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# Financial Issues in the Pacific Basin Region: Conference Summary

*This* Economic Letter *summarizes the papers presented at the conference "Financial Issues in the Pacific Basin Region" held at the Federal Reserve Bank of San Francisco on September 26–27, 2002, under the joint sponsorship of the Bank's Center for Pacific Basin Monetary and Economic Studies and the* Journal of the Japanese and International Economies. *The papers are listed at the end and are available at http://www.frbsf.org/economics/conferences/0209/index.html.*

The six conference papers examine important financial issues of relevance to the Pacific Basin. Four papers focus on Japan's banking sector problems. Two others focus on exchange rate policies in the Pacific Basin region.

**Japanese banking reform**

The persistent weakness of the Japanese banking system has been confounding that country's policymakers since the early 1990s, despite passing several programs to improve the situation. Among the most notable programs are two that were enacted in 1998. One is the Financial Reconstruction Act (FRA), which established a framework for dealing with failed Japanese banks; the other is the Rapid Revitalization Act (RRA), which allowed for the injection of public funds to solvent Japanese banks needing assistance to deal with their bad loans and clean up their balance sheets.

Mark Spiegel (FRBSF) and Nobuyoshi Yamori (Nagoya University, Japan) conducted an event study, analyzing how the news about the passage of these programs affected the equity values of Japanese banks. Their conjecture is the following: if market participants expected the passage of these laws to improve bank regulatory control in Japan, then equity values should fall for banks that are financially weak or poorly regulated. Their results suggest that, while there was some perception that the FRA would lead to adverse treatment of weaker regional banks, the market expressed a healthy skepticism that the overall regulatory changes of 1998 would lead to serious reform. This implies that the actual closures resulting from the FRA were expected to be limited largely to regional banks. In addition, they find that news concerning the passage of the RRA was treated as disproportionately beneficial to the weaker regional and large city banks in the Japanese financial system; that is, the market anticipated that the government's capital injections would simply allow these banks to postpone or avoid financial reforms, rather than induce them to clean up their balance sheets. The performance of Japan's banking system since the passage of the FRA and the RRA lends some credence to the notion that the markets were skeptical about the pace of reform afforded by these regulatory changes.

**Loans to Japanese borrowers**

David Smith (Federal Reserve System Board of Governors) conducts an empirical analysis of the Japanese banking system by assembling and analyzing data on loans to large Japanese firms. He tests the hypothesis that Japanese banks have been unprofitable over the past decade because they have been pricing their loans below profitable levels.

Smith's data show that the interest rate premiums on loans to Japanese firms were lower on average than those to borrowers from other developed countries. The lower premiums could reflect the underpricing of risks by Japanese banks due to one or more factors, including implicit government guarantees, strong relationship commitments to the borrower, and a desire to keep loans "performing" so as not to have to hold reserves against loan losses.

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However, the Japanese loans also were characterized by higher credit ratings, larger loan amounts, and—at least until 1997—longer maturities, all suggesting that they were less risky. This implies that they may have been priced appropriately. Indeed, after controlling for the characteristics related to loan riskiness in a regression analysis, the interest rate premium differences on loans from Japanese and non-Japanese banks disappears. Nevertheless, some question remains about how well these findings reflect typical loans to Japanese businesses.

**Bank regulation and financial crises in Japan**

Robert Dekle (University of Southern California) and Kenneth Kletzer (University of California at Santa Cruz) develop a formal banking sector model as a framework for understanding Japan's recent experience. In their model, government deposit insurance guarantees create moral hazard that encourages banks to underprice the true riskiness of their loans and to make riskier loans. Consequently, if adverse shocks hit the economy, depressing the value of the collateral underlying loans and leading some borrowers to fail, banks still will make more loans, even as the share of nonperforming loans in their portfolios rises. Eventually, the health of the banking sector deteriorates to the point that banks themselves become insolvent, bank loans dry up, and aggregate output declines.

The authors note that the dynamics of their model fit Japanese experience. As Japan was hit by a succession of adverse aggregate shocks in the 1990s, bank portfolios continued to deteriorate, and the market value of collateral (in particular, land) collapsed. The decline in collateral values in turn led to a fall in bank lending, a decline in physical investment, and finally, a fall in output.

**Bank failures and banking relationships in Japan**

A question of great interest to policymakers is how bank failures affect banking relationships, as reflected by the impact on the failing bank's customers. A bank failure interrupts the flow of credit to its customers, forcing them to find alternative financing. The extent to which these customers will be affected depends on such characteristics as their dependency on bank financing, their financial condition, and the industry to which they belong. If an individual bank failure is significant enough and signals the poor state of the financial sector or of the economy, it may adversely affect firms that are not only its own customers but also customers of other banks.

