-term bank loans to finance longer-term domestic projects (a so-called "maturity mismatch"). At the same time, the crisis revealed the vulnerabilities of using unhedged short-term foreign currency borrowings to finance domestic investment projects (a so-called "currency mismatch").

While the Asian financial crisis was essentially the external debt problems between financial institutions in both lending and borrowing countries, the crises in other emerging market economies—such as Russia (1998), Brazil (1999) and Argentina (2001)—were associated with external debt problems between sovereign borrowers and overseas private investors. The commonality was that both crises, preceded by the growth of private sector foreign lending, were triggered by a reversal of these capital inflows caused by a change in investors sentiment. Nevertheless, the conflicts of interests among creditors, and between creditors and borrowers were more complicated in the cases of Russia, Brazil, and Argentina than that of the Asian financial crisis, since the presence of a large number of individual investors made it extremely difficult to undertake restructuring negotiations about the foreign debt of indebted countries. That is, while in the crisis-hit Asian countries major borrowers of external loans were largely domestic banks (and financial institutions and companies) and major lenders were foreign banks, the major borrowers were sovereign and the major lenders were a large number of individual investors in other regions. Kruger (2003) pointed out that private creditors accounted for over two-thirds of outstanding Latin American debt by the late 1990s, while 66 percent of debt was to official creditors and the private creditors were largely banks (fewer than 20) in 1980-85.

Given that the trend toward growing volumes of gross flows, volatility, and swings in risk appetite that create turbulence in international markets is likely to continue in the foreseeable future, this paper discusses various measures for avoiding foreign debt crises and improving foreign debt management, both of which have been intensively discussed in the international community. Given that both private loan and sovereign bond problems

may re-emerge in the future, it is crucial to examine the external debt management practices applied in each case. Thus, Section 2 discusses external debt management practices with respect to sovereign bonds, as has been extensively discussed in recent years, while Section 3 deals with those practices related to private sector external financing. Section 4 discusses other tools to mitigate external debt problems.

2 External Debt Management for Sovereign Bonds

2.1 Background

In the 1990s, sovereign borrowers increasingly turned from bank loans to bond issues to raise international capital. As the international capital markets developed, an investor base available to provide financing for emerging market sovereigns increased, which helped diversify credit risk borne by investors. Instead, unsecured, medium-term, commercial bank syndicated loans—prevalent practices in the 1980s—became less prevalent, since syndicated loans showed themselves to be uncomfortably susceptible to rescheduling during the 1980s. Lenders were easily identifiable, could be contracted at the end of a telex line and were expected to behave with maturity and forbearance in the face of disappointing news from borrowers (Buchheit, 1995). During the 1980s, on the other hand, publicly-issued debt instruments (e.g., the Eurobonds and floating rate note issues) were almost never rescheduled and were paid on time in full. The main reason why sovereign bonds were not rescheduled in those days was that there were not very many of them and thus they were not thought worth the effort to try to reschedule in light of the limited debt relief that could be achieved from such an exercise.

This practice of excluding bonds from the unpleasanties of debt restructurings explains why investors were prepared to buy emerging-market sovereign bonds in the 1990s (Buchheit, 1995). Also, the increase in bond issuance reflected the preference of borrowers in those markets for fixed rate instruments, as compared with floating interest rate bases (e.g., the London Interbank Offered Rate) that are usually applied to bank financing. In the 1990s, therefore, bank loans became the exception and bonds became the lending instrument of choice for sovereign borrowers. As a result, the aggregate stock of bond indebtedness became simply too large to be ignored or excluded from requests for debt relief. Further, there was no provision for coordinated representation and leadership, unlike with the syndicated bank loans.

However, international bond finance has a serious downside if a country faces unsustainable debt, since private creditors have become increasingly numerous, anonymous

and difficult to coordinate. This problem is exacerbated by the variety of debt instruments involved and the range of legal jurisdictions in which debt is issued. When faced with debt restructuring, individual creditors, unlike banks, have more incentives to hold out for the best possible terms, or to sue for better terms. Also, disagreements over relative treatments for different types of creditors are more likely.

In general, countries facing severe liquidity problems go to extraordinary lengths to avoid restructuring their debts to both foreign and domestic creditors, since they recognize that even an orderly debt restructuring can damage their economy and future access to the international financial and capital market. Moreover, a disorderly restructuring can terminate access to the international capital market for years. The failure of collective action by the growing number of diverse sovereign creditors complicates and delays the process of finalizing a restructuring agreement. This causes economic distress to the debtor country and rapidly erodes the value of the creditors' claims in the process. For these reasons, a country tends to delay entering into discussions with their creditors, thereby compounding the situation and making the ultimate negotiations even more difficult.

To avoid such a disastrous situation, the restructuring of sovereign debt that takes into account collective action and creditor coordination is necessary. There are two main approaches with respect to changes in the terms of repayments of sovereign debt: (1) a contractual approach with collective action clauses (CACs) and (2) a statutory approach, the so-called "sovereign debt restructuring mechanism (SDRM)." The SDRM approach is more comprehensive than the CAC approach, since it would deal with the whole existing debt stock (including those that do not explicitly provide for collective action), while the CAC approach is applied to individual bond issues. Moreover, even if CACs became widely used, they would be applied only to new bond contracts and, thus, still fail to cover existing debt that lacked such clauses. The SDRM appears more advantageous since it permits the sovereign borrower and its creditors to act as if all of its debt were governed by a single CAC. Thus, the SDRM approach is regarded as a complement to the CAC approach.

