Center for Pacific Basin Monetary and Economic Studies

2002 Annual Report

Federal Reserve Bank of San Francisco

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About the Center

Since 1974 the Pacific Basin program of the Federal Reserve Bank of San Francisco has promoted cooperation among central banks in the Pacific Basin and enhanced public understanding of economic policy issues in the region. In 1990 the Center for Pacific Basin Monetary and Economic Studies was established by the Bank within its Economic Research Department to open the program to greater participation by researchers in other central banks, universities, research institutes, and international organizations. The Center's mission is to further international understanding of major Pacific Basin monetary and economic policy issues. The Center's programs are designed to carry out this mission through staff research, its visiting scholar program, its international network of research associates, and international conferences.

From the Director

Many East Asian economies rebounded in 2002, spurred by export demand and domestic macroeconomic stimulus. China paced the region with growth exceeding 7 percent. At the other extreme, Japan continued its decade-long stagnation. The region's overall economic outlook depends heavily on external developments, including the slower than expected recovery in industrial countries, the slow pickup in the global hi-tech sector, and geopolitical concerns.

As the region seeks to improve its resilience in the face of external shocks and to maintain growth, the need for substantial structural reform still remains in most of the area. Japan and China must resolve ongoing banking sector problems. Korea must strengthen bankruptcy procedures, Thailand must resolve its debt overhang and revive bank intermediation, Indonesia must restructure corporate debt and enhance asset recovery, and the Philippines must resolve its banking sector fragility.

This report summarizes the Center's research on Pacific Basin topics in 2002. Studies included analyses of the role of financial development for growth in the region, Japan's and China's banking sector difficulties, and monetary and exchange rate policy in Asia. Other papers assessed the economic effects of currency and banking crises in emerging markets. Several shorter studies addressed such issues as the lessons of Argentina's financial crisis for Asia, proposed changes to the international financial architecture for preventing and managing country crises, and financial sector reform in selected countries in the region. These contributions demonstrate the diversity of the Center's interests.

The Center also organized several joint programs with other institutions. Most notable was a week-long global seminar for senior policymakers on capital flow and monetary policy issues, conducted jointly with the World Bank in Paris. Another highlight of the Center's activities was the conference on "Financial Issues in the Pacific Basin Region" co-sponsored with the *Journal of the Japanese and International Economies.*

The Center disseminates its studies of Pacific Basin issues through various channels. Pacific Basin research results are issued as Center Working Papers and published in either the *FRBSF Economic Review* or in academic journals and books; shorter analyses are distributed as "Pacific Basin Notes" through the *FRBSF Economic Letter* series of the Bank's Economic Research Department. The Center's publications can be accessed through its website at www.frbsf.org/economics/pbc/. Information on how to participate in the Center's programs appears at the end of this Report.

I thank everyone who has contributed to the Center's activities during the past year, and I look forward to your future participation.

Reuven Glick, Vice President,
Economic Research Department, and Director
Center for Pacific Basin Monetary and Economic Studies

Working Paper Summaries

PB02-01 ▸ *The Disposition of Failed Japanese Bank Assets: Lessons from the U.S. Savings and Loan Crisis*

Mark M. Spiegel, FRBSF

This paper reviews Japan's experience with "put guarantees" recently offered in the sale of several failed banks that allowed purchasers of the assets of these banks to return them to the government if their value fell sufficiently low. These guarantees, meant to address information asymmetry problems, are shown to create moral hazard problems of their own. In particular, the guarantees make the potential purchasers of bank assets reluctant to accept first-best renegotiations with problem borrowers.

These issues also arose in the U.S. savings and loan crisis of the 1980s. Regulators in that crisis turned to an alternative guarantee mechanism known as "loss-sharing arrangements," in which the government agreed to absorb some portion of losses suffered on purchased assets.

The paper formulates a model of bank debt to examine the conditions determining the relative merits of these guarantees. The results show that both forms of guarantees reduce expected regulator revenues, while the impact of economic downturns on the relative desirability of the two guarantees is ambiguous.

PB02-02 ▸ *How Bad Are Twins? Output Costs of Currency and Banking Crises*

Michael M. Hutchison and Ilan Neuberger,
University of California, Santa Cruz

This paper investigates the output effects of banking and currency crises in emerging markets, with a focus on whether the simultaneous occurrence of currency and banking crises—"twin crises"—is a unique phenomenon and whether it entails especially large losses. Using a panel data set for 24 emerging-market economies over the 1975–97 period, the authors find that twin crises do *not* have any additional negative impact on output growth. That is, twin crises do not reduce output over and above the separate effects associated with a currency and banking crisis taken together. The results show that currency and banking crises are very damaging, reducing output by about 5–8 and 8–10 percent, respectively, over the following two to four years. The cumulative output loss of both types of crises occurring at the same time is therefore very large, around 13–18 percent. Twin crises are "bad" only in that they entail output losses associated with both currency and banking crises, not because there are additional feedback or interactive effects further damaging the economy. This result is robust to alternative model specifications, lag structures, and estimation procedures.