To shed light on these effects, Elijah Brewer III, Hesna Genay, William Curt Hunter (all from FRB Chicago), and George G. Kaufman (Loyola University) examine the stock prices of over 1,000 Japanese firms following the 1997 failure announcement of the Hokkaido Takushoku Bank and the 1998 failure announcements of the Long-Term Credit Bank of Japan and the Nippon Credit Bank. In line with previous research for the U.S., they find that the customers of a failed bank experience negative abnormal returns around the time of the failure announcement; the extent of this effect is related to the firm's financial characteristics. Firms with greater access to alternative sources of funding are less adversely affected by bank failure announcements. The authors also find that the adverse impact of a failure on the market value of firms that are its customers is not significantly different from the impact on firms that are not its customers. That is, bank failures are "bad news" for all firms in the economy, not just for the customers of the failed banks.

To the extent that these results for Japan are representative, they cast doubt on the importance of bank failures to bank customer relationships. They also raise questions about the meaningfulness of other studies' results finding significant adverse effects of a bank failure on its loan clients if those studies do not also test for the effect on firms other than the failing bank's clients.

**High demand for international reserves in Asia**

In the aftermath of the Asian financial crises of 1997–1998, many countries in the region purportedly moved to exchange rate regimes with greater flexibility. In theory, there should be less demand for foreign exchange reserves under flexibility. In fact, however, most Asian countries have accumulated substantial reserves in recent years.

Joshua Aizenman (University of California at Santa Cruz) and Nancy Marion (Dartmouth) analyze developing countries' demand for foreign exchange reserves, with special emphasis on understanding the reasons for the big accumulation of foreign reserves by Asian countries. Using panel data for 125 developing countries over the period 1980–1996, they show that reserve holdings can be predicted well by several key variables, including country population, GDP per capita, the volatility of international transactions, and political factors. The estimating equation also does a good job of predicting reserve holdings of East Asia countries before the 1997 financial crisis, but underpredicts their holdings after the crisis; that is, their reserve levels in recent years are higher than the estimated model can explain.

To explain this finding, they formulate several models that are consistent with this underprediction result. Specifically, one model shows that if raising taxes is costly and access to global credit is limited in times of crisis, then countries will choose to hold foreign reserves for precautionary reasons. This precautionary demand rises with higher perceived sovereign risk and higher fiscal liabilities (both explicit and implicit)—such as may occur in the aftermath of a crisis. This precautionary demand declines if policymakers are impatient (that is, if the discount rate is high) or political arrangements are unstable or corrupt. A second model shows that the demand for reserves is higher if policymakers are loss-averse, that is, they attach more weight to bad outcomes than to good ones. Hence, if a crisis increases the loss-aversion or the volatility of shocks, it also will increase the demand for reserves. The implication is that an econometric specification incorporating some of these factors would do better in explaining the observed high reserve holdings of Asia countries since 1997.

**Post-crisis exchange rate policy in Asia**

Leonardo Hernández (Central Bank of Chile) and Peter Montiel (Williams College) ask three questions about the exchange rate policies of Asian countries: (1) Are Asian countries managing their exchange rates more or less now than before the 1997–1998 crisis? (2) If they're managing their exchange rate, why are they doing it? (3) Does the specific experience of these Asian countries provide general lessons for other emerging markets?

The paper answers the first question by inspecting some simple statistical measures of the relative variability of exchange rates, foreign reserves, and domestic interest rates for the five Asian countries most affected by the crisis of 1997–1998—Korea, Thailand, Indonesia, Philippines, and Malaysia. They conclude that these countries manage their exchange rates *less* in the post-crisis period than before, but do so *more* than "purer" floaters, such as Germany/Euroland and Japan. (Malaysia, because of its capital controls, has been able to maintain a fixed exchange rate and is the outlier in the sample.) These results are consistent with those who argue that developing countries have a "fear of floating."

The authors attribute the continued intervention activity by Asian policymakers to a desire to limit the adverse competitive effects of appreciations as well as to a desire to accumulate reserves. Lastly, on the basis of the Asian experience, they argue that active management of the exchange rate is still feasible, even when countries maintain open capital markets. Thus, developing countries need not choose solely between adopting a hard peg or allowing full exchange rate flexibility.

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