An increase in emerging-market sovereign bond financing in the 1990s, such as that by Russia, Brazil and Argentina, has highlighted the need to promote private sector bondholders in crisis resolution. However, the issue of whether sovereign bonds should be included in a comprehensive debt restructuring in a crisis needs to be carefully examined. This is because a country will suffer from the tradeoff between the immediate cash-flow relief associated with bond restructuring and the reduction over the medium term in the country's ability to mobilize resources from private creditors. As well, there is a growing concern that restructuring of sovereign bonds in one country may abruptly affect other

emerging-market borrowers, increasing the risk of contagion. Moreover, this issue is likely to become important, even in Asia, in the near future, since governments began to actively issue bonds after the crisis to finance their growing fiscal deficits; and, at the same time, to establish the benchmark yield curve needed to develop sound corporate bond markets. So far, these bonds have been issued domestically, but once issued in the international market, for example in the context of the Asian regional bond market as discussed in Section 3, sovereign foreign debt management will become an important and necessary item on the policy agenda.

2.2 The Collective Action Clause (CAC) Approach

CACs permit a specified super-majority of holders of a particular bond issue to agree to a restructuring that would be binding on all holders of that issue. By preventing holdouts in individual bond issues, such clauses thereby facilitate any needed restructuring. However, the CAC approach requires separate decisions from holders of each individual bond issue, so that creditors of issues not accepting a restructuring offer have the right to pursue their interests in the courts in the country under which laws the debt instruments were issued.

Generally speaking, American-style bonds (bonds governed by New York law) dominate sovereign debt markets. The need for involving the private sector is stronger particularly when sovereign debt is structured in the form of American-style international bonds, since the bonds required 100 percent agreement. Namely, they do not include contractual provisions for qualified majorities to modify the terms of the bond and provisions to impose such modifications of minority bondholders. In the event of default, the bonds provide few contractual limitations on the ability of individual bondholders to initiate and benefit from litigation to obtain settlement of their claims through the attachment of assets and to apply pressure for a favorable settlement. Thus, American-style bonds essentially require the unanimous consent of the bondholders to the terms of any restructuring. This exposes the issuer to the risk of legal action by dissidents and the risk of triggering cross-default clauses in its other obligations, which in turn activates acceleration clauses requiring those other obligations to be repaid (Eichengreen, 1999b). Palacios (2002) also points out that under American-style bonds, a debt restructuring is possible through a debt exchange, but since the exchange is not binding on all bondholders, there are potential legal risks from creditors that hold out on the exchange and that can pursue legal action to claim a better deal from the sovereign, as exemplified in the case involving Peru in the 1997 Brady exchange.

Meanwhile, British-style international bonds (bonds governed by English law)

contain provisions for debtors, bondholders, or the trustee to call bondholder meetings, and provisions for a qualified majority of bondholders (e.g., 75 percent) represented at the meeting to agree to a modification of terms binding on all holders of the issue. There are two legal structures: Trust Deeds and Fiscal Agency Agreements. Under the former, individual holders are generally prohibited from accelerating the bonds and initiating litigation. Instead, the trustee accelerates the bond issue and initiates litigation on behalf of creditors holding a specified proportion of the principal (e.g., 25 percent). The trustee must distribute any funds recovered to all bondholders in proportion to the principal held, providing a *de facto* sharing clause.

As it is difficult for domestic borrowers to identify creditors holding their bonds, bondholders would be approached indirectly through paying agents and advertisements; which indicate the authorities' intention to renegotiate the bonds and invite bondholders to identify their claims and attend a meeting. Once creditors are identified and prior to a bondholder meeting, the borrower can have initial contacts with large creditors to build a basis for an agreement.

A high participation rate is critical to the success of a voluntary exchange. Under the British-style bonds, it is relatively easy to achieve a high rate. In the case of Trustee Deed bonds, limitation on the ability of individual creditors to initiate litigation provides a further incentive to participate in an orderly restructuring. In this sense, the negotiation of a voluntary exchange for a British-style sovereign bond is analogous to negotiations between an illiquid but solvent non-sovereign borrower and its creditors in the shadow of bankruptcy (IMF, 1999).

As a result of the apparent differences in the contractual provisions between American- and British-style sovereign bonds, the market tends to view the latter as subordinated to the former. This tendency is more pronounced for a less creditworthy sovereign borrower because of the adverse impact on the pricing and composition of new bond placements. Nevertheless, there is little evidence that British-style bonds command significantly higher spread than their American-style bonds. This suggests that the prospect of an orderly renegotiation may actually make some bonds more attractive than a possible messy default (Eichengreen, 1999b).