PB02-03 ▸ *Sudden Stops and the Mexican Wave: Currency Crises, Capital Flow Reversals, and Output Loss in Emerging Markets*

Michael Hutchison and Ilan (Neuberger) Noy ,
University of California, Santa Cruz

"Sudden stops" have been defined as the simultaneous occurrence of a currency crisis with a reversal in international capital flows. The authors investigate the output effects of financial crises in emerging markets, focusing on whether sudden-stop crises are unique phenomena and whether they entail an especially large and abrupt pattern of output collapse. Despite an emerging theoretical literature on sudden stops, empirical work to date has neither precisely identified their occurrences nor measured their subsequent output effects in broad data samples. Analyses of sudden stops may provide the key to understanding why some currency crises entail very large output losses, while others are frequently followed by expansions.

Using a panel data set over the 1975–97 period for 24 emerging-market economies, the authors distinguish among the output effects of currency crises, capital inflow reversals, and sudden-stop crises. They find that sudden-stop crises have a large negative, but short-lived, impact on output growth over and above that associated with currency crises. A currency crisis typically reduces output by about 2–3 percent, while a sudden-stop crisis reduces output by an additional 6–8 percent in the year it occurs. The cumulative output loss of a sudden stop is even larger, around 13–15 percent over a three-year period. The empirical results are robust to alternative model specifications, lag structures, and estimation procedures.

PB02-04 ▸ *On Discretion versus Commitment and the Role of the Direct Exchange Rate Channel in a Forward-Looking Open Economy Model*

Alfred V. Guender, University of Canterbury, Christchurch, New Zealand

Irrespective of whether discretion or commitment to a binding rule guides the conduct of monetary policy, the existence of a direct exchange rate channel in the Phillips curve causes the behavior of key economic variables in the open economy to be dramatically different from that in a closed economy. In the open economy, the policymaker can no longer perfectly stabilize real output and the rate of inflation in the face of shocks to aggregate demand, uncovered interest parity, and foreign inflation. If the exchange rate channel in the Phillips curve is operative, then in the open economy the policymaker faces an output-inflation tradeoff that differs substantially from its counterpart in the closed economy.

The analysis of the conduct of monetary policy reveals that the stabilization bias under discretion is weaker in the open economy relative to the closed economy. In the open economy, a “less conservative central banker,” one who attaches a smaller weight to the variance of inflation in the loss function, can be appointed to replicate the behavior of real output that eventuates under optimal policy. Evaluating the social loss function under discretion and commitment, the author finds that the existence of a direct exchange rate channel in the Phillips curve mitigates the pronounced differences between the two strategies that exist in case of high persistence in the stochastic shocks.

PB02-05 ▸ *Financial Structure and Macroeconomic Performance Over the Short and Long Run*

Jose A. Lopez and Mark M. Spiegel, FRBSF

The authors examine the long- and short-term relationships between indicators of financial devel-opment and economic performance for a cross-country panel. The long-term results are consistent with much of the literature in finding a positive relationship between financial development and economic growth. However, this relationship ceases to be evident after accounting for disparities in factor accumulation. These results therefore indicate that the primary channel by which financial development facilitates growth over the long run is through physical and human capital accumulation. The authors also identify a significant negative relationship between financial development and income volatility, suggesting that financial development does dampen economic fluctuations in the long run.

Unlike the long-term results, the short-term panel analysis fails to find a significant relationship between financial development and economic performance during the period surrounding the

1997 Asian financial crisis, both for a broad sample of countries and for a small sample of developing Asian nations.

Taken as a whole, the analysis appears to support the view that while financial development is beneficial over the long run, it may exacerbate short-term volatility in isolated episodes. One reason for this discrepancy may be that financial liberalizations are typically only partial, resulting in increased financial market distortions.

PB02-06 ▸ *Are Crisis-Induced Devaluations Contractionary?*

Ramkishen S. Rajan, University of Adelaide and Institute of Southeast Asian Studies, Singapore, and Chung-Hua Shen, National Chengchi University

Why are some currency crises followed by economic contractions, while others are not? Is there a difference in the output effects of a devaluation between "crisis" periods and "normal" periods? The analysis finds that contractionary effects tend to occur only during crisis periods. Building on this result, the authors go on to explore factors that cause a crisis-induced devaluation to be contractionary.

