Banking Reform in Southeast Asia

The region's decisive decade

Malcolm Cook

Routledge Studies in the Growth Economies of Asia

Banking Reform in Southeast Asia

This book empirically examines banking reform in the economies of Southeast Asia as they sought to adapt to major developments in the global economic system over the past three decades, including the globalization of finance, the debt crisis of the 1980s and the 1997–1998 Asian financial crisis. Focussing in particular on the turbulent decade of financial boom and bust from 1994 to 2004, it explores the ways in which states respond to powerful external shocks and the implications for policy choices, demonstrating how different political systems shape economic performance and policy choices. It sets out a detailed comparative analysis of the experiences of the five major regional economies, Malaysia, Singapore, Thailand, Indonesia and the Philippines, considering how banking reform responded to the challenges posed by global economic integration. The countries least affected by the crisis, Singapore and the Philippines, used the crisis effectively to further liberalize long-protected domestic banking sectors. The countries the most affected by the crisis, Indonesia, Thailand and Malaysia, all resisted external pressure to liberalize their protected banking sectors even when they experienced changes in leadership. In all five cases, the nature of the political system and their previous commitment to nationalist banking policies, more than the depth of the crisis or extent of foreign pressure, was the key determining factor in their crisis response and in the post-crisis changes to banking policy that are still playing out today.

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1 Introduction

The decade starting in 1994 was one wild ride for the major economies of Southeast Asia and the region's place in the global economic pecking order. From 1994 to the Asian financial crisis of 1997, Southeast Asia was on a high with the Asian Values discourse of political economic exceptionalism and superiority in full bloom.[1] Malaysia was committed to becoming a developed economy by 2020. Indonesia was being talked about in the same breath as China as a great power in waiting. Even the 'sick man' of Southeast Asia, the Philippines, was showing signs of joining its high-performing neighbours.

Then, the Asian financial crisis hit, and as fast and high as most of these economies were advancing in the previous years, as fast and deep fell they into severe economic dislocation. The number of officially unemployed in Indonesia exploded from 4.5 million in 1996 to over 20 million in 1998. The Asian financial crisis of 1997–1999 shook global financial markets and their *ad hoc* 'international architecture'. It shattered Southeast Asian economies' self-confidence in their assured emergence and led many in the West to focus on the region's political economic shortcomings and their similarities with the rest of the developing world. Today, Indonesia is no longer in the same sentence as China while *Vision 2020* is no longer the catch-cry of the Malaysian state.

The financial crisis was the single biggest economic challenge in the region's post-colonial period. The crisis significantly changed the economic and political trajectories of its most affected countries – Indonesia and Thailand – and brought into question much of the accepted wisdom about the region and its major economies. The challenge was amplified by the crisis' surprise nature and the hubris that had built up during the good times until 1997. Since 1999, the most affected economies and the region as a whole have been slowly recovering. Governments have shifted from immediate crisis responses to longer-term adjustment strategies while Southeast Asia is attempting to rediscover its regional *raison d'être*.

Focus of the book

The decade from 1994 and its three distinct but interconnected phases of boom, bust and recovery provide a unique analytical window into the political

Table1.1 GDP growth rates

	1994	*1996*	*1998*	*2000*	*2002*	*2004*
Indonesia	7.5	7.8	−13.1	5.4	4.4	5.1
Thailand	9.0	5.9	−10.5	4.8	5.3	6.2
Malaysia	9.2	10.0	−7.4	8.9	4.4	7.1
Philippines	4.4	5.8	−0.6	6.0	4.4	6.0
Singapore	11.6	7.8	−1.4	10.0	4.0	8.7

Source: International Monetary Fund, World Economic Outlook Database, April 2006.

economies of the region's major economies. The book will focus at the same time at three levels of analysis – the national, the regional and the global – using case studies of national policy responses to test the existing assumptions of regionalism and Southeast Asian studies and globalization. This is a bottom-up book with the ambition of fine-tuning through empirical analysis the deduced generalizations of Southeast Asian studies and discussion of globalization.

The spread of the crisis was far from uniform across the region and neither were its national political ramifications. Affected countries also responded in significantly different ways to the crisis. These regional differences undercut the strength of the regional assumption in Southeast Asia. Was Southeast Asia ever a coherent region of similar countries pursuing similar economic policies and growth paths? Is it accurate to describe the financial crisis as even a Southeast Asian crisis much less an Asian one? Singapore avoided all but the ripple effects of the financial crisis, while in Northeast Asia only South Korea was directly affected.

Two other elements of the crisis and the national responses to it complicate the regional picture and the long-held assumptions of Southeast Asian studies. First, the damage wrought on national economies by the crisis did not follow script. The Philippines, assumed to be the weakest state and economy of maritime Southeast Asia, navigated the crisis quite well. Rather, it, like Singapore, was only glanced by the crisis and proved quite resilient to the threat of contagion. In terms of suffering, the roll call of the most to least affected was Indonesia, Thailand, Malaysia, the Philippines and Singapore. Singapore and the Philippines did not even suffer a crisis-induced recession.

Second, banking policy responses to the financial crisis and its aftermath do not fit any predeterminable pattern and are not closely correlated to the depth of the crisis in each of the affected countries. All five countries responded to the crisis and to larger, global trends in banking to push for local bank consolidation, but the means of achieving this varied widely. The Philippine state took the lightest-touch approach leaving consolidation largely to the market. Malaysia took the strongest state-guided approach and fully reshaped the domestic banking scene through fiat.

Four of the five affected countries changed banking policy to allow foreign banks to play a larger role in the domestic banking market. Malaysia was the outlier here where the state allocated massive amounts of public funds to support

the local banking sector and refused to open up the Malaysian banking market to more foreign participation. The Monetary Authority of Singapore on the other hand used the crisis in its neighbours as leverage to open up in a limited manner the highly-protected Singapore banking market to greater foreign incumbent competition.

Just as all five countries had strict barriers to foreign bank entry and foreign incumbent bank expansion prior to the crisis, all five had domestic banking sectors where state banks (owned or controlled) were the most significant if not dominant players. Yet by 2004, only in Malaysia had state banks' market share grown in importance, while in others, state banks have been privatized, and private banks, local and foreign, have become larger players.

Roughly speaking, the crisis hit Indonesia and Thailand so hard that these states had no choice but to significantly liberalize their banking sectors, often in spite of nationalist desires to keep the sector closed. Both had no choice but to invite the IMF and World Bank and their conditionality in. In Malaysia, the state chose to vigorously defend their key banking policies against the crisis and refused conditionality-laden concessional credit from international financial institutions. The Philippines and Singapore chose to leverage the limited crisis impacts to liberalize their banking policies, with the Philippines inviting in the World Bank to support banking reforms by choice, not by necessity.

This tumultuous decade and the national differences discussed above questioned the strength of the regional assumption inherent in Southeast Asian studies and it reoriented global interest in Southeast Asia. In many ways, the hothouse period of growth until 1997 and the crisis did for Southeast Asian studies what the bubble economy and its decade-long deflation did for Japanese studies a decade earlier. During Japan's long lasting post-war boom, Japan's industrial policy and manufacturing sector garnered the vast majority of political economic research and, particularly, commentary.

Most of this research celebrated Japan's manufacturing prowess and the purported wisdom of Japan's economic policy-makers. The frenetic years of the bubble economy when the Nikkei stock exchange hit 40,000 and the long, slow-motion crash after this, when the Nikkei sank below 10,000, focussed attention on Japan's cloistered financial markets, the role of the *keiretsu* banks and the shortcomings of Japan's policy-makers.

Similarly, much of the focus on Southeast Asia's rapid and sustained economic growth, especially after the 1985 Plaza Accord, focussed on the region's export-manufacturing sector and the industrial policies that made this part of the developing world so uniquely attractive to manufacturing foreign direct investment. The boom years from 1994 to 1997, when portfolio inflows started to outstrip foreign direct investment inflows and Singapore became a net capital exporter to the region, started to shift the focus. The sudden crash of late 1997 to early 1998 and its roots in the foreign borrowing behaviour of large local banks and firms completed this reorientation along with its more critical treatment of the region's economic policies.

Here, Southeast Asia's story is not one of exceptionalism or successful lessons for the rest of the slower-growing developing world. Rather it is one of similarities

Table 1.2 Net portfolio investment ($ millions)

	1994	*1996*	*1998*	*2000*	*2002*	*2004*
Indonesia	3,877	5,005	–1,878	–1,911	1,222	4,409
Thailand	2,192	3,721	331	–712	–1,606	3,071
Malaysia	n/a	n/a	n/a	–2,472	–1,712	8,902
Philippines	888	4,065	–29	–553	746	–1,713
Singapore	–7,726	–10,283	–7,483	–9,901	–13,144	–7,041

Sources: The Economist Intelligence Unit various country profiles; Asian Development Bank, Key Indicators 2007: Inequality in Asia – Country Statistics.

with other developing regions and painful lessons learnt later than others. All five countries under study followed the developing world banking policy status quo; a strong, central role for state banks, strict limits on foreign banks, and regulatory forbearance (minus the case of Singapore) towards smaller private local banks often with strong links to larger conglomerates. All, to some extent, faced severe financial strain, soon after a wave of regional loosening of state controls on local banking practices and opening up of capital accounts. While Southeast Asia's export-oriented, foreign capital controlled manufacturing sector rewrote the textbook on industrial development, the region with its state-centred, domestically-biased banking sectors simply followed the existing textbook on developing economy banking.

Southeast Asia's wild ride from 1994 to 2004 and its similarities with other parts of the developing world reflect a larger global phenomenon that cannot be divorced from the regional and country-specific focus of this book. While the study of banking policy during this decade questions the strength of Southeast Asian regionalism and commonality, it deepens the understanding of how global forces shape policy choices in the region. In the decade under study, the global banking environment reversed itself from one tolerating closed, state-bank dominated banking sectors to one actively challenging them. This seriously rattled the previously cloistered world of Third World central bankers and bank owners. Financial services were incorporated into global trade talks at the behest of the developed world in the Uruguay Round launched in 1994. A series of deeper and more contagious financial crises increasingly limited to the Third World, the Asian financial crisis being the largest, significantly weakened many Third World banks, particularly large state banks. At the same time, huge, well-capitalized 'global' banks and their respondent home governments aggressively set their eyes on gaining greater access to long-closed, high-return Third World banking markets.

All Third World central banks are faced with this new and seemingly permanent global banking environment actively promoting liberalization. This new global environment is putting the most pressure on three particular banking policies that will be the policy focus of this book: barriers against new foreign bank entry and operational expansion of incumbent foreign banks, the predominant role of state banks, and regulatory forbearance toward small, weakly capitalized local banks.

These three policies are central to the Third World nationalist banking policy status quo across the globe. Barriers against foreign banks shield all local banks from foreign competition, permitting greater operational inefficiencies and higher returns on equity while guaranteeing that the majority of banking assets stay in local hands. The central role of state banks – a policy outcome – ensures that politicians and financial authorities can use the banking sector to pursue both personal and developmental interests through state banks. Regulatory forbearance towards small local banks facilitates large, often oligarchic interests to enter the high-return, protected banking sector at a low cost. Permission to establish small banks to serve as 'cash cows' for these interests' diversified conglomerates means that there are strong local vested interests in this nationalist policy status quo. The central role of state banks and regulatory forebearance towards small private local banks ensures a strong and politically well-connected lobby group for the maintenance of this status quo.

With the benefit of time for reflection, this book aims to analyse how, during the decade 1994–2004, the global, regional and domestic levels intertwined in Southeast Asia to spur significant change to long-held banking policies and their central role in larger policy paradigms. At the global level, it describes intensifying globalizing pressures for the dismantling of the long-standing developing world statist-nationalist banking policy status quo and the three banking policies under study here. At the regional level, it looks at how both the 1994–1997 boom years and the financial crisis has altered maritime Southeast Asia as a region both empirically and conceptually. Of course, the assumption that maritime Southeast Asia was a relatively coherent economic region with similar countries (minus Singapore) was a factor in the quick, contagious spread of the crisis from Thailand to its southern neighbours.

The national level and the politics of banking policy reform is the crux of this book, with particular focus on the financial crisis and its aftermath. The global and regional levels act as essential background to understand the national policy responses and how they were received internationally. One cannot understand the actions of any of the five states under study here without appreciating the new global pressures on their banking policy or the regional elements of the boom and bust periods covered.

However, the national differences touched on above, by necessity, make this a book of comparative political economy with an emphasis on national differentiation. Through the in-depth study of the different states' policy responses, the book will be able to tell us more about the nature and limits of globalization and regionalism. The decade under study certainly showed that, for Southeast Asia at least, globalization is far from all-powerful, and that states have ample room to mediate global pressures in ways that reinforce domestic policy interests, both reform and status quo ones.

These national differences and their lack of a discernible pre-determined pattern lead this book to shy away from trying to develop more generalizable comparative political hypotheses that other, braver works have done (such as MacIntyre 2003). It seems the only generalizable lesson to be drawn from this study is that theoretical

deduction and the academic impetus to systematize the world, while heuristically necessary, often leaves out more than it includes. This is a cautionary pre-theoretical book focussed more on analytical description, and the inevitable challenges this bottom-up, inductive approach throws up for theory-building. The fact that it is analysing five states hit by a very similar set of external challenges all at the same time simply deepens the resonance of its cautionary tone.

Chapters outlined

The next chapter provides the global level background. It analyses both the rationale and almost universal spread of the developing world's statist-nationalist banking policy status quo and the growing global pressures on it. After decades of insulation, developing countries' banking policies in particular and financial sector policies in general came under intense global pressure for change from the late 1980s to 1990s, with regional financial crises providing the greatest pressure points. This is particularly true for Southeast Asia given its very rapid growth, high level of trade-based global integration and its highly protected banking and financial sectors. This new intense globalizing pressure also played into how individual states responded to the financial crisis, making liberalizing policy responses more attractive and status quo ones more costly.

The five chapters that follow are the country studies and are the heart of the book and its sceptical claims about comparative political economy theory-building and theorizing about globalization. For clarity, each chapter will follow a very similar format focussed on the three distinct policy periods during the decade and the three specific banking policies under study. Each of these chapters will focus primarily on the political choices made and battles fought over banking policy during this period. These similarities in approach will help emphasize the underlying differences in policy choices, and their rationale, between the five states under study.

To highlight the critical role the financial crisis played in this decade of change, these five chapters are organized by the depth of the crisis in each country, in declining order. Indonesia comes first, followed by Thailand, Malaysia, the Philippines, with Singapore last. Singapore, in important ways, is included as the exception that underlines that there is no overarching rule. Singapore did not witness the same hubris and dangerous financial and banking policy decisions as its neighbours in the boom period. Neither was the Singaporean economy or state significantly damaged by the crisis. The 2001 global information technology slowdown posed a greater economic challenge. Yet, the fact that Singaporean financial authorities chose to leverage the financial crisis to push through banking policy reforms against local banking interests may be the most intriguing and telling story of the five.

The final chapter will first focus on what the decade under study has meant for Southeast Asia as a region. While almost all the action took place at the national level, the impacts may have been greatest at the regional level. It will then revisit the book's theoretical scepticism and review what the five case studies can tell us about Southeast Asian studies, comparative political economy, and globalization.

2 Globalization Arrives

Over the past 20 or so years, international political economy has been witnessing a titanic battle between the statist-nationalist banking policy status quo that has reigned supreme in the Third World, and new powerful globalizing (liberalizing) pressures led by powerful First World states and banking interests. It really is a good test of what happens when an immovable object (the policy status quo) confronts an unstoppable force (globalization).

This chapter focuses on the two parts to this battle that played out so tumultuously across Southeast Asia in the decade under study here. It begins by looking at the basis of the Third World banking policy status quo and its deep and almost universal entrenchment. Opening up Third World banking sectors to more private and foreign competition is politically much more difficult than opening up sectors of the real economy, especially when there is little or no local production in these sectors.

For example, Southeast Asia's remarkable manufacturing growth and global integration has been largely due to integrated circuit and information technology; a sector where foreign capital and exports dominate, and where there was no pre-existing local champions. Banking in Southeast Asia is an intensely domestic sector with very powerful state-owned local champions strongly in favour of the status quo.

Most North–South debate and development theories have focussed on the real economy and North–South trade and investment in production. Dependency theory had much to say about foreign direct investment and production, but little to say about banking. The promoters and critics of import substitution focussed primarily on the real economy and visible trade, ignoring financial services and banking. Yet, banking is much more central to the functioning of an economy, and state intervention and protectionism has always been much greater in the banking sector in all parts of the world.

The second part of the chapter looks at three new globalizing forces that have arisen, over the past 20 years or so, to place much greater, sustained pressure on dismantling this policy status quo in favour of greater local private and particularly foreign competition. Fortunately, when it comes to Third World banking, globalization has a relatively well-defined starting point and concrete dimensions, making it an easier sector to usefully explore the nature and power of

globalization. The three forces detailed are: the rising number and concentration of financial crises, the inclusion of banking policy in multilateral and bilateral trade talks, and the spread of technological advances in banking that undercut the efficacy of existing protectionist barriers. As this book clearly shows, financial crises have been the most abrupt and painful of these new forces. Yet the other two are structural and permanent, and may, over time, do more to dismantle the statist-nationalist banking policy status quo.

The status quo

Opening up banking sectors to more competition, especially foreign competition, has always been much more difficult politically than trade liberalization. Only 30 years ago, one could quite confidently talk about a global nationalist banking policy status quo where foreign banks were not welcome. All across the world, governments have been most hesitant to open up banking to full competition. Even today, avowed free trade countries like Australia ban foreign purchases of their largest local banks. Even mainstream banking theory is unconvinced of the benefits of free and total competition. Supporters of *free banking* are still on the wild fringes of financial economics and libertarian think tanks. The theoretical, regulatory and purely political reasons that made banking policy liberalization so difficult, late in coming and still incomplete in the rich First World are even more powerful and closely held in the poorer, much less stable and secure Third World.

Banks serve three economic functions that place them at the heart of any economy, and determine that the banking sector is deeply affected by changes to non-bank sectors and vice versa. First, like stock and bond markets, banks mediate between savers and investors, the lifeblood of any market economy. Banks are, except in rare examples like the present-day United States, the most important and the most widely accessible of these three savings–investment mediating institutions.[1]

The two economic functions that only commercial banks provide are money creation and running the payments system (settling of accounts when cold cash is not transferred). As banks are the major destination of most households' and firms' most liquid savings and the funds used to settle accounts, they are the most effective candidates to run the payments system. This means that banks collectively provide a public good that is essential to the smooth running of the economy. In this sense, banks are similar to public utilities. This system, along with overnight money markets, closely ties individual banks together, meaning that if one bank fails, others will see their bottom lines suffer, undermining systemic confidence. The payments system can only function well if people have confidence in its future effectiveness, with any significant loss of confidence placing a sharp brake on economic activity and society's sense of security.

The third and most important and inherently unstable function is money creation. Banks are the only financial institutions legally permitted to accept savings in the form of demand deposits (deposits with a guaranteed value that can be withdrawn on demand), and use these deposits to lend to others. As soon as a

borrower uses a bank loan backed by deposits to pay other agents, money is created (Bossone 2000). This demand deposit-taking power differentiates commercial banks from other forms of banks and non-bank financial firms, and places them at the centre of all economies. Alas, this very money creation power and the demand nature of deposits are also the banking sector's greatest source of instability and proclivity to collapse.

Banks and their customers face serious risks from banks' liability–asset maturity mismatch. Demand deposits, the cheapest and usually largest pool of bank liabilities, can be extremely volatile due to their very short-term maturity; theoretically, they can be pulled out *en masse* instantaneously. However, the repayment maturities of bank loans are much longer. Aggravating this central maturity risk is banks' very low ratio of liquid cash reserves (offering minimal private and social returns on investment) to illiquid loans (offering higher private and social returns). Hence, without help from the central bank, banks cannot meet depositors' withdrawal demands during a bank run.

Banks, due to their role as money creators and their need to make confidence-ensuring profits, are very highly leveraged institutions; i.e. their net worth (equity) to assets ratio is very low. This makes banks vulnerable to macroeconomic shocks or downturns in sectors where a large percentage of their loans are invested, such as the property sector, as we will see. More worryingly, this very low ratio creates two 'perverse incentives' for bank owners during crises that aggravate conflicts between the private interests of banks' controlling shareholder(s) and social interests overseen by the state. The low ratio and maturity mismatch, during times of crisis, severely undermine the franchise value of banks, encouraging risky or fraudulent behaviour when banks risk becoming insolvent (Brownbridge and Kirkpatrick 1999).

The first perverse incentive is to 'gamble for resurrection' when a bank's asset portfolio sours and/or bank runs are imminent. Gambling for resurrection is to rapidly increase the potential future revenue of the suffering bank by lending to high-risk, high-return borrowers. The gambling bank also increases the deposit rate to attract more deposits to gather the funds for these new loans. Through the higher interest rate spread between the much higher loan rates and the higher deposit rate, the troubled bank hopes to increase profits and counterbalance its souring loans.

Alas, in times of crises, most high-risk borrowers shunned by other banks are likely to fail to repay their loans, making this a frequently suicidal strategy. Given the bank's low net worth to asset ratio, though, even if this gambling strategy fails and the bank collapses, the controlling shareholder(s) do not lose too much. If the strategy works, or the central bank bails out the gambling bank to save it from collapse and the banking sector from more instability, however, the controlling shareholder(s) both save their bank and gain market share. The larger a bank gets and the more deposits are at risk from its collapse, the more the central bank is likely to bail it out to protect the financial system. This aggravates insolvent banks' morally hazardous incentive to gamble for resurrection by increasing the chances that any losses may be socialized through central bank intervention, while any gains stay with the bank.

The second, more nefarious perverse incentive is to 'loot.' Looting takes place when a bank purposively makes loans at 'below-market' rates to connected corporations, transferring wealth from the bank to these corporations (La Porta *et al.* 2001).[2] The highly leveraged, broadly-owned nature of banks encourages controlling shareholder(s) to loot the bank in favour of firms they either own privately or have a larger equity stake in (Akerlof and Romer 1993). Again, when a bank's future earning capacity is threatened, looting the bank becomes more attractive.

The interests of the central bank in ensuring banking sector stability again may inadvertently encourage looting. Bailouts of looted banks allow controlling shareholders to transfer wealth to their other commercial interests and often to retain control of the looted bank kept afloat by central bank funds, or, at least, to not lose the entire value of their equity stake in the looted bank. The smaller the bank, and the more it is controlled by a single shareholder with other commercial interests, the greater the risk of looting.

Banking policies favouring the proliferation of small banks controlled by larger conglomerates common in the Third World enhance the incentives for looting during crises. Banking policies that favour a few large – 'too large to fail banks' – increase the incentives for state bailouts and the costs involved in the transfer of losses from looting owners to the taxpayers. We will come across both looting and gambling for resurrection again later in the case study chapters.

To an alarmist, banking sectors are like houses of cards in a room with open windows. Their centrality means that the social benefits of a smoothly functioning banking sector supported by widespread and deeply-rooted confidence are great, while the lack of such confidence is severely disruptive. However, banking's nature means that it is an inherently risky and unstable sector more prone to seriously amplify swings in the macro-economy, with all other sectors feeling often very large ripples from its changing fortunes. Banking's inherently unstable nature and its economic centrality has led banking to be one of the most highly regulated and supervised sectors, where competition is purposively circumscribed.

In contrast to mainstream economic prescriptions for the real economy, mainstream banking theory prescribes that a central bank controls the number of banks operating at any particular time, the number and location of their branches, and the asset portfolio of banks. A central bank must issue a bank licence before any bank is allowed to set itself up and must issue branch licences before a bank can open up new branches. Classical banking theory, concerned with supervisory overload and protecting existing banks' franchise values, argues for a limited number of banks at any time to help ensure sectoral stability at the cost of the greater potential for collusion and higher profit margins. Banks' fractional reserve nature and their liability–asset maturity mismatch actually transform high returns on equity (ROEs) from a sign of bad market management to a confidence-inspiring sign of individual bank solidity.

The economic centrality of banking and banks' key role in monetary policy has encouraged most central banks to favour local banks, and to place limits on

foreign banks, especially in retail banking. The strong incentives pushing for very intense state supervision of locally operating banks supports this bias towards local banks, as it is often legally unclear whether the host or home central bank of a multinational bank should be the primary supervisor and potential lender of last resort. For host central banks, accessing information on the overall status and activities of foreign banks and their local operations is also more difficult than for local banks (Mathieson and Schinasi 2000).

The limiting of bank numbers and the supervisory interest in large established local banks intensify cartelization and rent-seeking incentives in the banking sector by guaranteeing a large pie cut into few slices. The size and centrality of banks provide their owners with political influence that is often ameliorated by banks' role as major buyers and arrangers of state debt. The state's interest in a stable, confidence-inspiring banking system with friendly bankers foments strong anti-competitive forces and buttresses the few established bankers' strong interest in the preferential policy status quo. The discipline of competition is sacrificed in the pursuit of inefficient and often elusive sectoral stability.

Banking and development

What is true for banking in general is true in spades for banking in the Third World. Banks are by far the largest savings–investment mediators in developing economies' less liquid and more uncertain markets. Banks draw into the formal economy the largest number of households and firms. This power to pull households, firms and potentially productive endeavours into the formal market is crucial for development and a key goal of development planning. A nation-spanning, well-functioning banking sector greatly benefits households by allowing them to move from less liquid, low-return forms of savings, like holding jewelry, to more liquid, dynamic forms of savings, like time deposits. It also gives them access to new forms of credit, often less costly and more certain than pawnshops and informal credit markets. Financial deepening, as measured by the increase in formal financial assets as a percentage of GDP, is one of the economic indicators most closely correlated with development (King and Levine 1993).

However, in developing economies where information on borrowers and banks' credit evaluation capabilities are more circumscribed, and the economy is more volatile, the risks associated with banks' maturity mismatch are much higher. While many banks in developing economies, recognizing these greater risks, have much higher capital to asset ratios, they also favour short-term loans backed by significant collateral – a safer but socially less rewarding set of credit decisions (Eichengreen and Arteta 2000). Alas, with developing countries' huge infrastructural demands and need to spur local entrepreneurial and manufacturing capacity, long-term credit lent on future earnings potential is what is most needed, not short-term, fully-backed loans.

Aggravating the conflict between the developmental needs of society and bank owners' private interests, it is often much more difficult for Third World central banks to prevent looting. Developing economies in general have many fewer

investors with the wherewithal to invest significant sums, increasing economic concentration and making the prudential goal of a wide dispersal of bank shares to counteract the potential for looting much harder to achieve. Large market actors are often diversified and politically powerful family conglomerates with opaque ownership patterns and strong interest in controlling a bank as a cheap source of credit, i.e. the proverbial cash cow to milk. Aggravating these difficulties further, central bank supervisors also face more difficulty obtaining and processing clear information of bank lending portfolios, and especially the amount of damaging 'connected lending' to firms affiliated with controlling shareholder(s) (La Porta *et al*. 2001).

For many Third World central banks, it is difficult to effectively limit the number of small, weakly-capitalized local banks as these central banks often have little autonomy from ruling politicians, who themselves may have little autonomy from local, oligarchic capital. This inability to limit the number of small, local banks brings the worst of both worlds. It stretches usually inadequate supervisory capabilities even more, while the small size of these banks and their owners' primary interest in using them as conglomerate cash cows mean that they add little competitive impulse. Large banks, often state ones, can still function oligopolistically with small, connected banks preferring the inflated interest rate spreads this provides over trying to take these behemoths on. While many Third World banking sectors have a large number of banks, their largest four or five still control an inordinate share of total banking assets. A large number of banks does not guarantee competition but it does guarantee a heavy supervisory burden.

These problems of a thin capital market and consequent economic concentration heighten the likelihood of looting, while the weaker supervisory capabilities of many Third World central banks along with the political weight of local diversified conglomerates with banking interests make discovering, preventing, and punishing connected lending much more difficult.[3] As we will see, often ruling politicians own or are close to such conglomerates, making the prevention and punishment of destabilizing connected lending a central bank interest but not necessarily one that is as closely held by the state's political masters. This lies behind the proclivity of Third World central banks to show great regulatory forbearance towards small, weakly-capitalized local banks, despite many of them having to repeatedly bail out these banks. Central bank regulatory weakness begets banking sector instability.

For developing countries, central bank incentives to favour local banks over foreign ones are even greater, as is the policy influence of concentrated local capital controlling local banks with no desire to face foreign competition. For most post-colonial economies, the inherited colonial banking sectors were very limited in national spread and services provided, and externally focussed. Most colonial banks established few branches, basing them solely in capital cities and major enclaves of colonial exploitation. These banks focussed their efforts on trade financing, ignored retail banking, and they often required local branches to keep surplus funds in metropolitan assets, leading to capital outflows from credit-starved colonies.

Third World central banks also are deeply worried that foreign bank operations may be more footloose and apt to leave during crises (Clarke *et al*. 2001). Foreign bank operations are guided by the investment decisions of their parent banks, and their investments, while often significant locally, are but a very small part of the parent bank's overall operations, and were viewed as at risk of being wound up when local conditions sour. Local banks, of course, have much more of their investment tied to the local market and have fewer ready alternatives when times get tough. They cannot pack up and leave.

These histories of externally-focused, narrowly-developed colonial banking sectors, and fears of capital outflows and crisis exits, have pushed Third World central banks to severely limit new foreign bank entry and foreign incumbents' local operations. The fact that a small investment by a global bank can be huge in local market terms, and their competitive advantages over nascent local banks, reinforces these nationalist biases. The centrality of the banking sector and the often very high level of metropolitan control at the time of Independence have made the banking sector a key sector for most post-colonial economic localization and decolonization efforts.

This drive to decolonize the local banking sector and reshape it to serve developing countries' need for long-term credit has spurred massive direct state intervention through the creation of state (development) banks (Hellman *et al*. 1997) and regulatory intervention to direct bank credit to priority sectors and locales seen to be ill-served by private banks (Fry *et al*. 1996). In the early post-colonial period, the state was often the only economic actor large enough and with access to enough funds to willingly bear the high costs of setting up national-scale banks, especially ones whose branch networks expanded beyond the small enclaves of high economic activity and wealth concentration that private banks, local and foreign, favour.

Through these extended 'missionary' branch networks, state banks have been able to involve more households and firms in the formal economy, and to contribute to nation-building at the cost of their allocative efficiency and competitiveness. On the other hand, state banks often have sole claim over state agencies' and corporations' banking deposits, often with no need to pay any deposit rate, giving them a substantial competitive advantage. Of course, these banks' advantages come at the cost of a lower return to the state as a whole.

State banks can, inefficiently, act as mechanisms to transfer the savings of the population towards favoured state programs and/or favoured individuals. This deflects fiscal demands into the banking sector and helps ruling politicians cement patrimonial support bases and nexuses of interests between politicians, state banks, their line agencies, and favoured segments of local capital. State banks also have been established to overcome local and foreign private banks' risk aversion to longer maturity loans and preference for short-term, collateralized loans to well-established firms, by providing such riskier but more socially beneficial loans. These longer maturity loans are often backed up with state guarantees to lower their cost and risk to the development bank itself; i.e. socializing their substantial maturity mismatch.

Direct state intervention into Third World banking sectors is very widespread, with state banks playing a much greater role than in the First World. Direct intervention, widely supported by the international policy community up to the 1970s, has played a key role in states' more general economic policy paradigms, and their goals of spurring development and nation-building and providing rents to politically influential actors and sectors.

Beyond state banks, Third World states have used their regulatory control over all locally operating banks to tie them directly to other economic policy objectives through directed lending programs. These programs require banks to lend a particular percentage of their overall loan portfolios to state-designated sectors or projects often at subsidized interest rates and longer maturities. They transfer fiscal burdens to banks and increase their direct contribution to state policy goals beyond the banking sector. Many of the Third World's industrial policy failures have been funded, unwillingly, by locally operating banks this way.

Foreign bankers in Southeast Asia contend that these programs strengthen the state's interest in limiting foreign bank market share, as they are the least willing to accept these limitations on operations, often opting to pay the fines for non-compliance instead. State banks are the most willing, followed by private local banks, and finally uncooperative foreign banks. Usually this is the same order for banks' predilections to skirt prudential regulations and their vulnerability to supra-national crises.

Almost all Third World banking sectors have displayed high (sometimes infinite) barriers to foreign banks, a large, privileged and often dominant role for state banks, and regulatory willingness to issue a large number of bank and branch licences to powerful locals despite the small scale of the banking market and these new banks. The special nature of banking and its centrality supports statist-nationalist policies of localization, limited competition, and directed lending. The uncompetitive nature of both state banks and most small local banks reinforces the rationale for high barriers to foreign banks. However, the instability and large size of state banks threaten financial stability and increase the likelihood and depth of financial crises. A large number of small banks with concentrated ownership stretch the usually limited supervisory resources of the central bank. Both of these nationalist outcomes create grounds for future liberalizing policy reversals, always by necessity, rarely by choice.

Globalization arrives

Third World banking policy's external environment fundamentally and rapidly changed from the late 1970s onwards in permanent ways that challenged this statist-nationalist banking policy status quo. A larger shift during this same time period within mainstream economics and economic policy formation towards neo-classical economics provided matching intellectual supports for the strong First World material interests driving this environmental change. This part of the chapter details the concrete aspects of this sectoral element of globalization and its disciplining power on states' policy choices.

The debt crisis that hit developing countries in the mid-1980s can be seen best as the cataclysmic signal of this new, globalizing era in Third World banking policy, with globalization defined as new, permanent external pressures on states and local markets for greater foreign entry and freer competition. Three main new challenges arose, each of them a manifestation of larger, more generic changes to the global financial architecture supported by the shift away from Keynesian economics towards neo-classical economics and globalizing policy reform. All have become permanent, growing characteristics of the external environment facing Third World states' banking policy.

Globalization by crises

The first major environmental change is the uptake in the speed, depth and spread of supra-national financial crises in the Third World from the late 1970s onwards. Financial crises have developed as the sharpest and strongest challenges to statist-nationalist banking policies. Financial crises have also fostered the most significant spillover effects into the real economy, making this new feature of the external environment the most likely to trigger sudden policy reversals and even sudden changes to their overarching political systems. Witness the political tumult in Argentina since the country's financial meltdown in 2001. Post-colonial Southeast Asia has been rocked by two supra-national financial crises that severely shook affected banking sectors, and both put banking policy status quo in doubt: the mid-1980s debt crisis, and the 1997 Asian financial crisis which is the high(low)light of the decade under study. Detailed discussion of the 1997 crisis will be limited to the following chapters.

The combination of the death of the Bretton Woods System from 1971 to 1975 and the financial ramifications of the oil shocks of the 1970s signalled a new global era of bank-led financial integration. This new era of more active international capital markets and less insulated developing economies helped trigger the huge growth in Third World public external debt, especially commercial debt, which foreshadowed the debt crisis. The end of the Bretton Woods fixed exchange rate system quickly led most states to float their currencies and pursue strong or weak exchange rate policies to suit domestic economic interests. The management of internal prices and growth rates replaced external price stability as the main monetary goal. The floating of currencies and sudden changes in exchange rate policy among creditor and debtor states led to much greater volatility in the local currency value of developing countries' ballooning external debt payments, exacerbating the currency risk faced by their economies, states and banks.

Following from the 1973–1975 oil shocks, international markets were awash with 'petro-dollars', while traditional borrowers in developed economies were subdued by their own economic problems associated with stagflation. At the same time that creditor and many debtor economies floated their currencies, international capital markets expanded and began to look more closely at willing Third World borrowers, many cash-starved from a terms-of-trade crunch triggered by the rising world price of crude oil.

Table 2.1 Third World external debt, 1970–1985 ($ millions)

Year	*1970*	*1980*	*1983*	*1984*	*1985*
Total debt stock	..	**561,754**	**806,692**	**843,066**	**936,928**
Long term debt	61,923	420,688	633,243	674,771	767,761
Public share[a]	46,279	350,567	528,969	573,603	674,564
Private share	15,645	70,101	104,274	101,168	93,196
Interest arrears	..	824	5,664	8,269	7,785
Use of IMF credit	756	12,363	33,870	36,032	40,244
Short term debt	..	128,723	139,579	132,264	128,923
Total debt as % of exports	..	133.5	201.4	188.6	213.7
Total debt as % of GNP	..	27.7	40.4	41.6	45.6

Source: World Bank 1990.

Note
a Includes publicly guaranteed debt.

The end of the Bretton Woods System further integrated developing countries into international capital markets by placing new pressures on their states to remove capital controls and allow for the free flow of capital, long-term and short, in and out of their economies. The Bretton Woods system, as part of the post-World War II desire to not revisit the traumatic interwar period, attempted to ‘embed’ liberal economic policy paradigms in society by maximizing the free flow of trade while minimizing politically destabilizing shocks to domestic economies (Ruggie 1982). To lessen the pain of domestic price changes required to keep the exchange rate steady as demanded by the fixed exchange rate system, states were allowed to impose controls on their capital and current accounts to insulate their domestic economies and exchange rates from international capital movements. However, with the end of the fixed exchange rate system, domestic price stability and/or balance of payments problems could now be met through exchange rate policy, even with open current and capital accounts. Consequently, the IMF quickly encouraged members to adhere to Article VIII of the IMF Agreement and to open up their current and capital accounts, and address balance of payments and inflationary problems through fiscal retrenchment and a freely floating exchange rate, not capital controls.[4]

From the early 1980s, a shift in mainstream economics that dismissed the classical separation between financial and trade economics bolstered Article VIII supporters’ case for ‘market-determined’ exchange rates. Along with supporting floating exchange rates, the neo-classical ‘Chicago School’ argues that the *laissez faire* premises of trade economics should be applied to finance, with open capital accounts being the equivalent of open markets in visible goods. Counterintuitively, many central bankers, both from the Third and First Worlds, have been some of the strongest proponents of neo-classical economics in banking and monetary policy-making processes (Silva 1995), despite the fact that, at its logical extreme, neo-classical economics calls for the dissolution of central banks.

The need for foreign capital, and the external pressures to adopt Article VIII and open capital accounts, have led many Third World states to gradually open up their current and capital accounts and relax their policy interest in exchange rate management and control over the domestic money supply. In return, foreign investors, especially short-term hot money investors, have been able to invest more easily in these markets, while local agents, especially larger corporations, banks and state bodies, have been able to access foreign credit and investment more readily. The lower interest rates and higher volume of credit available in global money centres like New York, London, Singapore and Hong Kong create strong incentives for overseas borrowings, boosting inflows of foreign investment capital and helping relieve the dearth of local investment capital suffered by developing economies.

However, more open capital accounts also allow foreign and local capital to leave these economies more easily when sentiment runs against them. The huge amount of free-floating investment capital in international capital markets combined with the hunger for this capital from globally very small developing economies means that capital inflows and outflows through open capital accounts can have huge ramifications on these countries.

The most detrimental outcome of this move to open up capital accounts and deficit financing has been a rise in the number, depth, spread and clean-up costs of financial crises and regional contagion affecting the Third World.[5] While the correlation between First and Third World financial crises has weakened over time, the correlation between supra-national crises within the Third World has strengthened, especially at the regional level (Bordo and Murshid 2002). More tellingly, these economic crises have also increasingly centred on banking sectors, many having high levels of currency risk due to heavy foreign debt exposure and a lack of hedging (Eichengreen and Arteta 2000).

The opening up of developing economies' capital accounts has been mirrored by a history of frequent and overlapping banking crises. Williamson notes that in a majority of Third World financial crises from 1980 to 1997, the affected country(ies)'s capital account had been opened recently, often with no reform of prudential banking regulations to ensure safer borrowing and lending practices among banks (Williamson and Mahar 1998). Developing economies with large directed lending programs – like the Philippines and Malaysia – and inflows of capital – like Indonesia, Thailand, Malaysia, and the Philippines from the early 1990s – were particularly vulnerable. Ironically, often the concessional loans provided to crisis-hit countries are conditioned on a further opening up of the capital account, while prudential taxes like the former Chilean one on short-term foreign capital are strongly discouraged.