Meanwhile, there are at least three problems with regard to implementation (Eichengreen, 1999b). First, foreign creditors are satisfied with the status quo so long as the belief remains that they will always get some money courtesy of the IMF. Second, neither creditors nor borrowers wish to weaken the binding role of debt by altering loan contracts in ways that might tempt borrowers to walk away from their obligations. By making it

easier for debtors to restructure their debts, investors may fear that debtors are prepared to walk away at the first sign of trouble and prompt them to liquidate the bonds. This kind of moral hazard may precipitate precisely the kind of bond market crisis that the international policy community wishes to avoid. Third, the issue of adverse selection may generate no price that adequately compensates creditors for bond covenants. Creditors generally know less than borrowers about borrowers' willingness and ability to pay. Thus, only borrowers with a high probability of default may find it attractive to accept the provisions. Consequently, the higher the price the markets charge for this type of bond, the riskier it is for creditors to purchase them.

Further, it has been pointed out that the incorporation of such clauses in bond contracts might reduce the supply of foreign financing to a country. However, this concern may not be valid considering that there is no apparent impact on British-style bonds. Also, emerging-market economies could be reluctant to introduce such clauses for fear of adverse signals it could send: governments do not wish to be seen as trying to make it easier for themselves to default (Boorman et. al., 1999). In addition, the clauses do not guarantee that a qualified majority of the bond holders would agree to restructure contractually obligated payments rapidly enough to avert a possible crisis and that a rapid workout would take place in the event of a severe crisis (Working Group of the G22, 1998). In addition, the Working Group of G22 points out that the use of such clauses might be seen as increasing the probability of an interruption of payments and therefore lead bondholders to raise the yields they demand.

Despite these concerns, however, the CAC approach has gained growing support from the US government and creditors in recent years, especially after the failure to gain support on the SDRM approach from both major creditors and debtors in April 2003 (as discussed later). In response to the recent calls for greater use of CACs, Mexico made a successful issue of dollar-denominated bonds including CACs in February 2003, and was followed by Brazil. Then, Turkey and Peru included CACs in their new international bond issues governed by New York Law. Both issues were priced tightly in relation to the yield curve and, thus, there was no evidence that the market had priced in a lower voting threshold. Thus, to date, the afore-mentioned concerns have not been reported. Subsequently, from the late 2003 to early 2004, Chile, Columbia, Costa Rica, Indonesia, Israel, Panama, the Philippines, Poland, and Venezuela have issued global bonds including CACs. All issues were heavily oversubscribed and priced broadly along the yield curve.

2.3 Sovereign Debt Restructuring Mechanism (SDRM) Approach

As for the SDRM, the IMF's First Deputy Managing Director announced in November 2001 the idea to create a legal framework, or a rule-based approach, to help countries with unsustainable debts to resolve them in an orderly and prompt manner. She came up with the idea after the experience of Argentina, which struggled to service its external debt of more than \$100 billion before the crisis and then defaulted on it at the end of 2001. Since there were no mechanisms in place then to restructure sovereign debts, the crisis deepened in Argentina and the interest rate on its dollar-denominated assets increased to more than 50 percent. Subsequently, the IMF released in September 2002 its proposal for an international bankruptcy court for insolvent countries, which would restructure unsustainable debts in an orderly and timely manner. The SDRM proposed a system that would allow a national government to request the convening of a disinterested international panel that would negotiate with a government's private creditors and arrive at a debt re-structuring agreement that required approval by a majority of the creditors that would then be enforceable on all of the country's private creditors. The intention behind the SDRM proposal was that rapid and orderly debt restructuring would help a country arrive at a sustainable debt situation, so that the unnecessary costs of the present drawn-out debt workouts can be averted and the debtor country be brought back on a path of economic recovery and development.

In particular, the SDRM proposal consists of (1) majority restructuring (allowing a sovereign and a qualified majority of creditors to reach an agreement that would become binding on all creditors), (2) deter disruption litigation (discouraging creditors from seeking to enhance their position through litigation during the restructuring process), (3) protecting creditor interests (giving creditors assurances that their interests are being protected during the restructuring process, and (4) priority financing (agreeing to give seniority and protection from restructuring to fresh private lending.) While the proposal does not include an automatic stay on the enforcement of creditor rights, any amounts recovered by a creditor through litigation would be deducted from its residual claim under an approved restructuring agreement. The priority financing is a feature unique to the SDRM, not shared by the CAC approach. Namely, that the SDRM would override the rights bond investors have to insist upon unanimous approval for a debt restructuring, thereby allowing governments to default but limiting the economic damage of default by giving more incentive to reach a speedy compromise on debt restructuring. Further, the IMF was supposed to play the role of the courts, which would require a modification in the articles of the IMF.