PB02-07 ▸ *Post-Crisis Exchange Rate Policy in Five Asian Countries: Filling in the "Hollow Middle"?*

Leonardo Hernández, Central Bank of Chile and Peter Montiel, Williams College

Following the 1997–98 financial turmoil, crisis countries in Asia moved toward either floating or fixed exchange rate systems, superficially consistent with the bipolar view of exchange rate regimes and the "hollow middle" hypothesis. But some observers have claimed that, despite the changes in their *de jure* exchange rate regimes, the crisis countries' policies have *de facto* been very similar in the post- and pre-crisis periods. This paper analyzes the evidence and concludes that, except for Malaysia, which adopted a hard peg and imposed capital controls, the other crisis countries are floating more than before, though less than "real" floaters do. The intermediate exchange rate policies pursued by most of the crisis countries during the post-crisis can be justified on second-best arguments.

PB02-08 ▸ *The High Demand for International Reserves in the Far East: What's Going On?*

Joshua Aizenman, University of California, Santa Cruz and Nancy Marion, Dartmouth College

This paper explores econometric and theoretical interpretations of the relatively high demand for international reserves by countries in East Asia and the relatively low demand by other developing countries. Using a sample of about 125 developing countries, the authors show that reserve holdings over the 1980–1996 period seem to be the predictable outcome of several key factors, including the size of international transactions, their volatility, the exchange-rate arrangement, and political considerations. Although the estimating equation does a good job of predicting reserve holdings in Asia before the 1997 financial crisis, it significantly under-predicts the reserve holdings of several East Asian countries after the crisis.

The authors show that this puzzling pattern in international reserve holdings is reasonably explained by extended models of reserve demand. Specifically, sovereign risk and costly tax collection to cover fiscal liabilities lead to a relatively large demand for international reserves. In the aftermath of a crisis, countries that have to deal with higher perceived sovereign risk and higher fiscal liabilities (both funded and unfunded) will opt to increase their demand for reserves. The models also suggest that countries with high discount rates, political instability, or political corruption find it optimal to hold much smaller precautionary balances. The authors also show that models that incorporate loss aversion predict a relatively large demand for international reserves. Hence, if a crisis increases the volatility of shocks and / or loss aversion, it will greatly increase the demand for international reserves.

PB02-09 ▸ *The Value of Banking Relationships during a Financial Crisis: Evidence from Failures of Japanese Banks*

Elijah Brewer III, Hesna Genay, William Curt Hunter, Federal Reserve Bank of Chicago, George Kaufman, Loyola University Chicago and FRB Chicago

This paper examines the impact of the failure of three large Japanese banks in 1997 and 1998 on the market valuation of nonfinancial firms in Japan. The authors estimate the impact of the failure announcements on the market valuation of the client firms of the failed banks as well as on firms without relationships with the failed institutions.

The results show that the market value of customers of failed Japanese banks are adversely affected at the time of the failure announcements. However, they also show that these effects are not significantly different from those experienced by all firms in the economy; that is, the bank failures represent “bad news” for all firms in the economy, not only for the customers of the failed banks. To the extent that these results for Japan are representative, they cast doubt both on the importance of bank failures on bank customer relationships and on the meaningfulness of the results of studies from other countries that find significant adverse effects for loan clients, but do not test for effects for other firms.

PB02-10 ▸ *Financial Intermediation, Agency and Collateral, and the Dynamics of Banking Crises: Theory and Evidence for the Japanese Banking Crisis*

Robert Dekle, University of Southern California, Kenneth Kletzer, University of California, Santa Cruz

The authors formulate a model of an endogenously evolving banking crisis in a growing economy subject to idiosyncratic and aggregate productivity shocks. The model incorporates agency problems at two levels: between firms and their banks and between banks and the banks’ depositors and deposit insurers. In equilibrium, banks have an incentive to renegotiate loans to insolvent firms, leading to an increasing contingent liability of the government with deposit insurance and regulatory forbearance. The growth rate of output is endogenous, and the authors explain how the agency problems affect the qualitative dynamics of the economy in this framework.

The results show that the dynamics predicted by the model fit the recent behavior of the Japanese economy well. 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 (land) collapsed. The decline in collateral values led to a fall in bank lending, a decline in physical investment, and finally, a fall in GDP.