The first supra-national crisis to rock the Third World in this evolving era of opening capital accounts and heavier and more diversified external borrowings was the debt crisis of the late 1970s to late 1980s. This global crisis hit the statist-nationalist economies of Latin America first and hardest triggering the infamous 'lost decade,' and had serious ripple effects around the world, including Southeast Asia, especially in the fiscally weak and vulnerable Philippines. More recently, a series of supra-national crises with serious contagion effects have hit

the Third World, highlighted by the 'Tequila Shocks' of 1994 out of Mexico, the 1997 Asian financial crisis that started in Thailand, and Argentina's 2001 financial meltdown. While these crises differed in point of origin globally and domestically, they all placed affected banking sectors under immense stress, triggering strong external and internal pressures for banking policy reform.

Both crises hit the affected Southeast Asian banking sectors very hard, leading to many local private and state banks to fall into insolvency, or at least illiquidity. The costs of recapitalizing banks during times of crises can fall on the state, or private sector actors can inject capital into the suffering banks or buy them out. During times of crisis, however, local capital markets are usually paralysed by uncertainty, and most large local firms able to ponder buying into banks have been hit by the crisis themselves, leaving them with shallow pockets (Peek and Rosengreen 2000). Foreign banks are often the only viable alternatives to the heavy use of state funds to recapitalize damaged local banks. This is especially true when large state banks are in need of recapitalization, as their very size puts them beyond the reach or interest of the vast majority of local players. Moreover, the damaged balance sheets of local banks reduce their franchise values and make them cheaper investment options for foreign banks than during normal times, when their franchise value is very high and their owners are loathe to sell.

The deep shock of crisis focuses affected financial authorities' minds on how to evade further crises, with their huge economic and social costs and threats to their own careers, shifting their banking policy interests. According to Peek and Rosengreen (2000), foreign banks offer at least three significant reasons why their greater presence would mitigate future crises. First, in financial crises both incumbent foreign banks and non-resident foreign banks are the willing recipients of withdrawals from local banks by depositors who fear for these banks' survival and thus access to their funds. However, capital flight to incumbent rather than non-resident foreign banks does not further degrade the balance of payments and permits these savings to be reinvested into the local economy, helping its recovery. In the early 1990s, the Philippine central bank and Department of Finance made it much easier for residents of the Philippines to open up foreign currency accounts in banks operating in the Philippines, successfully keeping much of the future capital flight to quality within the Philippine banking sector.

Second, local financial authorities can import prudential regulations speedily through allowing greater participation by major foreign banks with strong parent bank control. Often, Third World states choosing to open up their banking sector to new foreign banks have strict rules favouring global banks from large developed economies to help ensure they are importing the best. Less independent central banks or those who have to supervise banks owned by powerful local actors are often unable by themselves to enforce effectively strict prudential regulation on banks' lending portfolios, and may need to import prudential regulation through greater competition to make up for their weakness. State regulatory weakness can help foster banking sector liberalization, not hinder it. Latin American economies since the 1980s have been some of the most deeply and frequently hit by financial crises. After being some of the strongest enforcers of

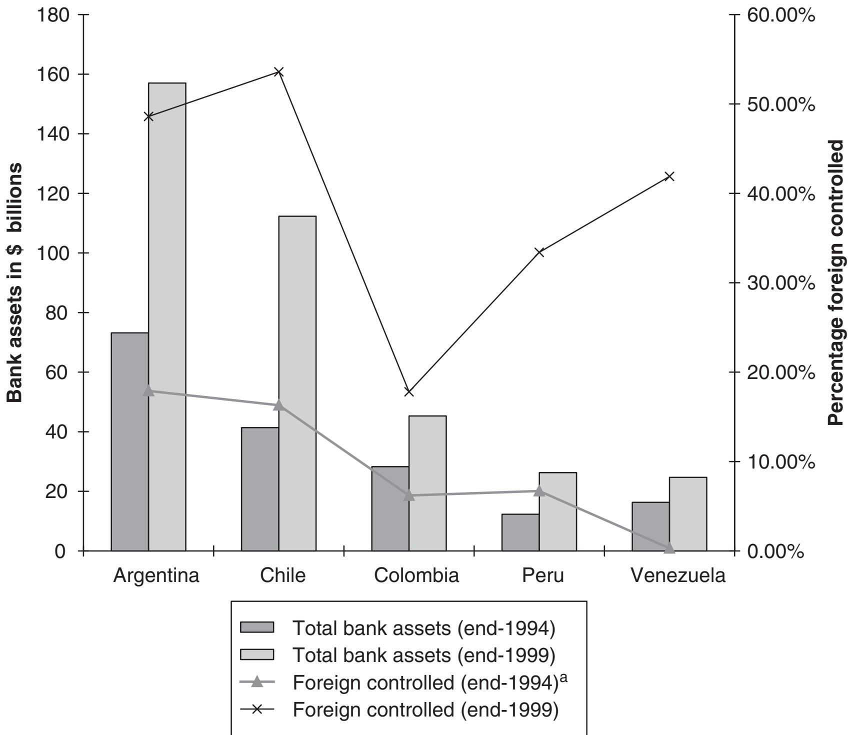

Figure 2.1 Foreign bank entry into Latin America

Source: IMF, 2000.

Note

a Ratio of assets in banks where foreign entities control more than 50 per cent of total equity.

the statist-nationalist status quo, today their states provide some of the most open banking sectors with the highest foreign bank market shares.

The third benefit contradicts financial authorities' fears that foreign banks may withdraw when crises hit, a worry that is made more real when foreign banks are only allowed to buy minority strategic stakes in local banks. Foreign banks' investment in individual developing economies is usually a very small percentage of their total global operations. This minimal exposure means that even when their lending portfolios are eroded by a crisis hitting that economy, it does not threaten these banks as a whole. If a foreign incumbent bank is committed to a long-term presence in that market, it has the means to ride out the crisis and not fold or seek lender-of-last-resort funding from the host state. Foreign banks' loan portfolios are usually less crisis-sensitive, meaning they are often the banks best placed to continue lending during crisis periods, helping recovery (Peek and Rosengreen 2000). These three benefits counterbalance Third World financial authorities' deep

worries about foreign domination and crisis departures, weakening their commitment to statist-nationalist banking policies during crises and after them.

In most developing economies, state banks are the dominant local banks, have the most non-commercial demands placed on their lending portfolios, and are the hardest for central banks to supervise. While many states provide blanket guarantees for local deposits during times of crisis to try to stave off bank runs and capital flight, pressures on them to cover state bank deposits are even greater, especially as often many of these banks' deposits come from the state itself. In normal times, this implicit state guarantee may also lead savers to place their deposits in state banks, especially in far-flung areas that private banks shun.

This combination of size, geographical spread and compromised lending portfolios usually mean that state banks are at the forefront of banking crises, and place the highest demands on limited state funds and regulatory resources. Consequently, crisis-empowered concessional lenders like the World Bank and IMF have placed the downsizing, closure or privatization of previously profligate state banks as central conditions for their crisis lending – loans that crisis-stricken states require in large amounts and quickly. However, the developmental and patronage benefits of state banks during normal times mean that financial authorities and/or their political overseers firmly resist pressures to privatize. State banks are often one of the most polarized sticking points in concessional loan negotiations. By far the greatest part of the rise in foreign bank presence in Latin America since the debt crisis has been through the privatization of state banks, with a similar process also occurring in Eastern Europe, exemplifying the depth of their crises and the respective states' commitment to banking liberalization.

After state banks, small, weakly capitalized local banks are usually the worst affected by crises and are not covered so surely by explicit or implicit state guarantees. The very reason they are not well-capitalized during normal times, when their protected banking sectors provide their owners with high returns on equity, also militates against their survival during crisis periods. Owners unwilling to boost their banks' paid-up capital when profits are high usually are not willing to do so during crisis times, but rather are more likely to gamble on resurrection or loot the bank to save their other concerns.

Depositors in small private local banks are the most likely during crises to move their funds to larger, local private banks, state banks with greater guarantees, or foreign banks. Like state banks, small, weakly capitalized banks are often the target of crisis-related concessional loan conditions, with local banking sector consolidation being a standard crisis response recipe, one larger banks actively support. Foreign banks provided with greater market access during and after crises often favour buy-outs of small local banks, if their desired local market niches are limited to the large metropolitan area(s) and do not need vast, expensive branch networks. Supporters of greater foreign bank entry note that matching local consolidation with greater foreign bank entry can minimize the chances of consolidation leading to cartelization (Gelos and Roldos 2002).

The debt crisis threatened the future shape and even existence of the World Bank and IMF, threats from creditor states that have energized these international

financial institutions to become more forceful agents of globalization. Changes to concessional lending sparked by the debt crisis and the failure of conditionality prior to the crisis to spur reform have added to the momentum for banking policy liberalization in the three policies under study. The depth and spread of the debt crisis sparked fierce criticism of the IMF and World Bank and their approach to lending from their creditor states, and accelerated the adoption of a tougher line on conditionality and wider, policy-oriented lending mandates. The debt crisis also increased affected Third World states' desperation for concessional funds, providing larger avenues for these lenders' policy influence, influence that was largely inimical to statist-nationalist policies. From the late 1970s, multilateral and bilateral concessional lenders have shifted funding away from project loans for infrastructure to program loans focusing on institutional and policy reform (Quereshi 1992). The debt crisis, Latin America's Tequila Shocks, the Asian financial crisis, etc. have focussed this institutional and policy reform energy on the financial sector.

Previous problems with non-compliance with loan conditions combined with the debt crisis to spur concessional lenders to tighten their loan conditionality from the late 1970s onwards. Conditionality became more front-loaded where institutional change and policy reform – rather than the previously-accepted promises of change – are often pre-requisites to loan disbursement (McCleary 1991). Concessional lenders began to cross-condition their loans more comprehensively, meaning that the failure to meet the conditions of one loan triggers the cancellation of other loans. The IMF, with its reputation of firmness, usually takes the lead role with other concessional lenders attaching their conditionality to those of IMF loans. International capital market lenders to Third World states, burned by the debt crisis and wanting the so-called IMF 'seal of good housekeeping', also tie their willingness to loan and the terms of these loans to the success or failure of concessional loan packages.[6]

The debt crisis made affected states like the Philippines more dependent on concessional loans at the same time that these loans' conditions were becoming stricter and more comprehensively linked. This new, tougher approach to conditionality with its broader scope has not waned since the late 1970s, with the scope of concessional lender reform interests continuing to expand to almost all facets of state action. The debt crisis introduced developing countries to a new, more turbulent external environment of open current and capital accounts and more hard-nosed relations with increasingly activist concessional lenders. The tolerant external environment for statist-nationalist banking policy was over.

Globalization by negotiation

Another slow-burning but severe blow to the external environment's traditional tolerance for statist-nationalist banking policies began in November 1982, when the United States Trade Representative, supported by other developed members, officially called for trade in financial services to be included in the General Agreement on Tariffs and Trade. Despite fierce opposition from many developing

members, led by India and Brazil, financial services were included for the first time in the 1986 Uruguay Round with the right of foreign services providers to set up shop in previously closed member economies at the forefront of these negotiations. Unlike crises, the inclusion of banking policies in trade negotiations has not created sudden external shocks, but rather has delivered irregular but seemingly permanent pressure on Third World states to dismantle statist-nationalist banking policies or face legally sanctioned retaliation in other economic sectors.

From its inception, two of the key functions and rationales of the General Agreement on Tariffs and Trade have been to shift domestic policy debates towards liberalizing policy options and to provide political cover for such shifts (Hoekman 1994). The inclusion of financial services under the General Agreement on Trade in Services is the most concrete and fundamental manifestation of the global intellectual shift to neo-classical economics and its ramifications for banking policy. It has transformed the General Agreement on Tariffs and Trade and the World Trade Organization into a permanent agent of banking policy globalization. North–South bilateral trade deals such as the United States–Singapore deal signed in 2003 – a growing trend in the world of trade diplomacy – have also focussed much of their attention on trade in services including banking.

Changes to First World export economies and to banking policy away from statist-nationalism encouraged their states' trade negotiators to agree with neo-classical economics' dismissal of the classical division between the real economy and finance. These negotiators placed the opening up of overseas financial markets as a key priority in the Uruguay Round. Two banking policy changes pursued by First World states attacked their local banks' bottom lines, and consequently encouraged these banks to lobby strongly for the inclusion of financial services in the Uruguay Round.

The first of these was the slow multilateral and bilateral progress by financial authorities towards opening up their domestic banking sectors to foreign entry, often on a reciprocal basis (Pauly, 1988). In 1992, the European Union, through the Second Banking Directive, removed almost all barriers to cross-border banking operations and investments within the Union, while today New Zealand no longer has any locally owned commercial banks. The opening up of First World banking sectors, while still incomplete, has been a major factor behind both the increase of intra-country bank mergers within developed economies and their states' push for the legalistic multilateralization of this banking liberalization initiative (Buch and Delong 2002). The consequent need to grow to survive within their home markets has spurred First World banks' interest in new growth markets and intensified their lobbying of home states to press for more open banking sectors globally (Guillen and Tschoegl 2000).

The second was the unilateral move from the 1970s onwards of financial regulators seeking more efficient and liquid financial markets to lower the traditionally high prudential firewalls between banking and other financial services. Regulators have increasingly let insurance companies and others into traditional banking services like consumer lending, hurting banks' bottom lines and encouraging

defensive mergers. First World banks now face new competition from each other and from other financial providers that they, like their Third World peers, had long been shielded from.

Both the hollowing out of developed economies and the rise of neo-classical economics has aided these banks' influence over the agenda-setting of multilateral and bilateral trade negotiations. While the actual calculation of services' share of national income is fraught with definitional difficulties, services as a share of national income and total exports has grown significantly in most developed economies since the late 1970s, and continues to grow.

For the United States, the trade surplus in services grew from US$300 million in 1985 to nearly US$74 billion in 1996, helping moderate America's yawning deficit in visible trade (Vastine 1997). By 1980, services sales by American affiliates overseas were already estimated to be US$150–200 billion, while service exports from the United States amounted to US$30 billion, emphasizing the benefits for the American economy of lower barriers to participation in foreign markets (Sapir 1985). These exports also clearly indicate the importance for service exports of service providers gaining a physical presence in host markets. Yet services had been largely shut out of multilateral market-opening trade negotiations in the first seven rounds of the General Agreement on Tariffs and Trade. Moreover, due to their delineation from visible trade in classical economics, service sectors were protected by a more diverse and comprehensive set of state policies against foreign entry derived from traditional concerns with market stability not allocative efficiency (Sampson and Snape 1985). All of this changed in 1982 with the inclusion of financial services in the Uruguay Round.

Most Third World states and banks are very worried about the consolidation of developed economies' financial sectors into very large, globally dominant firms. Many saw these growing First World state and corporate interests in financial globalization as the exact reasons to more fiercely defend the statist-nationalist policy status quo. Third World financial regulators opposed the 1982 American proposal to treat services as trade and to bring them into the fold of the General Agreement on Tariffs and Trade on three mutually supportive socio-economic grounds. They were: (1) fear of domination, (2) infant industry arguments, and (3) the infrastructural nature of services industries.

First, the consolidation of First World financial services sectors into larger firms increases the chances that these firms, if permitted, could dominate the developing economies they enter, as has happened in the quickly-opening Latin American banking sectors, sparking deeply felt worries about local economic control. With global financial conglomerates like Citigroup and Mizuho being much larger than many developing economies and their comparatively miniscule local banks, the fear of domination has held many Third World states back from fully opening their banking sectors.

This fear has also provided local protectionist lobby groups with a useful bogeyman to organize their campaigns around. The fact that the ratio of cross-border banking mergers and acquisitions to total mergers is much higher in the Third World than in the First World, with First World financial institutions being

the dominant purchasers, clearly indicates the largely one-way nature of North–South banking mergers, validating these worries in the eyes of globalization opponents (Buch and Delong 2002). These fears are strengthened further by the fact that in most developed economies, despite having relatively open banking sectors, the share of foreign banks is below 10 per cent, and foreign banks are less profitable than locals (Berger *et al.* 2002).

Second, closely associated with this fear of domination are the infant industry arguments that Third World service providers have not had enough time to develop to be able to fully compete with their First World peers, a protectionist caveat to free trade accepted in classical economics. Especially for complex, technologically-reliant services like banking and insurance, providers 'stay longer as infants', while comparative size is more important in determining competitiveness. Thus, even though most Third World banks have been protected since Independence or soon after, local opponents to banking globalization – especially local bankers – argue that protection needs to continue due to the complexity of services, shifting technological boundaries, and the enormous size of foreign competitors. The inability of these banks to penetrate developed economies or become major players in international capital markets provides concrete proof of their relative infancy and inability to resist marginalization in open competition.

Third, unlike most real economy sectors, services sectors act as infrastructure for the whole economy, and directly serve the public good, not only the private commercial good. The centrality of services like banking, accounting and legal services to the smooth running of society amplifies arguments for continued protection, allowing protectionists to shift the debate away from simple neo-classical efficiency grounds. All three grounds against the inclusion of services in multilateral trade negotiations present an image of Third World service sectors as ripe for foreign domination, a powerful post-colonial image supported by some of the trends noticeable in the opening up of some Third World services sectors like banking.

The depth of the intellectual and material interests behind the opposing positions to the inclusion of financial services in the Uruguay Round made these novel negotiations some of the most torturous on the agenda, and concluded with neither side capitulating or being satisfied. Their polar nature delayed the final agreement, reduced the number of members to commit to a schedule of liberalization commitments to only seventy, and predisposed financial services to be a key sticking point in the Doha Round of negotiations. The Doha Round never got to discuss banking policy seriously before agricultural disputes placed the whole round in the deep freeze.

Once financial services were included in the General Agreement on Trade in Services and brought into the Uruguay Round, American trade negotiators and other supporters had diametrically opposed interests to those of most developing members (the majority of members). The American stand called for negotiations to be based on standard General Agreement on Tariffs and Trade principles (Malmgren 1985), including the use of negative lists, hard commitment timetables, and the absolute most-favoured nation principle. Reflecting the foreign investment

nature of most financial services, the United States and its supporters also pushed very hard for the national treatment principle, where foreign and local firms must be treated equally. The United States Trade Representative bolstered their multilateral negotiating position by carrying out bilateral financial services negotiations with 40 other members, involving 30 Third World states including the five states under study in this book. The United States Trade Representative also compiled reports for the American Congress on the level of openness of these targeted economies and how their states' initial commitments would alter these levels.

Most developing members, and some developed members like the European Union, were against the national treatment and most-favoured nation principles espoused by the American negotiators (Hoekman 1994). They pushed for positive, less liberalizing commitment lists, soft commitment timetables, and the protection of some illiberal banking policies on the basis that they are prudential regulations; the so-called 'prudential carve-out'. This insistence on a prudential carve-out and the inapplicability of the most-favoured nation and national treatment principles clearly shows how developing members fought to maintain the classical division between finance and trade, with its greater allowance for regulatory and protectionist oversight in finance. They also fought hard to hive off negotiations over financial services from the traditional visible trade negotiations, to limit the horse-trading opportunities where their hard-fought access to traditional export markets in the North could be used as leverage during financial services negotiations.[7] However, developing members did insist that the 1965 Part IV addition to the Agreement, which calls on developed members not to demand strict reciprocity from developing ones, be duly noted (Sadli 1990).

The two sides crafted a compromise that awkwardly bridged the vast gap between negotiating positions with a hybrid list system as the agreed-upon modality. All participating members agreed to a set of general, 'horizontal' commitments, including the goal of liberalization and a most-favoured nation clause, and a positive list of specific, 'vertical' commitments. These lists provided for soft commitments and allowed particular commitment categories to be 'unbound' if individual members chose; i.e. no commitment offered. Developing members succeeded in incorporating the prudential carve-out into the final agreement and hiving these negotiations off. American negotiators succeeded in including services and setting the table for future rounds where new talks over the negotiating modality could be continued. They were also able to include supply by resident foreign affiliates in the positive list of commitments requiring host members to allow foreign entry, further eroding the conceptual borders between trade and investment and, hence, trade and services.

The fact that the American team twice walked away from these talks and in the end withdrew itself from committing to the absolute most-favoured nation clause for one based on reciprocity shows the limits to American negotiating power when opposed by numerous members. Interestingly, some countries' final sets of positive commitments were less liberalizing than their earlier initial offers, featuring a much greater use of reciprocity clauses and the unbound option (Ying 2000). Eventually only 70 of 132 members signed up to the final agreement, with

Table 2.2 Southeast Asian commitments (1 most closed, 5 most open)

Country	*Uruguay Round commitments*	*Existing policy, 1997*
Indonesia	3.15	3.20
Malaysia	2.40	2.40
Philippines	2.80	3.35
Singapore	2.25	2.70
Thailand	2.95	2.00
Hong Kong[a]	4.20	4.75
South Korea[a]	1.10	1.70
India[a]	2.70	2.25
Average	**2.69**	**2.88**

Source: Llanto and Abrenica 2002.

Note
a Provided for extra-regional comparison.

many having more open domestic financial services than their commitments to the agreement itself.

Clearly, the inclusion of financial services in multilateral trade negotiations will serve as a threat to protectionist barriers against foreign bank entry. The reiterated game nature of the General Agreement on Tariffs and Trade's negotiating rounds and bilateral trade negotiations mean that banking policy will repeatedly be discussed at this level. Many bilateral trade deals have fixed review periods. This creates opportunities for developed members like the United States to trade off deeper commitments on agricultural or textile imports for more substantial commitments on banking sector liberalization by targeted developing members. Such actions may fracture the domestic support for the statist-nationalist banking policy status quo by linking Third World exporters' and trade agencies' interests directly to developed members' interests in more open banking sectors. Finally, the commitments made in earlier multilateral rounds now have the weight of legal sanction behind them, making them permanent commitments backed up by an external enforcement capability.

Due to the looming prospect of having to open up their local sectors to greater foreign competition, the inclusion of financial services in the General Agreement on Trade in Services has had a strong, negative knock-on effect on financial authorities' willingness to coddle small, weakly-capitalized local banks. The first ground for opposition to these negotiations, foreign domination, has been transferred into grounds for local bank consolidation, now that these globalizing negotiations are a structural reality. Most see that the larger the local bank is, the more competitive it will be in the face of new foreign providers. This size factor creates strong, defensive incentives to sequence local bank consolidation prior to opening up further to foreign competition. Singapore's 1999 twin policy reform program of rapid state-directed local bank consolidation and more gradual sectoral liberalization favouring foreign incumbents is a good example of this linkage – a linkage large local banks often support.

As mentioned above, small local banks often are the most attractive acquisition targets for interested foreign banks wanting to test the waters of the new market. The multilateral nature of these negotiations provides all large banks around the world with new market access hopes, while the growing number of bilateral deals offers a more certain route to greater market access. This evolving external environment has encouraged states like Singapore and Malaysia that wish to see their local banks become more internationalized to push for local consolidation, to create larger local banks more able to defend local turf and seek new growth and diversification opportunities overseas.

State banks

The size of most state banks, as well as their frequently more opaque accounts, rarely makes them the target of this consolidation knock-on effect. Their imposing size and preferential access to consolidating authorities also often make them good candidates to lead consolidation efforts. In Singapore, for example, the state-controlled Development Bank of Singapore, like Malaysia's Malayan Bank, has been at the head of the consolidation and internationalization initiatives. The preferential access to state deposits and lending opportunities for state-sponsored or supported projects, however, may bring state banks into the centre of these negotiations along national treatment lines, especially given their privileged position in many developing economies.

Technological globalization

The impact of information technology innovations in the banking sector is noticeably different in nature than either supra-national financial crises or trade negotiations. The latter two place direct pressure on Third World financial authorities to move away from the statist-nationalist banking status quo or face concrete political and economic costs. Technological advances erode the status quo by undermining the efficacy of the policy levers used to protect local banks. Technological applications are also spread by competitive pressure where early, effective adopters gain a marked competitive advantage over the stragglers. Like supra-national crises and multilateral negotiations though, the ever-expanding application of technology is a permanent feature of the banking policy's external environment that was much less prevalent and corrosive to the statist-nationalist banking policy status quo prior to the mid-1980s.

Four related applications of technological advances in banking have complicated the continued efficacy of statist-nationalist policies and favoured foreign banking providers over state banks and small, weakly-capitalized local banks.[8] The first is the setting up and networking of automated teller machines. These ubiquitous machines throw a spanner into statist-nationalist banking policies in at least three ways. First, their introduction and rapid spread, and consumers' wide use of them, have forced all central banks to define them either as extensions of existing branches or as separate branches. The first, intuitive definition causes

problems, as it weakens authorities' grounds to bar incumbent foreign banks from setting up these machines, undercutting the efficacy of existing limits on branch numbers. If off-branch machines are conveniently defined as separate branches and are covered by existing branch limitations, this opens up a new avenue for foreign banks to claim discrimination and an abuse of the national treatment principle being pushed in the multilateral and bilateral trade negotiations.

Second, automated teller machines, through cooperative and commercially rewarding networks among banks, allow depositors in one bank to withdraw funds through the machine of a networked bank, further eroding the efficacy of brick-and-mortar branch limitations. When the host central bank and local banks allow incumbent foreign banks to join the network, their customer base is significantly expanded. If permission is not granted by the central bank, as often happens, refusing states create new grounds for claims of discrimination and betrayal of the national treatment principle. The rapid replacement of human bank employees and brick-and-mortar branches with automated teller machines in developed countries, and the more gradual replacement in developing ones, is a strong, visible manifestation of the commercial power of this technological innovation and how it reshapes banking practices.

Third, many banks have paid to join their automated teller machines up with either or both of the competing global automated teller machine networks, Cirrus and Plus. While the transaction fees for Cirrus and Plus withdrawals are usually more prohibitive than local networks, local financial authorities do not regulate these networks. Moreover, local banks have a commercial interest in joining up so their clients can access their accounts in countries where these local banks are not present, often due to the host states' own statist-nationalist prohibitions against foreign banks. Yet once a local bank becomes a member, depositors from any of the network's member banks can use their machines to withdraw funds, giving even non-resident foreign banks a beachhead in the local bank's often highly protected banking sector.

Point-of-sales systems are now almost as widely applied as automated teller machines, and their deterritorializing corrosion of local bank protectionism may even be greater. Point of sales systems are an innovative extension of automated teller machines and allow bank depositors to pay for goods using their automatic teller cards at participating stores. The networks can be separate from teller machine ones, and it is possible for banks to be excluded from teller machine networks but included in point-of-sales ones. These systems allow all depositors of participating banks to access their funds in a multitude of locations, often even withdrawing cash from participating merchants' tills. They further degrade the competitive advantage of a vast network of brick-and-mortar branches and the effectiveness of protectionist branching policies. The participation in point-of-sales systems is much more difficult to define as a form of branch, exacerbating the problems local regulators face when trying to limit foreign banks' participation in these systems.

Third is internet or e-banking. Internet banking theoretically means that banks can function without any brick-and-mortar branches and evade all territorially

bound attempts to limit them, such as bans on foreign bank entry. Unlike the first two technological applications, internet banking is constrained by not being able to offer clients cash withdrawal or cheque deposit services (Tan 2002). Yet almost all other key banking services like payment transfers, loans, etc. can be offered via the internet, with much lower operational costs than through traditional brick-and-mortar branches. In some advanced, wired economies like Finland and the Netherlands, internet banking services are used by more than half of all banking customers (Corvoisier and Gropp 2002). In the much less wired Third World, to date the penetration of internet banking has been minimal.

The greater perceived risks of 'virtual banking', and the heavy costs of setting up and maintaining a comprehensive internet banking site able to attract new clientele, heavily favour global over local banks. Global banks, more technologically savvy than local banks in the Third World, have deeper business development budgets to swallow the large and hidden start-up costs of establishing credible internet banking portals, and can spread these costs across a much larger and wealthier client base. The greater unease depositors and borrowers feel with this new form of deterritorialized banking also favours banks with strong, crafted reputations for solidity, technological ability, and profitability – reputations global banks usually possess more readily and can project more effectively (Wahba and Mohieldin 1998). Small, weakly-capitalized local banks do not have the deep pockets necessary to set up equally impressive portals and reputations. State banks often face similar financial and reputational hurdles.

The fourth innovation is the highest on the technological ladder: the data and communication systems that link all elements of a bank's operations together and allow for more timely and effective branch monitoring. Rapid advances in organizational software continually permit headquarters to gain a better understanding of and control over distant operations, reducing the non-financial barriers to foreign investment. Through such software innovation, foreign banks' interest in penetrating high-profit but higher risk developing economies has increased. The more these software innovations are fine-tuned and interconnected, and the more banks learn how to use them most effectively, the shorter the cognitive distance between home, office and anywhere else in the globe will become.

Like the inclusion of financial services in trade talks, these technological advances challenge policies banning foreign entry and limiting incumbent foreign bank operations the most. In this case, the threat comes from the competitive advantages global banks control when it comes to technological application and the ability of technology to evade policy tools or diminish their operational significance. If mainstream predictions about the impact of these technological advances on banking are not too far off the mark, then small, weakly-capitalized banks will suffer a direct knock-on effect as the start-up costs of technological application may be too high for them. Preparing for this assumed future, larger local banks are becoming more interested in acquiring their smaller local peers to provide themselves with a larger clientele over which to spread these necessary high 'lumpy' start-up costs. State banks, characterized by vast brick-and-mortar branch networks and complicated internal finances, will gain less commercial

leverage from these deterritorializing technological applications. They often are seriously constrained from absorbing their necessary high start-up costs, while their more politically compromised hiring practices often leave their less flexible workforce less able to adapt to new technology.

Together, these three structural shifts in the external environment of Third World banking policy provide a wide-ranging and multi-faceted challenge to the continuation of the statist-nationalist banking policy status quo. Politically, economically and technologically, times have changed permanently. These changes have made it much more difficult to maintain the Third World statist-nationalist banking policy status quo and the insulation it provides local banks, state and private. Whereas until the late 1970s to early 1980s the three banking policies under study here were largely a domestic issue insulated from external pressure, they are now near the top of the globalization agenda.

These three shifts and their local ripples – often in tsunami proportions – all strengthen local and external supporters of banking sector liberalization. Globalization for Third World banking has a clear, recent starting time and identifiable causes and transmitters, and is permanent. It is hardly surprising that after many decades of very similar statist-nationalist banking policies across most Third World states (and many First World ones), cracks in this consensus have appeared and are widening, with Latin America and parts of Africa leading the charge.

Southeast Asia is the best region to study the impact of these globalizing changes, as over the decade under study all three came to bear heavily on Southeast Asia's major economies. From 1994 to 1997, the region was the greatest beneficiary of greater capital flows to emerging markets once these markets and economies had overcome the legacy of the debt crisis. Southeast Asia's manufacturing success and the economic boom it created also garnered intense international interest in the region and its high-profit and cosseted banks.

The Asian financial crisis took the world and region by surprise, whereas financial crises were seen as par for the course in Latin America. The crisis certainly announced that a new era in banking was upon the region, and all banking sectors and the national policies that shape them are fundamentally different than in 1994, when all five countries followed the statist-nationalist banking policy status quo. Globalization in banking hit Southeast Asia hard in a short span of time, and has changed the way banking is conducted.

Finally, the story of banking globalization and national policy response is quite similar across Latin America, with all major economies opening up more to foreign banks. Southeast Asia, as the next five chapters will show, is a more varied story. Latin America's response largely validates the argument that globalization leads to liberal policy harmonization across affected countries. Southeast Asia largely questions this harmonization argument. Latin American states' similar policy responses strengthens the assumption that Latin America is a coherent region, while Southeast Asian states lack of similar responses questions this assumption for Southeast Asia.

3 Indonesia

Indonesia at the end of 2004 was a very different country than it had been at the beginning of 1994. In 1994, President Soeharto was on the cusp of his third decade in rule, and the only question in Indonesian politics was who would take over from Soeharto when he died; the assumption being this would be the only way his long rule could end. At the end of 2004 President Yudhoyono was settling down as Indonesia's first directly elected president and the country's fourth leader in six tumultuous years. In ten short years, Indonesia's political system had shifted from the most centralized of our survey, where President Soeharto had the only veto on major policy decisions, to the most decentralized political system, where 1000s of district-level politicians are key policy actors.

Indonesia's banking policy and banking sector went through a similar if less radical transformation. In 1994, Indonesia had a banking sector dominated by large, compromised state banks, a growing number of very small local private banks often linked closely to larger conglomerates, and a limited number of constrained foreign banks. The largest of these private banks were closely linked to the Soeharto regime, as were the largest debtors in this banking system.

Not only was Indonesia a long-standing proponent of the statist-nationalist banking policy status quo, it was implemented in a patrimonial manner in order to strengthen and broaden the one-party New Order regime (MacIntyre 1994). By the end of 2004, Indonesia's banking sector hosted many fewer small local private banks (their numbers declining monthly), fewer state banks, and larger and freer foreign-controlled banks. At the end of 2004, foreign controlled banks had a greater market share than local private banks. Banking policy and the banking sector were less patrimonial in operation and market forces were less fettered.

Much of the reason for these interlinked political and banking policy changes lays with the Asian financial crisis; Indonesia's 'Great Depression'. The Asian financial crisis created the economically chaotic circumstances for Indonesia's democratization and all of its ramifications, from radical decentralization to the independence of East Timor. The Asian financial crisis hit Indonesia much harder and its legacy has lasted much longer than any other country in Southeast Asia. The crisis itself fundamentally changed Indonesia's banking sector and banking policies in ways that are still unfolding today, a decade after the crisis first hit Southeast Asia's largest country in late 1997.

Globalization through crisis and the consequent increased leverage for international financial institutions pushing banking sector liberalization was the key factor in the banking policy changes that are covered in the second half of this chapter. Due to the depth of the Asian financial crisis in Indonesia and the Indonesian banking system, Indonesia had no choice but to solicit the heavily conditional support from the IMF, World Bank and Asian Development Bank. However, the trauma of the crisis and the heavy hand of the IMF during the periods of greatest chaos seriously undermined the long-standing cooperative relationship between the IMF and Indonesia. This downturn in relations has greatly limited the IMF's ability to influence a democratic and more nationalistic Indonesia in the future. Indonesia's painful path to democracy seems to have undercut the position of liberalizing technocrats and strengthened the voices for protectionism and nationalism.

Indonesia's political and banking policy experiences followed a very similar path in the decade under study here. From 1994 to mid-1997, the political system showed few if any signs of major change, while Indonesia's banking policies were still wed to the statist-nationalist banking policy status quo. Indonesia's seven state banks still held sway over the local banking sector just as state banks had since the days of Soekarno. In 1994 President Soeharto hosted the second APEC leaders meeting in Bogor as East Asia's long-standing and seemingly most secure leader and the doyen of Southeast Asia.

From mid-1997 to the end of 2001, Indonesia's political system went through its most wrenching changes since 1965. Soeharto stepped down a much diminished figure in May 1998. At the end of 2001, Soekarno's daughter, Megawati Soekarnoputri, was President and President Soeharto's most flamboyant and controversial offspring, Hutomo 'Tommy' Mandala Putra, was in jail facing a charge of ordering the assassination of a Supreme Court judge. Indonesia's banking system went through an equally turbulent period with 69 banks being closed (only one bank had been closed from 1965–1997). At the end of 2001, the central bank governor had been convicted of fraud, while government officials and the IMF were in a running feud over banking policy.

From late-1997 to mid-1998, Indonesia's political system was under significant external pressure to change, with world leaders encouraging President Soeharto to step down and for Indonesia to democratize. Democratization also led to a large number of international non-governmental agencies establishing operations in Indonesia. Late 1997 to mid-1998 also witnessed the most intense external pressure on Indonesian banking policy, with the IMF taking the lead. Some international financial organizations and bilateral donors still have much greater programs in Indonesia today than they had before the crisis, including the Asian Development Bank and Australia. The crisis opened up the Indonesian state and economic policy-making process to greater external influence, while its slow recovery and still daunting set of economic and social problems suggest that Indonesia will have to continue to accept foreign assistance and policy guidance.

From 2002 to 2004, Indonesia's new democratic system found its bearings under an amended Constitution and began to consolidate. In October 2004, former

General Susilo Bambang Yudhoyono became Indonesia's first directly elected president, winning a strong majority of the popular vote and taking 28 of 32 provinces. This resounding result put paid to worries that Indonesia's economic travails would lead nostalgic voters to support pro-Soeharto candidates and to fears that democracy would aid and abet the splintering of Indonesia *(disintegrasi)*.[1]

Similarly, during this period, Indonesia's banking policy shifted from simply dealing with the massive day-to-day challenges of the crisis and its banking sector aftermath, to focusing on rebuilding Indonesia's banking sector and defining the longer-term goals for its banking policy. In 2002, the state sold to a foreign consortium the largest bank it had nationalized during the crisis. The year 2004 saw a new central bank act and a deposit insurance act passed, IBRA (Indonesia's asset management corporation) complete its mandate, and Indonesia extricating itself from the final IMF program.

These impressive similarities between the political system and banking policy reflect how deep and destructive the Asian financial crisis was in Indonesia. The World Bank noted that 'No country in recent history, let alone one the size of Indonesia, has ever suffered such a dramatic reversal of fortune.'[2] The crisis undoubtedly changed Indonesia the most. These similarities also ably illustrate how closely linked banking policy and political control were under the New Order regime in Indonesia, and how these links were the New Order's and the banking sector's downfall.

However, they obscure another, longer-term story of the problems of banking policy reform. The decade under study here for Indonesia fell in the middle of what is now a quarter-century process of banking policy reform that started in 1983 during the depths of the developing world debt crisis. The banking policy reforms launched in 1983 aggravated the domestic ramifications of the Asian financial crisis and certainly its transformation from simply a currency crisis into a banking sector crisis. The crisis itself helped accelerate aspects of this banking policy reform process while delaying others.

One cannot understand changes to Indonesian banking policies from 1994 to 2004, and Indonesia's attempts to deal with the new forces of banking policy globalization discussed in the previous chapter, unless one first reviews the motivations and commercial and regulatory consequences of these earlier reforms. This chapter will begin by describing the earlier reforms and their banking sector impacts. Then it will focus much of its attention on the crisis years of 1997–2001, before ending by looking at how Indonesian banking policy has been changed by the crisis and its aftermath.

1983–1994 – First wave of reform

From 1983 to 1993, after more than 25 years of banking policy stability, Indonesian banking authorities launched a calibrated series of banking policy reforms that fundamentally altered Indonesia's banking sector. This decade of reform touched on all three aspects of the statist-nationalist banking policy status

quo while the changes they wrought on the Indonesian banking sector were central to how the Asian financial crisis played out in Indonesia.

They reduced the dominance of state banks and opened up the local banking sector to more foreign competition helping to moderate some of the problems with the statist-nationalist status quo. However, they also greatly increased the number of small local banks and the corresponding problems of regulatory forbearance, especially as many of these new banks were part of larger conglomerates and had politically connected controlling shareholders. On balance, these reforms did not replace the status quo with a liberal set of banking policies in line with rising global pressures. Rather, they only made the still cloistered banking sector more vulnerable to external shocks.

Banking sector liberalization in the 1980s

From 1983 to 1988, reforms focussed on reducing the dominance of Indonesia's seven main state banks that together routinely controlled 70–80 per cent of banking credit (Dobson and Jacquet 1998). In 1983, local bank licensing requirements were radically liberalized, leading to an explosion in the number of new local private banks. In 1988, *PAKTO* (the October Package) was enacted that opened up the Indonesian banking sector to – limited – foreign competition for the first time in two decades. This package 'grandfathered' the ten wholly-owned foreign bank branches established in Indonesia in 1968, and opened up the local banking sector to new foreign joint venture banks.