The SDRM approach is similar to that under corporate bankruptcy laws, such

as Chapter 11 in the United States. However, there are several key differences with those procedures (Bolton, 2003). First, sovereign states never get liquidated, so that sovereign debtors may become too strong. If so, it is the creditors that are in need of protection, not debtors, since there may be a greater risk of prolonged negotiation. Second, unlike corporations, where creditors are often able to impose a change in management team, sovereign governments cannot be replaced by their creditors following a default. It is also difficult for creditors to impose conditions on governments that would make a debt restructuring more acceptable. Third, sovereigns do not have to protect themselves against creditors racing to grab the debtor's assets, so that the going-concern value of a sovereign is more easily preserved and a stay in debt collection is less critical. On the other hand, sovereigns are more vulnerable than corporations to capital flight, and to currency and banking crises. These risks, not debt collection efforts, are more likely to harm the going-concern value of the sovereign. Thus, other supporting policies, as discussed in Sections 3 and 4, are necessary,

The International Monetary and Financial Committee (IMFC) endorsed the proposal in September 2002 and requested the IMF to develop a concrete SDRM proposal for consideration at their April 2003 Annual Meeting. The IMF Board held discussions in March 2003, based on an IMF staff paper on the "Proposed Feature of a SDRM", prepared after converging views within the Board and taking into account their extensive dialogue with private market participants, debt-restructuring practitioners and other workout specialists, academics, and members of the official community. The paper was discussed at the April 2003 Annual Meeting but did not get the full support needed from both developed and developing countries; while the CAC approach was encouraged by the United States and private creditors. In particular, Wall Street reacted with outrage to the idea, warning that capital flows to emerging markets would dry up if creditor rights were infringed. This reaction was compounded by the resistance from emerging market economies who feared losing access to international capital markets. As a result, the IMF conceded in April 2003 that there was not the required support to change the IMF's Articles of Agreement to launch the SDRM. Since then, the focus of external debt management has shifted from the SDRM approach to the CAC approach.

3 Foreign Debt Management for Private Loans

3.1 Developing Domestic Bond Markets

After the East Asian financial crisis, the increasingly prevalent view has been that

banks have not been functioning properly and that economic development should instead rely on domestic capital markets, particularly bond markets. This view claims that the heavy dependence of firms on bank loans was an important cause of the East Asian financial crisis and that domestic banks were poorly managed compared to those operating in some developed countries. It concludes that there should be less emphasis on bank loans in policymaking, and that Asian countries should instead develop domestic bond markets as alternative sources for financing enterprises, given that Asian countries have high saving rates and thus ample financial resources of their own.

As one way to deal with these mismatches and, at the same time, to mitigate unnecessary external finance, many now have the view that Asian countries should develop domestic-currency-denominated (domestic) bond markets as more important sources of financing. Reflecting this view, policy makers, international financial organizations, academics, and media have paid attention to the idea of developing domestic bond markets in Asia. This is because domestic bond markets could provide stable sources of longer-term domestic currency funding to domestic firms, and in the process help to reduce double mismatches and strengthen financial sector resilience. In addition, domestic bond markets might help to improve the efficiency of resource allocation through market-determined interest rates, spreading various borrowers' credit risks among a large number of dispersed investors, and serving as a buffer when banking sector problems occur. Moreover, domestic bond markets also help to enhance financial institutions' transparency through information disclosure.

Nevertheless, the sheer fact is that domestic bond markets are largely underdeveloped in Asia, despite its rapid growth in the aftermath of the crisis in the presence of credit crunches caused by banks; three major reasons are possible. First, there are only a small number of large, reputable private firms that can regularly issue a large amount of corporate bonds at relatively low costs and. Many firms are small- and medium-enterprises without good historical records of corporate performance. Their income streams are often highly idiosyncratic and volatile, so that their costs for bond issues tend to be much higher than those of the large firms. In addition, their credit demand is uneven and relatively small, which makes these issuers inappropriate potential issuers, especially in the early stage of bond market development.

Second, there is limited demand for long-term bonds, since (mostly risk-averse) individual investors, like households, tend to hold their assets in the form of liquid, safe bank deposits. More importantly, there are few institutional investors (such as pension funds, insurance funds, etc.) in Asia in the presence of low financial asset accumulation and low per capita income level.

Third, the underdeveloped informational, legal, and judiciary infrastructures prevent

domestic banks from developing further. In general, public investors are direct credit risk takers, so that accounting, auditing, and disclosure systems, enforceable laws, and sophisticated judicial systems need to be established to protect them from severe informational asymmetry in the corporate bond markets, and to seriously penalize dishonest corporate securities issuers and underwriters. Without adequate informational, legal, and regulatory infrastructures, information on issuing firms is less credible and transactions in the market are less fair and honest. Recent corporate scandals, even in more advanced countries such as the United States, have clearly been a source of turbulence and loss of confidence and have exposed weaknesses in the capital market's foundations. Structural reforms are needed in the areas of board independence, audit and remuneration committee independence, accountability regimes for CEOs and CFOs, accounting and audit standards, disclosure standards and practices, and enforcement standards to rebuild investor confidence. It is true that many Asian countries have attempted to integrate various types of official bonds and regularly issue government bonds with well-spaced maturities, hoping to establish effective benchmark yield curves. However, in spite of the remarkable growth of the government bond market, the corporate bond market has remained largely underdeveloped in the sense that the maturity of corporate bonds is short-term concentrated (such as in Thailand, Korea, and Malaysia) and the investors base lacks diversity (such as Malaysia).

For these three reasons, it can be said that a relatively long time is necessary to establish sound domestic bond markets. As the size of their economies grows, demand and supply of bonds are likely to increase, while informational, legal, and judicial systems will mature and advance.