PB02-11 ▸ *Loans to Japanese Borrowers*

David C. Smith, Federal Reserve Board

Though the Japanese banking system has been the focus of numerous empirical studies, there is scant empirical evidence on the characteristics of loan contracts between Japanese firms and their banks. This paper incorporates relatively new, contract-specific data on bank loans to large borrowers to help fill this gap. It examines how loans to Japanese companies compare with loans to similar non-Japanese companies, and how loans to Japanese borrowers vary according to the nationality of the bank making the loan. It also gauges the value of bank loans to Japanese borrowers by estimating abnormal stock price returns around the announcement of new bank loans.

Conferences and Other Activities

Center Conference

A highlight of the Center for Pacific Basin Studies activities during 2002 was the conference on "Financial Issues in the Pacific Basin Region" held at the Federal Reserve Bank of San Francisco on September 26–27. The conference papers examined important financial issues of relevance to the Pacific Basin.

Four papers focused on Japan's banking sector problems. Mark Spiegel (FRBSF) and Nobuyoshi Yamori (Nagoya University, Japan) analyze the anticipated impact of recent efforts to improve the health of the Japanese banking system by closing down failing banks and allowing surviving banks to clean up their balance sheets. David Smith (Board of Governors) examines the extent to which the unprofitability of Japanese banks over the past decade may be attributable to pricing their loans below profitable levels. Robert Dekle (University of Southern California) and Ken Kletzer (University of California at Santa Cruz) develop a formal banking sector model as a framework for understanding Japan's recent experience. Elijah Brewer III, Hesna Genay, William Curt Hunter (all from FRB Chicago), and George G. Kaufman (Loyola University) analyze how bank failures affect banking relationships by examining 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.

Two other papers focused on exchange rate polices in the Pacific Basin region. 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 since the 1997-1998 crisis. Leonardo Hernández (Central Bank of Chile) and Peter J. Montiel (Williams College) analyze whether Asian countries are managing their exchange rates more or less now than before the 1997–1998 crisis.

The conference also included a panel discussion on exchange rate regimes in Asia. The panelists included Menzie Chinn (UC Santa Cruz), Barry Eichengreen (UC Berkeley), Steven Kamin (Board of Governors), Ronald McKinnon (Stanford University), and Wataru Takahashi (Bank of Japan) and was moderated by Takeo Hoshi (UC San Diego).

All of the papers presented are available as Center Working papers and will be published in the *Journal of Japanese and International Economies*. A full summary is provided in *FRBSF Economic Letter* 2002-38 "Financial Issues in the Pacific Basin Region: Conference Summary."

Seminar for Senior Policymakers

The Center, jointly with the World Bank, organized a week-long seminar for senior policymakers on the subject of "Capital Flows, Monetary Policy, and the International Monetary System" in Paris in March. Reuven Glick was co-director of the workshop and Ramon Moreno, Mark Spiegel, and he were involved as lecturers. This is the fourth consecutive year that the Center has collaborated with the World Bank in this activity (the previous three workshops were held in Bangkok). The workshop sessions discussed the problems of managing capital flows, dealing with financial crises, and conducting monetary policy. The audience included over fifty experienced policy-makers from developing countries around the world (including the governor, general manager, or deputy governor of ten central banks, as well as research directors and other department heads).

Other Activities

Center staff also made presentations on Pacific Basin topics or international economic issues.

Mark Spiegel presented his paper, "The Disposition of Failed Bank Assets: Put Guarantees or Loss-sharing Arrangements?" at the Federal Reserve System Committee Meeting for International Economic Analysis hosted by the FRB New York in April. In July, he presented "The Impact of Japan's Financial Stabilization Laws on Bank Equity Values" at the Asia-Pacific Finance Association Meeting in Tokyo; in addition, he served as a discussant and made a presentation on "Argentina's Financial Crisis: Implications for Proposed Currency Arrangements in Asia," at a panel session organized by the Asian Development Bank Institute and the Latin American and Caribbean and Asia-Pacific Economics and Business Association (LAEBA). Also in July, he served as a discussant and presented "Financial Structure and Macroeconomic Performance over the Short and Long Run" (with Jose Lopez) at the East-West Center / Korean Development Institute Conference on the "Macroeconomic Implications of Post-Crisis Structural Changes" in Honolulu. In September, he presented the paper "The Impact of Japan's Financial Stabilization Laws on Bank Equity Values" at the Center Conference on "Financial Issues in the Pacific Region." He presented "The Role of Technological Catch-Up in the Relationship between Human Capital and Growth" at Louisiana State University in May and at the Workshop on Technological Change hosted by the FRBSF and the Stanford Institute for Economic Policy Research in November.