These joint venture banks could be up to 85 per cent foreign owned and had more liberal branching restrictions than the ten grandfathered foreign bank branches that were wholly owned. However, these new joint venture banks – 29 established by 1994 – were not provided with a level playing field with local banks. Their minimum paid up capital in 1988 was twice that of local private banks, while at least half of their loan volume had to go to the export sector, a creative fusion of banking and industrial policy. If joint venture banks were more than 50 per cent foreign owned, they could not borrow from Indonesia's dominant state banks, limiting their ability to raise funds locally.

These operational constraints combined with foreign banks' interests in mainly serving multinationals operating in Indonesia, and cherry-picking business from the major local conglomerates limited the competitive impact and growth of joint venture banks. By the end of 1996, the 31 joint venture banks operating in Indonesia accounted for less than 5 per cent of total banking assets. The ten grandfathered foreign bank branches accounted for less than 3.5 per cent of total assets.

Along with these two headline reforms, there were a series of others that further liberalized the Indonesian banking sector. From 1978, state, private and foreign banks were allowed to set their own interest rates on time deposits with maturities not exceeding three months. In 1983, financial derepression went further when credit ceilings for all banks were lifted (Habibullah and Smith 1997). During the 1980s, state-owned enterprises were allowed for the first time to place half of their deposits in private banks while, in 1989, local banks gained access to international capital markets.

These reforms were a huge boost to local private banks and a modest boost to new foreign banks. Local private banks could now be very easily established, could tap international financial markets, and their much lower interest rates and greater liquidity (and currency risk). At the same time, state banks were under the cosh as they lost their monopoly over state-owned enterprise deposits, bore the costs of government directed lending alone, and still faced limits on the interest they could charge on certain loans. However, as state banks are constitutionally protected from closure and their losses absorbed into the state budget, the pain they would feel would be borne by the state (Chou 1999).

The 1980s' reforms helped spur very rapid growth in the financial sector and an explosion in the number of local private banks. From 1983 to 1993, growth in the financial sector averaged 12.1 per cent per annum, easily outstripping overall GDP growth (Dobson and Jacquet 1998). From 1988 to 1995, the number of locally operating banks more than doubled from 111 to 240 (Enoch *et al*. 2003). However, the large majority of these new banks remained quite small, with many of the new local private banks serving as sources of cheap credit for connected firms, aggravating the supervisory demands on the central bank.

This massive increase in the number of banks operating locally and in need of prudential supervision was a case of history repeating itself. In 1966, early on in the New Order era, Indonesian banking authorities liberalized local bank licensing requirements to engender more competition. By 1968, 122 new local banks had been formed leading nervous regulators to tighten up licensing regulations again (Sato 2005). In 1983, we saw a similar licensing liberalization, yet there was no reversal two years later, or even a decade later. As we will see later, it would have been good if history had taught the right lessons of a quick reversal or, better yet, a more conservative approach to issuing new banking licences. The modern history of banking in Indonesia reaffirms much of classical banking theory, and particularly its concerns about the optimal number and size of banks.

If 1983 to 1988 was about increasing competition and freedom in Indonesia's state bank-dominated banking sector, 1991–1994 was about moderating this freedom and strengthening the banking sector as a whole. The period 1983 to 1988 was an era of policy success that clearly showed how eager local and foreign banks were to respond to these new openings. The period 1991 to 1994 was an era of policy failure, showing how difficult, but necessary, it is to enforce effective prudential regulation. The first era of liberalization strengthened the connections between Indonesia's banking sector and political system as it allowed many business leaders close to and in the Soeharto family to expand their commercial interests. The second era of tighter regulation attempted to impinge upon these interests.

In 1991, Bank Indonesia adopted the 8 per cent capital adequacy ratio that had been established as the international best practice by the 1988 Bank for International Settlements' Basel Agreement. This local adoption of a global prudential standard (that state banks in particular found hard to follow) was followed in 1992 by the passing of a new banking law focussed on improving Indonesia's prudential regulation and increasing the central bank's powers to supervise the

growing number of banks. The new law placed quite strict limits on 'connected lending' by private banks, unlike the banking law it replaced which had no specified limits (McLeod 1992). The new law introduced a ceiling on the value of loans to individual borrowers or groups of related borrowers of 30 per cent of the value of the bank's capital. The law was even stricter on connected lending putting a 10 per cent ceiling on loans to related parties.

The minimum paid-up capital for new local banks was quintupled (Pangestu and Habir 2002) in an unsuccessful attempt to encourage consolidation. At the same time, the minimum paid up capital for joint venture banks was only doubled, while foreign investors could now own up to 49 per cent of local banks. This created the back door possibility that a local bank's controlling shareholder could be a foreign entity, if a major local shareholder was willing to sell out or if the bank's shares were widely dispersed. Neither of these market conditions though was common.

In 1992, the recently listed Bank Summa and Bank Duta both became insolvent, requiring central bank intervention. It quickly became apparent that both had grossly overstepped connected lending restrictions, with Bank Duta rumoured to have lent more than half its total loan portfolio to related parties (Delhaise 1998). The 1992 law had limited loans to related parties to 10 per cent of the total portfolio. Bank Summa was eventually closed, allowing the large Astra consortium to fall into the hands of the Soeharto family (Sato 2005). Bank Duta, which was controlled by charitable foundations linked to the President, escaped closure. Today, these same foundations are at the centre of the Indonesian state's attempts to reclaim ill-gotten assets from the Soeharto family.

The 1992 problems of Bank Summa and Bank Duta clearly showed the need for the 1992 tightening of prudential regulations and the problems created by the explosion in new banks operating in Indonesia. They also clearly show that Indonesian banking authorities got their sequencing wrong. They liberalized before they regulated and the bad scenarios banking theory predicted were proven correct, as many banks imprudently strove for market share through offering higher deposit rates, while many banks decided it was best to lend to their own shareholders.

State banks fared even worse in the more competitive banking sector of the 1990s. In 1993, state banks only accounted for 53 per cent of the total banking credit, down from 71 per cent in 1988 (Dobson and Jacquet 1998). At the same time that state banks could list on Jakarta's nascent stock market and retain their profits, these profits dried up and state banks fell into crisis. Their inherent problems of politicized loan portfolios, operating inefficencies and the lack of a profit motive came home to roost.

In 1992, Indonesian authorities had to solicit a $300 million dollar loan from the World Bank to help bail out suffering state banks that faced high non-performing loan ratios (estimated conservatively at 20 per cent) and very poor capital adequacy ratios. In total, the bailout of state banks and emergency assistance to a few small private banks was estimated to have cost 2 per cent of Indonesia's GDP (Caprio and Klingbiel 1996). The 1992 invitation to the World Bank and its loan conditionality facilitated the passage and implementation of the 1992 law

Table 3.1 Financial sector growth, 1994–1997

	GDP Growth %	*Bank Loan Growth to Private Sector %*	*Stock Market Price Index*
1994	7.5	22.97	469.64
1995	8.2	22.57	513.84
1996	7.8	21.45	637.43
1997	4.7	46.42	401.71

Sources: BPS Statistics Indonesia; Llewellyn 1999; Asian Development Bank, Key Indicators 2007: Inequality in Asia – Country Statistics.

(Laurence 1999) and, in retrospect, acted as a small sign of what was to come five years later at a much higher cost to the state and country.

1994–1997 – Signs of vulnerability

The decade of 1983 to 1993 was one of the most dynamic and turbulent in Indonesian banking policy history up to that date. From 1994–1997, things were much calmer. Indonesian policy makers focussed on trying to get on top these changes and the problems they created. The problems that had led to a minor banking crisis in 1992 were still in place in this period, and in many ways grew more worrying. While the Asian financial crisis hit Indonesia after Thailand, signs of vulnerability, and Bank Indonesia efforts to deal with them, were visible well before the crisis hit.

The Indonesian economy and financial sector witnessed very rapid growth from 1994 to 1997, creating the illusion that the reforms of the 1980s had strengthened the economy. From 1992 to 1997, bank credit grew three times faster than GDP, even though GDP growth was quite impressive itself (Nasution 1999). The Jakarta stock market, buoyed by the growth in the banking sector, did even better. According to Statistics Indonesia, between 1994 and 1997 market capitalization grew close to fivefold. It was during this period that talk of Indonesia as a global economic power in waiting reached its peak (Hill 1996).[3]

Yet these impressive growth indicators contained signs of worry. The banking sector's loan/deposit ratio grew well beyond prudential limits. The 1992 banking act had capped this ratio at 110 per cent, yet by 1992 it was already 129 per cent and by 1995 it had reached 138 per cent (Nasution 1999). Credit card growth also boomed with growth of 30 per cent on 1996 and 28 per cent in 1997 (Claessens *et al*. 2000).

Individual banks, in their urge to compete, were lending beyond their prudential means, in order to grow, and Bank Indonesia could do little about it as it lacked clear information on what individual banks were doing. Bank Indonesia's supervisory capacity had not kept pace with the growing demands on its services, and by 1997 most bank branches were only evaluated once every 18 months (Soedradjad 2004). At the same time that banks were increasingly tapping international credit markets, getting in to new areas like credit cards, and in a grow-at-all-costs mentality, regulation was hamstrung by a lack of technical capacity and political independence.

In this period, the economic dominance of the Soeharto family and their close associates became more exposed, as did their growing role in the banking sector. In 1996, Soeharto family members controlled 16.6 per cent of the stock market by capitalization, while Indonesia's ten richest families controlled 57.5 per cent (Claessens *et al*. 2000). Only the Philippines exhibited a higher level of oligarchic concentration. By 1996, the largest bank in Indonesia for the first time in modern Indonesian history was a private bank, Bank Central Asia (BCA). BCA was controlled by Liem Sioe Liong's Salim Group, Indonesia's largest conglomerate and one with close ties to the President.

The problems of this growing presence became clearer in 1996 when the Bank Duta story was played over again with the failure of Bank Pacific. Bank Pacific, like Bank Duta, was closely linked to the Soeharto family, while the central bank even owned part of it. Like Bank Duta, Bank Indonesia was technically and politically unable to move in on the bank until too late. This failure led Bank Indonesia in December that year to ask the President to allow it to close down six insolvent banks. The central bank was rebuffed. In the same month, new regulations were passed allowing Bank Indonesia to advise the Ministry of Finance to revoke the licence of banks facing failure (Chou 1999). No clear procedures for revocation existed before. Even with these new laws, when the central bank asked for the same six banks to be closed again four months later, the President agreed, but asked the central bank to wait until after the October parliamentary elections. By then, of course, it was too late.

Globalization deadlock

While the main focus in this period continued to be dealing with problems relating to the 1980s reforms, Indonesia did not ignore growing globalizing pressures. Rather, authorities ensured that they maintained control over the pace and scope of banking policy liberalization. Like the other states in this survey, Indonesia took an active role in the Uruguay Round GATS negotiations in favour of protecting its policy autonomy and resisting pressures to open up the banking sector (Sorsa 1997).

As Table 2.2 in the previous chapter shows, Indonesia did not use the GATS negotiations as a multilateral means to open up its banking sector further. Rather, its commitments in 1997 were less liberal than the policies enshrined in the 1992 law, despite strong foreign pressure for greater commitments. This lack of interest in using GATS as an externally-driven way to bring more competition to the local banking sector also did not come from reform fatigue. In 1996, while holding off renewed pressures on the GATS front, banking authorities announced plans to privatize two state banks, with Bank Negara Indonesia (BNI) listing on the stock market.

In the 1980s, Indonesia unilaterally courted greater foreign competition through *PAKTO* before external pressures were particularly significant. In the 1990s, the same authorities resisted further opening through the multilateral GATS process. Globalization works best locally in non-crisis times, when it is invited in by the mediating state rather than forced upon it through external pressure.

1997–2001 – Consumed by crisis

Trying to describe and analyse the impact of the Asian financial crisis on Indonesia even in a book-length project is a daunting ask. Addressing it as part of only one chapter is even more humbling. Hence, this part of the chapter will focus only on the impacts of the crisis on the Indonesian banking sector, and the consequent changes to the three areas of banking policy under study.

This supra-national crisis hit Indonesia much harder, wrought deeper political, economic and banking policy change, lasted much longer and left a much greater political and economic legacy than any other country. What happened to the image of the Southeast Asian region as a whole as discussed in the Introduction, happened to a much greater extent to Indonesia. It went from being talked about as the emerging giant of the global economy in league with China to, even today, being seen by many as a 'flyover country' even lagging behind the Philippines.

What makes dealing with the crisis in Indonesia so challenging is that simultaneously, in a very compressed manner, the crisis led to fundamental changes in the political order, the role of international financial institutions in Indonesia, relations between the political rulers and state regulatory bodies, and the banking policies under study in this book. Even more, all of these changes were interlinked and took place in an atmosphere of economic meltdown and great social suffering. Globalization by crisis overwhelmed Indonesia's financial authorities and toppled its government. Indonesia's crisis experience is also the best example of how banking policies and their implementation are linked to the nature of the political regime, and how trauma in the banking sector can lead to regime change.

The political impact of the crisis, mediated through the economic collapse, was immeasurably enhanced by the fact that in the mind of much of the Indonesian public, the crisis was caused not by external forces and foreign imperialists, but by the patrimonial control of the Soeharto family and regime over the local economy. Most Indonesians blamed Soeharto, not foreigners and the 'curse of globalization', for Indonesia's trauma (Milner 2003). In the other crisis-affected countries, there was much more acceptance of 'structuralist' explanations for the crisis that laid most of the blame on external forces and actors. Memories of the 1992–1994 crisis and the increasingly prominent commercial presence of Soeharto's immodest children certainly helped in Indonesia's domestically-focussed judgment.

The economic and banking sector impact of the crisis was enhanced by the crisis' surprise nature and some key early response errors. This was then aggravated by worsening tensions between Indonesia's political rulers and the financial authorities – particularly Bank Indonesia, and between the Indonesian state as a whole and the IMF. The turmoil of the fall of the New Order regime and the re-establishment of democratic rule – three very different presidents in five years united by the fact that none of them were good crisis managers or administrators – then delayed and complicated Indonesia's policy response to the crisis and its deep impact on the banking sector.

Surprise vulnerability

As with the other crisis-hit countries, Indonesian authorities knew before the crisis hit that the local banking sector was overheating and increasingly vulnerable to external shocks. Indonesia, more than any other country, had had adequate warnings. The December 1996 request to close six banks was the first clear sign that authorities were worried. In March 1997, prudential regulations on loan growth and connected lending began to be enforced more strictly. In April 1997, the central bank increased the statutory reserve requirement from 3 per cent to 5 per cent to reign in bank lending, while new loans for housing (excluding low cost housing) were banned (Chou 1999). These moves showed that regulators were significantly worried about local banks overreaching themselves. However, they had no idea how big the impending currency shock would be, and how quickly and devastatingly it would be transformed into a banking crisis.

Indonesian authorities and the public as a whole were not alone in their surprise over the timing, speed and depth of the crisis. It took the whole world by surprise. Echoing the standard military truism of armies being well prepared to win the last war and unprepared to fight the next (kind of) war, regional states, with the support of international financial institutions, were well-protected against a recurrence of the 1980s debt crisis understood to have been caused, on the domestic front, by fiscal profligacy. International financial institutions, credit rating agencies, and regional financial authorities were caught off guard by the Asian financial crisis which had little to do with government balance sheets.

Indonesia in the mid-1990s had a strong and improving fiscal situation featuring a balanced budget. It also boasted the smallest current account deficit among the five crisis-hit countries (Enoch *et al*. 2003). It was deemed safe when compared to the series of crisis vulnerability measures formulated after the debt crisis. The Philippines and Thailand, not Indonesia, were the countries seen to be the most worrisome (Demigurc-Kunt and Detragiache, 1999). This is exactly why Indonesia was being talked about as an emerging economic giant, well-guided by a strong technocratic team in control of macro-economic and fiscal policy and supported by President Soeharto.

Indonesia in mid-1997 was the most vulnerable to the crisis, and Indonesian authorities had the greatest difficulty responding to the shock. Unlike the debt crisis and its domestic origins in public profligacy, the Asian financial crisis was a private sector led crisis, where the exposure of the economy as a whole to foreign debt and the consequent currency risk was the problem, not public foreign debt and budget deficits. The debt crisis was one where the private sector largely became crippled (in Latin America and the Philippines particularly) due to bad fiscal management. The Asian financial crisis worked the other way.

Looking at the economy as a whole, things did not look so rosy in 1997. While Indonesia had the lowest current account deficit, largely due to Bank Indonesia's comparative lack of reserves, it had the highest foreign debt to foreign reserves ratio. Much of Indonesia's public debt was also held in foreign currency, due to Indonesia's history of higher interest rates and relative comfort with foreign

exposure. Indonesia has had an open capital account since the 1960s. Indonesia's relative lack of foreign reserves also reflected the fact that Indonesia's real economy was less integrated than its regional peers. Indonesia's share of exports to GDP was significantly lower than the other countries in this survey. Hence, Indonesia had the worst export earnings to foreign debt servicing ratio, a common proxy measure for how well an economy can manage its foreign debt.

Looking at the banking sector, Indonesia was also one of the most vulnerable countries to the transmission of a currency crisis into a banking crisis. Indonesia's banking sector accounted for a massive 90 per cent of total financial assets in the 1990s (Dobson and Jacquet 1998). Unlike the Philippines, Indonesia did not have a deposit insurance system, despite the predominance of the banking sector and Indonesians history of shifting funds to Singapore during times of worry.[4] Despite *PAKTO*, foreign banks and their more prudent approach to lending still had a market share under 10 per cent. At the same time, Indonesia's local banks had the lowest capital adequacy ratio in the region (Sorsa 1997).

Finally, bank lending in Indonesia was extremely concentrated, especially among local private and state banks. Indonesia's 21 top debtors accounted for one-third of all non-performing loans, and all of these debtors were associated with President Soeharto (Asami 2000). Indonesia's banking sector was dominant, had overlent, had overlent to too few, and lacked a deposit insurance scheme to assuage depositors.

These problems with the banking sector became evident in the later months of 1997, when Indonesia's currency crisis transformed into a banking crisis, a corporate crisis and then a social crisis. The political crisis would come a few short months later. In July, Bank Indonesia began to intervene heavily to defend the rupiah's value. This included shifting assets from state banks to Bank Indonesia to help sterilization at the cost of weakening these state banks' already compromised bottom lines.

By August, the defence of the rupiah was abandoned and the authorities adopted an orthodox approach to exchange rate pressure. They floated the rupiah then raised interest rates sharply to moderate its slide. In the first week of September, Bank Indonesia announced, with few details, that it had begun to extend liquidity support to local banks hurt by the falling currency and rising interest rates.[5] On 8 September, reflecting the view that this crisis was a replay of the debt crisis, the government announced it would postpone 39 major public sector projects to ease the future fiscal situation (Asami 2000).

The unilateral steps to address pressure on the currency would not prove enough and, on 8 October, the Indonesian government announced it was following Thailand and seeking help from the IMF. On 23 October, the first – of four – IMF-led packages worth $23 billion was announced. This triggered an intense seven-year period of relations between the Indonesian state and the IMF that would leave both damaged and much more wary of each other. The reputation of the IMF in Indonesia was greatly damaged by the belief among many officials and politicians that the IMF conditions were ill-advised and went well beyond dealing with the currency and banking crisis to force change in unaffected areas.

In an example of reverse globalization, the IMF's role in Indonesia not only hurt its reputation (and leverage) in Indonesia, but in the region as a whole.

The conflict between the state and the IMF was at its greatest during the latter days of the Soeharto era, but has continued through all the democratically-elected administrations that have followed. It became clear early on that the Indonesian state were unwilling to fulfill all the elements of the first IMF package – a situation that was subsequently repeated. This first package called for a program to consolidate and privatize state banks. More than a decade later, no state bank has been privatized. Like future packages, economic conditions also worsened quicker than expected, undermining the assumptions behind the package.

This new relationship between the IMF and Indonesian state also got off to a bad start. The first steps taken under the bailout package and their incomplete, politicized implementation helped spark the banking crisis. This was unfortunately ironic as, at the time of the package's negotiations, banking sector problems were assumed to be quite minor with non-performing loans estimated at only 8 per cent, a falsely reassuring assumption (McLeod 2004). Problems were seen to be limited to a small number of local private banks and state banks. Hence, with no public notice beforehand, on 1 November, the Ministry of Finance closed 16 small insolvent private local banks accounting for less than 3 per cent of total banking assets. At the same time, the government announced that it would guarantee the deposits of all small depositors up to a value of 20 million rupiah. This one-off insurance pledge covered the majority of depositors but only a minority of total deposits.

The surprise nature of the closures and the limited, hastily announced deposit guarantee led to many affected and uncovered depositors to quickly shift their deposits to state banks, as people assumed that these banks had an implicit guarantee on all deposits (Chou 1999). This flight to state banks was not only limited to the 16 affected banks but to many other small local private banks, as people were worried about more closures. Rather than calming the banking sector, the nature of these closures heightened the sense of panic.

In December, this sense of panic deepened while tensions with the IMF grew. In the first week of December, rumours were rife that President Soeharto was gravely ill. On 12 December, the Jakarta Stock Exchange fell by 7.6 per cent on the back of these rumours. The fevered reaction to these rumours highlighted the political dominance of Soeharto, and how closely his regime was associated with the health of Indonesia's economy. In the same month, these connections were reaffirmed in a more corrosive manner. One of the President's sons was able to reopen his closed bank, Bank Andromeda,[6] by buying the licence of another bank (Bank Alfa) and shifting all of the accounts of Bank Andromeda to this new one. The son of the leader, after threatening to sue the Ministry of Finance, was able to undermine the closure program, leading to mounting questions about President Soeharto's commitment to the IMF package and to delinking his regime from the banking sector.

The latter months of 1997 brought home how bad things were in Indonesia. In 1997 alone, Indonesia's foreign debt grew by 48 per cent, largely due to rupiah

depreciation, while at the end of the year only 22 of 282 listed on the stock market were estimated to have sufficient cash flow to service their debts (Nasution 1999). Things in the banking sector were even graver, as the non-performing loan ratio had increased to over 32 per cent by the end of 1997, while local banks' overdrafts with Bank Indonesia had reached 15.3 trillion rupiah, up from only 1.4 trillion at the end of July 1997. By May 1998, this overdraft had ballooned to 79.7 trillion, while the non-performing loan ratio peaked at close to 50 per cent by December 1998.

Crisis mounts

By 1998, all involved realized that Indonesia faced a very serious economic crisis with mounting social costs. Yet, this did not spur closer cooperation between the state and the IMF or between Indonesia's political rulers and financial authorities. Rather it spurred relationship breakdowns on both fronts at the time that Indonesia needed the IMF and international support the most. The unintended consequences of the first package and the speed of Indonesia's decline forced both sides to agree to a more comprehensive package on 15 January. This package called for a more aggressive approach to dealing with the stresses on the banking sector, and for a more comprehensive withdrawal of the state from the economy. This package also signalled a shift to a more comprehensive approach to dealing with the crisis, and one focussed on the collapsing banking sector.

Institutional response

This new package was quickly followed by the establishment in February 1998 of the Indonesian Bank Restructuring Agency (IBRA), an asset management corporation charged with acquiring banks' worst non-performing loans and helping them rebuild their capital adequacy ratios and balance sheets. IBRA would quickly become one of the most important and controversial agencies of the state, as the problems in Indonesia's banking sector rapidly grew worse.

IBRA was set up to ease the pressure on local banks and on Bank Indonesia, which faced a financial nightmare over the growing costs of liquidity support, by socializing their non-performing loans. At one point, more than 160 banks in Indonesia were receiving emergency support from the central bank. Bank Indonesia provided the start-up capital for IBRA through government guaranteed short-term bonds paying 14 per cent interest which began to mature in 2004. IBRA though was set up under the Ministry of Finance to insulate Bank Indonesia from any further damage to its bottom line. IBRA also helped shield Bank Indonesia from further accusations of favouring particular banks. Bank Indonesia's liquidity support program was widely criticized as not differentiating between insolvent banks – not worthy of recapitalization – and illiquid ones, letting the banks' shareholders off lightly and of favouring banks like BCA that were politically well-connected.

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IBRA's beginnings were not smooth. IBRA's first head barely had time to set up office before he was fired by President Soeharto in February. Five more would face the same fate during IBRA's short existence, with one also arrested on fraud charges. President Soeharto, haunted by the lessons of November 1997, announced that IBRA's interventions into weak local banks would remain unpublished in order not to spark panic. However, in light of the Bank Alfa scandal, this simply deepened suspicion that IBRA would be used to support favoured banks, especially as early on IBRA was supposed to administer failed banks, not take control of them from their shareholders, many of whom had already looted them (Delhaise 1998).

Despite these inauspicious beginnings, IBRA soon became the central agency in rebuilding Indonesia's shattered banking sector. Within 18 months, it had gained control of 54 banks, including BCA, and had acquired 500 trillion rupiah in bank assets. Later in 1998, IBRA also gained control of 108 Salim Group companies, as well as part of the package the Salim Group negotiated to pay off the 53 trillion rupiah in emergency support provided to BCA by Bank Indonesia (McCarthy and Sentana 2000). As Gary Hufbauer claimed, except for the small foreign-controlled banks, IBRA essentially owned the banking sector (Hufbauer 1999). Figures back this claim up, as state control of the banking sector peaked at close to 80 per cent by the end of IBRA's acquisitions, the highest level of any of the crisis-affected countries (Claessens *et al*. 2000).

IBRA was the largest asset management corporation set up in Southeast Asia during the Asian financial crisis. It was the single most important institutional response to the crisis and established the means to save the banking system from collapse, coordinate the consolidation of the local private banks through closures, and later the introduction of greater foreign competition through the sale of nationalized local private banks to new foreign entrants. The first of these sales, though, would have to wait until 2002, despite repeated promises, significant external pressure and a decided lack of local buyers.

If the first IMF package went badly, the second one went even worse, leading the IMF to suspend further loan disbursements only four months later to the day. Adding to the pain, much of Indonesia's non-IMF aid monies were cross-conditioned with the IMF program, meaning that the suspension of the IMF program caused significant collateral damage. The problems with the second package were clear on the day of its announcement, 15 January. On the same day, President Soeharto announced that there would be no further bank closures. Soon after that he fired four Bank Indonesia directors, the bank's Governor and the first head of IBRA.

In March, concerns over the President's commitment to the IMF program and dealing with the crisis came to a head. On 10 March, President Soeharto was selected again for his seventh five-year presidential term. He then appointed his most infamous daughter, Tutut, and his very close business confidant, Bob Hasan, to his new cabinet. Five days later, the IMF suspended payments. Ten

weeks later, President Soeharto reluctantly 'abdicated' to be replaced by his vice-president, Bacharuddin Jusuf Habibie.

During this first half of 1998, when relations between Soeharto and the IMF collapsed and Soeharto's hold on power quickly disappeared, not all was lost on the banking crisis front. As discussed above, IBRA was formed and began to clean up the banking sector. In line with the second IMF package, the definition of non-performing loans was tightened to deal with the criticisms of the liquidity support system, and to gain a better idea of the depth of the destruction. On 3 April, a third agreement with the IMF was signed that led to the freezing of the assets of seven of the worst performing local private banks (four of which were linked to Soeharto). All had borrowed funds worth over 500 per cent of their total equity from the central bank (Laurence 1999). On 22 April, the paid up minimum for local private banks was raised to 250 billion rupiah in a further sign that Bank Indonesia, with the support of the IMF, was focussed on the consolidation of local private banks. This condition, though, was relaxed less than two months later as it became clear few banks could abide by it (Chou 1999).

The fall of Soeharto helped re-establish to some extent the relationship between the Indonesian government and the IMF that was the lynchpin to the international support for Indonesia's recovery. However, the negative legacy of the IMF's dealings with Indonesia remains strong even today, and has coloured relations with every post-Soeharto administration.

The IMF suspended loans again in 1999 during the short-lived Habibie administration over the Bank Bali scandal. Proving that political control over the banking sector was far from over, Bank Bali, a local private bank, was accused of siphoning off millions of dollars to support candidates close to President Habibie in the upcoming parliamentary elections. This crisis only came to light through the due diligence study by Standard Chartered Bank, and involved the improper use of Bank Indonesia and IBRA funds. In November 2001, the central bank governor was convicted of fraud over the Bank Bali case while involved in an unseemly public battle of wills with President Wahid.

In this same year, the IMF's relationship with the Wahid administration hit the rocks. The Indonesian administration was angry over the IMF's opposition to parts of the proposed central bank act. At the same time, the IMF strongly disapproved of the way Rizal Ramli, the Coordinating Minister for the Economy, was pushing Indonesia to sell bonds securitized by Indonesia's energy sales to Singapore. Such bonds would undercut the negative pledge clause of the IMF's loan (the clause that requires these loans have first claim to a government's foreign exchange earnings). Ramli was threatening the IMF's own bottom line and its AAA credit rating.

Ramli was quickly replaced by Burhanuddin Abdullah as Coordinating Minister for the Economy, and the offending articles in the Central Bank Act of 1999 that required the existing board (including Governor Sabirin) to step down were removed. Burhanuddin Abdullah used to work for the IMF and was a much less confrontational character than Rizal Ramli

Democracy's delays

At the same time that Indonesia's relations with the IMF were fraying, the country's bottom-up democratization created new delays for dealing with the crisis. The frequent turnover of administrations meant that many of the top officials in charge of addressing the crisis kept changing. Also democratization increased the number of political actors with a veto over policy choices (MacIntyre 2003).

The democratization process gained much of its energy from freeing up and institutionalizing the previously latent opposition against the New Order's marriage of the Golkar party, the state and the Soeharto family. This deepened the anger stirred up by the Bank Bali scandal, and led to the early resignation of President Habibie in October 1999 after he lost the support of the parliament. This sense of moving beyond the New Order era also had some more problematic elements. One was that the focus on Soeharto-era corruption, especially around the early crisis response, has made many government officials more hesitant to make important decisions in case they later come back to haunt them. Certainly, the arrest of Governor Sabirin and the fraud charges against the IBRA head cast a dark shadow over the whole government, especially as many suspected political interference in the Sabirin case.

This problem particularly affected the sale of local private banks to foreign banks – a key means to help distressed banks recover. Standard Chartered Bank's plan to buy Bank Bali, even before the scandal scotched it, was put into peril by the bank employees demonstrations against the sale and the support for these demonstrations by some politicians. In 2000, the sales of BCA and Bank Niaga were also put on hold after legislative resistance. Democratization often provides protectionists more avenues for political pressure, thus acting as a curb to globalization.

The depth of the crisis and these new delays unfortunately constrained the government's ability to address the crisis, which further aggravated the crisis itself. While the other crisis-affected countries were into full recovery mode by 2000–2001 and focussed on longer-term policies to prevent the next crisis, Indonesia was still stuck trying to keep its economic head above the water and the banking sector from collapsing. In 2000 the rupiah fell by 25 per cent and fell again by 15 per cent in the first quarter of 2001. Local banks still faced negative spreads on their loans in 2000 and a lack of willing and able customers, making it impossible for them to grow out of the crisis like banks had in Malaysia and the Philippines.

However, despite all of these problems, by the end of 2001 things were starting to look better. IBRA's work and other key policy changes started to deliver results, and began to help reshape the Indonesian banking sector. In late 1998, the first move to deal with Indonesia's large but crippled state banks was taken. On 3 October, the three weakest of Indonesia's seven major state banks were merged into Bank Mandiri, which automatically became Indonesia's largest bank. The idea was that by merging state banks, this would ease supervision and make it easier to privatize them when that decision was taken. Since the beginning of the crisis, Indonesia has been under external pressure to either close or privatize its state banks (with foreign banks as the preferred potential purchasers). So far neither has happened, showing the

continued political allure of large state banks, something that Indonesia shares with all the other states in this survey. While state banks are the weakest and most compromised, they are also the most difficult to close or sell.

Foreign banks suffered the least during the crisis but, unlike local private banks and state banks, could not clean up their balance sheets by selling off their worst non-performing loans to IBRA. Hence, even as late as 2002, the then foreign bank branches grandfathered in 1992 still had a non-performing loan ratio of 20.2 per cent, well above the banking sector average (Sato 2005). In May 1999, the first small step was taken to give foreign banks a larger role in the Indonesian banking sector. Joint venture banks were permitted to lift their foreign ownership ceiling from 85 per cent to 99 per cent, while if the foreign partner bank came from one of the top 200 in the world, branching limits were lifted on their joint venture operations in Indonesia. Like the first moves in state banks, this was far less than outsiders, including the IMF, wanted. Yet, it did provide these smaller niche banks the opportunity to grow and move into new areas, especially as few if any local bank owners had the funds to expand.

In the post-Soeharto era, local bank consolidation, largely through closure, also picked up speed as IBRA gained more authority and confidence. By the end of 2000, IBRA had nationalized 13 banks, while Bank Indonesia had issued 15 local private banks with merger notices (Takayasu 2001). Eight banks were also merged with Bank Danamon, to ease their future resale, and then nationalized. By the end of 2000, Indonesia had 99 fewer banks than in 1997, while 69 of these accounting for 20 per cent of the total banking sector had been closed. Local private banks' market share had shrunk from 52 per cent in 1996 to only 35 per cent in 2000, including those under IBRA's control (Sato 2005). The gains private banks had made since 1983 had been wiped out. We will see a similar story with Thailand's finance companies in the next chapter.

Simultaneously, Bank Indonesia was reborn through the 1999 Central Bank Act passed during President Habibie's term. The 1999 Central Bank Act, to be quickly modified by the 2004 Central Bank Act, aimed to secure the central bank's institutional future. It was made independent from the Ministry of Finance with a board of six to nine members on five-year renewable fixed-term contracts. Reflecting the problems with Bank Indonesia's liquidity support program in the early days of the crisis, the new law strictly limited Bank Indonesia's lender of last resort responsibilities. This new law insulated the central bank from direct political pressure, strengthened its position in the state and reduced its role in the economy.[7] These changes protected the future of the central bank and made it a more suitable central bank to oversee further erosion to the statist-nationalist banking policy status quo, including the purchase by foreign banks of some of Indonesia's largest local banks.

2001–2004 – Cleaning up

By mid-2001, IBRA began to focus primarily on selling off the banks it had gained, harkening the shift in policy from simply dealing with the crisis itself to

restructuring the banking sector to ensure it would be more resilient and easier to supervise. In July, IBRA sold off 10 per cent of BCA as a precursor to many larger sales to come. While 1997–2001, saw little scope for greater foreign bank participation in the Indonesian banking sector, from 2002, foreign banks became the focus of banking sector reform.

Certainly, the Indonesian economy and banking sector were far from being in the clear in late 2001. In October, Sukanto Tanoto's Uni Bank closed down at a cost of $600 million, after having more than a half of its loan portfolio extended to the RGM conglomerate. In 2006, Sukanto Tanoto, still in control of RGM, was rated as Indonesia's richest man. However, things were improving. Relations with international financial institutions had calmed, with Indonesia being the Asian Development Bank's largest customer in 2001 (Khambata 2001). At the same time, Indonesia's foreign debt had declined from 140 per cent of GDP in 1998 to only 50 per cent by the end of 2001, reducing Indonesia's need to continue to rely on IMF funds. Only two years later, on 31 October, Indonesia's last loan program with the IMF ended. By 2006, Indonesia had settled all outstanding accounts with the IMF – the main source of globalizing pressure during the crisis.

In March 2002, IBRA, now under the Ministry of State-Owned Enterprises, sold a majority stake in BCA to an international consortium led by Farallon Capital out of the United States and including Deutsche Bank. Indonesia's largest and most controversial local private bank was out of the hands of Indonesia's largest conglomerate and in the hands of foreign capital after a fiercely contested bidding process.[8] The BCA sale was quickly followed by the sale by IBRA of a controlling stake in Bank Niaga to Malaysia's Bank of Commerce.[9] This sent a powerful message that the Indonesian state was focussed on reforming the banking sector in ways that suited the new globalizing pressures, and even the biggest non-state banks were not immune. By the end of 2002 and the sales of BCA and Bank Niaga, foreign-controlled banks controlled over 30 per cent of banking assets (Sato 2005).

This process of greater opening continued throughout 2003 as more of Indonesia's largest nationalized banks were sold off to large foreign interests. The Singapore state became a major player in the Indonesian banking sector when its holding company, Temasek, bought Bank Danamon and was part of a consortium that bought BII (Bank Internasional Indonesia). At the same time that Indonesia was selling off the largest private local banks to foreign interests, Bank of China, after a four-decade absence, had its banking licence renewed. As we will find out later, Indonesia was not the only country to invite the Bank of China back in the interests of closer commercial relations with the world's new economic power.

Indonesia's new open approach to foreign ownership in the banking sector continues today. In 2006 alone, seven smaller local private banks were sold to foreign banks that have started to develop significant automated teller networks to expand their retail reach. Today, Indonesia's banking sector is very open to foreign bank entry, signalling a significant erosion of the statist-nationalist banking policy status quo in the aftermath of the crisis.

While the entry of foreign banks into Indonesia's long-protected banking sector has been the biggest change since 2001, it has been far from the only one.

Table 3.2 IBRA bank sales – changes in ownership structure of former business-group-affiliated banks, 1997 and 2003

Name of Bank [Former owner Business Group]	Old Ownership Structure (end of 1997)		New Ownership Structure (end of 2003)			
			Foreign Shareholders		Domestic Shareholders	
	Shareholders	*Shareholding Ratio*	*Shareholders*	*Shareholding Ratio %*	*Shareholders*	*Shareholding Ratio %*
1 Bank Central Asia (BCA) [Salim]	Soedono Salim	23.16	Farindo Investments (Mauritius)	52.03	IBRA	8.50
	Second son of Salim	23.15	(Consortium of Farallon Capital Management of the United States and Djarum Group of Indonesia		Second Son of Salim	2.09
	Third son of Salim	23.15			Third son of Salim	1.84
2 Bank Danamon Indonesia [Danamon]	PT Danamon International	48.0	Asia Financial (Indonesia) Pte. Ltd	51.0	IBRA	48.1
	Publicly listed shares	52.0	(Consortium of Temasek Group of Singapore and Deutsche Bank of Germany)		Publicly listed shares	0.9
3 Bank Niaga [Tirtamas]	PT Tunasmas Paduarta	39.5	Commerce Asset-Holding Bhd	51.0	IBRA	45.1
	RHB Bena Sdn Bhd	20.0	(Consortium of Malaysian investors)		Others	4.0
	PT Austindo Teguhjaya	10.5				
4 Bank International Indonesia (BII) [Sinar Mas]	PT Sinar Mas Multiartha	51.0	Sorak Financial Holdings Pte. Ltd	51.0	IBRA	42.5
	Publicly listed shares		(Consortium of Temasek Group Of Singapore and Kookmin Bank of Korea)		Others	6.5

Source: Sato, Y. 2005.

In the last few years, all aspects of the statist-nationalist status quo have been under review, including local bank consolidation. By 2010, Bank Indonesia expects that 40 per cent of local banks will either merge with each other or be bought out by foreigners leading to a banking sector with 70–80 lenders down from the 131 present at the end of 2006 (*Tempo* 2006). In 2006 Bank Indonesia introduced a one-presence policy banning controlling shareholder(s) from controlling more than one bank. A more radical and state-driven plan that called for the formation of five anchor banks that others would merge with was dropped. Malaysia was able to carry out a very similar plan showing the relative strength of the Malaysian state in general and its superior leverage over local banking interests.