3.2 Developing Regional Bond Markets

Given the afore-mentioned three constraints presently restricting development in Asia, it can be seen as cost-ineffective to develop a local domestic bond market in each country. Fixed costs for establishing institutional infrastructures are relatively expensive and economies of scale are limited in such small individual markets. Unless there are cost-effective and sound bond markets, firms are discouraged from raising funds from the bond market and continue to depend on cheaper bank loans. Therefore, many have lately begun to focus on an idea of developing a regional bond market in Asia, since this could exploit economies of scale by incorporating a larger number of issuing firms and investors—thereby, raising both supply and demand of bonds. Moreover, this regional bond market could help diversify corporate financing, provide an extra investment avenue, and better tap and more effectively mobilize not only abundant regional financial resources (accounting for 20

percent of world savings) but also improve corporate reputations within Asia.

In line with this view, Prime Minister Thaksin Shinawatra of Thailand, since the mid-2002, has become a strong proponent of an Asian regional bond market. In particular, Thailand proposed the establishment of the Asian Bond Fund (ABF), where regional governments voluntarily contribute 1 percent of their foreign reserves (amounting to \$1.3 trillion) to a fund designed to purchase regional bonds. The proposal also included the establishment of an Asian credit agency focused on regional bonds. This proposal has generated strong interest across the region. In its efforts not to fall behind this move, Japan has quickly expressed strong support for an idea of an Asian regional bond market and since the early 2003 has shown initiatives by promoting offshore Japanese yen-denominated bond issues by Asian governments and firms. It has also stressed that governments should issue sovereign bonds more actively and regularly in order to complement corporate bond placements in terms of volume and maturity in countries where bond markets are underdeveloped. Liquid and deep government markets would also contribute to establishing benchmarks in the domestic markets. It has also supported the idea of issuing Asian basket currency-denominated asset-backed securities consisting of packages of local-currency-denominated government bonds.

Thailand's ABF proposal to jointly develop an Asian regional bond market, using the region's ample foreign reserves finally resulted in a declaration at the second ministerial meeting of the Asia Cooperation Dialogue forum in Thailand on June 2003. The ABF was launched with an initial sum of about \$1 billion under the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP) Group comprising of central banks of 11 economies. For the time being, the ABF is set to invest in US dollar-denominated bonds issued by Asian governments and quasi-governments in EMEAP economies other than Japan, Australia and New Zealand, although the ultimate goal is to move away from excessive dependence on the US dollar. The fund is to be managed by the Switzerland-based Bank for International Settlements. Meanwhile, in August 2003 the Association of Southeast Asian Nations (ASEAN) plus three (Japan, Korea, and China) endorsed the idea of fostering an Asian regional bond market, as a measure to enhance monetary and financial cooperation beyond an existing currency swap network that had gradually developed since May 2000. In the same month, Japan introduced a system to officially guarantee local currency-denominated bonds issued by Japanese capital firms operating in Asia; this in order to promote local currency-denominated bond markets.

In spite of growing zeal for developing an Asian regional bond market, it should be recognized that such advantages must be weighted against the costs of leaving currency

mismatch problems unresolved. This reflects that bond issues in an Asian regional market would be likely to be denominated not in the local currency (unless some guarantees are provided), but in regional key currencies (such as yen, Singapore dollar, Korean won, etc.), due to the lack of demand for such bonds. Even if the bonds could be issued in the local currency (so avoiding a currency mismatch), this could lead to nonresidents having substantial holdings of the local currency, which can, in turn, give rise to currency speculation. Moreover, the issuance of asset-backed securities might be able to diversity credit risks, but this does not imply that the credit risks associated with underlying assets are removed. In addition, Asian governments need to integrate individual countries' securitization laws before starting moving in this direction. Further, the Tokyo offshore market because of a weak institutional infrastructure and high costs has so far remained underdeveloped. More importantly, each member country needs to improve their domestic informational, legal, and judiciary infrastructure to levels comparable to those of advanced countries in the region. Since this requirement is more stringent than that of the case of developing an infrastructure adjusted to specific countries' development stages, it is likely to take a quite long time to achieve regional convergence.

These considerations lead to the conclusion that it would be difficult to develop a sound regional Asia bond market in the short- or medium-term, especially if a large number of developing countries are included in the membership. Asian governments should remember that they will be unable to foster a regional bond market without initially making efforts to develop their own domestic bond markets. In other words, there is no easy solution for preventing the occurrence of another crisis like the earlier East Asian financial crisis. Without taking into account the various constraints (causing underdeveloped domestic bond markets) faced by respective countries, the idea of developing an Asian regional bond market is mostly likely to end up as a pipe dream.

3.3 Improving Corporate Governance

East Asia is generally characterized by a corporate governance system of family businesses. Family-based firms generally operate as economic entities within the context of a relationship-based system and exercise control over the majority of corporations¹⁾. This family-based corporate governance system contrasts with the equity market-based governance system (often observed in the United States) and the bank-led governance system (frequently observed in Japan and Europe). Under a family-based governance system, family members initially act as owner-managers. When family businesses are almost

entirely financed internally and remain limited in their scope and scale, the asymmetry of information between financiers and owners on the one hand, and between owners and managers on the other hand, is not usually very severe (Khan, 1999). This is because there is no effective separation between financiers and owners, or between owners and management. Since firms' growth depend critically on their ability to mobilize internal resources, they attempt to take advantage of market opportunities quickly and efficiently. Without constant self-monitoring, this would not be possible to achieve. Thus, this family-based governance system emerges as a way to economize transaction costs, particularly when there are insufficient institutional and legal foundations and undeveloped credit markets.