Reuven Glick served as a discussant at the Bank of Japan conference on "Exchange Rate Regimes in the 21st Century" in July and at the Center's conference on "Financial Issues in the Pacific Basin Region" in September. In October, he spent a week at the Hong Kong Institute for Monetary Research, where he presented the paper "Capital Controls and Exchange Rate Instability in Developing Economies." He also made a presentation on the U.S. economic outlook to officials and staff at the Hong Kong Monetary Authority. In addition, he spoke to the Finance Women's Association in San Francisco on the world economic outlook in January. He also participated in a panel organized by the Cal-Asia Business Council, on "Asia's Financial Outlook" in June.

Ramon Moreno was a discussant at the American Economic Association Meetings in Atlanta in January and at a conference on "Asset Price Bubbles" organized by the Federal Reserve Bank of Chicago in April.

As in previous years, the Bank and the Center received central bankers, government officials, academics, and researchers who are interested in Pacific Basin issues or topics related to emerging markets.

The Center bid farewell to Ramon Moreno, Associate Director of the Center, who departed the Federal Reserve Bank of San Francisco for a position as Head of Emerging Market Issues at the Bank for International Settlements in Basle. The Center also welcomed a new staff economist, Diego Valderrama, who joined the Bank after completing his Ph.D. at Duke University.

Center Staff

Director

Reuven Glick

Concurrently, Vice President, International Research Section, Economic Research Department.
Ph.D. Economics, Princeton University, 1979.
Formerly Assistant and Associate Professor of Economics and International Business, New York University, 1979-85; Consultant, World Bank, 1982-85; Economist, Federal Reserve Bank of New York, 1977-79.

Staff Economists

Ramon Moreno

Associate Director of the Center and Senior Economist.
Ph.D. Economics, Columbia University, 1993.
Formerly with the United Nations Development Program.
Departed FRBSF November 2002.

Mark Spiegel

Research Advisor.
Ph.D. Economics, University of California, Los Angeles, 1988.
Formerly Assistant Professor of Economics, New York University, 1988-94; Consultant, World Bank, 1989-94.

Diego Valderrama

Economist.
Ph.D., Economics, Duke University, 2002.
Joined FRBSF September 2002.

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Edmund H. Chiang

A.B. Economics, 2002
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B.A. Mathematical Methods in the Social Sciences and Economics, M.A. Economics, 2002
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Saumitra Saha

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Northwestern University

Executive Staff Assistant

Chrystie T. Nguyen

Visiting Scholars

2002

Joshua Aizenman
University of California, Santa Cruz

Paul Bergin
University of California, Davis

Thomas Cargill
University of Nevada, Reno

Alfred Guender
University of Canterbury

Michael Hutchison
University of California, Santa Cruz

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Korea Institute of Finance

Eek-June Chung
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Betty Daniel
SUNY Albany

Michael Dooley
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Charles Engel
University of Washington

Jeffrey Frankel
University of California, Berkeley

Maria Gochoco
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Stephen Golub
Swarthmore College

Arthur Grimes
Reserve Bank of New Zealand

Eric Hansen
Reserve Bank of New Zealand

Michael Hutchison
University of California, Santa Cruz

Kengo Inoue
Bank of Japan

Wolfgang Kasper
University of New South Wales, Australia

Sawaichiro Kamata
Bank of Japan

Michio Kitahara
Bank of Japan

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Meiji University, Japan

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People's Bank of China

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Ronald McKinnon
Stanford University

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Kee-Jin Ngiam
National University of Singapore

Jurg Niehans
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Kenneth Rogoff
University of California, Berkeley

Andrew Rose
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Tomohiko Sakamoto
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Byung Han Seo
Bank of Korea

Reza Yamora Siregar
Association of Indonesian Economists

Inwon Song
Bank of Korea

Glenn Stevens
Reserve Bank of Australia

Jose A.R. Tan, III
Philippines Central Bank

Alan Taylor
University of California, Davis

Shang-Jin Wei
Harvard University

Nobuyoshi Yamori
Nagoya University, Japan

Soccoro Zingapan
National Economic Development Authority, Philippines

Diana Zhumabekova
Australian National University

Center Working Papers

Recent Center Working Papers are available on the Internet at
http://www.frbsf.org/economics/pbc/index.html

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PB96-03	Byung Han Seo	Inflation and the Government Budget Constraint in Korea
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Participation

Two types of participation in the Center's activities are possible:

Visiting Scholars. Visiting Scholars are invited to conduct research at the Center on Pacific Basin monetary, financial, and economic policy issues of interest to the United States and other nations in the region. The Center is prepared to receive up to three Visiting Scholars at a time. In principle, the terms of Visiting Scholars are for six months; in special cases, shorter or longer terms can be considered. To qualify, a Visiting Scholar must have an established research record in terms of publications in professional economic journals and the ability to interact in English with other researchers.

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Participation in the Center's Programs

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