The year 2003 saw the first significant step in addressing the problem of state banks. 40 per cent of Bank Rakyat Indonesia, one of the four main state banks, was sold off to investors in a manner to ensure no single entity gained too significant a stake. In 2005, the Indonesian state went further and announced a plan to privatize BNI. However, until large shares of the behemoth Bank Mandiri are sold off or a majority stake of a major state bank is put on the market, skepticism about the interest of the Indonesian state in addressing the problems of state banks will continue to hold. While state banks have caused the most problems, they are proving the most resilient of the three pillars of the status quo.

The year 2004 saw the passage of two more banking laws. The 2004 Central Bank Law provided the newly-empowered parliament with more say over the selection of the central bank board, aligning the political oversight of the central bank with Indonesia's new democratic political system. Many in parliament and beyond had felt that the 1999 law had gone too far in removing the central bank from political oversight. This new law also calls for the creation of a new financial sector supervisory agency that would remove the primary responsibility of the bank supervision from the central bank. Not surprisingly, Bank Indonesia has resisted this loss of power. It is now expected that the Financial Services Authority will be established by 2010, eight years after it was first supposed to be formed as part of one of the ill-fated IMF program loans.

The year 2004 also saw the passage of the long-delayed deposit insurance law in September. This law aims to both provide bank depositors with a greater level of confidence, while limiting the central bank's financial exposure to future bank runs. The law creates a self-funding deposit insurance system under an independent authority that covers deposits under 100 million rupiah. However, echoing the problems of 1998, it still calls for state-supported blanket coverage during times of crisis.

Indonesia's banking sector and banking policies went through the largest changes of any of the countries in this book during the decade under study. From having a very closed banking sector with a huge number of small banks, Indonesia today has the most open sector of the five countries and, along with Thailand, have seen the greatest consolidation of the financial sector. Indonesia's political system has followed a similar path to liberalization, and today Indonesia

is the most decentralized state in the region, having the most active democratic system – still in the process of consolidating itself just as the banking sector is.

These wrenching changes have all stemmed from Indonesia's vulnerability to the 1997–98 financial crisis, and Indonesia is the best example of the power of banking sector globalization by crisis. However, the pain of the crisis and the breakdown in relations and confidence with the IMF means that the democratizing Indonesian political system is now less open to advice from international financial institutions, and much more concerned about maintaining economic policy autonomy. Indonesia's political transformation has also meant that Indonesia has been less willing than its neighbours to embark on bilateral trade negotiations and the avenues these create for further banking sector liberalization.

Globalization in the banking sector bit Indonesia very hard in 1997–1998. Now, the leading country in the region is much shyer about letting the IMF and World Bank in, or engaging in discussing new ways of opening up its banking sector and economy.

4 Thailand

Thailand's banking system in particular and the political system in general had the second wildest ride during the period from 1994–2004. Like Indonesia, Thailand is still recovering from its extreme financial boom – riskily centred on property and foreign borrowings – from 1994 to 1996, and the depth of the crisis that hit with full force in mid-1997. The extreme volatility in Thailand's financial sector opened up, under duress, new room for foreign banks and increased the role for state owned banks. It forced a rationalization of the financial system, including the virtual removal of the category of finance companies that were at the root of the boom and bust cycle, and the nationalization of Thailand's worst performing banks. Banking globalization via financial crisis reformed the Thai banking system against the interests of its private banking elite and Thailand's enduring economic nationalism (Milner 2003). This form of globalization by no choice has helped disrupt the Thai political system, and has made further, post-crisis banking sector liberalization uncertain.

While the crisis hit Indonesia the hardest, it hit Thailand first and, like Indonesia, Thailand's economy and political system is still recovering from the crisis a decade later.[1] The 2007 military coup that replaced Prime Minister Thaksin Shinawatra certainly has some of its origins in the stresses and changes to the Thai political system brought on by the crisis. Of course, Thaksin was catapulted to power in 2001 on the back of the nation's crisis shock and Thaksin's promise to help Thailand recover. While the crisis spurred democratization in Indonesia, and Indonesia now seems to be on a sustainable and popularly legitimate political path, Thailand's democracy is under great strain and the country is more divided.

While the crisis hit Thailand first, it has been the slowest to recover politically, and was one of the slowest to have shifted from simple crisis reaction to longer-term policy reformulation to strengthen the financial sector and mitigate against further crises. This apparent delay in response is directly linked to many of the reasons that Thailand was the first to go under, and to the severity of the crisis' challenge to the Thai political system.

The crisis eroded the basic underpinnings of the political system in Thailand and Indonesia. This slowed down their governments' initial responses to the

crisis, and deepened the political elite's nationalist anger at outside intervention, particularly the IMF. It also meant that crisis response – both short-term reaction and longer term policy reformulation – became deeply entwined with the crisis-triggered reshaping of the political system.

This was not the same case for Malaysia, the Philippines and Singapore, whose political systems were not as severely tested – and were not changed – by the crisis. For Thailand and Indonesia, this truly was a political economic crisis, with the political and economic dimensions during the depth of the crisis acting to aggravate each other. The economic shock of the crisis eroded the pillars of the political system, which in turn was less able to effectively respond to the crisis, hence deepening it and its erosion of the political system.

At first glance, Thailand seems an odd candidate to have gone under first. It appeared quite sound when looking at the three banking policies under study here. Thailand hosted the fewest state banks – only one (Krung Thai) – before the crisis, a small number of private local banks (15) and a large number of foreign banks operating in Thailand (21). The Thai banking sector was also the most profitable in the region and boasted the greatest spread between deposit and loan rates (Sorsa 1997). Thai banks, on paper anyway, also had the highest capital adequacy ratios in the region, well above the recently-introduced Basel 1 standard. While these are certainly bad indicators for financial sector efficiency and the cost of capital to the economy, it should have meant that Thai banks were the best placed to ride out any bout of regional volatility.

The Thai economy also looked in good shape, as it was the star performer in maritime Southeast Asia, growing the quickest from 1986–1996. The national balance sheet was in very good shape, with Thai government debt equal to only 5 per cent of GDP in 1996 (Dixon 2004). The Thai bond market even suffered in the mid-1990s from the lack of government bond issues. Finally, as a legacy of the 1980s financial crisis that led to a series of bank and finance company failures, the Bank of Thailand had established the Financial Institutions Development Fund (FIDF) to help financial institutions deal with market volatility and to protect depositors.

At second glance, and with the benefit of hindsight, not all was so robust. Some of these apparent strengths were actually weaknesses. It turned out that capital adequacy ratios were grossly exaggerated (Kawai and Takayasu 1999). Thailand's booming economy and the financial sector policies undertaken to leverage (figuratively and unfortunately literally) this boom also made the financial sector much more vulnerable to external shocks.

At the same time that Thailand's and Southeast Asia's boom was attracting foreign attention and new pressures to open up its cosseted financial sector, Thailand' strong sense of nationalism and fear of economic domination greatly limited the role of foreign financial institutions in Thailand. These limits, and the ways in which the Thai authorities tried to benefit from foreign money without letting foreign banks in, aggravated the local financial sector's vulnerabilities. Ironically, in time, these policies and their failure led to an even greater foreign presence in Thai banking.

1985–1992 – First wave of reform

This eight-year period began with the establishment of the FIDF in November 1985 through an amendment to the Bank of Thailand Act. The establishment of the FIDF signalled the end to the crisis response of the mid-1980s crisis, itself triggered by significant balance of payments deficits. The FIDF's goal was to protect depositors and help financial institutions through rough patches by the infusion of funds and management advice. Echoing Thailand's largely market-driven approach to banking, this new stabilizing agent was funded by a 0.5 per cent tax of banks' year-end deposits and, while it could advise, it had no power to replace management. The FIDF was not a deposit insurance system.

The late 1980s also witnessed the beginnings of Thailand's decade-long boom that helped it recover quickly from the problems of a few years earlier. Thailand's boom was impressive in scale and in its close linkages to the financial sector. While Thailand grew quicker than its southern neighbours from 1986–1996, the Stock Exchange of Thailand, while also surging, did so less than its regional peers. Instead, most of the growth in the financial industry was in the banking and finance sector. Credit growth from 1988–1995 averaged 22 per cent a year, while financial institution's claims on the Thai private sector rose from 83 per cent of GDP in 1990 to 147 per cent in 1996 (Kawai and Takayasu 1999).

Unfortunately, these impressive growth statistics reduced the incentives on financial authorities to keep a close eye on the underlying health of the financial sector, at the same time that the financial authorities' steps to deepen Thailand's financial markets and further integrate its economy into the global one increased the need for close supervision. Painfully, as in the case of Malaysia (as we will see) and Indonesia, some of the key reforms taken to address the 1980s financial crisis, and the limits of the Thai financial system's ability to deal with rapid growth, helped set the scene for the next crisis a decade later. Again, one is reminded of the wistful military axiom about the risks of learning to win the war just fought, leaving one unprepared for the new type of war that is to come.

Like its neighbours, Thailand traditionally has had a local bank dominated financial system with strict limits on foreign bank participation and entry. In 1964, Thailand banned new foreign banks (Dobson and Jacquet 1998), and the existing foreign banks were limited to one branch each. Foreign bank branches also were required to maintain 'exposure to Thailand of no less than 70 per cent of total deposits and borrowings raised in the country'. The ceiling on foreign ownership of local banks was kept at a low 25 per cent. Unsurprisingly, foreign investors only bought into Thailand's largest local banks, given their inability to gain either a controlling share or even a significant say on the board. Reinforcing its nationalist approach to banking, Thailand defined off-site ATMs as bank branches, strictly limiting foreign banks' ability to leverage technology to override their single branch restrictions. In 1996, foreign banks only accounted for 8 per cent of the banking market.

Unlike its neighbours, the Thai banking sector has never been state bank-centred. Rather, large local banks closely associated with the leading diversified

conglomerates have been the major players. By 1993, the three largest local banks in Thailand accounted for 50 per cent of banking assets, while the smallest six only accounted for 6 per cent. These diversified conglomerates were also closely associated with Thailand's political parties meaning that, even though state banks did not dominate, large banks and their owners were well-plugged into the political system (Crone 1988). Before the crisis, the ten richest families in Thailand controlled roughly 50 per cent of the stock market in market capitalization terms (Claessens *et al*. 1999).

Authorities realized that this banking sector structure limited the scope for competition, and served the rural population (the majority of the electorate) and small and medium enterprises particularly badly. Small and medium enterprises are particularly important for Thailand, as they account for more than 50 per cent of the country's manufactured exports (Fratzscher 2002). In 1987, banks were required to deepen their engagement with the rural sector and small and medium enterprises. Each bank had to ensure that loans to the agricultural sector were maintained at a minimum value of 14 per cent of their deposit base, and loans to the small and medium enterprise sector were maintained at a minimum value of 6 per cent of their deposit base. According to Bank of Thailand statistics in 1996, agriculture only accounted for 2.7 per cent of commercial bank loans, down from 7.0 per cent in 1991, suggesting these directed lending requirements were not closely monitored or followed.

Authorities also focussed on encouraging finance companies to open and grow as a means of deepening the financial system in market segments that the traditional banks were unwilling to service adequately. Finance companies are different from banks as they are not allowed to accept deposits. Instead, they raise funds by issuing promissory notes or borrowing funds from banks themselves, which then lend on to customers. Most finance companies in Thailand also acted as securities firms.

Authorities supported the growth of finance companies, despite the fact that they had performed particularly badly during the 1980s crisis, leading to 22 of them being forced to merge with stronger ones and 25 of them being rehabilitated. The FIDF has always been busier dealing with the weaknesses of finance companies than banks. The FIDF's regulatory burden has been aggravated by their smaller size and looser regulatory framework.

Finally, in 1990–1992, the government announced the first post-crisis three-year plan for financial reform. This plan initiated the first wave of financial sector liberalization, as banks were given much more freedom to set deposit and lending rates, while banks, finance companies and large firms in general were given more freedom to access international financial markets. On the supervisory front, the plan introduced the Basel 1 standard for capital adequacy ratios for banks and established a local credit rating agency.

Altogether, these reforms were aimed at deepening the financial sector, tying the local economy more closely to the global one and favouring sectors of the economy traditionally ill-served by local banks. However, they increased the regulatory burden of financial authorities through significant directed lending

programs and support for the foot-loose finance company sector. The rapid growth of the economy and the even more impressive growth of the financial sector encouraged further innovation along these lines, while covering up any potential vulnerabilities created.

1993–1997 – Signs of vulnerability

During this short four-year period, Thailand's economy crested and then began to face serious difficulties, with the financial sector at the forefront. The second three-year plan from 1993–1995 accelerated the growth of the financial sector and introduced efforts to turn Bangkok into a regional financial centre. Ironically, Labuan in Malaysia was established in the same era with the same goal. The Thai economy began to go sour in 1995–1996 exposing the new vulnerabilities in the financial sector that would be in full view during the 1997–1998 financial crisis. These problems in many ways swamped the 1995–2000 five-year plan for financial reform, and set the cause of financial reform back for more than a decade.

Consistent with the first three-year plan, the second also expanded the functions of commercial banks and finance companies. In 1992, finance companies were allowed to sell government bonds (which had largely dried up due to budget surpluses), while in 1996 they were allowed into the leasing business. In March 1994, they were permitted for the first time to open up branches outside the Bangkok region and, in August 1994, they were allowed to open up branches overseas. In 1995, finance companies were allowed to issue certificates of deposit in foreign exchange.

Finance companies were beginning to look more like banks, despite their laxer regulatory system, and to attract much more business. Finance company loan growth grew at an average of 30 per cent per annum from 1988–1995 (Fratzscher 2002), and by 1996 accounted for 21 per cent of credit extended (Kawai and Takayasu 1999). Finance companies were particularly active in stoking a real estate bubble and in short-term, foreign currency borrowing. By the time the crisis hit, Finance One, the largest finance company, had assets of $4 billion, equal to Thailand's twelfth largest bank (Delhaise 1998).

Opening to the world

The single biggest impact of the second three-year plan was the creation of the Bangkok International Banking Facilities (BIBF) and its subsequent rapid growth. The BIBF was the institutional and regulatory innovation that was supposed to open the way for Bangkok to become a regional offshore financial centre like Singapore and Hong Kong. It facilitated local banks' access to international financial markets, while offering incumbent and non-incumbent foreign banks a new way to do business with local banks and local firms large enough to borrow offshore. BIBF licence holders could accept deposits from outside Thailand in foreign currency, and then either lend into Thailand (out-in loans) or lend to non-Thai customers (out-out

(Continued)

loans). Out-in loans proved to be much more popular, accounting for close to two-thirds of all BIBF loans by 1996, most of these being short-term loans.

All local banks were provided with offshore licences under the BIBF, while 12 of 14 incumbent foreign banks joined. Twenty-two non-incumbent foreign banks were also issued BIBF licences. Foreign banks were encouraged to believe that a BIBF licence was a stepping stone to an eventual full banking licence, which would permit them to enter and/or expand their operations in the local market. All BIBF licence holders were encouraged to funnel business through this new offshore market as BIBF transactions were exempt from numerous taxes, including stamp duties, while BIBF operations only paid a 10 per cent corporate tax rate rather than the regular 30 per cent.

In August 1994, Provincial International Banking Facilities were added to the BIBF. PIBF licence holders could operate outside Bangkok and also lend in baht, heightening their exposure to currency risk. The BIBF initiative was well received, with 1994–1997 witnessing a sharp uptake in foreign borrowings, especially among the local banks gifted a BIBF licence. Finance companies were also keen customers of the BIBF. In 1995, bank lending exceeded GDP for the first time ever, while by 1997 it had hit 127.4 per cent of GDP. Local banks went from having local deposit and lending rates controlled and having very limited access to offshore borrowing and lending, to having freedom to set their own rates and having the government bringing the offshore markets to them in less than a decade, and less than a decade after many of these banks had been hurt by the 1980s crisis.

In 1995, the first five-year plan for financial reform was introduced, which built upon its three-year predecessors. It included the granting of seven more BIBF licences to non-incumbent foreign banks, and elevation of seven BIBF licences to foreign banks to full foreign bank licences, increasing the number of foreign bank branches from 14 to 21 by 1996. However, at the same time that the BIBF was being expanded and foreign banks began to play a larger role in the Thai banking sector, signs of impending financial doom were appearing. These would lead quite quickly to the death of the BIBF and Bangkok's plans to be the next Singapore in offshore banking. By 2006, all the BIBF and PIBF licences had been cancelled.

In 1995, regional credit rating firms began to get nervous about the state of the Thai banking sector and local Thai banks. Thomson even began to downgrade Thai banks (Delhaise 1998). In May 1996, the Bangkok Bank of Commerce failed and was taken over by the state. By the end of the year, the FIDF had poured the equivalent of 9 per cent of GDP into recapitalizing overstretched finance companies (Hickson and Turner 1999). By 1996, the real estate bubble in Bangkok was deflating, putting finance firms and banks that had overexposed themselves to this bubble in trouble. Non-performing loans (NPLs) in the banking sector increased by more than 50 per cent with the NPL ratio growing to 12 per cent in 1996, up from 7.6 per cent the year earlier (Dobson and Jacquet 1998).

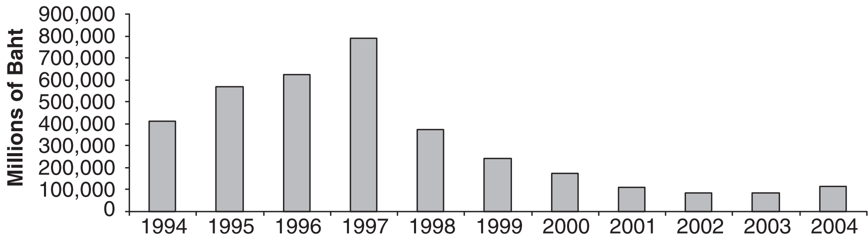

Figure 4.1 Thailand's local banks' foreign exposure

Source: Bank of Thailand.

Not only was the real estate bubble burst, the Thai economy as a whole started to sag. Exports shrank by 1.3 per cent, helping the current account deficit explode to 8 per cent of GDP, casting serious doubt on the health of the Thai economy. Unfortunately, just as the real estate bubble burst and the current account deficit began to yawn, Thailand's financial exposure was at an all-time high. On the back of the 'out-in' success of the BIBF, total short-term debt foreign debt exceeded 26 per cent of GDP.

By the end of 1996, Thailand's party was over. The economy as a whole was slowing, international financial markets were turning their back on Thailand, and local banks and finance firms were under growing strain. Sensing this turn in fortune, BIBF inflows into Thailand began to slow appreciably in 1996 and became negative in 1997. The Thai stock market in 1996 was the worst performer in the region, falling in value by over 35 per cent, with the value of the property stock sub-index falling by almost half.

1997–2001 – Consumed by crisis

The year 1997 was ushered in with a sense of economic malaise and a new government promising to address the growing economic problems and steady the financial system. Within seven months, the first IMF loan was being organized and the Asian financial crisis was officially under way. Within eleven months that government had stepped down in defeat. Unfortunately, the fragmented nature of the Thai political system, and the close links between Thailand's small devotee parties and financial institutions under stress, compromised attempts to address the looming crisis. Once the crisis had been recognized as such and the IMF was invited in, the IMF program and its stringent demands heightened nationalist feelings. This further complicated the political response to the crisis, delaying much needed reform and dashing confidence in international capital markets.

If the political problem in Indonesia was an over-concentration of power in one man – President Soeharto – in Thailand, the problem was the over-diffusion of

power and the inability of the government to rise above powerful individuals' self-interest (MacIntyre 2003). Ironically, the Thai constitution at this time almost guaranteed a diffusion of political power by creating a electoral system strongly biased towards multi-party coalition governments, as a legal bulwark against a return to authoritarian rule brought on by the 1992 coup. (Similarly, the new constitution that followed the fall of Soeharto in Indonesia and the decentralization bill have greatly diffused political power in Indonesia, making economic policy-making more difficult and the path of painful structural reform more treacherous.)

In early 1997, former General Chaovalit, as prime minister, brought together a coalition of six parties to form a new government promising economic reform, particularly in the financial sector. It would last less than a year. The new government was soon faced by the first default by a major finance company, Finance One. This led the Ministry of Finance and Bank of Thailand on 3 March to demand that banks and finance companies tighten loan-loss provisioning, and for the ten weakest finance companies to immediately raise further capital or face closure.

However, some of the ten named and shamed finance companies had close ties to politicians in the ruling coalition, who balked at the call for them to raise new capital. Instead, state funds were injected into the ten to ensure their survival. Then in June, a new finance minister called for the merger or closure of 16 of the worst performing finance companies. Forty-three per cent of these companies' loans had been extended to the overheated property sector (Sakulrat 2001). Again, senior politicians in the ruling coalition were able to quash this order and organize for the Bank of Thailand, through the FIDF, to inject 430 billion baht (roughly 10 per cent of GDP) into these 16 finance companies to keep them afloat. The governor of the Bank of Thailand subsequently quit (MacIntyre 2003). The first attempts at consolidation failed as politicized regulatory forbearance won out.

The political tussle over the closure of the worst performing finance companies consumed much of the first half of 1997, while Thailand's economy continued to suffer and foreign investors' views of Thailand and its government continued to decline. By July, the economy was in free fall. The baht was floated in the first week of July after the Bank of Thailand had spent over 90 per cent of its foreign reserves trying to defend a nominal peg against a basket of currencies heavily weighted to the appreciating American greenback. By July, what had begun largely as a finance company crisis had expanded to become a full-blown economic crisis about to consume the currency, the banking sector and the stock market.

International response

Thailand's financial authorities, while failing in their initial attempts to consolidate the finance company sector, were active in putting in place other policy responses to the mounting crisis. These were accelerated greatly with the entry of the IMF. Their entry strengthened those pushing for structural reform to

the financial sector and nationalist concerns over foreign intervention. Prior to the first IMF program three policies were enacted that together strengthened the Bank of Thailand's and the Ministry of Finance's ability to address the crisis.

First, in March 1997, The Ministry of Finance established the Property Loan Management Organization (PLMO) to purchase finance company and bank loans that used property as collateral, as a means to shift the burden of dealing with the property bubble collapse to the state. Then, in April, the Bank of Thailand issued new guidelines on financial sector mergers to clarify the Bank's authority in this area and to clarify the path for local bank and finance company consolidation, politics allowing. Finally, in June, the Bank of Thailand capped deposit rates to preclude suffering banks from gambling for resurrection.

Regionalism good, globalization bad

In August 1997, the Thai government received a $17.2 billion loan organized by the IMF that provided it with much needed funds to address the spiralling crisis, and sent a message of global support for Thai reform efforts. The IMF-organized bail-out included significant support from Japan, Australia, China (taking on a new regional role) and even Malaysia. The United States government though did not participate, due to Congressional backlash over the presidential financial intervention in the 1994 Tequila Shocks in Mexico. The wide range of support from countries in East Asia lent the package credibility and deepened the sense of regional integration. The lack of an American contribution though was very badly received in Thailand and Southeast Asia as a whole. During the crisis period and after, the Asian Development Bank, Japan and Australia have contrasted their more generous and understanding approach to the crisis and its fallout to that of the United States, the IMF and World Bank.

Ill feeling towards the United States and 'the West' in general deepened with the local backlash against the nature of the IMF crisis packages. The regional image of the United States was further hurt by frequently replayed comments by Treasury officials and leading American economic commentators arguing that the crisis was a necessary corrective, and that it proved that East Asia's approach to economic management was inferior. The initial Thai package served as a good signalling device for regional integration and a *cause célèbre*/conspiracy theory basis for those in the region critical of globalization, the IMF and World Bank, and American global power.

Beyond delivering powerful if unintended messages, the IMF package also kick started Thailand's crisis response and strengthened the hand of its reformist bureaucrats. Unfortunately, the scope and depth of the program quickly raised significant political opposition in Thailand and stoked nationalist concerns about foreign manipulation. The first IMF package included increases to fuel and sales taxes that immediately sparked popular anger and were quickly forgotten. These nationalist concerns have since been used by opponents to liberalization to tarnish those seeking liberal reforms. In many ways, the series of IMF programs in

Thailand played out in a similar, if less cataclysmic, fashion to those in Indonesia. Thai authorities also decided to quickly pay off their outstanding debts to the IMF and to free themselves of its conditionality. 'Never again' is the slogan aimed at the IMF in Southeast Asia today.

The IMF package was a very ambitious one that focussed on financial sector liberalization, including a further liberalization of the current account, new liberal foreign investment laws and the legalization of foreign bank purchases of local banks. The IMF package also focussed on strengthening the institutional response to the crisis by calling for the establishment of a deposit insurance system, and the creation of an inter-agency body to take control of addressing the problematic finance company sector. It had the ambitious goal of bringing the Thai financial sector up to international standards by 2000, indicating that authorities at the IMF did not realize the scale and scope of the challenges facing Thailand.

Crisis response

In October 1997, the government established the Financial Sector Restructuring Agency (FRA) that took over responsibility for the rehabilitation of 58 suspended finance companies. It had an ambitiously short mandated life span of three years, again showing that local authorities might not have realized the scale of the crisis facing them and the length of time it would take to deal with it. An asset management corporation was also established to help the FRA dispose of the assets it may acquire from these firms. Eventually, 56 of the 58 finance companies under the FRA closed, leading to a massive consolidation of the sector, and indicating how far the Thai response had moved from the first half of 1997.

In the same month, parliament passed amendments to the Commercial Banking Act that permitted foreign incumbent banks or foreign banks with a BIBF licence to buy up to 100 per cent of distressed local banks for a period of ten years. The foreign ownership ceiling on non-distressed local banks was also raised from 25 per cent to 49 per cent for the same period of ten years. Foreign investors quickly raised their stakes in the largest and best performing Thai banks. Purchases of distressed local banks would have to wait longer and worked out to be less smooth.

Thai negotiators at the WTO, helping to reduce pressure for greater liberalization, took advantage of these new crisis responses and included them as bound items in the negotiations over financial services. This is a good example of how commitments by a state in one arena of globalization – negotiations with the IMF – can assist them in another one – the WTO. Thailand was the only state out of the five under study in this book that used the Uruguay Round to commit to a more open banking sector.

October was a particularly busy month, as the Bank of Thailand law was also amended to allow the Bank to enforce management changes on distressed local banks receiving FIDF help. The law was further amended to require the FIDF to provide a blanket guarantee to all depositors and creditors to financial institutions in advance of the planned introduction of a deposit insurance system. Seven years

later, Thailand was still waiting for such a system, while the FIDF was still burdened with this blanket guarantee.

Backed by these new powers over the banking sector, from November, the crisis response shifted from a primary focus on finance companies at the core of the crisis, to the much larger and more important local banks also facing the prospect of collapse. In one of his final acts as prime minister, Chaovalit pushed through reforms that allowed for bank closures. He then resigned after less than 11 months in power, dogged by friction with the IMF and within the ruling coalition over the proper response to the crisis.

He was replaced by Chuan Leekpai from the Democratic Party, who was also constrained by a coalition government. Chuan, unlike Chaovalit, was not linked to the military and had the reputation of being a clean-handed liberal reformer able to manage the crisis response better, and get along with the IMF and international financial community. Others claim that the popular association between Chuan, the Democratic Party that he led and the IMF reforms has tarnished his party (Dixon 2004). The Democratic Party has not won an election since Chuan's term in office and is particularly unpopular in the poor and populous north.

The Thai approach to problematic banks had three major foci. First, there was upfront significant state liquidity support for the banking sector, mostly through the increasingly beleagured FIDF. Thailand's initial support to banks was more than $24 billion, roughly 20 per cent of GDP, higher than either Indonesia or Malaysia (Claessens *et al*. 2000). Second, the Thai state nationalized the worst performing banks – seven in total – with the plan to then sell them off to major foreign banks. Fortunately for Thailand, these seven banks were all quite small, reducing the financial hit to the state from their nationalization or the political backlash from the later sale of some of these to foreign banks.

These two initiatives were departures from script, as the state and major foreign banks became much more deeply involved in the banking sector. By the end of the crisis, the Thai state controlled close to one-third of total banking assets. The sale of nationalized banks to major foreign ones deepened the position of foreign banks in Thailand and allowed the successful buyers to evade the one-branch limitation. Both of these departures emphasized how deep the crisis was, and how it required the state to act against its banking policy traditions.

Finally, the Thai government offered local banks stronger support to satisfy the mandated capital adequacy ratios and loan loss provisions. Yet management teams of banks seeking support from this 300 billion baht pool had to resign. Unsurprisingly, only two banks accepted this bitter medicine. The Thai state did not set up a asset management corporation to buy off banks' NPLs during the crisis period, and even the banks that were nationalized were only nationalized once their original shareholders' capital had been wiped out (Claessens *et al*. 2000).

The lack of an asset management corporation to help banks clear their growing NPL ratios echoes the Philippines and its market-led approach. Thailand's NPLs peaked in 1999 at 48.6 per cent, with half of these to suffering small and medium enterprises (Takayasu 2001). This response fit well with Thai banking policy traditions and the lack of political support for the state to

Table 4.1 NPL ratios

% to total loans	*1998*	*1999*	*2000*	*2001*
State-owned Banks	62.45	62.84	21.63	5.59
Private Banks	40.48	30.59	18.00	14.42
Foreign Banks (full branch)	9.81	9.94	6.60	3.20
Total Commercial Banks	42.90	38.57	17.70	10.50
Finance Companies	70.16	49.22	24.48	9.46
Total	45.02	38.93	17.90	10.46

Source: Bank of Thailand.

play the lender of last resort (Asami 2000). The state opted for a market-led approach, despite the fact that this greatly slowed down the unwinding of these NPLs, which acted as a deadweight on the economy. The state was also unsure about the legal ramifications of forcefully taking over NPLs and disposing of them through an asset management corporation. Many of the large family conglomerates like Thai Petrochemicals were responsible for some of the largest NPLs and were very well connected politically.

Again, the Thai NPL story echoed the situation in the other crisis-hit countries and lessons learnt from previous financial crises in the developing world. Foreign banks exhibited the lowest NPL ratios by far, while state banks had the highest among all banks followed by local private banks. In the case of Thailand though, the state bank figures were inflated by their inclusion of figures from Bank Radanasin (until it was sold) and Bank Thai, both created to help mop up NPLs. Finance companies in Thailand were weighed down by the highest NPL ratios of all.

The adoption of a market-led approach to NPLs was also greatly aided by the fact that the FIDF was already deeply in hock due to the blanket guarantee and its role in recapitalizing finance companies and banks, and absorbing finance companies' non-performing assets. In total, the FIDF suffered losses of over 1.4 trillion baht.

Consolidation

The Thai state took a varied *ad hoc* approach to consolidating the assets of the closed and failing finance companies and the worst performing small banks. First, in February 1998, the FIDF recapitalized and took over four banks – Bangkok Metropolitan Bank, Siam City Bank, First Bangkok Commercial Bank and the Bangkok Bank of Commerce. Later it would recapitalize and take over Union Bank of Bangkok, Laem Thong Bank and Nakornthon Bank.[2] In August 1998, Krung Thai Bank took over First Bangkok Commercial and Bangkok Bank of Commerce, despite its own troubles and the damage this would cause its bottom line.[3] Krung Thai had been poised for privatization before the crisis hit with the first minority stake sold in 1993.

Thai financial authorities then created two new banks to take over the remaining assets of the failed finance companies and some of the nationalized banks. In

January 1998, the Ministry of Finance announced the establishment of Bank Radanasin ('good bank') to take over the assets of the 56 closed finance companies that the FRA had failed to sell off. Later Laem Thong Bank's (Thailand's smallest bank) assets were also added to Bank Radanasin. Bank Radanasin was set up with initial seed funding from both the World Bank and the Asian Development Bank. Later that year, Bank Thai was established to take over the assets of 13 failed finance companies and the Union Bank of Bangkok. The FIDF was the largest shareholder in this newly created bank with 49.98 per cent of shares.

This series of moves left the state with a larger and weaker Krung Thai Bank, two new banks, one under the Ministry of Finance (Bank Radanasin) and one, in practice, under the FIDF (Bank Thai), and three nationalized banks, Nakornthon Bank, Bangkok Metropolitan Bank and Siam City Bank, again under the FIDF. In 2002, the Ministry of Finance announced that the Bangkok Metropolitan Bank had been merged with Siam City Bank after the Bank of Thailand had transferred both banks' bad assets to a special asset management corporation. The Ministry of Finance guaranteed that the merger would result in no direct job losses or branch closures indicating that political fears of job losses again trumped commercial concerns with operating efficiency.

The second step in this process of cleaning up and consolidating the financial sector was to encourage major foreign banks to buy up these new state-owned banks. This would ease the financial burden on the FIDF, ease foreign pressure on Thailand to open up its financial sector, and bring in new money and expertise to help the sector recover and provide better services. In this sense, Thailand followed the orthodox steps recommended for banking crises: use the state to consolidate weak and failing banks and then sell them (the weakest of the bunch) on to foreign banks. Foreign banks, long muzzled in Thailand, were particularly keen to gain greater access to this market. In the end though, this second phase has met with mixed success, as foreign banks have been somewhat gun-shy to buy out the worst affected banks, and nationalist politicians have railed against so-called fire sales. In 1999, there was a censure debate in parliament over sales to foreign banks at the height of the authorities efforts to offload the newly nationalized banks.

It started off quite well as, in December 1997, taking advantage of the new rules on foreign buy outs of local banks, Singapore's state-owned Development Bank of Singapore raised its holdings in the struggling Thai Danu bank from 3.4 per cent to 52 per cent. In April 1999, this bank was renamed as 'DBS Thai Danu' Bank. Thai Danu was never controlled by the FIDF and this was purely a willing private seller–willing foreign buyer purchase. It was also the first of the four major foreign bank purchases during the Thai crisis.

Six months later, the Dutch giant ABN-Amro (one of the keenest foreign banks in Southeast Asia at this time) acquired a 75 per cent stake in the Bank of Asia, boosting its branch network from one to 121. Its name was subsequently changed to ABN Amro Bank of Asia This again was a sale of a private local bank to a foreign bank holding a BIBF licence, in line with the new regulations on foreign bank purchases.

Foreign bank purchases of the recently nationalized banks proved more difficult and slow. One reason for the hesitancy of buyers was the short-term problems that the Development Bank of Singapore and ABN Amro faced in merging with their new Thai purchases. Despite being a relatively small purchase, Thai Danu quickly weighed down its new parent bank's NPL ledger. By the middle of 1998, Thai Danu accounted for 44 per cent of the Development Bank of Singapore's total NPLs (a good sign of how resilient Singapore was during the crisis). Casting further doubt on the sageness of Singaporean bank's Thai venture, Thai Danu stock quickly fell to a quarter of the value of the purchase price (Vatikiotis and McBeth 2001). Thai Danu only returned to profit in 2001. A second reason was the difficulties involved in negotiating what should be done with the nationalized banks' NPLs.

In the end, only two of the remaining five nationalized banks were sold off to major foreign banks, both in 1999. The first to be sold was Nakornthon Bank, which was bought by Standard Chartered Bank in September 1999. A month later, the United Overseas Bank of Singapore bought out Radanasin Bank. Standard Chartered, which had been in Thailand for over a century and was established there before the first local bank, expanded its branch network from a solitary branch to 68 through its purchase. Likewise, Bank Radanasin delivered United Overseas Bank 65 new branches.

In both cases, the foreign parent bought 75 per cent of the Thai bank's shares, and struck a deal with the FIDF in which the FIDF would be responsible for 85 per cent of losses accrued over the next five years from NPLs and would receive 95 per cent of the profits from any NPLs that delivered gains. At the time of the sales, 80 per cent of Radanasin's and 65 per cent of Nakornthon's loans were non-performing. The FIDF hoped that this 'ring-fencing' agreement on NPLs would serve as an attractive model for the future sale of Siam City Bank and Bangkok Metropolitan Bank. In the case of the sale of the 75 per cent of Nakornthon, the FIDF made an initial profit of 5.37 billion baht while it lost 1 billion on the sale of Radanasin.

While keeping almost all the responsibility for NPL losses with the FIDF, this did not prove a successful model for future sales. Attempts to sell Bangkok Metropolitan Bank to Hong Kong Shanghai Bank (the first bank ever to operate in Thailand) and Siam City Bank to Citibank (the largest of the foreign incumbent banks when the crisis hit) both failed.

The four foreign purchases of local banks roughly doubled the share of foreign banks in the local market. These four banks, as new foreign banks have proved in other Southeast Asian markets, have been at the forefront of electronic and consumer banking, fee-based income generation and the expansion of ATM networks, forcing the large local banks to respond. The four banks, partially due to the parlous state of their local purchases, have also been aggressive at rationalizing their local operations, including the closing of numerous branches. These purchases and the raising of the foreign ownership in large local banks also helped the Thai economy's bottom line, as foreign purchases of local bank shares equalled 22 per cent of total foreign direct investment inflows from 1997–2002 (Dixon 2004).

By 2001, the reformation of the Thai banking sector in response to the crisis was over. Finance companies had seen their share of the financial sector shrink from over 20 per cent before the crisis to only 4 per cent in 2002, and now finance companies barely rate a mention in Thailand. Foreign banks, helped by the four purchases detailed above, saw their market share rise from 8 per cent before the crisis to just under 20 per cent. These so called four 'hybrid banks' holding roughly 5 per cent of total banking assets though do face stricter supervision (Dixon 2004). The share of local banks remained roughly the same at over 70 per cent of the financial sector, but now with state banks playing a larger role. The three largest banks still controlled close to 50 per cent of total banking assets as well. Local banks though have become much more conservative now, as their loan/deposit ratio by 2002 had settled at 80 per cent, down from an imprudent 110 per cent in 1997 (Pandey 2006). However, Thailand still boasts a comparatively high interest rate spread and cost structure.

2001–2004 – Cleaning up

The year 2001 not only witnessed the shift from a focus on crisis response to longer-term reform, it also witnessed a veritable revolution in Thai politics. An ethnic Chinese tycoon, Thaksin Shinawatra took Thai politics by storm, winning the election in January 2001. He had earlier served as Foreign Minister under Chuan in 1994 until he had to step down for conflict of interest, and then served for four months as deputy prime minister at the end of the Chaovalit government in 1997. His newly founded Thai Rak Thai (Thais love Thais) party won the most seats in the 2001 election, the first held under the 1997 constitution that tried to reverse the fragmentation of the political system that so bedevilled the political response to the crisis.

Thaksin came to political prominence as a nationalist responding to the crisis, promising to rebuild the Thai economy and national pride. His party was briefly repackaged as the Thai Patriot Party. He not only criticized Thailand's traditional political elite for its lack of leadership during the crisis, he even the questioned the Thailand export-oriented, outward-looking development model, arguing it made Thailand too vulnerable to external forces and did not serve the needs of the poor majority. Thaksin and the Thai Rak Thai party won the largest number of seats and then swept almost 80 per cent of the seats in the 2005 election, reorienting Thai politics towards a one-party democracy and showing the success of the constitutional reforms in addressing fragmentation. Thaksin's political success also highlighted the rift, worsened by the financial crisis, between metropolitan Bangkok where the Democratic Party still held sway and the poor rural north where Thai Rak Thai did extremely well.

While presenting himself as an economic nationalist in the run-up to the election, when Thaksin took office he proved to be quite pragmatic. Following up on an election promise that won him support from the Bangkok business elite, the government set up the Thai Asset Management Corporation, the first general asset management corporation established to address Thailand's NPL situation.

Established in October 2001 by the FIDF, this asset management corporation took over control of 732 billion baht of non-performing assets and had restructured 97 per cent of these by December 2003. Overall, it was able to achieve a recovery rate of 47 per cent of the value of assets sold, more than 50 per cent better than the 30 per cent average achieved by the FRA. The Thai Asset Management Corporation also managed to gain a higher price for assets sold than their purchase price, exemplifying its comparatively good management and the recovery of the Thai economy. The Thai Asset Management Corporation helped restructure much of the remaining NPLs, especially those held by state-controlled banks.