However, as family businesses grow and external corporate finance becomes important, self-monitoring incentives decline with a corresponding rise in agency costs. Thus, a potential conflict arises due to the separation between dominant owner-managers and external financiers (such as banks or minority shareholders). In particular, asymmetry in information may arise between banks and family-based firms as borrowers. The adverse selection problem arises, since banks as external financiers are not able to perform careful selections of borrowers due to the lack of inside information about their investment projects, and thus end up selecting risky borrowers. The moral hazard problem also arises because borrowers misuse borrowed funds through the selection of more risky projects. Further, asymmetry in information may occur between family-business firms as equity issuers and purchasers, and consequently, the interests of minority shareholders may not be appreciated.

These agency problems emerge, since the separation between owner-managers and external financiers increases the cost of information gathering and processing in respect to family businesses as borrowers, and thus external financiers do not have proper incentives to monitor borrowers by paying such high costs. In some cases, family-based businesses develop into highly-leveraged firms after an initial period of internal financing, as has been seen in Korea (Koike, 1993). Prior to the Asian financial crisis, many firms in Asia heavily relied on bank finance; and those domestic banks, which heavily depended on external borrowing, were not in a good position to effectively monitor the firms they had financed.

As family-based firms are likely to remain dominant in Asia, it is important to consider policies to improve their corporate governance, thereby improving the soundness of domestic banks and in return lower external debt problems (through an avoidance of currency and banking crises). For example, inclusion of non-family members to the board of directors and

1)For example, the share of top 10 families in the total market capitalization in 1996 was 57.7 percent in Indonesia, 52.5 percent in the Philippines, and 46.2 percent in Thailand (Yoshitomi and Shirai 2000). The share of top 15 families was 38.4 percent in Korea and 28.3 percent in Malaysia.

a reduction in the share of family ownership are ways to improve governance. Alternatively, a shift from a family-based corporate governance system to a bank-led governance system by reorganizing and recapitalizing banks is likely to improve their corporate governance. Thus, countries should formulate appropriate country-specific policies by considering the relation between their current family-based corporate governance system and their banking sector, since corporate governance is closely related to the soundness of the banking sector. Further, the implication of a domestic interest hike and a credit crunch on the family-oriented corporate governance system needs to be carefully examined.

3.4 Improving the Soundness of the Banking Sector

There are a growing number of proponents for the introduction of global standards for capital adequacy requirements, accounting, auditing, disclosure, and so on, along with the strengthening of prudential supervision and regulations. It is now widely recognized that the only feasible approach to enhance the use of such standards for preventing a crisis is for governments and international financial institutions to encourage the public and private sectors to identify and adopt international standards for minimally acceptable practices. Although the particulars of these arrangements can differ and individual countries can take different routes to achieve these ultimate objectives, depending on culture and traditions, a country active in international financial markets must eventually meet internationally accepted standards.

Since the Asian financial crisis, government interference in the operation of banks has been lessened, particularly when it takes the form of directed credits to government-targeted industries and firms, and also of overly generous bailing-out of insolvent banks. With strengthened prudential regulations, connected lending by banks to family businesses has been lowered. Information on ownership, bank loans, and investments are now officially disclosed while making controlling shareholders and managements liable for any bank failure. Prudential and supervisory regulations are being strengthened in terms of CAMEL (Capital adequacy, Asset quality, Management competence, Earnings, and Liquidity).

4 Other External Debt Management Policies and Practices

4.1 Exchange Rate Stabilization Policy

Currently, a large number of monetary authorities face a trilemma: the impossibility of simultaneously achieving (1) exchange rate stability, (2) full financial integration, and (3) monetary policy independence. If a country attempts to achieve exchange rate stability and

monetary policy independence, it needs to introduce capital controls. If a country attempts to promote full financial integration and monetary policy independence, it needs to adopt a flexible exchange rate regime. If a country attempts to achieve exchange rate stability and full financial integration, the very rigid fixed exchange rate such as the currency board system or a currency union should be considered by abandoning monetary policy independence. As a result, it has become more difficult to single out the most appropriate exchange rate regime under capital account liberalization.

In the aftermath of the Asian financial crisis, the selection of an appropriate exchange rate regime has become an important policy measure to minimize the reoccurrence of a capital account crisis and external debt problems (for example, reducing excessive foreign borrowing by increasing the volatility of the exchange rates). In the beginning, the world paid attention to the so-called two corner solution: a free float exchange rate regime as one corner and a currency board, dollarization, or common currency union as the other. Since the collapse of the currency board in Argentina in 2001 and the increased recognition of the difficulties managing a currency board and common currency union, middle-ground exchange rate regimes have gained popularity in recent years.

Bergsten et. al. (1999), for example, proposed an innovative form of the crawling basket peg regime with a band. Namely, a country should stabilize the real effective exchange rate at a predefined level that is compatible with balanced medium- and long-term economic development, redefine the reference parity on a regular basis, and peg the local currency to a basket of currencies. The new approach suggests that the real effective exchange rate should be allowed to appreciate against the reference parity during economic overheating. By contrast, a monetary authority should assess whether the parity is sustainable and apply a credible, transparent, and gradual mechanism, when confronting downward exchange rate pressure. Any doubts about sustainability would call for timely readjustments including changes in the parity itself. The authority could then defend the sustainable parity in a flexible way (e.g., no hikes in the domestic interest rate at an unbearable level and at the same time, a protection of foreign reserves). The domestic interest rate can be aligned transparently to a foreign interest rate, augmented with a well-defined risk premium that takes into account the characteristics of the country until the local currency regains its reference parity.

This innovative approach differs from the conventional crawling peg regime in that it establishes a method for adjusting the exchange rate. In contrast, the conventional approach crawls the exchange rate based on inflation differentials and/or allows for conducting monetary policy as long as the exchange rate fluctuates within the band. This idea could be

a valid option for Asian emerging-market economies, since such a regime helps to stabilize the real effective exchange rate without generating a significant currency misalignment. At the same time, such a regime mitigates the problems associated with exchange rate volatility that prevails under a flexible exchange rate regime. Central parity should be determined and adjusted based on the sustainable level of international competitiveness. The weights should be trade-weighted and could be implicit (without publicly being announced) to avoid speculative attacks. The width of a band should be flexibly adjusted considering the movements of capital flows. In this way, this regime is supposed to cope with the issues of currency misalignments and their adverse impact on trade (the issues on the current account side), while coping with capital movements (the issues on the capital account side) by setting a sufficiently wide band.

However, the crawling basket (REER) peg with a band has two reservations. First, it is generally difficult to precisely evaluate an equilibrium exchange rate that is consistent with internal and external balances. This makes it harder to determine the size and timing of changes in parities on a regular and transparent basis. As well, frequent changes in the bands and parities undermine credibility and increase uncertainty, which might trigger a speculative attack. Further, the regime does not solve the problems of misalignments if massive and volatile capital flows occur. Second, Asian economies have been experiencing a large-scale structural change in their industrial structure, and, especially after the outbreak of the crisis, rapid and substantial financial and corporate sector restructuring. These changes are likely to generate various real disturbances to countries economies, thereby shifting the equilibrium levels of real exchange rates that are consistent with long-run internal and external balances. Thus, unless their nominal exchange rates are flexible enough to accommodate these fundamental changes, the exchange rates of Asian countries are likely to cause misalignments, which would distort the efficient resource allocation between tradable and non-tradable goods and services sectors.

A common currency union could be a viable long-term option in Asia, but not a short- and medium-term option. Currently, Asian economies have diverse exchange rate regimes and some economies have expressed their strong commitments to maintaining the existing exchange rate regimes. For example, the currency board system was adopted in Hong Kong in 1983, a de facto pegging to the US dollar has been used in China since 1994, and a pegging to the US dollar at a single parity has been implemented in Malaysia since September 1998. Singapore has adopted a managed floating system since 1973. Meanwhile, Korea, Thailand, and Indonesia have adopted a managed floating exchange rate regime after being forced to abandon a quasi-rigid exchange rate regime, but recently returning to

stabilizing their exchange rates against the US dollar.

It seems it will take a substantial time for Asian countries, which have diverse economic structures, to set in place moves toward monetary and fiscal policy coordination with the region. At this stage, it also appears that the political will toward such policy coordination is not very strong among Asian countries. While the idea of a common currency union has been occasionally discussed in the context of the ASEAN, its immediate application seems impractical. This is because the ASEAN member countries differ substantially in terms of the degree of capital account convertibility, stages of economic development, and political and social features. Such obvious differences make it extremely difficult particularly for some economically weak ASEAN member countries to discuss the loss of monetary policy independence and the limited use of fiscal policy that were envisioned in the European Monetary Union. Furthermore, inclusion of other Asian countries in this discussion would make it an even more difficult task to realize.

Another exchange rate policy, one that has gained growing popularity among academics in recent years, is the basket peg. The basket peg is superior to a single currency peg and could be an option in Asia given its diversified trade partners. While progress on the internationalization of the yen is closely associated with this issue, an increase in the weight of the yen in the basket of foreign currencies may promote the use of the yen in trade and financial transactions within the Asian region.

4.2 Controls on Capital Inflows

One measure seriously considered is of the policy implemented in Chile in the early 1990s, as a measure for reducing short-term capital inflows and hence short-term foreign borrowing. Thanks to a successful comprehensive economic program, Chile achieved high economic growth and has received massive capital inflows since the late 1980s. The surge in capital inflows was compounded by a general wave of international capital flowing to emerging economies. However, substantial capital inflows made it difficult for the central bank to maintain the aforementioned real interest rate targeting. In response, Chile introduced capital controls to contain the massive capital inflows particularly through adopting unremunerated reserve requirements and minimum holding periods on short-term borrowing from non-residents. The controls aimed at achieving four main goals: (1) to slow down the volume of capital inflows and tilt their composition toward longer maturities, (2) to reduce or at least delay any real exchange rate appreciation stemming from these inflows, (3) to allow the central bank to maintain a large differential between domestic and international interest rates and thus to conduct an independent monetary policy, and (4) to

reduce the vulnerability to international financial instability (Edwards, 1999).