With the rapid and largely successful mission of the Thai Asset Management Corporation complete, efforts shifted to focussing on the future and, on 6 January 2004 the Ministry of Finance and the Bank of Thailand released a financial sector master plan for the next decade after it had been approved by Cabinet. Work on this master plan began in early 2002 under a new Bank of Thailand governor after Governor Sonakul had been fired by Prime Minister Thaksin in mid-2001 over a dispute over interest rate policy. This master plan further advanced the consolidation of the local financial system, offered potential new openings to foreign banks, and called for a deposit insurance system to replace the existing blanket guarantee on deposits.[4] This master plan, in many ways, tried to systemize the different approaches taken during the crisis and provided financial markets a clearer time-line for programmed policy changes.

On the consolidation front, the plan established a 'one presence' policy, requiring that there be only one type of deposit-taking institution for each financial conglomerate. The types of banking licences were also reduced to two types, commercial banks needing a tier-1 capital base of at least 5 billion baht, and retail banks needing a tier-1 capital base of at least 250 million baht. Retail banks are not allowed to conduct business in foreign exchange or in derivatives. From 2004–2007, finance companies would be allowed to apply for retail or commercial banking licences. In the second three year period, new investors could apply for commercial and retail banking licences.

Openings to foreign banks were more limited as the types of licences available to foreign banks was reduced to two – full foreign bank branches and subsidiaries of foreign banks. Confusingly, full foreign bank branches are not be allowed to open up any new branches, while subsidiaries may, in the future, be allowed to open up new branches, but no promises were given on when or how many. These new foreign bank licences are aimed at cleaning up the BIBF/PIBF disaster and to encourage foreign banks to merge with local financial institutions. Foreign stand-alone holders of BIBF/PIBF licences were encouraged to apply for licences as a full foreign bank branch. BIBF/PIBF licence holders that wish to upgrade to a subsidiary licence must first merge with or acquire a local Thai financial institution. So far this has yet to happen. Finally, from 2007, non-incumbent foreign banks without a BIBF/PIBF licence (all of these have now been retired) may be able to apply for either of these two new banking licences 'contingent on suitable economic conditions'.

Finally, the financial sector master plan calls for the consideration of a deposit insurance system aimed at protecting small depositors. In 2004, 98 per cent of depositors in Thai banks had deposits of 1 million baht or less. In late 2004, Cabinet approved a draft law to introduce such a deposit insurance system called for by the first IMF loan package in 1997. Such a system would also reduce the FIDF's contingent liabilities and help put it on a healthier budgetary path. As of the writing of this book, no such system has been introduced.

The market's response to the master plan has been quite positive. Some of the very few remaining (only five in 2007) finance companies have been successful in their application for banking licences, including AIG Finance and Thai Keha Credit Foncier which are now both retail banks, while TISCO finance company won a commercial banking licence. Kiatnakin Finance and Securities has been the most impressive of all, as it won a commercial banking licence in 2005 after having been one of the 58 finance companies put under the FRA in 1997. Kiatnakin and Bangkok Investment were the only finance companies out of the 58 under the FRA not to be closed. New foreign banks and old foreign holders of BIBF licences have also successfully transferred their licences with Societé General (never a BIBF licence holder) gaining a full foreign bank branch licence in June 2005 and Indian Overseas Bank winning one in March 2007.

Not all has been going so well on the foreign bank front, as some foreign banks have withdrawn due to disappointing returns or changed their tactics. In 2001, Sakura Bank, the Industrial Bank of Japan and Dresdner Bank closed shop in Thailand. In 2004, the DBS Thai Danu Bank merged with the Thai Military Bank (TMB) overturning the foreign buy out of Thai Danu. The Development Bank of Singapore was left with 16 per cent of the larger Thai Military Bank. In 2005, ABN Amro sold ABN Amro Bank of Asia to Singapore's United Overseas Bank, which then merged it with UOB Radanasin. ABN Amro now holds a full foreign bank branch licence and is again back to a sole branch.

These set-backs for foreign banks in Thailand are consistent with steps taken by these same banks in other Southeast Asian markets, and are testament to changing strategies at the parent bank head offices.[5] Unfortunately, the 2007 coup in Thailand has stopped the momentum for banking sector reform in Thailand, and new avenues for reform like the United States–Thailand free trade negotiations that have been abandoned. Until the political instability unleashed by the crisis is resolved in a permanent manner, the future of the Thai economy and banking sector reform remains uncertain.

5 Malaysia

Unlike Indonesia and Thailand, the Asian financial crisis did not lead to a significant change in Malaysia's political system. A coalition led by UMNO (United Malays National Organisation) still rules Malaysia as it has since Independence in 1957. However, the crisis and its aftermath did play a significant role in the timing and manner of Prime Minister's Mahathir's retirement on 31 October 2003 after more than two decades in power. He stepped down as a significantly less internationally influential and welcome figure. In 2004, under new leader Abdullah Badawi, UMNO led the *Barisan Nasional* coalition to one of its greatest ever election victories. The Malaysian political system was the most resilient in the face of the 1997 crisis.

Likewise, the crisis and its aftermath did not lead to a greater role for international financial institutions in Malaysia or greater entry rights or operational freedoms for foreign banks, despite the severity of the crisis in Malaysia. Rather, both in the boom times of the early 1990s and the crisis and its aftermath, the Malaysian state took a very concerted defensive approach to the forces of banking sector globalization. The depth of the crisis and the policy response of the Prime Minister and his chosen team simply permitted the state to push through a long-stalled local bank consolidation program. By 2004, the Malaysian banking sector was no more open to foreign banks, incumbent or otherwise, had many fewer, larger local players, and state and state-affiliated banks were still favoured. Malaysia's statist-nationalist banking policy status quo was equally the most resilient to pressures of globalization, and Malaysia today still boasts the most protected banking sector.

This story of political and policy continuity, despite the shock of the Asian financial crisis and the new pressures for banking policy liberalization, highlight the strength of the UMNO-led political system in Malaysia and its willingness to expend significant effort and taxpayers' funds to defend its chosen economic policies from external pressures. More so than any other state under study here, the Malaysian state and its UMNO-led regime are defined by a statist-nationalist economic policy paradigm known as the NEP (National Economic Policy), and its goal of communal redisribution to the majority, but poorest, Malay community. Malaysia's banking policies have been a central part of the NEP and its socio-economic goals since its political origins in the 1960s, and Malaysia's

responses to the new globalizing pressures on banking policy can only be understood through this light. The state-defining commitment to the NEP has so far trumped the pressures of banking sector globalization, despite the rising costs of defending these policies.

This chapter will begin with a short description of the NEP and its associated banking policies, before looking at the Malaysian state's policy responses to the three different periods of the decade under study. Throughout these three periods, the policy responses have been very consistent despite these three periods being very distinctive. Malaysia boomed in the early 1990s, was severely tested from 1997 to 2000 by the financial crisis, and has recovered well since.

NEP in brief

The NEP's impact on the Malaysian political economy and social psyche has been so profound that this acronym for a twenty-year development plan has become code for Malaysia's political economic ideology since 1971 (Milne 1986). 'NEP' is still used by most local and foreign political economic analysts as short-hand for the dominant economic policy paradigm. The plan's redistributive goals are frequently used to legitimize policy change or non-change by the state even today, more than fifteen years past its official end in 1991. The very transformation of this policy document into a heavily laden and multi-purpose idiomatic expression is the best indication of the radical and seemingly permanent changes it has brought to Malaysia. Prime Minister Mahathir's political career has been defined by the NEP. First as a 'Young Turk' radical within UMNO he led the charge for its introduction, then as Prime Minister from 1981 he deepened its implementation and evolution.

The NEP, when it was announced in 1971 as the economic policy response to communal riots that shook Malaysia in 1969, focussed on the communal 'balancing' of Malaysia's economy through continued growth and the transfer of economic wealth and control from foreign to Malay (bumiputra) capital.[1] Earning the accolade of being the most ambitious affirmative action program carried out in the developing world (Snodgrass 1995), this called for Malaysia's equity ownership situation to be radically transformed. By 1991, the NEP called for foreign ownership to be reduced from over 60 per cent of shares to no more than 30 per cent, while the bumiputra share ownership, both direct and indirectly through state 'trusteeship', should expand from 2.4 per cent in 1971 to no less than 30 per cent. Non-bumiputra Malaysian equity ownership made up the remaining 40 per cent, showing the NEP's philosophy of continuing to allow the local ethnic Chinese and Indian communities limited room to grow, while being free from the fear of state expropriation.

The NEP aimed at nurturing and maintaining a Bumiputra Commercial and Industrial Community and a burgeoning, modern bumiputra middle class that would eventually allow state-fettered market forces to contribute to the uplifting of the bumiputra community as a whole. The successful fostering of a confident and competent bumiputra capitalist class, supported by a modern bumiputra

middle class spanning both the public and private sectors, would undo the community's crippling paradox of political pre-eminence and economic marginalization. It would also closely bind these emergent social groups to the state and UMNO, deepening the nexus of interests between UMNO, the state and bumiputra capital. The comprehensive end-targets of the NEP demanded that bumiputra political pre-eminence be seriously put to use for preferential economic improvement. The NEP fundamentally reoriented and deepened the role of the Malaysian state in the economy, while the plan's twenty-year time frame and lack of detail on policy implementation left this paradigmatic shift up to the leading bumiputra political and bureaucratic leaders of the time.

NEP and banking

Reform of the banking sector has been at the centre of the NEP. Banking policy reforms enacted in the 1960s to respond to bumiputra economic dissatisfaction even foreshadowed the NEP. In 1965–1966, the state set up a fully state owned bank aimed solely at serving the bumiputra community, called Bank Bumiputra. With state backing, Bank Bumiputra quickly grew to become the second largest bank in Malaysia behind Malayan Bank with the most expansive branch network. Furthering these interests, in 1966 Bank Negara took over the ethnic Chinese Malayan Bank, the largest and quickest growing local bank, when it faced prudential regulation problems and the threat of a major bank run. The central bank for the first time used its discretionary powers to take control of a bank. Since 1966, no move, however, has been made to resell the bank to the private sector, and it is still in state hands today. In a matter of two years, the two largest local banks were state-owned and the ethnic Chinese community lost control of the largest local bank. Malayan Bank and Bank Bumiputra became the two main sources of bank credit for the creation and support of the Bumiputra Commercial and Industrial Community.

Following from this, NEP entrenchment was quickest and NEP intervention the deepest in banking, public works, and traditional exports. From close to 0 per cent bumiputra ownership of bank shares prior to 1965, by 1982, up to 77 per cent of shares in local banks were controlled by the bumiputra community directly or through state trusteeship (Hara 1991).[2] Reform of the banking sector was necessary, as the quick ascension of the Bumiputra Commercial and Industrial Community required that the chosen members of this state-nurtured class have quick access to large sums of borrowed money, most often from compliant state banks.

The first kinds of state intervention that helped sway bank share ownership so sharply towards the bumiputra community were those that favoured the licensing and growth of state-owned or state-linked bumiputra banks. After the Bank of Nova Scotia was granted a licence for a single branch in 1972–1973, no other foreign bank has been given a non-Islamic banking licence. Moreover, incumbent foreign banks were not allowed to open any new branches or transfer existing branch locations to new growth areas until quite recently. Showing the administrative power

and continuity of the Malaysian state, these continuing bans are still in place despite never having been codified in law.

The Ministry of Finance, through the Foreign Investment Committee, administratively defined the banking sector as a strategic sector. Consequently, a ceiling of 30 per cent foreign ownership has been placed on share ownership in each local bank, with enforced penalties on local banks that overshoot this ceiling. The central bank, Bank Negara Malaysia (BNM) interpreted the 30 per cent bumiputra share ownership target to apply not simply to the sector as a whole, but to individual banks, making it a much more interventionist target.

Finally, again by administrative regulation, foreign firms operating in Malaysia had been required until mid-2003 to raise at least 50 per cent of their local bank financing needs from local banks. This restriction was enforced on resident foreign multinational corporations to ensure that local banks learnt how to deal with this more demanding and sophisticated clientele, a major banking market they had shied away from. This developmental policy, however, has also eaten into the foreign incumbent banks' traditional market of home country, locally operating firms. It also requires multinationals to seek central bank approval before any bank credit is raised locally.

Legislatively, the Banking Act of 1973 also withdrew the licences of any bank the Ministry of Finance deemed to have 'become owned or controlled by a foreign government' (Article 6:1). This was the first and only legislation to actively reduce the number of incumbent foreign banks in Malaysia. Perwira Habib Bank had to be localized when its controlling Pakistani partner, Habib Bank, itself was nationalized (Khin 1986). The Banque de L'Indochine et de Suez also had to localize itself in 1982 when the French Government nationalized this bank; its localized Malaysian operations renamed itself the Malaysian French Bank. Three banks controlled by the Indian government also merged and localized their ownership by creating the United Asian Bank in 1972 in preparation for the 1973 law, with Malaysian Indian Congress interests taking control. Altogether, the restrictions on new foreign banks were absolute, while those on incumbent ones were quite strict, and were both quite effective in overwhelming the foreign banks' competitive advantages in brand name, economies of scope and scale, and product innovation. By the mid-1980s, the foreign bank market share had shrunk to around 25 per cent for both deposits and loans, down from over 60 per cent at the beginning of the NEP period. The number of incumbent foreign banks operating in Malaysia declined from 22 in 1970, to 16 in 1982 where it has stayed since.

For local banks, the creation of Bank Bumiputra and the takeover of Malayan Bank foreshadowed a period of more intense state intervention in favour of the creation and growth of bumiputra banks. Similar to other fields of intervention, ethnic Chinese banks and the ethnic Indian United Asian Bank were allowed to grow without state help. However, when it bought a controlling stake in Kwong Yik Bank, Malaysia's first locally owned bank opened in 1903, Malayan Bank in 1970 began a process that greatly accelerated in the late 1990s, namely banking sector consolidation through the acquisition of ethnic Chinese banks by state-owned or linked bumiputra banks.

Bumiputra banking interests also gained through the acquisition of ethnic Chinese banks by state-linked or owned non-banking entities. In 1975, the Fleet Group, UMNO's corporate arm, bought out 100 per cent of Bian Chiang Bank. In the early 1980s, rising bumiputra stockmarket star Rashid Hussain bought out Development & Commercial Bank, formerly owned by the Malaysian Chinese Association stalwart H.S. Lee, who was granted the bank licence upon retirement from politics. All of these transactions were allowed to go ahead, as the Minister of Finance waved Article 23B of the 1973 Banking Act. This article bars any individual, like Rashid Hussain, from owning more than 10 per cent of a single bank, and any legal person other than an individual, like the Fleet Group, from owning more than 20 per cent of a bank. In 1976, the central bank moved in on the largest ethnic Chinese bank, the United Malay Banking Corporation, and took it over for violating prudential regulations. Its ownership was then transferred gradually to state-owned PERNAS. By 1976 the three largest banks in Malaysia, two of them originally owned by ethnic Chinese, were state-owned. From 1971 to 1985, six new bumiputra banks were created through buyouts, state takeover or new licences, while no ethnic Chinese or Indian bank acquired a bumiputra bank.

Three other changes to the banking sector were more directly tied to the NEP's numerical targets on equity ownership. First, from 1971, Bank Negara encouraged foreign incumbent and locally owned banks in Malaysia to reorganize their equity ownership structure to match NEP targets. No article in the 1973 Banking Act requires such reorganization, but locally operating banks felt pressured to reorganize to maintain good working relations with Bank Negara, which could veto new branch applications or ownership changes (Chin 1983).

This process of coerced change altered the communal identities of two originally ethnic Chinese banks. Oriental Bank from 1976 changed its controlling shareholder to the police pension fund turning it into a bumiputra bank, while Southern Bank restructured along NEP lines when politically well-connected Killinghall bought out a Chinese partner's share to make the bank majority owned by bumiputra interests (Chin 1983). Through these varied bank ownership moves, ethnic Chinese banks went from being the only local players prior to 1965, to only having one of the top ten banks in Malaysia by 1990 that was clearly an ethnic Chinese bank (Searle 1999).

Finally, Bank Negara began to impose large directed lending requirements on all banks' lending portfolios, justified both along classical developmental and NEP lines. The largest and still-continuing program started in 1976 requires each bank to direct a minimum of 20 per cent of new loans and advances to the bumiputra community. All banks also had to guarantee that at least 12 per cent of all outstanding loans and advances were held by the bumiputra interests by end-June 1978. Penalties for not achieving these levels were clearly set out and have been carefully enforced. This directed credit program had no direct link to poverty alleviation or industrialization goals, as no maximum amount or sectoral preferences were placed on these loans, and many went to large bumiputra business concerns and were used to buy shares.

Bumiputra interests were also carefully looked after in the other directed credit lending programs of the central bank as, in both the low-cost housing loan program and the program for small and medium industry loans, special measures were put in place to favour loans to the bumiputra community. For example, in 1972 the central bank set up the Credit Guarantee Corporation to help banks cover the higher risks of lending to small and medium enterprises, with each bank given a mandatory quota of government guaranteed loans to these underserved firms. A percentage of the loans given out from these quotas was reserved for the bumiputra community – up to 50 per cent of loans depending upon the market sector – while guaranteed loans to bumiputra clients were allowed to be larger than to non-bumiputra clients. By 1985, lending to the bumiputra community, greatly driven by these directed lending programs, had reached 28 per cent of total loans, still below the community's share of population but far above the 4 per cent of 1968 (Jesudason 1989).

The banking sector shifted from one dominated by foreigners and ethnic Chinese, to one where by the early 1980s the bumiputra community received preferential lending treatment and controlled, mostly through state trusteeship, the largest and quickest growing banks. From the announcement of the NEP, foreign banks were actively discouraged and local ethnic Chinese and Indian banks were not favoured. State banks and small bumiputra-controlled banks were actively favoured. Bank Negara also strictly reduced all banks' lending freedom through directed credit programs that, at times, together approached 40 per cent of total loans. The central bank also curtailed resident foreign multinationals' corporate borrowing freedom, forcing them to direct their business to less-than-willing local banks.[3] The depth and duration of this multi-level intervention into what had been a relatively open banking sector clearly shows the statist-nationalist intrusive nature of the NEP and the central role banking policy plays within it.

1994–1997 – The second phase

In the early 1990s, the Malaysian state focussed on introducing the second phase of the NEP. This second phase focussed on transferring economic assets from the hands of the state to those of chosen bumiputra (Malay) capitalists with strong ties to UMNO. The Bumiputra Commercial and Industrial Community was judged to be mature enough to compete in the market. At the same time, banking policy also focussed on local bank consolidation in response to the traumatic debt crisis in Malaysia from 1985–1986. The state as a whole was focussed on the evolution of the NEP, while Bank Negara was also interested in strengthening the local banking sector by reducing the number of banks through persuasion not administrative fiat.

Malaysia's period of hothouse economic growth between the 1985–1986 crisis and the 1997–1998 Asian financial crisis provided the ideal climate for the UMNO-led Malaysian state to pursue its plans for the second phase of the NEP. This second phase called for the privatization of selected state assets to chosen bumiputra business leaders. The Kuala Lumpur Stock Exchange, the major arena

Table 5.1 Growth indicators (billion ringgit)

Year	*%GDP growth*	*% growth, bank deposits*	*% growth, bank loans*	*Net capial inflows*	*Current account balance*	*Balance of payments*
1991	8.7	18.5	20.7	14	−12.5	3.4
1992	7.8	16.2	9.9	19.2	−4.2	16.7
1993	8.3	23.3	12.0	24.2	−5.4	29.2
1994	9.2	13.1	16.5	28.2	−11	−8.3
1995	9.5	21.9	28.3	16.3	−17.8	−4.4
1996	8.2	26.7	27.6	23.2	−13.0	6.2

Source: Bank Negara Annual Reports, 1991–1997.

through which state assets were divested, boomed during this period, and state-controlled but divested assets became its massive leading counters.

Malaysia's stock market grew very rapidly. By 1997, it was the third largest in East Asia, only behind Tokyo and Hong Kong. Valued at over $200 billion, it was one of the largest stock markets in the world in relation to its GDP (Delhaise 1998). Foreign portfolio investors contributed heavily to this growth, as local market analysts estimate that up to 60 per cent of the market's trading volume involved foreign funds prior to the crisis, while the Securities Commission estimates that up to one quarter of traded stocks were foreign owned.[4] By 2002, it had slipped to the seventh largest in East Asia, with Seoul, Shanghai, Singapore and Taipei now ahead of it.

However, UMNO and the state's goal of actively fostering a bumiputra commercial class, outside the state but closely linked to it and UMNO, contradicted the central bank's goal of rapidly reducing the number of local banks. The boom also permitted resistant local bank owners to deflect the central bank's indirect, market-based means to promote local bank mergers, undercutting Bank Negara's ability to push through its consolidation plans, and effectively stalling the process before it began. While the external economic environment for banking policy during this decade was much less turbulent, its longer-term globalizing forces discussed in the previous chapter became more apparent and the Malaysian state's defensive approach to these clearer.

NEP paramountcy

The NEP's second stage primary goal of nurturing a growing bumiputra commercial and industrial class more deeply and widely entrenched in Malaysia's private sector clashed with the central bank's plan to consolidate the local banking sector. Throughout this period of macro-economic stability and growth, the demands of phase two triumphed over sectoral policy reform in banking and its adjustment to the new external environment. This decade saw the continuation of the transfer of more bank licences to state owned firms, select bumiputra financiers, and ethnic Chinese financiers with close and mutually beneficial ties to UMNO and

Table 5.2 Banking sector restructuring

Acquired bank	*Ethnicity*	*Acquirer*	*Ethnicity*	*Year of transfer*
Kong Ming	Chinese	EON	State (Bumiputra)	1992
UMBC	State (Bumiputra)	Sime	State (Bumiputra)	1995
D&C	Chinese	RHB	Bumiputra	1990
Security Pacific	Chinese	AMMB	Bumiputra	1994
MUI	Chinese	Hong Leong	Chinese	1994
Bank Utama	Bumiputra	Cahya Mata Sarawak	Bumiputra	1992
Defunct credit cooperatives, UOB Kota Kinabalu	Chinese, foreign	Phileo-Allied	Mixed	1994

Sources: Various editions of Bank Negara Annual Reports and the Kuala Lumpur Stock Exchange Annual Company Handbook.

the Malaysian state. Moreover, when the central bank had a chance to retire a banking licence surrendered due to the merger of two foreign incumbents, it chose to transfer it to a local entity, contradicting its goal of local consolidation. Most of these transfers of ownership also contravened the 1989 limits on bank shareholdings for individuals and/or corporations, showing that the Malaysian state would ignore laws when central policy interests are involved.

These transfers of ownership approved by the Minister of Finance and Bank Negara further centralized local banking control within the hands of the state (the new EON[5] Bank and Sime Bank) and select bumiputra financiers (Azman Hashim's takeover of Security Pacific Bank and Rashid Hussein's takeover of Development & Commercial Bank). The central bank's 1982 freeze on the issuance of new bank licences meant that would-be local bankers had to convince present bank owners to transfer ownership and gain approval from the consolidating central bank and Minister of Finance. The lack of new licences and the unwillingness of previous owners to sell meant that close relations with the Minister of Finance were crucial. Finance Minister Anwar Ibrahim oversaw all of these transfers of banking licences.

Consolidation denied

Bank Negara introduced a two-tier regulatory system on 1 December 1994 to spur local bank consolidation in parallel with the continuing consolidation of banking assets in bumiputra hands. While the consolidation of assets in bumiputra hands was quite successful, the attempt to reduce the total number of local banks was not. Banks with shareholder capital of more than one billion ringgit could be granted Tier One banking status. Tier One banks alone could offer customers multiple

(Continued)

foreign exchange accounts with no limit on the size of deposits exempt from reporting to Bank Negara. Exporting firms could keep foreign funds in these accounts without having to exchange them into Malaysian ringgit, opening up a new large market niche for Tier One banks and pleasing exporters. (UMBC 1994). This new supervisory system, a main cog of the consolidation drive, was supposed to lead to mergers and a banking sector of a few large, multi-purpose Tier One banks and small niche-playing Tier Two banks (Choo and Choo 1995). Before its introduction, no local mergers had taken place.

However, the ebullient rise of the Kuala Lumpur stock market largely precluded the two-tier supervisory system from achieving its consolidation ends. Through this period, publicly listed banks' share values rode the cresting market, increasing these banks' shareholder funds. Bank owners unwilling to dilute their control over the bank on selling more shares to gain Tier One status used borrowed funds to buy up the new shares in their banks to maintain control while raising their shareholder funds to over one billion ringgit. Between its introduction and the 1997 financial crisis, only one merger took place (in 1996 when RHB Bank took over Kwong Yik Bank, a former ethnic Chinese bank 100 per cent controlled by state owned Malayan Bank). The consolidation drive, the main element in preparing the local banking sector for a more competitive, globalized future, stalled during this period in the face of the interests in bumiputra class formation and the stock market ramifications of high sustained growth fueled by foreign portfolio investment.

The very growth that helped thwart the new supervisory system also increased external pressure on the Malaysian state to open up its banking sector. Malaysia's hothouse economic growth (focussed on the export-manufacturing sector), combined with its highly protected and profitable banking sector,[6] made it a country of focus during the Uruguay Round of financial services negotiations. The United States Trade Representative selected Malaysia as one of the thirty developing members with which it would seek bilateral negotiations over financial services to buttress the ongoing multilateral negotiations. Equally, other state leaders from Australia to the People's Republic of China used diplomatic channels and visits to push their home banks' interest in entering the Malaysian market. The International Monetary Fund, an observer to the Uruguay Round's negotiations on financial services, also used its annual monitoring visits to Malaysia to press for greater market access for foreign banks – pressure greatly diluted by the fact that the Malaysian state had no outstanding loans with the Fund.

On the multilateral front, the Malaysian state and Bank Negara responded by attempting to lead a common Southeast Asian response against the inclusion of financial services in the Uruguay Round. Leveraging the fact that SEACEN (Southeast Asia's regional centre for central bank research and cooperation) is based in Kuala Lumpur, the Malaysian state took the role as SEACEN negotiator in talks over the inclusion of financial services and then the nature of the Financial Services Annex (BNM 1999a). The Malaysian state first pushed against

the inclusion of financial services, and then, once they were included, for a discrete and limited negotiating framework that took into consideration developing members' fear of foreign domination. Malaysian state officials and the Prime Minister also used 'South–South' fora, such as the G-15 and the United Nations Conference on Trade and Development (UNCTAD), to push their case for the banking policy status quo.

The Malaysian state's final commitments in financial services in the extended Uruguay Round provided no greater access to the banking sector, only promising the status quo. Malaysian negotiators also took full advantage of the unbound option, unbinding (i.e. excluding) numerous areas of banking policy (including automated teller machine regulations) from their commitments. During the financial services negotiations, the Malaysians pushed hard for members to be allowed to introduce higher levels and new forms of protectionism in their commitment schedules. In the insurance sector, Malaysia did just this (Judge 1999).

While the Malaysian state did resist pressures to open up during the Uruguay Round negotiations, Bank Negara has consistently warned local bankers that external pressure will eventually lead to a more open banking sector in preemptive need of local consolidation. Despite great hopes and fears, the Financial Annex of the General Agreement on Trade in Services, in its first negotiating life, failed to force policy punctuation upon unwilling members like Malaysia. Its permanency as a feature in the General Agreement on Tariffs and Trade, though, does provide Bank Negara with a new lever to force policy change.

Chinese exception

On the bilateral front, the Malaysian state's interest in closer economic and political ties with the People's Republic of China and state-owned Malayan Bank's interest in entering the Chinese market did lead to a one-off reopening of the Malaysian banking sector. The Bank of China's Malaysian licence had been suspended in the 1950s after bilateral diplomatic relations had been broken off. The Malaysian state's ban against state-controlled foreign banks from operating in Malaysia then meant that, without changes to banking legislation, the Bank of China could not re-enter Malaysia. But, Chinese financial authorities demand reciprocal treatment for mainland Chinese banks when considering applications from foreign banks to enter the attractive mainland Chinese banking sector.

In 1996, suitable changes were made to the 1989 Banking and Financial Institutions Act to allow Bank Negara to reactivate the Bank of China's suspended banking licence, permitting the bank to reopen its original branches (Hew and Cheah 2000). So far, only the Bank of China has benefited from this change in legislation. Unlike 'global banks', the Bank of China, while much larger than even Malayan Bank, does not have a noticeable head start technologically over local Malaysian banks. Malaysian banks are also confident that they can compete effectively in mainland China and remain profitable, confidence that does not extend to the mature banking sectors of the First World. Here, overarching economic and diplomatic interests permitted an exception to the statist-nationalist banking policy status quo.

Adding to the growing external pressure on Malaysia to open up its banking system, the widespread application of new banking technologies during this period threatened to undermine the Malaysian state's protective *cordon sanitaire* around the banking sector. These new technological applications, *ceteris paribus*, should help incumbent foreign banks gain a stronger foothold and hurt local banks. However, Bank Negara quickly developed new administrative regulations to minimize incumbent foreign banks' use of them. First, the central bank defined off-site automated teller machines as separate branches as they are in Singapore and Thailand. Hence, foreign incumbent banks cannot open up off-site automated teller machines to expand their catchment areas due to the existing ban on new foreign incumbent bank branches. Bank Negara does not permit foreign incumbent banks either to join the local banks' extensive automated teller machine interconnection network or to establish their own, parallel teller machine interconnection network. This multi-faceted limitation on incumbent foreign banks' use of automated teller machines means that the central bank has turned what should be a competitive advantage for foreign incumbent banks into a competitive advantage for already favoured local banks.

Bank Negara adopted a similar market-limiting approach to regulating foreign incumbent banks' establishment of internet banking portals. Recognizing the technological superiority of foreign incumbent banks, Bank Negara allowed local banks to open up transactional and communicative internet banking portals from 1 June 2000, while foreign incumbent banks were only allowed to open up such portals from 1 January 2002 after obtaining Bank Negara approval (Soon 2001). Again, the wide scope for administrative discretion in the Malaysian state allowed these significant new barriers to foreign banks to be introduced with no change to banking laws, and thus no avenue for legal challenge. Foreign incumbent banks' public disagreement with these policies shows their frustrations at seeing one of their strongest competitive advantages in the Malaysian market taken away from them and provided to local banks (Oh 2000).

1997–2000 – Blinsided by crisis

The 1997–1998 Asian financial crisis served as the largest and most substantial shock to Malaysia's NEP and its associated banking policy. While the IMF's estimate that Malaysia's non-performing loan ratio may have reached 30 per cent in late November was slightly lower than the 1985–1986 peak (IMF 1999), this second externally-generated financial crisis triggered a more comprehensive response from a Malaysian state seeking to protect the NEP.

Like 1985–1986, the Asian financial crisis triggered a deep split within UMNO emanating as a challenge to Prime Minister Mahathir. It led to a further, selective narrowing of the NEP in the real economy. However, yet again, the crisis response offered foreign banks no new openings, while state and politically well-connected banks again benefited from the state's crisis response strategy. Rather than opening up the long-protected banking sector, the crisis permitted further consolidation of local banks in favour of state controlled banks (Takayasu 2001).

The changes in and interaction between the political system, state structure, and fiscal resources again explain the crisis response path chosen. Malaysia's Asian financial crisis and the state's policy responses were very much like the 1980s debt crisis writ large.

Malaysia's vulnerability

In 1997 Malaysia did not seem to be on the brink of an economic collapse or particularly vulnerable to regional contagion. Using the standard pre-1997 indicators, Demigurc-Kunt and Detragiache (1999) calculated that Malaysia in 1996 and 1997 was at little risk of a financial crisis, while the Philippines was at much greater risk. Yet the 1997 crisis hit Malaysia much harder than the Philippines.

On the worrying side, bank lending in Malaysia accelerated much quicker than the economy as a whole and the banks' deposit base. Malaysia's bank lending as a share of GDP ballooned from 85 per cent in 1985, to 120 per cent in 1994, to 160–170 per cent in 1997, the highest share among crisis-hit economies (Athukorala 1998). Partially due to strict Bank Negara rules on foreign borrowings, however, locally-sourced capital funded most of Malaysia's huge increase in bank credit, unlike in Indonesia and Thailand. Large firms like UMNO-linked Renong and the Lion Group though did borrow heavily overseas, inflating their gearing ratios and currency risk.

Second, new interest in Malaysian stocks increased the amount of hot money entering Malaysia. From the early 1990s, Malaysia's foreign capital inflows shifted from a heavy bias towards foreign direct investment towards more volatile portfolio investment. Portfolio investment, mostly in the stock market, spiked from 13.2 per cent of total inflows in 1994 to 43.3 per cent in 1995 (Athukorala 1998). While helping to drive Malaysia's impressive growth, this shift in global financial integration made Malaysia's economy more vulnerable to foreign investors' fickle risk- and- return inclinations and 'herd mentality' panics. The increased exposure was fine when foreign capital flowed in, but quickly transformed into a serious problem when it stampeded out in 1997–1998. Luckily, Malaysia's lack of a large external debt insulated its economy somewhat from the macro-economic pain inflicted by this stampede.

Third, Malaysia's declining export and foreign direct investment growth was matched by an increase in capital goods imports partially tied to major infrastructure projects. Malaysia's current account deficit began to yawn, growing from a manageable 2.2 per cent in 1995 to a more worrying 10.2 per cent in 1996 and 5.9 per cent in 1997 (BNM 1999a). After Thailand's collapse, these large deficits sparked fears among spooked investors that locals would be unable to service their mounting foreign obligations. Despite Malaysia's relative lack of foreign liabilities, foreign investors fled Malaysia too, showing the power of the herd mentality and the costs of being exposed to it.

Fourth, central bank regulatory forbearance permitted much of the growth in bank lending and stock market turnover to be tied again to the broad property sector and a raging high-end property bubble. Like the prologue to the 1985–1986

crisis, local banks' lending portfolios were heavily exposed to the broad property sector's 'irrational exuberance'. Any fall in skyrocketing property prices meant that borrowers could not pay back their loans to local banks. Any depreciation in the local currency meant that local entities earning local currency but owing foreign currency would be squeezed. The lending and stock market bias towards property and the yawning current account deficits in the face of slowing export growth triggered both.

The Asian financial crisis and its domestic ramifications took Malaysia by huge surprise, deepening its disruptive impact. Bank Negara only publicly began to worry about an asset price bubble in March 1997 when it issued prudential guidelines trimming bank's new loan exposure to the broad property sector, and equities loans. In March 1997, Bank Negara encouraged banks to reduce their exposure to equities loans to 15 per cent of new loans. Most central bankers would see such an exposure as quite imprudent. The Malaysian state even contributed to the IMF-organized crisis packages for Thailand and Indonesia in mid-1997. Finance Minister Anwar Ibrahim's 1998 budget initially projected a growth rate of 7 per cent in line with Malaysia's pre-crisis growth trajectory.

Yet, by the third quarter of 1997, the Malaysian ringgit was under severe attack and the stock market and property prices were in freefall, triggering severe stress on the banking sector and macro-economic decline. The ringgit fell over 50 per cent against the US dollar from June 1997 to early January 1998, while the stock market fell 70 per cent. The final revised estimates for the 1998 budget tabled in October 1997 predicted a real GDP growth rate of 2–3 per cent. In 1998, Malaysia's real GDP actually shrank by 7.4 per cent. At the peak of the crisis, Prime Minister Mahathir claimed the crisis had cost Malaysia $250 billion, $200 billion due to the collapse of the ringgit and $50 billion from the Kuala Lumpur Stock Exchange's paper losses (*Business Times of Singapore* 2001a).

The much larger roles bank lending and the stock market played in the Malaysian economy by 1997–1998 were largely responsible for the sharp recession. With stock market capitalization running at 300 per cent of GDP, a 70 per cent decrease in capitalization in less than half a year hammered corporate bottom lines and corporate and individual savings. The NEP's second phase, to breed bumiputra retail investors through state-run investment funds and its push for state asset divestment through the local stock market, was instrumental in the bourse's boom. It was equally instrumental in the deep and wide-ranging pain felt in the economy when the market crashed.

Another more telling banking sector element of the crisis was that the souring of loans affected a larger number of banks, raising the clean up costs and complexity. At the peak of the crisis the state bank recapitalization special vehicle Danamodal identified fourteen financial institutions requiring recapitalization, and put eleven others on a watch list (*The Star*, 1999). The fourteen identified included some of the largest bumiputra banks in the country, including Arab-Malaysian Bank, RHB Bank, and Perwira Affin Bank.

Yet Danamodal's list of troubled banks came out only after two of Malaysia's largest state-owned banks, Bank Bumiputra and Sime Bank, had already been

recapitalized. The larger size of local banks, the quick decline of their loan portfolios, and the significant number of banks at risk of insolvency meant that the Malaysian banking sector faced collapse. In the early months of the crisis the estimated clean up costs ballooned upwards of 15 per cent of GDP, at a time when the economy and state revenues were shrinking, and interest rate spreads on Malaysian public and private debt were rising sharply in international credit markets.

The new global pressures for liberal banking policy reform weighed on all affected states and banking sectors. Yet, the Malaysian state was the only one of the crisis-affected states not to liberalize its rules on foreign incumbent banks and new foreign bank entry. This, by itself, is an indicator of how strong these external pressures to liberalize access were on the weakened, protected banking sectors and states of the region and the depth of the Malaysian state's statist-nationalist commitment.

Two multilateral processes detailed in Chapter 2 dovetailed nicely with foreign banks' enthusiasm to expand in crisis-ravaged Malaysia. First, the crisis shifted multilateral concessional lenders into high gear, organizing bail-out packages and promulgating technical advice for crisis-stricken countries. A major part of these packages and advice was the major overhaul of banking policies that encouraged local bank consolidation and closure, the closure or privatization of state banks, and most importantly much greater access for foreign incumbent banks and new foreign entrants: i.e. the end of the statist-nationalist status quo.

Second, at the same time, early steps were being taken towards the World Trade Organization's Doha Round of negotiations, with member states beginning to lobby for their priorities in the coming round. As in 1982, financial services were at the top of many developed members' agendas, including the United States and the European Union. Logically, crisis-hit states like Malaysia could present moves to open up their crisis-ravaged banking sectors as Doha Round commitments above and beyond those made at Uruguay, increasing the diplomatic benefits of any such liberalizing steps. Showing the diversity and growth of these pressures, in May 2002, United States Deputy Treasury Secretary Kenneth Dam launched the Bush Administration's push for a more liberal regime for trade in financial services in Malaysia. Dam also visited South Korea, Thailand and the People's Republic of China (Hamid 2002).

Internal feuds in UMNO over how to respond to the crisis opened the door further for a change to a market-friendly, liberal paradigm in tune with Malaysia's external environment. The 1997–1998 crisis triggered a split within UMNO and the formation of an opposing coalition based around an UMNO spin-off that failed to root out UMNO and the Barisan Nasional electorally. Deputy Prime Minister/Finance Minister Anwar Ibrahim accused Prime Minister Mahathir and his supporters of manipulating the NEP for their personal gain, while shirking UMNO's mission to help the bumiputra community.

More importantly, though, Anwar, while in UMNO and after his expulsion in September 1998, argued that the main causes of Malaysia's crisis were domestic, not external. He argued that a more market-friendly, liberal approach to economic

policy was needed to reduce corruption and state collusion with chosen business leaders. Anwar focussed attention on the domestic policy weaknesses that exposed the Malaysian economy to contagion from Thailand.

Reflecting his orthodox stance on the crisis, Anwar's last budget as Finance Minister in 1998 imposed a 'virtual IMF program' of expenditure cutbacks, despite Malaysia's fiscal strength and wide array of quasi-fiscal resources like Petronas and state investment funds. These cutbacks, originally supported by Prime Minister Mahathir, included a 5 per cent cut in senior civil servant salaries and banning civil servants' overseas vacations. The Ministry of Finance enforced an immediate 10 per cent cutback in public spending, programmed to rise to 18 per cent by the end of the financial year. Bank Negara, under Governor Ahmad Don, kept monetary policy in line with traditional IMF crisis guidelines, and allowed panicky markets to determine both the value of the ringgit and interest rates. Three-month interbank rates peaked at over 11 per cent, while the ringgit continued to slide.

The Finance Minister and Bank Negara's liberal interpretation of the crisis and Anwar's challenge for the leadership of UMNO sparked hope among foreign investors that Malaysia's statist-nationalist economic policy paradigm might be changed significantly in a liberal direction. They hoped a change in the political system would change the state's policy paradigm. The domestic costs of the 1997–1998 crisis, banking policy's changed external environment, and a leadership challenge within UMNO all pointed towards the crisis sounding the NEP's death knell.

Defending the status quo

Malaysia's political system, state structure and fiscal strength were crucial in explaining the Malaysian state's interest in and ability to avoid paradigmatic change, while reaffirming the state interests in the NEP's statist-nationalist banking policies. The centralization of political power within the Prime Minister's Department and Bank Negara's lack of operational independence were key institutional factors undermining the viability of Anwar's challenge. The centrality of statist-nationalist banking policies to the NEP and its UMNO-led nexus of UMNO, state and bumiputra capital interests protected the banking sector from globalization. The Malaysian state's sound fiscal position allowed it to reject a bail-out package and quickly mobilize huge amounts of local capital to clean up the wounded banking sector and bumiputra business class. Through very firm and comprehensive state intervention, the Malaysian state was able to transform the 1997 crisis from a threat to the statist-nationalist banking policy status quo into a means to strengthen it.

Underlining the high level of political control over the state, sequenced changes to Malaysia's political system and state structure led to the triumph of Prime Minister Mahathir's heterodox interpretation of the crisis. By the end of 1997, the split within UMNO between Mahathir and his chosen heir apparent had spilled over into public. Anwar, whose 'Vision Team' had done very well in

UMNO's 1996 party elections, publicly adopted a very different stand on the crisis from his leader.

The Prime Minister argued that the causes of the crisis were untrammelled global markets and immoral First World speculators, with Malaysia as their hapless victim (Mahathir 2000). Anwar Ibrahim and his supporters countered that many of the causes were structural weaknesses in the Malaysian economy, an economy led by Prime Minister Mahathir for the last sixteen years and defined by the NEP. As reflected in the 1998 budget, this orthodox argument, then with a strong institutional basis in the state, called for a liberal crisis response of fiscal retraction, and remaining open and responsive to jittery foreign investors. Unsurprisingly, the foreign business media threw its weight behind Anwar, painting him as Malaysia's hope while criticizing Mahathir.

Prime Minister Mahathir's first move to quash Anwar's leadership challenge was to set up a new Cabinet-level economic team outside of the Ministry of Finance, Bank Negara, and his own Economic Planning Unit. On 22 November 1997, the Prime Minister established the National Economic Action Council, bringing together selected economic experts from state agencies, national universities and a government think tank close to the Prime Minister, ISIS. The Prime Minister appointed Daim Zainuddin, who was UMNO Treasurer, as Minister for Special Functions and placed him in charge of this new Cabinet-level arm of the bureaucracy. The National Economic Action Council took over the development and coordination of the Malaysian state's response to the crisis.

The formation of the Cabinet-level Council and the appointment of Daim Zainuddin, who as Finance Minister and prime ministerial confidant had managed to defend and deepen the NEP during the 1980s' debt crisis, undercut the Ministry of Finance and Bank Negara's institutional primacy in dealing with the crisis and their ability to push their competing, orthodox line. The personalized centralization of power within the office of the Prime Minister provided Mahathir with the means to quell an intra-party and intra-state challenge to his authority.

Mahathir enhanced his personal control over the Malaysian state's response in August 1998, when Governor Ahmad Don and Deputy Governor Fong Weng Phak left Bank Negara before the end of their three-year fixed terms after public disputes with the Prime Minister over monetary policy. Despite being under the cloud of an official corruption investigation that was quickly dropped, Director General of the Prime Minister's Department's Economic Planning Unit and Chief Cabinet Secretary, Ali Abul Hassan bin Sulaiman, was quickly appointed as the new Governor. This substitution clearly moved the central bank much closer to the Prime Minister, undermining further the central bank's claim to be operationally 'independent within the government'.

In early September 1998, the political challenge died when the Prime Minister removed Anwar Ibrahim as Finance Minister and Deputy Prime Minister, while UMNO's Supreme Council removed him from all party posts. In late September, after leading public rallies against the Prime Minister and UMNO calling for *reformasi* (liberal reform), Anwar was jailed and charged with sodomy. Daim Zainuddin took over as Finance Minister, while Abdullah Badawi became Deputy

Prime Minister. In the 1999 elections, the *Barisan Alternatif* (Alternative Front) organized by the new party *Keadilan* (Justice) led by Anwar Ibrahim's wife, Wan Azizah, failed to topple UMNO and the Barisan Nasional from power.

Barisan Nasional won 77 per cent of seats nationally, including all the seats in Sarawak. Institutionally, Anwar's challenge was vanquished and the same team that 'saved' Malaysia and the NEP from the 1985–1986 crisis was back at the helm. Barisan Nasional's impressive powers of incumbency and UMNO's hegemony within this coalition again closed off any political space for competing policy approaches.

Dr Mahathir and Daim's heterodox crisis response synchronized many different policy responses to protect the NEP. Again, the ailing banking system was at the centre of this process of reaffirmation through reform. The Malaysian state first insulated the Malaysian economy and state from their external environment's pressures to abandon the NEP. The Malaysian state, while taking on small, targeted crisis-related loans from concessional lenders, refused a comprehensive bail-out package, despite plummeting credit rating and rising debt premiums, for fear of being required to dismantle NEP policies (Nesadurai 2000). Backing up this refusal of concessional, conditioned funds and the Prime Minister's rhetoric against foreign portfolio investors and the global financial architecture, on 1 September 1998, Malaysia imposed stiff controls on portfolio capital outflows.[7] Once these outflow controls were in place, on 2 September 1998, Bank Negara withdrew the ringgit's freely tradable status overseas and pegged it at 3.80 ringgit to one dollar. The peg was only lifted for a managed float against a basket of currencies in July 2005 in conjunction with the People's Bank of China's shift from an explicit dollar peg.

Through this trio of actions, the Malaysian state effectively insulated the Malaysian economy and economic policy-making processes from external political and market pressures to liberalize. The Malaysian state was the only one of the five crisis-affected countries to peg its exchange rate and not to seek an IMF-led bailout. Malaysian capital controls during this period also were the most comprehensive.

The Malaysian state's strong fiscal position allowed it to mediate the crisis by absorbing its costs while defending the NEP. By refusing a bail-out package, the Malaysian state kept the NEP insulated at the cost of having to rely on local savings and expensive capital markets to fund the clean up. Fixing the exchange rate and imposing comprehensive capital outflow controls enhanced the Malaysian state's control over monetary policy at the cost of reduced investment inflows and rising anger within the investment community. As we have seen, Indonesia and Thailand chose the opposite mixture of benefits and costs, largely because their fiscal weakness and greater exposure to the crisis left them with little choice. The Malaysian state's unique willingness to aggravate its external environment and refuse concessional funds in time of crisis exemplifies its fiscal strength and the opportunity costs it is ready to absorb to maintain policy autonomy.

Once insulation had been established, Bank Negara and Ministry of Finance under their new heads reversed monetary policy. Monetary policy shifted from an

orthodox contractionary one to a heterodox one of low interest rates, declining statutory reserves and looser prudential regulation. Through a series of changes to monetary policy and prudential regulations, the central bank pushed large amounts of liquidity into the local market, reduced reported banks' non-performing loan ratios and necessary loan loss provisions, and boosted banks' falling profit margins. The central bank also issued a 100 per cent blanket guarantee of deposits in local banks to minimize capital flight to foreign banks. With local bank deposits running well over 100 per cent of GDP, this one-off guarantee exploded the Malaysian state's contingent liabilities.

The central bank took two major steps to boost liquidity to encourage private investment and the paying off of loans that had fallen into arrears. First, with the policy autonomy provided by the ringgit peg and capital outflow controls, the central bank rapidly lowered the interest rate it charged to banks to borrow money, triggering falls in banks' lending rates to their customers. Simultaneously, the central bank drastically cut its traditionally high statutory reserve requirements (money banks keep with the central bank) from 13.5 per cent of total deposits in January down to only 4 per cent by October, freeing up approximately 38 billion ringgit or almost one-seventh of 1998's GNP (Narayanan 1998). The supply of capital to banks increased sharply to spark new lending, to boost the real economy and to lower non-performing loan ratios.

The sector-specific crisis responses depended on this insulation and pump-priming of the Malaysian economy. The victorious crisis response path focussed on state intervention to ease the crisis-related pressures on the NEP in general and the banking sector in particular. It focussed on narrowing the NEP in the real economy and deepening it in the banking sector through state-guided consolidation. The Malaysian state used this crisis to discipline the Malaysian economy in some sectors while protecting the NEP and its limits on competition in others.

The easing of monetary policy benefited all firms saddled with variable rate loans. Pegging the ringgit helped both importers and exporters plan more effectively and bolstered their willingness to sign long-term contracts. Beyond loose monetary policy, the Malaysian state also used banking policy and the budget to ease conditions for local firms, especially those owned by the bumiputra beneficiaries of the NEP's second phase. The 1997–1998 crisis hit the NEP and its chosen bumiputra tycoons very hard, requiring the state to intervene directly to ease pressures on these firms and ensure their future viability.

The Malaysian state retreated from phase two of the NEP and renationalized many major bumiputra firms. The NEP's inherent weakness of relying on politically-chosen neophytes to run huge privatized firms forced the Malaysian state to reverse the NEP's progress to stave off paradigmatic collapse. The Malaysian state, once the battle between Mahathir and Anwar had been settled, used the crisis' leverage to restructure the scope of the NEP and to discipline its chosen beneficiaries.

In 1999, the Prime Minister and Bank Negara strongly encouraged banks, suffering losses and huge loan loss provisioning demands, to stimulate the moribund economy by increasing corporate lending. Both the Prime Minister and Bank

Negara called on local banks to increase lending by 8 per cent despite soft corporate demand. Bank Negara warned that it would carefully monitor the growth of individual banks' lending portfolios. The Corporate Debt Restructuring Committee was established to help negotiate the restructuring of non-performing loans worth over 5 million ringgit. This committee was mandated to seek solutions between banks and their loan customers that favoured the continued viability of loan customers, not the maximization of the returns to damaged local banks. Finally, the central bank raised the directed credit minimum to the bumiputra community from 20 per cent of total loans to 30 per cent of new loans, indirectly subsidizing these loans.

These three moves further constrained banks' ability to manage their portfolios during the crisis, in the interests of helping suffering corporations, especially bumiputra ones, recover. Despite the parlous state of many banks, the Malaysian state sought to channel bank credit to maintain economic growth and communal redistribution.

Dealing with the banks

The 1997–1998 crisis triggered the comprehensive state response in the region to shelter local banks from the worsening external environment and foreign banks' acquisitive advances. The state ruthlessly used the crisis to reorganize the banking sector through local consolidation. The crisis strengthened the state's hand versus reluctant local small bank owners whose interests were finally sacrificed. Banking policy's central place within the NEP meant that opening to foreign banks was never considered. Rather, the state worked hard to minimize local banks' risk of insolvency, then transformed them to resist more effectively the reaffirmed dangers of globalization.

To ease the plight of local banks, Bank Negara eased prudential rules on how to calculate non-performing loans from the international best standard three-month classification applied by the central bank under Governor Don to a much easier six-month classification. Bank Negara also allowed banks to remove loans made to government projects or private sector projects the government supported – mainly coming from state-owned banks – from the non-performing loan roster, even if they were not being serviced. Finally, the terms by which restructured loans could be redefined as performing loans were loosened, completing the cosmetic overhaul of bank loan reporting. Bank Negara also redefined how banks could calculate the interest rates they charged on loans, permitting the interest rate spread between deposit rates (cost to the bank) and loans (revenue for the bank) to boost local banks' sagging profit margins. This, of course, raised the cost of credit to the recovering real economy (Gunasegaram 2000).

While these provisions benefited the whole banking sector, the most expensive and direct forms of crisis-driven state intervention into the banking sector targeted local banks badly hit by the crisis. Unlike the heterodox crisis reactions discussed above, this form of direct state intervention started when Anwar Ibrahim and Ahmad Don were still in control of the crisis response and echoed

mainstream theory on how to deal with banking crises. Starting in March 1998, the main state economic agencies discussed setting up a state run asset management corporation to help clear banks' books of non-performing loans. In June 1998, a special act of Parliament established *Pengurusan Danaharta Nasional*, commonly called Danaharta, as a wholly-owned special purpose vehicle of the Ministry of Finance Inc. After issuing zero-risk rated local bonds with full government backing, Danaharta acquired from local banks non-performing loans with a face value of 47.49 billion ringgit at an average discount of 40 per cent.

Danaharta absorbed some 43 per cent of total non-performing loans. In the process, Danaharta became the single largest property owner in Malaysia and the majority shareholder of the Philippines largest steel company, the National Steel Corporation. Danaharta was set up with the full support of the Minister of Finance, Anwar Ibrahim, after the idea of raising or removing the 30 per cent foreign equity ceiling on local banks had been discarded with little debate. Danaharta, established with the huge amount of state guaranteed funds, pre-empted a greater role for foreign banks in Malaysia. The Malaysian state socialized a large share of the non-performing loans and inflated the state's contingent liabilities to ease pressure on local banks and to insulate them against foreign banks' push to enter Malaysia.

Soon after Danaharta, Danamodal, a special purpose vehicle charged with injecting funds into illiquid local banks was established. Bank Negara invested three billion ringgit in seed money into Danamodal, while the final 2 per cent cut in banks' statutory reserve requirement from 6 per cent to 4 per cent was conditional on banks' using this new liquidity to buy state-guaranteed Danamodal bonds worth up to 8 billion ringgit (Nantha 1998). Danamodal's primary mandate was to inject capital into suffering banks and other financial institutions to help them meet capital adequacy ratios in return for normal or preferred shares. In total, Danamodal injected 7.6 billion ringgit into ten financial institutions and worked in tandem with Danaharta to save local banks and pre-empt the need for foreign bank entry.

Danamodal and Danaharta were funded by state-guaranteed local bond issues bought mostly by state pension and investment funds, adding to the state's fast growing, less transparent contingent liabilities. The speed with which these two bodies were set up and their ability to raise such large funds domestically so quickly again shows the administrative strength of the Malaysian state and its impressive financial resources. The Malaysian state's historically strong fiscal position and administrative nature again helped defend the NEP's statist-nationalist banking policies. This historically strong fiscal position permitted the Malaysian state to save the NEP's leading firms and to run significant budget deficits since, despite a return to healthy growth, funded mostly by domestic, often state, investors.

The main banking reform carried out due to the 1997–1998 crisis was the implementation of Bank Negara's long-stalled local consolidation drive. Early on, it looked as if the consolidation program might actually reduce state control over the banking system. In 1998, both state-controlled Sime Bank and Bank Bumiputra were merged with chosen bumiputra banks to avoid their collapse.

Prior to each, unlike subsequent mergers, Danaharta absorbed both banks' outstanding non-performing loans at full face value. The Ministry of Finance also gave their acquiring banks, RHB Bank and the Bank of Commerce respectively, the right to sell to Danaharta at full face value for the first 18 months of the merger any loans absorbed from these acquired banks that fell into arrears. For Bank of Commerce's acquisition of Bank Bumiputra alone this option amounted to about 7 billion ringgit (Nantha 1999). These generous merger terms eroded Danaharta's bottom line for the benefit of the chosen bumiputra saviour banks.

Looking more closely at these two state-arranged mergers, a political logic drove the consolidation process that reallocated control over the banking sector towards state-owned and UMNO-linked banks. UMNO-linked Bank of Commerce again benefited from the crisis and quickly became the second largest bank in the country, taking control of Bank Bumiputra's vast branch network. While the Ministry of Finance Inc. was permitted to own up to 40 per cent of the new merged entity through its stake in Bank Bumiputra, it chose to take up only 30 per cent of the new entity to allay local investors' fears of state control due to Bank Bumiputra's checkered history (Nantha 1999).

However, Renong, the firm that absorbed the UMNO party's investments in 1988, was the Bank of Commerce's largest shareholder and second largest in the new merged entity after the Ministry of Finance. When the Ministry of Finance took over Renong's parent, United Engineering Malaysia in 2001, it also took over a portion of Renong's equity position in Bank Bumiputra-Commerce. While on the surface it appears that this merger reduced the role of the state in the banking sector, the state still controlled this larger bank.

Like Danaharta, Danamodal's mandate includes actively supporting the consolidation of the local banking sector. Danamodal's resources were instrumental in organizing the merger between Rashid Hussain's RHB Bank and the floundering Sime Bank. Danamodal injected 1.5 billion ringgit into RHB Bank to fund its acquisition of Sime Bank, scuttling Phileo Allied Bank's plans to invest 1 billion ringgit to acquire a controlling share of Sime Bank (Yeow 1998). The state used Danamodal's state-guaranteed funds to transfer Sime Bank to a chosen bumiputra bank, rather than permitting a multi-ethnic bank close to disgraced Anwar Ibrahim to buy out the wounded state. Phileo-Allied's bid would have required no state funds.

Through Danamodal's 1.5 billion injection of funds into RHB in return for preferred shares and normal shares and investments by other state investment funds, like Khazanah and the Employees Provident Fund in RHB Bank and its parent RHB Capital, RHB Bank, the third largest local bank, fell into state hands during the crisis (Toh 2001a). State control was guaranteed when Danamodal refused to sell its 1 billion ringgit of preferred shares back to RHB Capital at a 38 per cent premium, preferring to flip these preferred shares into normal voting shares and maintain control of RHB Bank by denying itself its first profit valued at 380 million ringgit. Both Danamodal and Danaharta's bottom lines were undermined in the interests of these two mergers that maintained state control over the banking system, and limited foreign incumbent and local ethnic Chinese banks' ability to grow.

Table 5.3 The original anchor banks

Anchor bank	*Merged banks*	*Total assets (billion ringgit)*	*Anchor bank market share gain*
Malayan Bank	Pacific Bank, EON Bank	112	5%
Multi-Purpose Bank	RHB Bank, Phileo-Allied Bank, Oriental Bank, Sabah Bank, International Bank Malaysia	99	15%
|Bumiputra-Commerce	Hong Leong Bank	90	5%
Perwira Affin	Arab-Malaysian Bank, Bank Utama, Bank Simpanan	72	10%
Public Bank	Hock Hua Bank, Wah Tat Bank	40	1%
Southern Bank	Ban Hin Lee Bank	24	2%

Source: Jayasankaran 1999.

The local bank merger drive expanded from badly damaged state banks to all local banks after Governor Don's and Anwar's removal. On 29 July 1999, Bank Negara, under Governor Ali, shocked local market watchers when it announced a plan to fold the existing twenty-one local banks into six 'anchor banks'. Bank Negara provided the affected banks the list of which banks were to merge with which remaining anchor banks, along with a very tight multi-phase timetable. This set in place a merger process that was the opposite of a market-driven 'willing buyer–willing seller' one. This plan, announced after a minimum of consultation, clearly favoured particular state banks and those close to Finance Minister Daim, while punishing those seen as close to Anwar Ibrahim.

Bank Negara justified such a forced and speedy consolidation program by appropriating globalization discourse's contention that individual states, especially small, open Third World ones, have little choice but to change policy in lockstep with the globalizing world. Bank Negara argued that the rushed, state-driven consolidation process was necessary as the crisis showed that small banks were the most vulnerable, and that small family-owned banks could not survive in the new global banking environment (BNM 1999a). All Malaysia's small family-owned banks were ethnic Chinese. State-owned large banks like Sime Bank and Bank Bumiputra were the worst hit by the crisis, while smaller family-owned niche players like Hock Hua and Ban Hin Lee Bank rode out the crisis quite well. Governor Ali also blamed local bank owners for being selfish and ignoring the 'national consideration' in their earlier refusals to merge, providing us with a different take on how globalizing markets should work (BNM, 1999a).

Looking more closely at the designated anchor banks, it is clear that NEP demands and the political interests of Finance Minister Daim – the avowed architect of the plan – shaped the plan and undermined its mainstream economic rationalizations. RHB Bank, Arab-Malaysian Bank and Hong Leong Bank, the fourth, fifth and sixth largest local banks respectively, would have been natural candidates for anchor status if the plan worked along commercial not political lines. RHB Bank had been deemed strong enough to absorb Sime Bank, while Hong Leong Bank was consistently rated along with Public Bank as Malaysia's best-run banks. All three owners had gained their banking licences under Anwar and were seen to be close to him. None of the banks were included in the lucky six.

Rather, the plan called for the small Multi-Purpose Bank, with its strong links to Daim's family investment fund (Jayasankaran 1999), to absorb RHB Bank and the largest finance company and significantly expand its total banking assets. Perwira Affin Bank, controlled by the Armed Forces pension plan, though badly damaged by the crisis and losing money, was also included in the lucky six. Its share of banking assets under the plan would have tripled. Only one true ethnic Chinese bank, Public Bank, would remain with no appreciable rise in its market share. Southern Bank whose ownership was split between a Chinese family and two bumiputra business people with good political connections was to remain, but with no real gain in market share.

Daim's plan triggered unprecedented public criticism, especially within the ethnic Chinese community. Reacting to this firestorm, on 2 August 1999, Bank Negara released a second press release refuting claims that the consolidation plan would reduce the role of ethnic Chinese banks in Malaysia and run roughshod over minority shareholders, both questionable rebuttals. Owners of excluded major banks quickly rallied to lobby the Prime Minister directly. The furor the plan caused in Malaysia's local banking community and the criticism it engendered in the local Chinese press prompted Prime Minister Mahathir to step in quickly and take control of the plan away from Daim and to reprioritize the NEP's policy goals over its personalized manipulation.

The Prime Minister's personal intervention was the first sign of the impending rift between these two hometown friends that led to Daim's stepping down. A rapid softening of the plan was especially politically salient for UMNO and the Prime Minister. An election loomed in which Barisan Nasional would be highly reliant on ethnic Chinese votes, given Barisan Alternatif's, and its leader Anwar Ibrahim's, popularity among disaffected Malays (Felker 2000).

The combustible mixture of a deep crisis, public frustration and a national election threatened UMNO's uninterrupted grip on power. The Prime Minister had to act quickly to defend the NEP's policy goals and Barisan Nasional's support within the ethnic Chinese community. Showing the incumbency biases of first-past-the-post electoral systems, Barisan Nasional's share of the vote dropped from 65 per cent in 1995 to 57 per cent in 1999, yet it still won 77 per cent of the seats (Felker 2000). UMNO's losses were even graver, as it's share of the peninsular bumiputra vote fell below 50 per cent (Khoo 2000), heavily eroded by gains for *Parti Islam se Malaysia* of Barisan Alternatif. Barisan Nasional and UMNO

were very dependent on the votes of non-bumiputra voters and voters from Sabah and Sarawak.

On 20 October 1999, Bank Negara issued a new press release substantially reconfiguring the consolidation plan, after Mahathir had publicly stated than other banks may be granted anchor bank status and keep their banking licences. The new plan added four new anchor banks and made the consolidation process more market-friendly, by allowing non-anchor banks the half-freedom to choose which anchor bank they would merge with and by relaxing the end-date for mergers. The four new anchor banks were state-controlled RHB Bank, state-owned EON Bank (a surprise inclusion), the bumiputra Arab-Malaysian Bank, and the ethnic Chinese Hong Leong Bank.

The Utama exception

The flexibility of the consolidation process to the electoral interests of UMNO and Barisan Nasional showed up again when Bank Utama balked at being acquired by any of the ten anchors and lobbied for its own anchor status. Bank Utama, though a small bank known to have a politically compromised loan portfolio,[8] was in a unique position to resist the Prime Minister and Bank Negara. Sarawak Chief Minister Taib delivered all of Sarawak's seats to Barisan Nasional in the dicey 1999 election, helping Barisan Nasional keep their treasured two-thirds majority in Parliament. Chief Minister Taib's ability to bring out the vote and his loyalty to Barisan Nasional meant that the Sarawak state-controlled Bank Utama was politically very well connected. Long after the new deadline for completed mergers of December 2000, the central bank permitted Bank Utama to buy out RHB Bank to gain anchor bank status, despite RHB Bank having a loan base six times larger than Bank Utama (Ismail 2002).

At the time that Bank Negara approved the merger plan, Bank Utama's reported non-performing loan ratio rested at 18.5 per cent, more than double the industry average of 8.1 per cent. Bank Utama was also the only anchor bank that failed to meet the anchor bank requirement of having minimum shareholder funds of at least 2 billion ringgit (Ismail 2002). The political needs of Barisan Nasional, UMNO and the NEP trumped sectoral concerns over prudential regulation and banking stability.

At the end of the process, there were only ten local banks, down from twenty-one in 1997. In 2002, three of the top four and one of the remaining six local banks in Malaysia were state-owned. Among the other five, two were clearly ethnic Chinese banks, one is a private bumiputra bank created by the second phase of the NEP, and two were multi-ethnic private banks with strong political connections. The consolidation process reasserted state control over the banking sector. The interests of particular bank owners and the tradition of regulatory forbearance towards small banks were sacrificed for continued local bank protectionism and a large role for state banks.

Whether or not it has made local banks any more able to compete directly with major global banks is unclear. Malayan Bank, still Malaysia's largest, and larger

Table 5.4 Final anchor bank groupings

Anchor bank	*Merged banks*	*Total assets (billion ringgit)*	*Anchor bank asset growth* [a]
Malayan Bank	Pacific Bank, Phileo-Allied Bank	117.5	16%
Bumiputra-Commerce	None	82.0	0%
Bank Utama	RHB Bank	64.9	656%
Public Bank	Hock Hua Bank	50.9	13%
Arab-Malaysian Bank	None	41.1	0%
Multi-Purpose Bank	Sabah Bank, International Bank Malaysia	38.3	40%
Perwira Affin Bank	Bank Simpanan	33.1	34%
Hong Leong Bank	Wah Tat Bank	30.2	4%
Southern Bank	Ban Hin Lee Bank	25.1	77%
EON Bank	Oriental Bank	23.6	71%

Source: Based on (*Business Times* 2000), table modified by author to include Bank Utama's acquisition of RHB Bank.

Note:
[a]Only includes commercial bank assets, excludes assets gained by mergers with merchant banks and finance firms.

after the consolidation process, is still only the fourth largest bank in Southeast Asia. Moreover, despite Bank Negara's repeated threats to enforce the Banking and Financial Institutions Act (1989)'s provisions limiting individual and corporate ownership of banks, in early 2002 eight of the ten anchor banks still violated these laws, with some violations growing worse since 1997–1998 (Hammim 2002).

The ability to shrink the number of banks from twenty-one to ten within three years shows the strength of the Malaysian state in the banking sector, a strength that was maximized during the 1997–1998 crisis. More striking, the Ministry of Finance and Bank Negara implemented this long desired but heavily resisted policy without any change to banking law or any aggrieved owner suing the state. Prime Minister Mahathir was able to use his dominant position in UMNO and UMNO's fusion with the state and its fiscal strength to see off the greatest threat to the NEP and the most serious challenge to his own leadership. The fiscal strength of the Malaysian state and the personalized nature of UMNO and state combined to offer him this impressive latitude.

UMNO's responses to the crisis and its political backlash were similar to the 1985–1986 crisis. Control over the party was centralized in the hands of the very few, undermining the party's and state's institutional strength, and personalizing party control and state power. It also clearly showed the operational weakness of Bank Negara, as the consolidation process was negotiated largely within UMNO between Finance Minister Daim and Prime Minister Mahathir. The fiscal strength of the Malaysian state allowed it to mobilize 60 billion ringgit to clean up the banking crisis. Political centralization ensured this money was used to force through consolidation in a way that suited the statist-nationalist status quo.

2001–2004 – Looking forward

By 2001, Malaysia was well on the way to recovering from the crisis. Both internal economic and external political pressures on the Malaysian banking sector had eased. By 2003, Danamodal had closed shop after helping local banks survive the crisis, while Danaharta was well advanced in dealing with the NPLs it had inherited. Danharta ceased operations in December 2005. The Anwar threat to UMNO dominance had subsided. The WTO process and its focus on banking liberalization had stalled and Malaysia was yet to commit itself to any bilateral trade negotiations that would challenge the statist-nationalist banking policy status quo so stoutly defended in the previous period. The relative calm after the immediate crisis response permitted the Malaysian state to consider the future of banking policy in a less reactive, more consultative manner.

The Malaysian state's most significant banking policy announcement since the end of the Asian financial crisis suggests that these external pressures may be bearing limited liberalizing policy results. After an impressive round of consultations, the Malaysian Ministry of Finance released in early 2001 the indicative Financial Sector Masterplan that set out the likely banking policy reform course for the next ten-plus years. The plan identifies itself as the Malaysian state's response to the financial sector weaknesses exposed by the Asian financial crisis and the growing external pressures for it to open up the financial sector, including the banking sector.

Like Singapore's 1999 plan, it features three stages of banking policy reform that, if completed, would liberalize somewhat foreign access to Malaysia's banking sector. The first stage, programmed to last until 2004, is local bank consolidation. The second stage calls for minor liberalizing changes where foreign incumbent banks will be given more operational freedom, including the right to set up a parallel automated teller machine network but not to join the existing local bank one or operate off-branch machines.

The third stage, projected to begin around 2007, will issue a limited number of new foreign bank licences and provide greater operational freedom for foreign banks. So far the government is sticking to this schedule of phases. Even if these stages are completed as planned within their loose time frame, the Malaysian state will still have the most restrictive policies on foreign entry among our five countries. In March 2006, the National Economic Action Council announced that the third phase may be delayed until at least 2009, to allow local banks more time to prepare for fuller competition.

The Malaysian Ministry of Finance has stated it would begin stage two only when it is satisfied that stage one has strengthened the surviving local banks enough to compete effectively with freer foreign banks. Moreover, it has stated that the timeline provided in the Masterplan is indicative and not a hard and fast rule. With most observers believing that the Malaysian state wants a yet-to-be-seen second round of mergers that will reduce the number of local banks from ten to five or six, stage two was still not in place by the end of 2004. In 2006, Bank Bumiputra-Commerce did buy Southern Bank. Bank Negara has also announced

that it will not countenance the foreign takeover of any local bank, suggesting that the 30 per cent foreign equity cap will stay.

The Financial Sector Masterplan suggests that banking policy will be judiciously liberalized in terms of foreign entry and operational freedom to address the growing incoherence between banking policy's external environment and the NEP's statist-nationalist banking policies. On 1 April 2003, the central bank ended the restriction on foreign-owned firms in Malaysia that required them to obtain 50 per cent at least of locally raised credit from locally-owned banks. Foreign-owned firms though still need Bank Negara approval for locally obtained loans of 50 million ringgit and above. In the 2005 Annual Report, Bank Negara announced that foreign incumbent banks could apply in 2006 for four more branches each, as long as one was in a rural area and one in a semi-urban area. Foreign incumbent banks are now also permitted to set up their own ATM network.

While the Masterplan does offer limited openings to foreign incumbent banks that are being brought on line on time, the slow pace and limited liberalizing goal of the Financial Sector Masterplan contrasts with the quicker pace and greater access offered foreign players in equities, insurance and Islamic banking. Just as banking policy foreshadowed the imposition of the statist-nationalist NEP, banking is likely to be one of the last service sectors opened up to full foreign competition, especially given the apparent demise of the Doha Round and the Malaysian state's continuing commitment to the NEP. Proposed free trade deals with the United States and Australia may put new pressures on banking policy, but this is still only speculation.

6 The Philippines

Despite being hit directly by the Asian financial crisis, the Philippines followed a distinctly different banking policy reform path from the countries already covered during the decade under study. This, despite the fact that, like these other countries, the Philippines boomed from 1994 to 1997, was hit by the Asian financial crisis from 1997 to 2000, and has since been on a slower more uncertain recovery path. Yet, of the five countries (including South Korea) hit directly by the crisis, the Philippines was the least damaged. It, like Malaysia, also did not have to reorient its statist-nationalist banking policy due to the 1997 crisis.

Unlike Malaysia, though, this was not because the Philippines fiercely defended this status quo. Rather, it was because it was already being dismantled when the crisis hit. The crisis simply helped accelerate its dismantling with the solicited help of international financial institutions. Historically, the Philippines was the strongest regional proponent of the statist-nationalist banking policy status quo. At the granting of Independence in 1946, one state-owned bank, the Philippine National Bank, controlled close to 60 per cent of the local banking market. Through the 1948 General Banking Act, the newly independent state banned new foreign bank entry when there were only four colonial banks in operation, and limited foreigners to owning a maximum of 40 per cent of the now heavily protected local banks. It also banned the four foreign incumbent banks from opening up any new branches. By the 1960s, the Philippine banking sector featured powerful state banks with compromised lending portfolios, and a large number of smaller local banks with strong connections to politically favoured conglomerates overseen by a cowed central bank. Yet, as we will see below, by the time the Asian financial crisis hit, the story was much different.

The banking policies that created this situation were already being dismantled before the Asian crisis, because the Philippines had already suffered its watershed supra-national financial crisis over a decade earlier. The debt crisis of the 1980s in the Philippines was analogous to the Asian financial crisis in Indonesia. It led to a severe economic downturn that took the Philippines a decade to recover from and savaged state-owned banks. The value of the peso and the state-owned banks never recovered. The debt crisis also toppled a long-standing patrimonial one party state and ushered in a second era of democratization.

Table 6.1 Debt crisis indicators, 1983–1987

Year rate	*Current account ($millions)*	*Balance of payments ($millions)*	*Government deficit (billions of pesos)*	*% GNP growth*	*Peso-US$*
1983	–2750	–2068	9.17	1.11	11.07
1984	–1298	+258	7.8	–7.07	16.58
1985	–77	+2301	19.4	–4.12	18.57
1986	+1022	+1247	35.3	1.86	20.356
1987	–444	+264	51.9	5.81	20.556

Sources: 1990 Philippine Statistical Yearbook; Lamberte *et al*. 1992, 12.

Just as the Marcos New Society regime was much more economically damaging to the country than Soeharto's New Order one, the economic fallout from the debt crisis in the Philippines was greater than what we have seen so far in Indonesia. Unlike Indonesia, the Philippine state, despite trying, has been unable to wean itself from international financial institutions' concessional financing. Also, the end of the Marcos era sparked off a concerted, if slow and uneven, liberal reform effort in the Philippines attempting to dismantle statist-nationalist policies in a huge range of sectors. This reform effort has persisted across all the post-Marcos elected governments, with all of them appealing to the need for the Philippines to catch up with its neighbours and position itself to benefit from globalization. Philippine reformers were trying to replace the traditional appeals to economic nationalism by blaming this for the Philippines' lack of progress, and appealing to the potential and demands of globalization to justify reform.

Banking reform was near the top of the agenda of post-Marcos liberal reform, particularly as it was a key conditioned component of the international financial institutions' program loans that kept the Philippines afloat. Banking reform focussed on three areas, saving the three major distressed state banks whose non-performing loan ratios exceeded 90 per cent and then reducing their dominance of the banking sector, rebuilding the bankrupt central bank and opening up the banking sector to foreign banks. One cannot but help feeling a sense of *déjà vu*.

This major liberalization process and its banking policy reforms, begun during the Aquino period, was extended during the boom years and the 1992–1998 Ramos administration; then it was severely tested externally by the Asian financial crisis and domestically by the 1998 coming to power of President Joseph Estrada, a Marcos loyalist from the silver screen. The fact that the Asian financial crisis and the reversion to a more patrimonial administration deepened banking policy liberalization indicates the resilience of these reforms. However, Estrada's 1998 electoral landslide exposed one of the significant domestic political challenges facing liberal reform in the Philippines. Since 2001, and the coming to power of President Macapagal-Arroyo, reform in the banking sector has largely stopped, as the focus has shifted to other more troubled sectors like electricity.

1994–1997 – Signs of stability

The period from 1994 to 1997 was a short-lived period of macro-economic stability and liberalizing policy reform in the Philippines that brought much hope that the Philippines may finally catch up with its higher-flying neighbours. The period of hothouse growth that washed across Southeast Asia from the late 1980s hit the Philippines when President Ramos came to power (fortuitously for him), and from 1993 to 1997 the Philippine economy grew rapidly.

For the first time in that generation, the lights were back on almost all the time, the budget was balanced, democracy was consolidated and a strong presidency was able to push through reform with less resistance. The good external environment for emerging markets in this period was matched by a good domestic environment for policy reform and a commitment not to revisit the trauma of the 1980s. Even the World Bank was talking about the Philippines as a star performer.

Banking reform in many ways foreshadowed this brief 'golden age'. By the end of 1994, Philippine banking policy had undergone its greatest and most rapid transformation since Independence. In 1992, the Philippines was still the strongest and longest-serving proponent of the statist-nationalist banking policy status quo in our study. By 1995, it had the most open banking sector, with further opening planned.

In June 1993, the New Central Bank Act was passed, restructuring the insolvent central bank. This Act transformed the central bank from the financial lynchpin of the Marcos era statist-nationalist patrimonialism to the main promoter of the calibrated opening of the Philippine banking sector and the professionalization of local banks. This law reshaped Philippine state structure to support the new paradigm and removed a fiscal black hole. It ended the central bank's quasi-fiscal functions and strengthened its institutional independence from the government.

In May 1994, the Foreign Banks Liberalization Act was passed, opening up the Philippine banking sector to new foreign entrants. The 1994 bill, by allowing increased and open-ended foreign competition, addressed some of the central bank's regulatory limitations and unleashed market forces in favour of local bank consolidation. The pressing fiscal need to make the central bank solvent again spurred the passage of the 1993 law, while the central role banking policy reform played in the Ramos administration's plans to change Philippine society led to the 1994 law.

However, this rapid growth and subsequent declining need for conditioned concessional lending did not slow down the reform momentum generated by the Philippines' economic collapse in the 1980s in general or in the banking sector. The fact that reform momentum continued and was transformed into repeated liberalizing changes to banking legislation despite the declining need for concessional loans indicates the domestic nature of reform efforts, and the secondary, supporting role external actors, as agents of globalization, played in this process.

Banking policy reform during this era was greatly aided by the fact that it was part and parcel of a much larger and more ambitious economic and social agenda

aimed at reforming the Philippines social order and enhancing its position in the world. One of the main thrusts of Ramos' overall economic policy reform program was fiscal consolidation to balance the budget, reduce public debt, and shift public borrowing from international to local markets. Progress towards these goals would reduce the economy's and state's vulnerability to external shocks like the 1980s debt crisis, and increase the state's economic policy autonomy.

Symbolically, reducing the need for concessional loans with policy conditions also built up important political capital externally by presenting the Philippine state in a better light, and domestically by countering populist criticisms that the Ramos administration and the Philippine state was captured by concessional lenders. The Ramos administration set 'graduation' from the IMF and World Bank as a fiscal reform and regime legitimization benchmark, even referring to the 1997 post-program monitoring agreement as a 'post-graduate' agreement.

Aided significantly by rapid economic growth, the Philippines' fiscal situation improved markedly during the Ramos period. The Philippines experienced its first budget surplus in decades in 1994. Consequently, Philippine state borrowings from concessional lenders and from international creditors declined, reducing the state's exposure to the external environment. However, the new macro-economic and exchange rate stability and the Philippine state's improving credit rating led large local firms to re-enter international capital markets to take advantage of lower interest rates and greater liquidity, after being shut out for a decade due to the 1983 debt repudiation.[1] While the Philippine state was reducing its reliance on concessional lenders and using this to burnish its image, local firms were increasing their exposure to the external environment.