In the beginning, a 20 percent reserve requirement was imposed on new foreign borrowing and applied to foreign loans to banks and nonbanks. Trade credit was exempted from the requirement provided that shipment takes place within six months. A holding period was also introduced and set to equal the loan maturity with a minimum of three months and a maximum of one year. In July 1992, the reserve requirement was raised to 30 percent and the minimum holding period was set at one year. Also, the coverage was extended to trade credit and loans related to FDI projects. In 1995, capital controls were strengthened further by extending the coverage to the Chilean stocks traded in the New York Stock Exchange Market and to international bond issues. In June 1998, the reserve requirement was lowered to 10 percent after Chile began to face capital outflows. In September 1998, the reserve requirement was further lowered to 0 percent. With respect to FDI inflows, Chile imposed a three-year minimum stay requirement until 1992 and then lowered the minimum stay period to one year. While FDI-related loans were subject to capital controls, no restrictions were imposed on the repatriation of profits from FDI projects.

Edwards (1999) estimated the tax equivalent for foreign funds that stayed in Chile based on the reserve requirements, the length of time to stay, and the opportunity cost. He found that the shorter the length of time that investment funds remain in the country, the higher the implicit tax rate was. Also, he stressed that the implicit tax rate rose sharply in 1994-95 and was high even for longer maturities. For example, the average implicit tax was 80 basis points even for three-year investments in 1997.

Thus, the initial coverage of the reserve requirement was partial. The initial protection of trade credits and other non-debt creating capital flows from regulation reflected strong support for export development or for practical reasons, such as the difficulty to control informal flows. Also, various types of foreign borrowing were initially exempted from capital controls. For example, inflows of less than US\$10,000 were exempted for the purpose of facilitating trade credit (Eichengreen, 1999a). This invited investors to break up larger transactions into smaller ones for the purpose of evasion.

Therefore, the government extended the coverage to virtually all forms of foreign financing other than FDI in 1995. Foreign banks then established domestic investment firms to exploit the FDI loophole. In response, the government stopped authorizing financial FDI-related projects after mid-1995. These events indicate that capital controls should minimize exemptions and that the controls are likely to become ineffective in the end due to circumvention.

Chilean capital controls are generally viewed as price-based measures and thus are perceived by academicians and policy makers favorably. Stiglitz (1999) supports these

controls as a way to manage volatile markets in developing countries. Ito and Portes (1999) also support market-based measures to discourage short-term capital flows²⁾. Eyzaguirre et. al. (1997), Herrera et. al. (1997), Valdes-Prieto and Soto (1998), and Laurens and Cardoso (1998) showed that there was weak evidence that capital controls altered the composition toward longer-terms, although there was mixed and weak evidence that they reduced the magnitude of capital inflows.

In contrast, Cowan and De Gregorio (1998) constructed a subjective index of the effectiveness of capital controls, and proved that capital controls indeed discouraged short-term capital inflows. Furthermore, Valdes-Prieteto and Soto (1996) demonstrated that the controls were not fully evaded, affected the composition of capital inflows, and discouraged short-term capital inflows. However, the controls did not affect the aggregate volume of capital inflows. To conclude, despite the fact that problems remain with respect to the measurement of capital inflows, weakness in econometric tools, and misspecification problems, it is fair to say that the Chilean capital controls did not alter the amount of capital inflow but helped to alter its composition. However, these effects were temporary and thus the controls could not be regarded as long-term policy instruments. Therefore, capital controls just provide a breathing space to mitigate double mismatches arising from excessive dependence on short-term borrowing until prudential supervision and regulations are adequately implemented, as well as the risk management capacity of banks become sufficiently strengthened. (Eichengreen, 1999a). Thus, capital controls should not be used as an excuse to delay the implementation of necessary reforms³⁾.

2)Chile also removed controls on capital outflows. However, the removal did not have a significant effect on net capital inflows. Chile gradually liberalized the restrictions on capital outflows over the decade. Outward FDI was liberalized in the early stage of 1991-92, followed by a gradual liberalization of bank lending abroad. Since 1992, access by institutional investors to foreign financial markets was gradually liberalized. The minimum holding period of capital was reduced from three years to one year in 1995. The data indicate that capital outflows gradually increased after the liberalization. Nevertheless, Nadal-De Simone and Sorsa (1999) indicated that the impact of capital outflow liberalization on net inflows of capital was ambiguous. This is because liberalization increased residents' holdings of foreign assets, which resulted in reduced net inflows of capital, while leading to larger inflows of capital by lowering perceived uncertainty of investing in Chile and by lowering domestic asset prices.

3) In this light, Eichengreen argued that Chile's zero reserve requirement implemented in 1998 reflected a policy to enhance flexibility by adjusting the tax rate depending on the movement of capital flows. Since supervision and regulation of the banking system has been strengthened sufficiently, it is no longer necessary to supplement prudential supervision with disincentives for foreign funding. This policy is consistent with the view that emerging-markets should impose capital-import taxes as a third line of defense against financial instability until adequate risk management and regulatory supervision systems are developed. Furthermore, Chile adopted a floating regime in 1999, which contributed to a reduction of reserve requirement.

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