Reform commitment

Harnessing the fact that the Philippines had fallen far behind its neighbours, President Ramos and his supporters echoed some of the reformist language of Marcos' New Society. Ramos' own long involvement in the Marcos administration and his recruitment of many of the New Society's leading intellectual figures strengthened his administration's links with this earlier failed attempt at comprehensive reform under Marcos' New Society dictatorship. Stretching it, one can portray the Ramos administration's reform successes as delivering what the New Society's planners had failed to deliver.

Like the New Society movement, the Ramos administration argued that technocratic, liberal reform was the necessary and best means to end Philippine society's domination by a self-serving oligopolistic elite that had kept the Philippines from reaping the benefits of global economic integration (Ramos 1994). Replacing the New Society's focus on state intervention, the Ramos administration argued that market forces were the best means to social empowerment and national redemption. Ramos, like his Latin American counterparts (Aitken 1996), leveraged the Philippines' tradition of anti-oligarch political populism by mixing liberal reform, globalization and social emancipation into one political message.

The new Ramos administration packaged this message in the 'Philippines 2000' program, a phrase ironically coined by the historically protectionist Philippine Chamber of Commerce and Industry. This quickly-cobbled-together package ambitiously called for the Philippines to become a newly industrialized economy like its regional peers by the year 2000. Unlike Malaysia's NEP, few quantitative targets were ever released in line with Philippines 2000, which remained largely rhetorical aspiration.

Three mutually supporting reform agendas anchored the Ramos administration's economic policy reform program under this catch-up theme. First, the administration worked overtime to sell the benefits of the Philippines to prospective foreign direct and portfolio investors. The administration opened up many more export processing zones, offered more incentives, and embarked on more government investment road shows. The administration identified key sectors of the economy controlled by 'pernicious cartels', such as telecommunications, downstream oil, airlines and banking, as the first sectors to be offered to new competition to erode the oligarchs' social grip. Banking reform was thus part of reforming the way the country worked.

The second agenda focused on the chronic fiscal situation, especially its revenue side where privatization was the main thrust. Privatization promised windfall revenues and advanced the first agenda of making the Philippine economy more open and competitive. The other fiscal reform thrust built on the Aquino administration's comprehensive tax reform package by introducing another that expanded the tax base while providing targeted tax relief to poorer workers.

The third agenda, which, according to Ramos' right-hand man retired General Jose Almonte, was never achieved, was to restructure the Philippine bureaucracy into a professional, legal-rational bureaucracy. Ramos era reformers to this day claim this was the most important of the reform agendas, the most difficult to achieve, and the one that progressed the least.

Two intermingled informal groups of these reformers helped convince presidential candidate Ramos of widespread liberalization's virtues, and put it into practice through their leadership of bureaucratic line agencies once Ramos gained power. The most influential group called themselves the 'Philippines 2000' group. Almonte led this behind-the-scenes group and was instrumental in convincing the president of the social reform and populist benefits of liberal economic policy reform.

The second group made up many of Ramos' cabinet appointments to economic portfolios called themselves the 'Origs' (Filipino English abbreviation for Originals). This group was instrumental in instructing President-elect Ramos in neo-classical economics' basics and how economic policy should be changed to achieve them. Once Ramos had been elected, the Origs ensured that the desired policy reform under their Departments prospered. Both groups also linked up with local think tanks and economics departments to workshop their reform ideas. They used the more open state structure and policy-making process to bring non-state supporters in to help shape sectoral policy reforms and to legitimize them.

Fidel V. Ramos, despite the backing of President Aquino, won only 24 per cent of the popular vote in the 1992 elections, a wafer-thin plurality. His quickly

formed *Partido Lakas-Tao* (Strength of the People Party) did not win a majority of seats in either house of Congress, while the Marcos loyalist ticket, Joseph Estrada, won the vice-presidential election. He garnered the highest vote tally of any candidate in the election. Yet the Ramos administration was able to oversee one of the most fundamental and sustained periods of economic policy reform, often in the face of strong oligarchic opposition.

The Ramos administration manipulated the fluid nature of the Philippine political system to overcome its weak legislative position. Soon after the election, the administration combined two presidential powers and the Philippines very weak party system to fashion an executive-legislative coalition able to initiate and deliver reforms. Counterintuitively, the Ramos administration turned the political system's and state structure's institutional fluidity into an effective conduit for reform.

Post-Marcos electoral politics in the Philippines features a large (though declining) number of presidential candidates backed by weak devotee parties and reliant on regional voting patterns, oligarchic financial backers, and opportunistic alliances with local power holders (Lande 1996). These parties have little programmatic basis, no mass base, and only weak centralized funding mechanisms. This fluid institutional basis allows individual politicians to gravitate before or after elections to the constellation of political forces they deem most likely to gain or to hold on to power (Montinola 1999). Winning the presidency acts as a magnet for these individual operators in both houses of Congress.[2] The Ramos administration and the Lakas-Tao party worked hard to organize a coalition of supporters in both houses. It was called the 'Rainbow Coalition', and was engineered primarily by Jose De Venecia, another beneficiary of the Marcos era, who became the Majority Speaker in the House of Representatives.

The Philippine president's power over the purse and its pork-barrel funds was the main presidential incentive behind the Rainbow Coalition and the reforms it delivered. In good pork-barreling fashion, every annual budget sets aside funds for projects that are recommended by individual Senators and Representatives, with the President and Department of Budget and Management having the final say when such funds are to be released and to whom. The ability to gain more assured access to greater amounts of pork provided the strongest incentive to join and remain loyal to the Rainbow Coalition and to provide general but conditional support of the Ramos administration's economic reform program. Ironically, working within the Philippine presidential system, the liberal reform project aimed at fundamental social reform prospered on pork-barreling support from traditional local power holders.

Mirroring the reformist efficacy of presidential pork barrel funds, the wide and deep scope of presidential appointments in the Philippines allowed the Ramos administration to place its economic reform supporters in key bureaucratic positions, including state corporations. President Ramos appointed General Jose Almonte as National Security Adviser and permitted him to expand his powerful portfolio quickly to include a broad definition of economic security. Ramos sprinkled other members of the Philippines 2000 across the state's higher level

economic positions, including the Tariff Commission, the Philippine National Bank, and the Securities and Exchange Commission.

He appointed Origs as Secretaries and Undersecretaries of the leading economic line agencies, with Roberto de Ocampo moving from heading the state-owned Development Bank of the Philippines to become the Secretary of Finance. The weakness of *Lakas-Tao* and the other parties in the Rainbow Coalition meant that President Ramos was under little pressure to apportion cabinet positions in accordance with party traditions or coalition requirements. The fluidity of the Philippine party system provides the executive with a surprising amount of policy latitude, as long as the pork barrel continues to roll.

This attempt to find win-win solutions between the interests of local oligarchs and economic policy reform slowed down reform momentum but reduced opposition towards it. At times, the compromises reached twisted particular sectoral reforms away from opening up markets to satisfying the particularist demands of large firms. The Ramos administration was strongly committed both to social reform through market competition and to listening to and incorporating the interests of local business, creating a delicate balancing act. This pragmatic approach spawned a smoother and more productive reform path that allowed many of the delayed reform assertions of the late Aquino period to be realized in a more limited manner.

Banking reform

These institutional manipulations and compromises set the general direction of policy reform. The complicated nature of legislative reform and the brevity of Ramos' single six-year term made such a pragmatic approach necessary. The passing of two landmark banking laws that reshaped the banking sector and its relationship to the state underlined the administration's focus on banking reform and its effective leveraging of the political system and state structure.

1993 New Central Bank Act

The state's weak fiscal position and the Central Bank of the Philippines' compromised bottom line forced its resurrection to the top of the reform agenda. From 1983 to 1993, the Central Bank of the Philippines suffered deficits, with annual losses never below 10 billion pesos, an annual loss figure more than fifteen times the central bank's net worth (Taningco, 1993). During this same period, it lost approximately 100 billion pesos on its exchange rate guarantees on private sector loans, largely to Marcos cronies, alone (Jayasuriya 1992). The central bank could not continue to function under such losses, and some formula had to be reached to pass on these losses to the government. Strongly encouraged by concessional lenders and the reformist Governor Cuisia, state banking experts crafted bills to address this fiscal black hole and the institutional revamping of the central bank. The goal was to transform the central bank's function from its traditional statist developmental one to the classical narrow one of domestic price stability and improved prudential oversight of the financial system.

The 1993 law established a new central bank called the *Bangko Sentral ng Pilipinas*. The law provided the new central bank with a clean balance sheet and paid-up capital fully subscribed to by the government of 10 billion pesos, to be raised to 50 billion within two years. The liabilities of the old Central Bank of the Philippines, valued at over 300 billion pesos then were shifted to the government's newly created, off-budget Central Bank-Board of Liquidators.

The size of this fiscal hole underpinned the transformation of the central bank's function. The new law banned the central bank from engaging in development financing and its prior fiscal agency functions. Its monetary policy objectives were narrowed to domestic and external price stability, with the law emphasizing domestic price stability. Unlike the Malaysian case, the Monetary Board of the new central bank does not need to advise the Secretary of Finance before it changes policy, while the Monetary Board has extensive powers to pursue its policy objectives. The President appoints the members of the Monetary Board to guaranteed six-year contracts to ensure policy consistency and institutional independence. The 1993 law requires the Board to be made up of the Governor, one appointee from the government, and three to five representatives from the private sector.

The new central bank had a much narrower, more technical mandate, a firmer financial basis and was institutionally much more autonomous. This institutional transformation and the huge costs involved with it for future generations is the clearest example of how the basis of economic policy-making in the Philippines has changed since the end of the Marcos era and the damage that era wrought on the country.

1994 Foreign Banks Liberalization Act

The passage of the 1994 law was much more contentious – and symbolically important – than the 1993 law for three reasons. First, the 1993 law recast relations between the central bank and the government. The 1994 law reshaped relations between the state and the banking sector, and between local and foreign banks. Hence, foreign embassies, incumbent foreign banks, and local banks had strong, often divergent interests in this law that they actively lobbied Congress to consider. Second, all actors involved knew that the 1993 law had been fiscally necessary. There was no powerful fiscal argument for opening up the local banking sector to new foreign entrants, except for the potential for another crisis and the need to bail out insolvent banks. The Bankers' Association of the Philippines and local bank owners counter-argued that opening up the Philippine banking sector to new foreign banks while local banks were still recovering from the debt crisis would undermine their recovery, making them more vulnerable to collapse (Banal 1994). Third, the 1994 bill directly contravened the 1948 General Banking Act's nationalist spirit and reversed forty-six years of policy continuity.

The open nature of the Philippine economic policy making process, the need for funding from international financial institutions, the strong divergent policy interests of affected actors, and the Ramos administration's willingness to compromise with local business to advance reform guided the passage and content of

Table 6.2 New foreign banks, 1994–2001

Name	*Country of origin*	*Entry year*	*Entry mode*
ANZ Banking Group	Australia	1995	One of the 'lucky ten'
Chase Manhattan Bank	United States of America	1995	One of the 'lucky ten'
Bangkok Bank	Thailand	1995	One of the 'lucky ten'
International Commercial Bank of China	Taiwan	1995	One of the 'lucky ten'
ING Bank	Netherlands	1995	One of the 'lucky ten'
Deutsche Bank	Germany	1995	One of the 'lucky ten'
Korea Exchange Bank	South Korea	1998	One of the 'lucky ten'
Fuji Bank	Japan	1995	One of the 'lucky ten'
Bank of Tokyo Mitsubishi	Japan	1995	One of the 'lucky ten'
Development Bank of Singapore	Singapore	1995	One of the 'lucky ten,' then switched 60% owned local subsidiary in 1998, later raised to 100%
Bank of China	People's Republic of China	2000	Took over above license
Chinatrust Commercial Bank	Taiwan	1996	60% owned local subsidiary, later raised to over 90%
Dao Heng Bank	Hong Kong	1996	60% owned local subsidiary
Banco Santander	Spain	1996	60% owned local subsidiary, later raised to 100%
Malayan Bank	Malaysia	1997	Purchased 60% of local bank, later raised to 100%
TA Bank	Malaysia	1997	60% owned local subsidiary
Keppel Bank	Singapore	1997	Purchased 100% of distressed local bank
UOB	Singapore	1999	Bought 100% of distressed local bank
ABN Amro	Netherlands	1999	Bought 60% of local savings banks
Amex Bank	United States of America	2002	Bought 100% of local savings banks

Source: Various local newspaper articles from 1997–2002; Llanto and Abrenica 2002.

the 1994 law. This spirit of tactical compromise also influenced the Bankers' Association of the Philippines' public campaign. While publicly recognizing that liberalizing reform was inevitable, the Association flatly rejected the Aquino era approach to banking reform as characterized by the Teves Bill that had been tabled again in the new House of Representatives. The Teves bill called for letting foreign banks, with no restriction on numbers or country of origin, enter the Philippines by applying for a foreign bank licence, opening up a 100 per cent owned local subsidiary or by buying up to 70 per cent of a local bank.

The Association lobbied for four diluting amendments to this extremely liberal bill. First, it only wanted a maximum limit of six to ten new foreign bank licences to be issued. Second, it wanted the home countries of the recipient banks to be geographically diverse, not concentrated in the United States or Japan. Third, the Association pushed for a high, permanent minimum paid-up capital per branch. Fourth, it wanted strict branching limitations on the new entrants. Foreign incumbent banks, also members of the Bankers' Association of the Philippines, were in favour of a law more closely resembling the Teves bill, especially one that lifted their branching restrictions.

While the Teves Bill was retabled in the House of Representatives, the new chair of the Senate Committee on Banks, Financial Institutions and Currencies, Senator Raul S. Roco, with technical support from the Philippine Institute of Development Studies, drafted an alternative bill. Roco, convinced the Teves Bill was doomed, tabled a compromise bill that included many of the Bankers' Association of the Philippines' suggestions. The Senator also organized public hearings in support of his bill where heads of the foreign incumbent banks and other groups that might benefit from more banking competition could voice their support. Senator Roco, due to his powerful personality and known presidential aspirations, was able to dominate the joint committee to reconcile the House and Senate Bills.

Both the new central bank and the Office of the President, while supporting the passage of a law in general, tactfully stayed on the sidelines of the intra-Congressional dispute. However, the executive and the IMF agreed to include the passage of the law as one of the preconditions for the release of a US$650 million standby agreement that had already been delayed (Tiglao 1994a). The legislative reform tradition of the Philippine state and its open economic policy processes allowed an individual Senator to direct the passage and content of the 1994 law. The small number of Senators makes it a much easier body to lobby effectively. The public hearings, not mandated by law, organized by Senator Roco as committee chair, allowed pro-reform voices a larger say in the deliberations, helping to undercut legislative opposition.

The 1994 law was a compromise between the Teves Bill and the interests of the Bankers' Association of the Philippines. On the Association's side, the law provided for only ten new foreign bank licences and required that they be distributed to banks from a geographically diverse set of home countries. These new entrants had to invest a minimum of 210 million pesos of permanently assigned capital and 35 million more for each additional branch. The new entrants were

only guaranteed the right to three branches, with three more dependent on approval by the Monetary Board. Finally, the law placed a 30 per cent ceiling on the market share of fully-owned foreign banks, the same share the four foreign incumbent banks controlled in 1946. The four colonial incumbent banks' market share at this time was around 10 per cent.

The 1994 law also satisfied the interests of foreign incumbent banks and potential new entrants excluded from the 'lucky ten'. The 1994 bill allowed all foreign banks in the Philippines to open up to six branches, easing the 1948 ban on new branches for foreign incumbent banks, and permitted these new branches to be in growth centres outside Metro Manila. The law also allowed an individual foreign bank to buy up to 60 per cent of the voting stock of an existing local bank, or subscribe to up to 60 per cent of the voting stock of a new locally incorporated banking subsidiary. Either of these latter modes of entry, or foreign incumbent expansion, raise the foreign equity ceiling above the majority-control 50 per cent and allow foreign banks to evade branching limitations. The cost of buying up to 60 per cent of a local bank naturally encouraged foreign banks choosing this mode of entry to focus their attentions on smaller banks. Here, the control interests of small local bank owners were undercut for greater foreign competition and foreign direct investment. Here, the new modes of foreign entry provided a new impetus for local bank consolidation.

After the passage of the two landmark laws, banking reform did not stop. Rather, the market ramifications of the 1994 law and the state's mediation of banking's changing external environment advanced it. The central bank drafted new bills to amend the 1993 New Central Bank Act to counter the court system's strong tradition of favouring local bank owners in the cases they file challenging central bank supervisory actions. These amendments, still bogged down in Congress today, aim to strengthen the *Bangko Sentral*'s hand when it comes to closing down erring banks and punishing their owners. The amendments also provide individual supervisors with greater legal protection against court cases filed by angry bank owners.

With the courts leaning in favour of owners, the ability to sue individual supervisors has been identified as a key reason for regulatory forbearance. In 1996, new bills calling for the revision of the 1948 General Banking Act were filed in both houses of Congress looking to further open up the banking sector and more clearly define banks' relations with the central bank. Unlike the 1994 Bill, these two Congressional bills were first drafted by the central bank and then tabled, indicating a shift in the origin of reform to the line agencies and institutionalization of the reform effort.

However, the more immediate reforms to the local banking sector emanated from the market ramifications of the 1995 release of the ten foreign bank licences. Foreign banks' interest in the booming Southeast Asian region, where other banking sectors were still closed, and the high profit margins of local banks triggered great interest in the ten licences, with up to thirty global banks expressing interest. Some global banks like Dutch giant ABN-Amro that failed to be one of the lucky ten were interested enough in the local market to buy into local banks, a more expensive mode of entry.

As expected, most of these new banks focussed on trade financing, underwriting and large commercial loans. However, some like the Hong Kong Shanghai Banking Corporation (an incumbent) and new entrants like ABN-Amro moved into retail banking, the turf of large local banks. Foreign bank market share expanded rapidly, from 9 per cent in 1995 to 17.5 per cent in 1997. Foreign banks operated 220 branches nationwide by 2000, up from less than ten in 1994 (Milo 2000). Led by Citibank and some of the more aggressive new entrants, like the Development Bank of Singapore, banks began to focus much more on the lower risk consumer lending market, especially credit cards and housing and car loans.[3]

Three noticeable benefits developed from invigorated foreign competition. First, the greater presence and growth potential of global banks sped up the introduction of international best standards in prudential behaviour and customer service that the central bank, crippled by an uncooperative court system, was unable to enforce itself. Local banks wanting to compete with these new, stronger players were forced to adopt new operational procedures or risk losing their best staff and 'unconnected' customers. Second, greater foreign competition introduced better financial products and put pressure on the historically high interest rate spreads for non-preferred borrowers. The average interest rate spread and return on equity began to fall from 1995 (Milo 2000), while the availability of consumer products like car loans, credit cards and unit trusts took off.

Third, foreign banks' cherry picking, encouraged by the remaining branching limitations, forced local banks down market. To compensate for lost business in 'the big end of town', local banks focused more on badly served sectors like small and medium enterprises and the middle class. These changes, if deep enough, may break the limited, risk averse mind-set of local banks traditionally biased towards the big end of town and related lending, and support the Philippine financial sector's catalytic role in development.

However, one of the greatest hopes of the 1994 law's promoters was not realized by the introduction of greater foreign competition: the merger of smaller local banks with large locals. Rather, smaller local banks became the target of foreign banks. Prior to the 1997 Asian financial crisis, moves to merge among major local banks were muted, as they adopted a wait-and-see attitude towards their new foreign competition. Some of the larger banks, such as Yuchengco's Rizal Commercial Banking Corporation and Ayala's Bank of the Philippine Islands, however, did take advantage of the new higher foreign ownership ceiling to bring in new foreign capital.

Philippine financial authorities successfully leveraged banking's new technologies to advance their reform interests, and largely ignored the General Agreement on Trade in Services negotiations. Unlike Malaysia, Singapore and Thailand, the Philippine central bank does not define off-site automated teller machines as branches, meaning that foreign banks can, with the approval of the central bank, operate these machines off-site despite existing branching legislation. Equally, foreign banks are allowed to participate in automated teller machine interconnection networks and point-of-sales system networks along with local banks. Local banks are also allowed to receive payment for foreign bank

credit card bills. Finally, there is no differentiation between local and foreign banks when it comes to internet banking, permitting foreign banks to exploit their technological competitive advantage.

Bangko Sentral's regulation of technology provides a level playing field for foreign and local banks that permits foreign banks to minimize the competitive burdens of the existing, legal branching restrictions, while maximizing their technological competitive advantage. The central bank hopes to use competitive pressure from foreign banks to force local banks to improve their own management of technology. Regulation of banking technology lies solely in the hands of the central bank, making its liberal nature a strong indication of the central bank's active support for reform. It is no longer the defender of local banks and the statist-nationalist status quo.

Multilateralism muted

The Philippine state's banking policy commitments under the Financial Annex of the General Agreement on Trade in Services were neutral and defensive. The Philippine state's 1995 commitments, while more liberalizing than any of their regional peers, were less liberalizing than the existing policies. Even though the Foreign Banks Liberalization Act had already passed allowing for ten new foreign bank licences, the initial 1995 commitments only promised to allow six new licences. In the 1997 revised commitments, Philippine negotiators only promised what already had been delivered by the 1994 law. What for many international political economy scholars is the most significant globalizing change in banking policy's external environment had no effect on the Philippines' liberalizing momentum. Crises and concessional lenders have been far more important.

Financial authorities indicated there were two reasons why the Philippine commitments were neutral and defensive. First, the main state players in banking policy reform were not part of the negotiating team for the General Agreement on Trade in Services. Second, like most developing members, the Philippine state approaches multilateral trade negotiations defensively, guided by the motto 'don't give too much away'. This favours committing only what you have already implemented or even less, to provide you with more negotiating room in the next round. The reiterated game basis of the multilateral trade negotiations may actually reduce individual negotiating rounds' liberalizing potential, as negotiators fear committing too much in one round and then facing new commitment demands in the next round. Unlike Thailand and Singapore, the Philippines has also been slow to enter bilateral free trade negotiations – agriculture is still highly protected and politically sensitive – meaning this new means for globalizing pressure on banking policy has yet to play any role in the Philippines.

1997–2001 – Buffeted by crisis[4]

The Asian financial crisis triggered a serious economic slowdown centred in the banking sector that reinforced the liberalizing banking policy reform path

embarked upon since the debt crisis. Unlike the debt crisis, which helped topple the Marcos regime and its statist-nationalist paradigm, the Asian financial crisis acted as a qualified external support for globalizing reform efforts.

Like all other crisis-hit countries, the 1997 regional crisis and its domestic contagion effects took the Philippines by surprise. The Philippine economy's continued vulnerability to external shocks abruptly ended the Philippines' rising wave of impressive GDP growth, fiscal consolidation, a stable exchange rate, and a bullish stock market. From July 1997 to June 1998, the Philippine stock market lost 60 per cent of its value in peso terms, while the value of the peso halved in relation to the US dollar. Per capita GNP declined from US$1167 in 1997 to US$912 in 1998. The banking sector was not left unscathed. In 1998, total assets declined slightly, reversing growth exceeding 20 per cent per annum prior to the crisis. In 1998 the total amount of non-performing loans almost doubled despite the decline in assets, and the official non-performing loan ratio moved up from 2.8 per cent at the end of 1996, to 4.7 per cent by the end of 1997, to 10.4 per cent by the end of 1998.

Despite this sharp fall off in economic progress so soon after the Philippines belatedly joined the regional boom, the regional crisis and its muted domestic contagion reaffirmed the benefits of banking sector reform. The harshness of the mid-1980s debt crisis and the radical political and policy shift that ensued provided a new level of economic insulation from external crises. Of the five countries commonly labeled as 'crisis-hit', the Philippines was the only one not to see its 1998 annual growth rate turn sharply negative.[5] Like the economy as a whole, the Philippine banking sector was not as badly affected, with non-performing loan ratios below the others until their states set up asset management corporations to socialize local banks' bad loans. The Philippines temporarily improved its place within the Southeast Asian order of economic success, moving from the most devastated country during the debt crisis to the least damaged of the four Southeast Asian countries hit directly by this crisis.

The debt crisis and a long history of domestic macro-economic and financial turmoil mean that Philippine banks today are among the most conservative in the region, with capital adequacy ratios well above the international standard of 8 per cent. Since the debt crisis, the central bank has ramped up its prudential regulation of lending portfolios, helping local banks keep their exposure to the overheated property sector quite low (11 per cent in mid-1997) and shifting property firms' search for funds to the Philippine Stock Exchange. The freedom granted to local and foreign banks to offer foreign currency accounts with few restrictions, and to use these funds to lend in foreign and local currency, locally insulated local banks and the local economy against external volatility. Philippine banks now do not have to borrow from foreign banks to benefit from lower-interest foreign currency loans, while capital flight out of the peso can remain within local banks and the local economy.

In mid-1997, while only 1 per cent of Thai banks foreign loans and deposits were due to local entities less likely to 'herd out' of the country during crises, 52 per cent of Philippine banks' foreign loans and deposits were due to locals (Intal

1998). The Philippines' much lower level of financial intermediation of course also meant that the banking sector's role as a crisis amplifier was more muted than other higher velocity economies like Malaysia. While Malaysian banking assets' value doubled from 85 per cent of GDP to over 160 per cent from 1985 to 1997, the Philippine banks' asset value, excluding interbank loans and government loans, only grew from 19 per cent of GDP in 1985 to 24 per cent in 1994 (Intal 1998).

Two banking reforms stemming from the debt crisis contributed to the Philippines' relative insulation from the regional crisis. First, the downsizing of state banks after the debt crisis and the staged privatization of the Philippine National Bank (resting at 70 per cent at the beginning of the crisis) pre-empted a more serious contagion effect. State banks in every crisis-hit country were the most badly damaged by the crisis, and suffered from more rapidly deteriorating loan portfolios and higher non-performing loan ratios. True to form, by 2001, the Philippine National Bank's non-performing loan ratio was over 53 per cent, Landbank's was at 26.27 per cent, and the United Coconut Planters Bank, still under government sequestration, was at 22.82 per cent, the three highest ratios among universal banks (Lucas 2002). Had the Philippine National Bank not shrunk from the first to the seventh largest bank in the Philippines from the debt crisis to the Asian financial crisis, and had the Development Bank not fallen out of the top ten, the regional crisis would have bit much harder.

Locally-operating foreign banks were the least damaged class of bank by the crisis in the Philippines and regionally. At the end of 2000, foreign banks' share of non-performing loans rested at 3.2 per cent, while their total share of outstanding loans was almost four times larger at 12.1 per cent. Foreign banks acted to stabilize the Philippine banking sector and economy during both crises, while state banks acted to destabilize it. The different fortunes of both sets of banks due to the banking policy shift spurred by the debt crisis meant that the post-shift Philippines was much less vulnerable to crises in 1997 than it had been in the mid-1980s; the opposite story to Indonesia, Thailand and Malaysia.

The 1997 crisis offered new opportunities for liberal banking policy reform. Impressively, this deepening occurred across two presidential administrations and two central bank governors. Even when the second of these presidents, Joseph Estrada, fell in a 'constitutional *coup d'état*' in January 2001, *Bangko Sentral* Governor Buenaventura, a former Ateneo high school classmate of President Estrada who succeeded Governor Singson, was the only official closely associated with the deposed President to survive. In the face of calls for his removal emanating from the new Macapagal-Arroyo administration, Governor Buenaventura's survival upheld the sanctity of his fixed contract term and the central bank's newly won independence.

During the crisis, state action advanced banking policy reforms in two of the three policies covered by this thesis, at a high cost to small local banks and weaker large locals, and to the benefit of foreign banks. First, the central bank under Governor Singson (Governor Buenaventura's predecessor) opened up the banking sector even further to foreign banks. The central bank announced in 1997

that foreign banks would be allowed to buy up to 100 per cent of officially designated crisis-affected local banks threatened with insolvency, such as Monte de Piedad Bank (bought out by Singapore's Keppel Bank) and Westmont Bank (bought out by Singapore's United Overseas Bank). These foreign purchases saved the central bank from either closing or bailing out these small local banks and permitted excluded foreign banks a new entry mode that evaded branching limitations. From 1998 onwards, under the new governor, Rafael Buenvaentura, the central bank publicly lobbyied for large foreign banks to enter the Philippines by acquiring weaker local banks.

This new activist stance was most clearly shown when the central bank went to bat for Hong Kong Shanghai Banking Corporation in its push to buy into a local thrift bank. The 1994 law only covered commercial banks – the main players – and did not extend to thrift banks.[6] The thrift banks' own reform process achieved through changes to the Thrift Bank Law in 1994 did not include allowing foreign banks to buy up to 60 per cent of local thrift banks. After some creative legal interpretation, the central bank permitted the 60 per cent sale of the thrift bank to the British bank to go through by basing its decision on the 1979 universal banking regulations and the British bank's universal banking status (Dumlao 2000). Other foreign incumbent banks like Standard Chartered quickly sought to become universal banks themselves to take advantage of this new loophole for foreign universal banks. Here the Philippines' oft-criticized legal complexity aided liberal banking reform by offering a willing central bank a way to skirt remaining statist-nationalist banking policies.

Backing up this new opening up of the local banking sector, in 1998 the Department of Finance and central bank approached the World Bank for a US$600 million Banking Sector Restructuring Loan. The passage of the new General Banking Act and the transformation of these new emergency loopholes for foreign banks into permanent legal rights were two of this new loan's primary conditions. Again, the fiscal weakness of the Philippine state provided a cogent rationale for liberal technocrats within the Philippine state to access external funds to strengthen their case. In 2000, the General Banking Act, first tabled in 1996, was passed, entrenching these new loopholes and triggering the release of the corresponding World Bank loan tranche. Technocratic, liberal reformers were able to mediate the crisis and the Philippine state's exposure to the external environment to gain needed fiscal resources and support from the World Bank.

Second, the central bank acted during the crisis to accelerate the local bank merger process that the 1994 bill failed to spark. Most painfully for local banks, during the crisis the central bank repeatedly raised the minimum paid-up capital required to maintain a commercial banking licence and the expanded universal banking licence. By 2000, the Philippines had the third highest paid-up capital minimums in Southeast Asia, behind much wealthier and consolidating Singapore and Malaysia.

With local banks saddled with growing non-performing loan ratios and the lack of investor interest in new share offerings, this staged increase in paid-up capital minimums aimed to force mergers among local banks by overwhelming the

Table 6.3 Select bank mergers, 1998–2002

Acquiring bank	*Merged bank*	*Year*	*Comments*
Development Bank of Singapore (Phils)	Bank of Southeast Asia	1998	Gave up lucky 10 license to buy 60% of Bank of Southeast Asia and its branch network
Equitable Bank	PCIBank	1999	First major local bank merger, President Estrada and state pension plans were heavily involved in merger.
Global Bank	Asian Bank	2000	Global Bank owned by Metrobank, Philippines' largest bank.
Global Bank	Philbank	2000	See above
Bank of the Philippine Islands	Far Eastern Banking and Trust Company	2000	Allowed Bank of the Philippine Islands to become the largest bank.
Metrobank	Solidbank	2000	Allowed Metrobank to regain top status.
Prudential Bank	Pilipinas Bank	2000	Two smaller banks, had no major impact.
Hong Kong Shanghai Banking Corporation (Phils)	PCI Savings Bank	2000	First of four 'colonial' banks to buy local bank, helped expand its branch network.
Bank of Commerce	Traders Royal Bank	2000	Traders Royal Bank was a former crony bank close to collapse. Bank of Commerce was interested in its branch network.
PBCOM Bank	Consumer Savings Bank	2001	Bought to expand branch network. Central bank had placed a moratorium on new bank licenses.

Bank of Commerce	Pan Asia Bank	2001	Bought to expand branch network.
ABN-Amro Bank	TA Bank	2001	Allowed ABN-Amro to upgrade from a savings bank to commercial bank license. TA Bank's Malaysian parent badly hit by the Asian financial crisis.
Banco de Oro	Dao Heng Bank	2001	Dao Heng Bank sold out of the Philippines due to disappointing growth.
Bank of the Philippine Islands	Development Bank of Singapore (Phils)	2001	Family Bank subsidiary bought Development Bank as Development Bank switched strategies from organic growth to a strategic partnership with major local bank.
Export & Industry Bank	Urban Bank	2002	Urban Bank was closed down by central bank in 2000. Central bank and Philippine Deposit Insurance Corporation helped fund merger

Source: Various local newspaper articles and press releases from 1997–2002; Milo 2000, 29; Comments by author.

emptying war chests of their conglomerate owners. At least one bank failed to meet the new minimum for banks and saw its banking licence downgraded to a thrift bank licence. In 1998, the central bank also issued a circular announcing new tax and accounting breaks for banks in the process of merging. Governor Buenaventura issued a stark warning for small banks, local and foreign, when he outlined his future vision of a banking sector dominated by five or six mega-banks, at least two of them foreign (Buenaventura 2000).

The Philippine state's refusal to help local banks aggressively advanced reform at the cost of local banks during this crisis. Most remarkably, contrary to World Bank advice, both the Department of Finance and the central bank refused to establish an asset management corporation to help local banks clear their non-performing loans. This refusal to bail-out banks' bad loans extended to individual banks, as the state-owned Landbank's proposal, made by its chairman Margarito Teves, for the state to absorb its bad debts was firmly rejected (Lucas and Yap 2000). The Philippine state was the only one of five crisis-hit states not to set up such a state-owned special vehicle, choosing rather to pursue a legal process to allow foreign investors to set up private asset management corporations in the Philippines.

This refusal to set up an asset management corporation or ease accounting rules on non-performing loans hurt overextended local banks, making them more likely to collapse, as Urban Bank and Orient Bank did, and ripened them for mergers. This passive approach depressed the local banking sector, with non-performing loan ratios continuing to edge upwards relentlessly until 2002, peaking at close to 20 per cent. At the same time, banks had to increase their loan loss provisions and paid-up capital minimums, reducing their incentives and funds for new lending. Philippine bank lending to the real economy was still stagnant six years after the crisis.

The ability to continue liberal reform in the banking sector during the crisis highlighted how reforms reproduce themselves. First, it exposed the large number of policy actors supporting this process and their instrumental intertwining. The central bank used its regulatory powers to open up the local banking sector further, push mergers and refuse bail-outs. The Department of Finance and central bank used the crisis and the Philippines' weak fiscal situation to bring in the World Bank and to justify costly non-action through the refusal to set up an asset management corporation. Led by Senator Roco, Congress passed the new General Banking Act 2000, making permanent the emergency provisions allowing foreign banks to buy out distressed local banks in line with the conditions of the solicited World Bank loan.

Second, counterintuitively, state weakness and the disastrous use of state funds during the late Marcos era acted as good rationales for the central bank and the Department of Finance to refuse to set up an asset management corporation and socialize the costs of the crisis. (Local banks may not have been too happy with an asset management corporation either, as this would have required them to open up their loan books to central bank scrutiny. This would have been very useful in the central bank's unsuccessful efforts to crack down on connected lending.)

Third, the new market forces released by the 1994 bill insulated the economy and banking sector, and encouraged incumbent and excluded foreign banks to take over distressed local banks. This strategy of foreign buy-outs reduced bail-out pressure on the state and countered the macro-economic and market confidence costs of banking failures. The spurt of new foreign banks operating in the Philippines and local bank mergers, and the Philippines' relative insulation from the crisis, showed that the liberal reforms were beginning to deliver their desired market outcomes.

Patrimonial challenge

The regional crisis coincided with the end of the Ramos administration and boosted the presidential campaign of Vice-President Joseph Estrada. Estrada came to power in June 1998 garnering 40 per cent of the popular vote (16 per cent more than President Ramos won in 1992). The patrimonial Estrada administration, cut short by a constitutional *coup d'état* in January 2001, exposed the continuing institutional weaknesses of the Philippine state, and the continuing appeal of populism. In the less than three years that Estrada stayed in power, the depth of this domestic threat to technocratic, liberal reform was clearly exposed.

The Estrada administration from its electoral campaign onwards tempered pro-poor populism with technocratic policy reform pledges in an effort to win over wary concessional lenders, foreign and local investors, and the Makati business elite. President Estrada appointed a very well-received economic team, with the new head of the National Economic Development Agency and the Department of Budget and Management coming from the mainstream University of the Philippines' School of Economics. The Estrada administration aggressively called for constitutional reform to advance the Philippines' response to globalization, including allowing foreigners to own land, a political taboo in the Philippines. Like Ramos' push for constitutional change, Estrada's quickly failed, due to Filipinos' bad memories of Marcos' constitutional manipulation. The Estrada administration also organized the World Bank program loan for banking sector reform and pushed through the 2000 General Banking Act. Estrada's appointees, Governor Buenaventura and the Monetary Board, used the crisis to push technocratic, liberal reforms in the banking sector. Are not these signs of reform continuity backed by strong political support across two very different administrations?

Yes. However, other aspects of the Estrada administration and its banking policy clearly indicate how the fluidity of the Philippine political system and state structure can contribute to reform reversals and undermine external support for the Philippine state. The Estrada administration highlighted two major areas of structural fluidity and their retarding effects on reform. First, Estrada won despite having a very weak and loosely formed party behind him and little more than the populist campaign slogan, *para sa mahirap* (for the poor). His vice-presidential candidate Senator Edgardo Angara lost heavily to Gloria Macapagal-Arroyo, who ran with Ramos' chosen presidential candidate Jose De Venecia. The

triumphs of the former movie star Estrada and the daughter of the popular former president Diosdado Macapagal clearly show the electoral benefits of personal celebrity and the superfluous nature of party and programmatic politics. As with economic nationalism in the pre-Marcos era, technocratic, liberal reform is electorally irrelevant, and has no permanent party backing due to the ephemeral nature of parties. While the NEP is the core of UMNO's programmatic and patronage politics, policies play little or no role in Philippine election campaigns.

President Estrada's electoral campaign relied primarily on his charisma and a coalition of financial backers and local political power holders who could deliver votes. Estrada's front-running position from the beginning of the unofficial campaign in mid-1997 assured he was able to attract many backers from both of these overlapping, self-interested groups. Like President Ramos, President-elect Estrada and his backers were able to quickly overturn their minority position in Congress by attracting opposition members eager to gain access to state resources. Estrada's electoral strategy left his administration more dependent on satisfying the particularist interests of his backers, while his lack of a permanent, mass-based programmatic party provided his administration with more latitude to satisfy these. The Ramos administration leveraged this fluidity to advance technocratic, liberal reform, the Estrada administration used it to return to Marcos era patrimonialism.

Second, the Philippine state's weak bureaucracy and the wide range of presidential powers permitted the Estrada administration to satisfy these particular demands that often undermined reform efforts. Two examples from the banking sector serve to show this element of state weakness. As with our previous cases, political interests coloured the central bank's local bank consolidation drive and the use of state resources to support it. The first merger between two major local banks saw the mid-sized Equitable Banking Corporation acquire PCIBank, the third largest bank in May 1999. Equitable Banking Corporation beat out other larger bidders and quickly completed the merger acquisition without even carrying out a due diligence study of PCIBank's books. Equitable Banking Corporation quickly moved up from being the fifteenth largest bank with a limited branch network and client base to become the third largest bank with a vast branch network and a growing share of the lucrative remittances market. George L. Go and the Go family who controlled the Equitable Banking Corporation were close friends of President Estrada, with George L. Go serving as chairman of one of Estrada's numerous charity foundations (Esguerra 2000).

Equitable Banking Corporation's takeover of the much larger PCIBank was only made possible by strong support from state-controlled pension funds, the SSS and GSIS, for its quickly organized bid. The two main state-owned pension plans financed 47 per cent of the purchase price, while 46 per cent came from unnamed investors via an Equitable Banking Corporation subsidiary (Tiglao 1999). The two state pension plans' participation in the Philippines' largest ever corporate takeover was the first time the plans acted as the main funders of a buyout (Tiglao 1999). This contradicted both plans' tradition of buying small, minority stakes in local firms and acting as passive investors. In the face of strong

market and pension contributor reaction to this use of state funds, the Department of Finance issued instructions in May 2000 that the two pension plans could not hold more than 30 per cent of the voting stock of any local corporation. Both state funds lost heavily on this politicized investment (Batino 2000a).

In July 2000, Lucio Tan issued a capital call for the damaged Philippine National Bank that would dilute present stakeholdings by 50 per cent. The Department of Finance refused to partake, thus seeing its share in the bank diluted to below 15 per cent.[7] Other minority shareholders, fearful that Tan's control of the bank would reduce its share value, protested against the capital call and the government's refusal to partake in it to maintain a significant stake in the bank (Arpon *et al*. 2000). Later that month, the Department of Finance permitted Lucio Tan to gain control of the Philippine National Bank after his firm had been the only bidder for the capital call's tranche of Philippine National Bank stock. Rather than declaring it a failed bid, as is required by law when there is only one bidder, the Department allowed Lucio Tan to gain control of the fifth largest bank in the country, despite his corporate grouping being its largest single debtor (Batino 2000c). In direct contradiction of earlier state plans to ensure that the Philippine National Bank did not fall into the hands of a single entity, a close friend of President Estrada gained control of another major local bank, exacerbating its already significant connected lending problems.

External support withdrawn

Relations between the Philippine state and its concessional lenders quickly soured under the Estrada administration, further hindering reform and fiscal consolidation progress. From claiming the Philippine state as a model reformer before the crisis and the *Bangko Sentral* as a model respondent to the crisis (Taguinod 2001), the IMF, World Bank and the Asian Development Bank quickly changed their tune, canceling existing loans and threatening future access. Under the Estrada administration, despite promising another comprehensive tax reform program, tax revenues as a share of GNP plummeted while the budget deficit ballooned. Fiscal gains made during the boom years of the Ramos administration quickly dissipated, aggravating the Philippine state's need to borrow funds externally.

Led by the IMF, concessional lenders refused to renew the Philippine state's 'seal of good housekeeping' in 2000 or to permit changes to the IMF's agreed-upon, cross-conditioned fiscal performance targets (Batino 2000b). Rather, in response to the Philippine state's inability to match these targets, the IMF delayed the release of US$314 million of its program loan, directly threatening up to US$1.7 billion in cross-conditioned loans (Panes 2000). The IMF also publicly questioned the Philippine state's serial use of IMF emergency loan facilities and its continued ability to access these facilities (Arpon and Lucas 2000).

The Philippine economy and its state's reform drive survived the Asian financial crisis well. However, it survived the Estrada administration less impressively.

The state mediated the external challenges to strengthen reform, while the domestic challenge of the Estrada administration and its control over the Philippine state undermined these. The fluidity of the Philippine state structure, instrumental in the paradigmatic shift of the mid-1980s, showed itself to be a double-edged sword. This fluidity permitted the President to manipulate policy implementation. Moreover, the continued fiscal weakness and vulnerability of the Philippine state was aggravated by the Estrada administration undermining the state's relationship with concessional lenders and their continued financial support for the Philippine state.

The Estrada administration clearly showed the continued commitment of the central bank and other agencies to technocratic, liberal reform. On the other hand, this curtailed administration also showed how the Philippine state's fluidity and the disconnect between electoral politics and economic policy reform can significantly hinder reform.

2001–2004 – Slowing down

By the end of 2000, the Philippine political system was on the brink of collapse, with hundreds of thousands of people in the street demanding the president's impeachment, with the economy, particularly the value of the peso, teetering on the edge. International financial institutions, a necessary funder of the Philippine state, had been completely alienated by the Estrada administration's fiscal impropriety. Much of the Philippine population had been equally alienated by the charges of corruption. Something had to break. In January 2001, after days of huge demonstrations in Manila and elsewhere, the chief of the military withdrew support for the president and his term was over. With the forced stepping down of the President, the Philippine economy and society could start to recover.

International financial institutions quickly grasped the chance to support a more like-minded regime. President Macapagal-Arroyo is a former economics professor. When Estrada was deposed, the World Bank quickly committed up to US$200 million in direct budgetary support to the new Macapagal-Arroyo administration concretely symbolizing its support for the change of administrations and its hope that it would revive favoured reforms (Cabacungan 2001). As with the debt crisis, concessional loan conditionality played a supporting role in deposing a patrimonial president inimical to the concessional lenders policy interests.

However, relations between the Philippine state and the World Bank soured over the failure of the Philippine state to fully privatize the Philippine National Bank, one of the key conditions of the US$600 million Banking Sector Restructuring Loan. In May 2001, the Macapagal-Arroyo administration withdrew from this loan after only half the funds had been disbursed, citing the inability to sell the remaining 15 per cent state stake in the Lucio Tan-controlled Philippine National Bank before 30 June the loan deadline.

Four aspects of the tense relationship between the Department of Finance, the World Bank, and the Philippine National Bank led to the abandonment of this

loan. First, the World Bank's fatigue over the Philippine state's failure to address the problems of the Philippine National Bank or clear it from its books meant that no further delays in full privatization could be considered. Second, for the Department of Finance, the bank's horrible bottom line increased the costs of privatization. The Philippine state records assets at book, not market value and, by 2000, the 40 peso market value of the bank's shares was only half their book value. The sale of bank shares at present market value – the value potential bidders demand – would have required a significant accounting write-off by the Department of Finance. The offer price for the state shares in the Philippine National Bank that led to the failed bids were always set markedly higher than the market value to try to minimize this potential write-off.

Third, the bank's very high non-performing loan ratio and the fact that most of these non-performing loans were politically motivated meant that the bank was a large and damaged asset requiring a massive capital injection to balance its books. Fourth, after Lucio Tan gained control of the bank with his share rising above 70 per cent by the end of July 2000, other investors were not interested in buying up the state's remaining 15 per cent stake. Such a small stake would provide them with no say over bank management and how the bank dealt with loans to Lucio Tan's other corporate interests, while its damaged asset base promised little potential for a return to profitability or a higher share price. By 2001, the World Bank was insisting that the Philippine state sell its minority stake in the Philippine National Bank to a market where nobody was interested in it, except at a discounted price that the state was unwilling to accept.

In 2002, the long struggle to privatize the Philippine National Bank in a manner that did not strengthen the economic grip of Marcos-era tycoons suffered a reverse. In late 2000, during the chaotic denouement of the Estrada regime, the Philippine National Bank experienced what amounted to a bank run. To stave off collapse, the central bank lent it 25 billion pesos in emergency funds. In 2002, this loan was transferred into shares increasing the state's ownership stake to 45 per cent and reducing Lucio Tan's to 45 per cent. Today, the Philippine National Bank is jointly owned by the Philippine state and Lucio Tan in direct contradiction of the goals of the privatization program first launched during the Aquino administration some 15 years ago.

Since 2001, hopes that the Macapagal-Arroyo administration would turn the clock back to the pre-crisis days of wide-ranging liberal reforms and strong foreign interest in the Philippine economy have largely gone unrealized. President Macapagal-Arroyo has been unable to form a sustained effective executive–legislative coalition committed to liberal reform like the Philippines 2000 team and the Origs. Rather, reform has been slower with further reforms to the banking sector stalled. The amendments to the Central Banking Act aimed at giving supervisors more legal protection are still pending more than a decade after they were first tabled in 1996.

Equally, since 2001, foreign bank interest in the Philippines, which stayed strong during the crisis, has dimmed. In 2001, Hong Kong's Dao Heng Bank exited the Philippines when it sold out to the locally owned Banco de Oro.

Similarly, the Development Bank of Singapore gave up its banking licence in preference for a larger strategic share in the Ayala family-owned Bank of the Philippine Islands. Many of the eager foreign banks who entered the Philippines soon after the passage of the 1994 law found the market less dynamic and local competition more fierce than expected. The foreign bank share of the market has largely stagnated at around 15 per cent. Banking policy reforms and foreign bank interest were central to the Philippine story in both the 1994–1997 boom period and the 1997–2000 limited crisis period and advancing. Since 2001, both have stalled.

7 Singapore

The 1994–2004 decade exemplified the comparative strengths of the Singaporean political economy and highlighted its differences from its regional peers. Singapore did not go through a serious boom–bust cycle in the 1990s, and the Asian financial crisis only glanced Singapore. Its financial sector continued to grow, partially due to Singapore's role as a regional safe haven, as did Singapore's foreign exchange reserves, while its local banks bought into their crisis-ravaged neighbours. Singapore has yet to suffer a banking sector crisis. Rather, the 2001 global information technology trade meltdown hit Singapore much harder, triggering its worst recession as an independent economy and questioning the sustainability of its development model. Singapore's political system faced no serious challenge during this period and the hand-over of power with the ruling People's Action Party (PAP) from Prime Minister Goh Chok Tong to Lee Kuan Yew's son, Lee Hsien Loong, in 2004 was very smooth.

Despite this decade of comparative political and economic calm, Singaporean banking policy underwent significant change, with a concerted, state bank-led campaign for local bank consolidation and a gradual opening up to foreign banks within the domestic banking market. Singapore was not forced to open up its banking sector or step on the toes of powerful local bankers by the Asian financial crisis or by any other external agent of globalization. Yet Singaporean financial authorities, like in the Philippines, consistently liberalized foreign bank access during this decade.

Like Bank Negara in Malaysia, Singapore's central bank, the Monetary Authority of Singapore (MAS), pushed through a calibrated process of local bank consolidation, triggering emotional public complaints (a relatively rare occurrence in Singapore) from affected local bankers. Today, Singapore has half as many local banks as it had a decade ago, while foreign banks now play a much larger role in the domestic banking market, with further policy openings in the offing. As with Malaysia, the strong links between the political executive and the central bank facilitated the speed and comprehensiveness of the local bank consolidation programme while, in the decade from 1994–2004, these links between the political executive and the MAS, already strong, were strengthened.

Singapore was not forced to globalize its long-held statist-nationalist domestic banking policies, rather it chose to and, like the Philippines, used the regional financial crisis as leverage to accelerate domestic banking reforms opposed by

local vested interests. Singapore is the only country in the region to have used bilateral preferential trade agreements as a means for further banking policy liberalization. Hence, even though the World Trade Organization is presently paralysed and not acting as an agent of banking sector globalization, the commitments Singapore has made under certain bilateral trade deals will continue to require banking policy liberalization.

In both these cases, Singapore has not tried to resist the growing external forces for banking policy reform, but instead tried to mediate them in ways to support a gradual process of domestic banking sector reform while keeping control firmly in the hands of the Singaporean financial authorities. The fact that Singapore chose to take a basically defensive stance in the WTO's financial services negotiations offering no major changes to existing policy, unlike in the case of bilateral trade negotiations with the United States, again casts doubt on the liberalizing impetus of multilateral trade negotiations when it comes to services. Among our case studies, only Thailand chose to use the WTO as an external means to liberalize banking policy.

1971–1994 – Going offshore

In 1971, the MAS was established to oversee monetary policy and supervize the banking system, and the Singapore state gained full sovereign control over banking policy. When the newly-independent Singapore state earlier gained control over industry policy, authorities set out to establish Singapore as a regional manufacturing sector. Singapore actively sought out foreign direct investment in newly-created export processing zones, supported by generous tax incentives and strong regulatory support. Singapore was the first country in Southeast Asia to pursue an export-oriented industrialization policy and has been the most consistent and successful applicant of this regional model.

Exemplifying very strong paradigmatic coherence across economic sectors, the newly-minted MAS quickly established Singapore as Southeast Asia's – then East Asia's – predominant offshore banking centre. Appreciating the huge growth in the Eurodollar market from the 1950s onwards and the benefits this has delivered to London, Singapore financial authorities created the Asian Dollar Market in 1968 and invited foreign banks to come and base themselves in Singapore, to manage East Asia's growing savings pool and demand for investment. Offshore banks were offered very attractive tax treatment and a strong, light-touch regulatory environment. Since its establishment, the MAS has successfully sought to deepen and diversify Singapore's role as a regional financial centre.

Singapore was the second country in Southeast Asia to try to establish itself as Southeast Asia's regional financial centre. Philippine authorities tried to make Manila into a regional financial centre in the 1960s. Yet, while Manila's bid failed, Singapore's has been extremely successful. In 1968, the Asian Dollar Market managed funds worth $30 million. By 1988 this had increased to $273 billion. Bangkok's and Labuan's more recent efforts to cut into Singapore's

pre-eminent position in offshore banking, as we have seen, have also met with little success.

At the same time that Singaporean financial authorities have been strongly committed to positioning Singapore as an offshore financial centre, they have been equally keen on keeping clear lines of division between the Asian Dollar Market and the domestic banking system. Singapore has long resisted the internationalization of the Singapore dollar and kept very different rules for the offshore and domestic banking markets. Hence, banks operating in both markets must keep separate accounts for Asian Dollar Market transactions and for transactions in the local banking market.

Data difficulties

Singapore's commitment to keeping the local banking market and the Asian Dollar Market separate has not carried through completely to the MAS' annual reports and publication of statistics. As in many other areas of political economic research, getting fully disaggregated data on banking operations in Singapore is difficult. When compiling statistics on Singapore's financial sector, the MAS treats both the Asian Dollar Market and the local banking sector as elements of Singapore's financial sector. Also, while the share of the domestic banking market is provided, there is no further breakdown of this figure into either foreign-owned banks or state banks operating locally. The IMF in its solicited 2004 Financial System Stability Assessment of Singapore noted that the MAS publishes 'few statistics on foreign branch operations'.

This makes it close to impossible to access data comparing state-owned banks to private local banks, or local banks to foreign-owned banks. Singapore may have the most robust and healthy local banking sector in Southeast Asia, but it does not have the most statistically accessible one. Financial crises seem to lead affected central banks to be more willing to publish more statistics more widely.

While Singapore was the first country in the region to remove all capital controls and free banks to set their own interest rates as a means of strengthening the monetary policy basis for the Asian Dollar Market (Chong Tee 2003), Singapore has maintained very similar domestic banking policies to its neighbours since Independence. In the domestic banking sector, it limited the presence and operational role of incumbent foreign banks while letting no new foreign banks in. Incumbent foreign banks were not allowed to open new branches or freely change the location of existing ones. Likewise, foreign ownership in local banks was limited to 20 per cent, the lowest of the five countries under study. As with Malaysia, the large number of 'grandfathered' foreign banks in Singapore has meant that foreign-owned banks have always had a significant position in the local banking market despite these strict limits on their growth.

In the same year that the Asian Dollar Market was opened with the local branch of the Bank of America as the first operator, financial authorities established

Singapore's second state bank, the Development Bank of Singapore (DBS). The first state bank established was the Post Office Savings Bank in 1877. DBS quickly became the largest bank operating in Singapore's protected domestic banking market, and later became Southeast Asia's largest bank. When DBS bought into the Philippines during the Asian financial crisis, it alone was larger than the whole Philippine banking sector. DBS' rapid growth was certainly aided by its privileged access to state deposits, as with other state banks. Yet, DBS has also always run itself as a commercial bank and has been less weighed down than its regional state bank peers by 'missionary branches' (Singapore of course has not been burdened with a countryside bereft of private banking services) or political pressures to act non-commercially.

By the mid-1970s, Singapore hosted a local banking sector similar in make-up to its maritime Southeast Asian neighbours: a predominant state bank, a small number of local private banks with three major groups – Overseas Chinese Banking Corporation (OCBC), the Overseas Union Bank (OUB) and the United Overseas Bank (UOB) – and a number – over twenty – of foreign incumbent banks with strict limits on their operational freedom.

In 1990, the MAS provided foreign investors their first new major opening to the Singapore banking market without undercutting its protected nature. The foreign ownership ceiling on local banks was doubled from 20 per cent to 40 per cent making it, along with the Philippines, the highest such ceiling in the region. This invitation to foreign capital was limited, however, as a single or related foreign group could only hold up to 5 per cent of a single local bank. Local banks' complicated share ownership schemes meant that local owners lost little or no management control even with the doubling of the foreign equity ceiling.

This doubling of the ceiling facilitated local bank's ability to manage the next set of policy changes focussed on increasing the relative size of local banks. Changes to the Banking Act in 1993 required that locally owned banks raise their minimum capital funds to a substantial $800 million by 1998; and to raise their capital adequacy ratios to a minimum of 12 per cent (1.5 times the BIS standard). The amendment also required that all of this 12 per cent be in Tier-1 capital. Foreign bank branches were required to raise their minimum capital funds to $200 million and maintain the BIS capital adequacy ratio of 8 per cent, of which 4 per cent must be Tier-1 capital and 4 per cent must be Tier-2 capital (Tan 2001).

The higher capital adequacy ratio of local banks put them at a competitive disadvantage, reinforcing the relevance of the strict limits on foreign bank branches for their competitive position. However, Singapore banks have traditionally supported much higher capital adequacy ratios than legally required. Unlike Thai banks with the BIBF, Singapore banks did not use the Asian Dollar Market as a funding source, but rather largely as a venue for excess liquidity (IMF 2006). In 1991, Merrill Lynch rated OCBC as the world's strongest bank with a capital adequacy ratio of 17 per cent, followed by DBS at 16.2 per cent and UOB at 15.5 per cent. The local bank's willingness to maintain such conservatively high

Table 7.1 Singapore's regionalization (percentage of GDP)

	1992	*1993*	*1994*	*1995*	*1996*	*1997*
Net private capital flows	–2.7	9.4	2.5	1.3	–10.1	–5.5
Net direct investment	2.1	5.5	4.8	4.9	4.3	5.3
Net portfolio investment	3.3	0.5	1.1	0.9	–16.2	–14.4
Change in reserves[a]	–12.3	–12.9	–6.7	–7.2	–11.1	–14.6

Source: International Monetary Fund.

Note
a A minus sign indicates an increase.

capital adequacy ratios helps explain why Singapore has never suffered a banking sector crisis – over even severe financial sector stress. Yet, it also shows how protected Singapore's local banking sector has been for banks to be able to maintain such high capital adequacy ratios and remain quite profitable at the same time.

1994–1997 – Going regional

The three year period in the run-up to the regional financial crisis was a relatively quiet one for the Singapore economy, with the balance of payments staying in healthy surplus, foreign reserves growing rapidly and net foreign direct investment staying positive. Underneath this statistical calm, though, there was a significant shift taking place in the Singapore economy that would accelerate during the crisis.

While Singapore's capital account remained in (very) minor deficit from 1992 to 1996, and the current account stayed in healthy surplus, there was significant change in the national financial accounts, as Singapore firms, with the strong support and counsel of the economic authorities, began to invest much more heavily outside Singapore. Singapore's large stable of strong state-owned firms like Temasek led this 'regionalization' charge as they sought new growth areas outside Singapore's small and mature domestic market. Singapore's local banking market was definitely showing signs of maturation and limited growth potential, as the four largest local banks accounted for 80 per cent of corporate bank borrowing in Singapore from 1992–1996 (Dekle and Kletzer 2001).

After boasting a surplus in net portfolio capital inflows in 1992, from 1993 to 1997, Singapore witnessed a growing deficit. A similar – though much more modest – story was told in the direct investment accounts, as Singapore's traditionally huge surpluses in this area also began to shrink, as strong inflows were countered by growing outflows by local firms. Singapore's domestic economy was becoming more regionally integrated at the same time that its neighbours were booming and seeking new sources of investment.

The only significant banking policy change during this period built on the 1993 amendments, and helped prepare Singapore's domestic banks for a greater regional role and to face greater competition within their own market. In 1996,

there was a further amendment to the Banking Act that required locally owned banks to raise their minimum shareholders' funds from the $800 million required in 1993 (with a five year grace period to build up these funds) to a much more substantial $1.5 billion by 2001.[1] There was no change to the minimum shareholders, funds required to maintain a foreign bank branch licence.

These rapid and significant increases in local banks' minimum capital requirements testify that, even before the regional financial crisis hit, Singapore's financial authorities were pushing local banks to become more assertive and outward looking and less comfortable remaining within the cloistered domestic market. The very success of the Asian Dollar Market, which had attracted over 100 foreign offshore banks to Singapore, created a unique avenue for external pressure for liberalization, once foreign banks and financial authorities became much keener in the 1990s to access Southeast Asia's dynamic economies. Singapore was on the top of the list of the United States Trade Representative's push in the Uruguay Round to open up Southeast Asia's local banking markets. This focus on Singapore's banks and banking market, and how to make them more dynamic and open, would intensify. In August 1997, the government launched a financial sector review that would lay the basis for the most significant changes to Singaporean banking policy under the MAS.

1997–2001 – Crisis avoided

To varying degrees and sequencing, Indonesia, Thailand and Malaysia all suffered in 1997–1998 a currency crisis, a banking crisis and a stock market crisis that together delivered a macro-economic crisis. Singapore suffered neither a currency crisis nor a banking crisis, and certainly did not suffer a macro-economic one. Singapore's currency did dip almost 10 per cent against the dollar in 1997, while the local bourse did fall by 2.2 per cent in 1996 and a further 31 per cent in 1997. Singapore property prices in 2003 – after both the Asian financial crisis and the global information technology industry one of 2001 – were still 35 per cent below their 1996–1997 peaks (IMF 2006).

While Singapore suffered blowback from the regional crisis and its equity and property markets were hit hard, the Asian financial crisis was more an opportunity for Singapore's banks and banking sector than a challenge or, as in Indonesia, a full-blown meltdown. Singaporean banks had not exposed themselves in any great measure to the property sector, nor had they over-reached themselves in the Asian Dollar Market. Rather, throughout the crisis, Singaporean banks matched or bettered the incumbent foreign bank branches' performance, even when the local banks' new ventures into their crisis-ravaged neighbours were included. Local banks had lower NPL ratios than their foreign competitors from 1999–2002 and a higher return on assets from 1998–2002. Both bank deposits and total assets grew each year during the crisis.

Three sets of changes in 1998 foreshadowed the results of the 1997 financial sector review, and its significant advancing of the authorities' efforts to regionalize local banks and provide foreign banks more competitive room in the

Table 7.2 Singapore banking sector stability

	1999	*2000*	*2001*	*2002*
Local banks NPLs to total loans (%)	5.3	3.4	3.6	3.4
Foreign banks NPLs to total loans (%)	6.5	5.4	3.7	3.7
Local banks after tax RoA	1.2	1.3	0.8	0.8
Foreign bank after tax RoA	0.3	0.5	0.5	0.8

Source: International Monetary Fund.

Singapore banking market. First, Deputy Prime Minister Lee Hsien Loong, son of Lee Kuan Yew, took over as Chairman of the MAS and took personal responsibility for the coming financial reforms. Chairman Lee pushed these reforms through against local bank owners' complaints and some resistance from within the MAS. The fact that everybody assumed, correctly, that Lee Hsien Loong was the prime minister in waiting certainly helped him in this push.

The appointment of Lee as MAS chairman fused MAS directly with the top level of Singapore politics, making it the least 'independent' monetary authority in the region and the one most able to push reforms through against the wishes of local bank owners. Bank Negara came a close second on both of these scores, indicating that central bank independence is not a panacea for banking sector reform, especially as structural reform in any sector demands strong political support.

In 1998, two state-linked banks triggered a wave of local bank mergers that the earlier increase in local banks' minimum capital requirement had failed to deliver. As in Malaysia, the indirect policy approach to local bank consolidation failed to achieve its goal and more direct means were required, with state banks in the lead. In 1998, state-linked Keppel Bank and the private Tat Lee Bank, rumoured to be Singapore's weakest local bank and the only one that reported a loss in 1997, merged, becoming the first local banks to merge in over two decades (Chia 1999). Temasek Holdings was Keppel Corporation's largest ordinary shareholder, and in 2000 was its only significant one, holding over 32 per cent of voting stock. DBS nominees were next at over 12 per cent. Soon after, DBS took over the Post Office Savings Bank, ending the independent existence of Singapore's oldest local bank. This second merger meant, though, that the share of state banks in the local banking sector remained the same. State banks as a category did not grow in size or number during the consolidation period, unlike in the cases of Malaysia, Thailand and Indonesia.

Finally, in 1998 DBS took the lead in pushing Singapore's local banks overseas (beyond Malaysia) when it bought a majority stake in Hong Kong's Kwong On Bank. As we have already seen in the previous chapters, DBS also extended its operations into the Philippines through the purchase of the Bank of Southeast Asia in the same year. In 1997–1998, DBS also extended its small operations in Indonesia by buying out its local joint venture partner in Bank DBS Buana. By 2000, foreign assets accounted for a quarter of Singapore's local banks' total assets.

The 1999 reforms

In 1999, the MAS financial sector review delivered a five-year plan to liberalize the local banking sector that focussed on further local bank mergers and greater operational freedom for incumbent foreign banks. Bank mergers would facilitate local banks' expansion overseas by increasing their size, while the greater level of competition locally would act as an incentive to seek expansion overseas. The plan was a two phase one with an initial period of liberalization in 1999–2001 and, conditions permitting, a further period of reform in 2001–2003.

In the initial period of reform, foreign banks received three new openings to the local banking market. The MAS, in announcing these reforms, noted that technological evolution was seriously undercutting Singapore's protectionist banking policies and making the status quo untenable. Despite such powerful language, only one of the three liberalizing reforms was particularly significant. The most significant reform was that a new banking licence, the 'qualifying foreign bank' license was created, and four lucky incumbent foreign banks – Citibank, ABN Amro, Standard Chartered and BNP Paribas – received one. This new licence allowed licence holders to open up to five new branches each and more off-site ATMs, while branch relocation was also liberalized. These banks were also allowed under this license to set up their own ATM network separate from that of Singapore's local banks.[2]

The first tranche of reforms also lifted the 40 per cent foreign ownership ceiling on local banks, theoretically making it possible for a local bank to be bought out by foreign investors. However, at the same time as the ceiling was lifted, financial authorities poured rain on the idea of letting any of the existing local banks be bought out by foreign capital. There was also official MAS support – but not a legislative guarantee – provided for the goal of ensuring that at least half of total Singapore resident banking deposits remained in locally owned banks. Finally, local banks were required to maintain a majority of Singapore citizens or permanent residents on their boards to ensure that the bank boards would continue to act 'in the national interest'.

Finally, eight foreign banks with offshore licences were upgraded to a 'restricted foreign bank licence', which permits licence holders to accept Singapore dollar deposits. However, they cannot accept non-bank deposits of less than $250,000 and cannot pay interest on such deposits. Restricted banks are also limited to a single branch. Both the expansion of the number of restricted banking licences and the qualifying foreign bank licences were introduced as a gradual means to expand the foreign presence in the local banking sector, with the promise of more such banking licences in the future.

In 2001, two more banks received qualifying foreign bank licences – HSBC and Maybank – while all licence holders were permitted to open up to 15 separate service locations – up to ten of them allowed to be branches and the rest off-site ATMs – and provide debit services through the EFTPOS system. In 2001, the new 'wholesale banking licence' was introduced to replace the restricted foreign bank licence and the qualifying offshore banking licence. While this was largely

a change in semantics, 15 banks gained this licence in 2001 with five more in 2002. The goal is to shift all offshore banks to wholesale banks, giving them greater access to Singapore's non-retail banking sector, just as the qualified foreign bank licence has given its six recipients more space in retail banking.

The 1999 reforms did not have any new policies to force mergers, but the MAS indicated in the launch of the five-year plan the goal of having only two, much larger, local banks left at the end of the process that would individually be able to compete directly with foreign banks. Urged on by the two 1998 mergers, the greater local presence of foreign banking giants and a committed MAS, Singapore's private local banks responded reluctantly. In July 2001, Keppel Tat Lee bank's short-lived independent existence ended when it was bought out by OCBC. This was quickly followed by Singapore's largest ever bank merger, when UOB took over OUB turning the Union Overseas Bank into Singapore's largest domestic lender. Today, Singapore has three local banking groups – DBC, OCBC and UOB – each of which control two separate banks.

By 2001, Singapore's local banking sector was very different than in 1997, with a much larger and growing foreign bank presence and very many fewer, much larger local banks, with a private bank as the largest one. All of these changes happened very quickly, without the pressure of a domestic financial crisis or the need to borrow from international financial institutions. However, this burst of unprecedented banking sector reform and liberalization was not over, as more reforms were introduced from 2001 to 2004, with bilateral trade negotiations being the most powerful new avenue for banking sector liberalization.

2001–2004 – Opening up

The Singapore state's commitment to banking sector reform and the MAS' links with Singapore's leaders continued. In 2001, Deputy Prime Minister and MAS Chairman Lee Hsien Loong also became Finance Minister, placing three of Singapore's most important economic policy portfolios in the hands of one person. This impressive concentration of responsibility in the hands of one senior political figure led the IMF in 2004, as part of the financial system stability assessment, to recommend that the MAS chairman be less encumbered with other responsibilities. When Lee Hsien Loong became Prime Minister in 2004, he relinquished the chairmanship of the MAS. His replacement was his predecessor as prime minister, now Senior Minister Goh Chok Tong. The appointment of Senior Minister Goh suggests that this may be an IMF recommendation that goes wanting.

In another sign of continuity, the MAS continued to expand the openings to qualified foreign banks. In 2004, qualifying foreign banks were permitted to expand their presence to 25 customer service locations that could either be branches or off-site ATM locations, while from 2005 new wholesale banking licences became available.

Foreign banks have responded well to these new openings, with qualified full banks taking full advantage of their new operational freedom. By 2007, their own ATM network had over 140 different ATM locations (more than one-third of them Citibank ones), and each bank customer could use this network without charge. However, different banks have focussed on different strategies, with Citibank focussing on ATMs, while Maybank has focussed on branches.

Altogether, foreign banks operating in the Singapore banking market accounted for 45 per cent of the local banking market by 2004 – the highest proportion by far of the five countries surveyed in this book (IMF 2006). In this year, Singapore's local banking sector featured five local banks (the Islamic bank of Singapore under DBS was established in 2007) under the three remaining local banking groups, six qualified full banks, 16 foreign bank branches and 38 foreign-owned wholesale banks.

The program of local bank consolidation, regionalization and greater competition in the local market were also leading to noticeable changes in the functioning of Singapore's remaining local banks. From 2001 to 2003, local banks became more efficient as non-interest expenses fell from 44 per cent to less than 40 per cent, while the share of fee-based income for these banks also rose. At the same time that their home market was being eroded by more competition, local banks' foreign regional operations began to rise and accounted for close to one-third of total profits in 2003, up from 0 per cent in 2000 at the height of the regional financial crisis. By 2004, the goals of the 1999 reforms and their antecedents had largely been achieved.

However, the period 2001–2004 was not only a story of successful continuity but one of significant change in the modes of banking policy liberalization as in November 2000, free trade negotiations between Singapore and the United States – the state pushing hardest at the multilateral level for access to Southeast Asia's banking markets – began, with the deal coming into force on 1 January 2004. Australia also announced the beginning of trade negotiations with Singapore in 2000 and signed a deal in 2003. Japan started negotiations with Singapore in 2000, its first ever bilateral free trade talks, and both countries signed a deal in January 2002. Understandably, these preferential trade negotiations have focussed on issues of foreign bank market access and have not touched on local bank consolidation (there is not much scope left for this in Singapore anyway) or the role and position of state-owned banks.

Singapore's regionally unique role as a free trade port, with no appreciable agricultural sector and few if any sunset local manufacturing industries able to fight for continued protection has made it an attractive partner for bilateral trade deals and a willing participant. Access to services markets have been a particularly key focus of trade deal discussions with Singapore, though trade in gold fish proved a particularly complex issue for Japan. The fact that Singapore does not have a significant agricultural sector or sunset industries means that it has few sacred cows to defend, and can focus more on maintaining existing limitations in services. However, other states are particularly keen to deal with Singapore to get more access to their services areas.

American exceptionalism

This has been true in the area of banking as it was a major point of negotiation in the deals with the United States, Japan and Australia. Likewise, the banking sector results from these separate negotiations reinforced two power-based axioms about bilateral free trade (more accurately, preferential trade deals). First, the United States, Japan and Australia did not receive the same commitments from Singapore in the area of financial services, questioning the ability of disparate bilateral trade deals to act as effective stepping stones to broader multilateral agreements. Second, the United States got the most in terms of banking commitments, followed by Japan, then Australia; the stronger the country, the better deal they can strike. For each of these three countries, Singapore was the first Southeast Asian state they signed a trade deal with, and certainly the Americans see the Singapore deal as a template for further deals in the region.

American negotiators were able to get Singapore to agree to lift the quota of new qualifying foreign bank and wholesale banking licences for American banks, with the quota for qualifying foreign bank licences to be lifted within 18 months and the quota on wholesale bank licences to be lifted within three years. Japan and Australia also received the lifting of the quota on wholesale banking licences. Beyond that, American qualifying foreign banks (still only Citibank) can now negotiate with local banks to access their much larger ATM networks, with American wholesale banks allowed to follow in 2008.

When the FTA took effect in January 2004, Citibank, as a qualifying foreign bank, was permitted to expand its customer service locations to 30 in its first year and an unlimited number from 2006. Any new American qualifying foreign bank licence holder would also not face any limits on service locations. Citibank now has the largest and widest presence of any qualifying foreign bank in Singapore, giving it a competitive advantage over the other five non-American banks. Through this bilateral deal, Citibank now faces very few operational limitations on its local retail operations. It will be very interesting to see how quickly other American banks receive qualifying foreign bank licences given these new operational freedoms.

States having trade deals with Singapore, or those keen to negotiate one, will certainly take the banking commitments to the United States as a benchmark. Bilateral trade deals are partial reiterated games, as commitments given in earlier deals are often demanded in on-going negotiations with other countries. Yet, the different interest sets and power relations between countries mean that no bilateral trade deal will ever be a perfect template for any future deal.

Australia and Japan were able to gain new commitments in the banking sector from Singapore through their deals' review processes. Singapore's trade deals with the United States, Japan and Australia, as is the norm in these deals, have a review process, where each country can seek new commitments over time from the other. In the case of Australia, in the first review of their deal with Singapore in 2004, the eventual relaxation of the quota on wholesale banking licences was added, with Singapore agreeing to provide Australia commitments in this area that would be no less generous than those provided to banks from the United

States. Similarly, in the 2007 review of the 'economic partnership agreement' between Japan and Singapore, Japan was able to gain new commitments from Singapore in banking, including the opening for a single Japanese bank to have its licence elevated to that of a full (non qualifying) foreign bank and the waving of the quota on wholesale banking licences. These review processes mean that these bilateral deals are living documents and hold the potential for future openings in banking policy. These reviews are much more frequent and regular than multilateral trading rounds, providing them with greater potential to deliver future banking policy liberalization.

Singapore today features the smallest number of local private banks and state banks among the countries covered in this book. At the same time, it also hosts the largest number of foreign banks with the largest market share. Foreign banks though are still not allowed, even if there is no legal barrier, to buy local banks in Singapore, unlike the cases of the Philippines and Indonesia. Both Singapore's banks and financial authorities have been the most proactive in their response to the new forces of globalization in banking. Singapore banks have extended their reach into the region on the back of the financial crisis, while the MAS used the regional crisis and growing pressure for foreign bank policy liberalization to reshape the Singapore local banking sector in very short order, even though the island state largely evaded the crisis and its banking sector fallout.

8 Globalization mediated

This concluding chapter will look at what the tumultuous decade of 1994–2004 in Southeast Asian banking tells us about the force and impact of globalization, and about maritime Southeast Asia as a region. Globalizing forces in banking are increasingly powerful and disciplining, yet they fall short of forcing rapid policy convergence along liberal, market-friendly lines across Third World states. Rather, as we have seen, domestic political factors determine how different Southeast Asian states are willing and able to defend or discard the statist-nationalist banking policy status quo, and the broader paradigms – like the NEP – it is embedded in. Southeast Asia is also a notably different region in 2004 than it was in 1994, both in terms of its place in the global economy and the links that tie the regional economies and states together. Indonesia was the undisputed leader of Southeast Asia in 1994, with President Soeharto as the region's senior leader. Today, Indonesia is still distracted with the huge domestic changes brought upon it by the Asian financial crisis, as is Thailand, and has been among the slowest to join new trends, such as the pursuit of bilateral trade deals.

Globalization

The globalizing changes to banking policy's external environment have helped trigger the relatively new banking policy divergence between Southeast Asian states, with the Philippines and Malaysia as regional book ends – the Philippines as the liberalizing one and Malaysia as the statist-nationalist one. Globalization and its three forces identified in this book have had serious and growing ramifications for all regional states, yet their banking policy responses have not converged in line with these pressures. Southeast Asian states' mediation of banking policy's globalizing external environment reaffirms the disciplining power of globalization. It also reaffirms the differing capacities and interests of states to mediate globalization to favour their domestic political interests.

Globalization affects all states, but stronger and more centralized states have a greater capacity to mediate these effects in ways that favour the status quo. Malaysia's stoic defence of its NEP banking policies throughout this decade emphasized this state strength advantage, as did Singapore's and Malaysia's rapid local bank consolidation efforts during the crisis. The less coherent and

institutionalized nature of the Indonesian and Thai states hurt their ability to deal with both the rapid financial sector growth in the early part of the decade and then the crisis that dominated it, leaving them very exposed, so exposed that both political systems did not survive intact. The Philippine banking sector, economy and political system had been so badly hit by the 1980s debt crisis that, by the time the 1990s rolled along, its banking policy was already liberalizing in line with globalizing pressures.

This book reverses the standard treatment of globalization and domestic policy change to strengthen its conclusions about globalization. Rather than treating globalization as an omnipotent, generic force, it narrows its focus to changes to one policy area's external environment, and identifies three key external environment changes and their material and temporal origins. Each is a significant global change that began at roughly the same time, thus providing a distinct starting point for its treatment of globalization. The three changes' different mechanisms of transmission and varied impacts on different local actors also means that they could be effectively separated analytically, allowing for a more nuanced and detailed discussion of globalization.

Globalization through crisis

The supra-national financial crisis that hit Southeast Asia in 1997 was a watershed event for the affected states and for Southeast Asia's integration into the global economy. The miracle was over! It had by far the greatest effect on banking reform in the affected states, and played a strong role in Singapore's 1999 liberalization and the Philippines' continued liberalization.

Four characteristics of the crisis contributed to it becoming such a sharp break for the affected countries and for the region as a whole. First, it shortened policy response times and demanded quick, decisive action, intensifying the incoherence between globalizing market logic and statist-nationalist banking policies' domestic political logic. States already pursuing banking policy liberalization, like the Philippines, fared relatively well, while those trying to defend the statist-nationalist quo suffered. Small local banks and state banks that were the most favoured by the statist-nationalist status quo were the worst hit by the crisis. Foreign banks that were the worst off from the pre-crisis status quo benefited the most from the crisis.

Second, the 1997–1998 crisis was the only one of the three globalizing changes that directly challenged the solvency of local banks, especially politically compromised state banks and looted local banks connected to large, diversified conglomerates. The crisis changed the institutional nature of both banking sectors independent of paradigmatic and banking policy change. It led to an increase in foreign bank market share in each of the countries under study, as foreign banks had fewer NPL problems, except in Singapore (see Table 7.2), and served as a domestic capital flight destination. Small local banks suffered the most and underwent consolidation in each market (often by being purchased by foreign banks), while the market share of state banks, counterintuitively, rose in the worst hit countries – Indonesia, Thailand and Malaysia.

Fourth, the crisis directly affected the states themselves. As illustrated by the Malaysian state's successful efforts at statist-nationalist defence in the face of the Asian financial crisis, the crises seriously raised the financial burden of statist-nationalist banking policies. They required rapid, comprehensive, and costly intervention at a time when the costs of borrowing internationally and locally were abnormally high, much too high a price for Indonesia and Thailand to contemplate. For the Philippines' more liberal banking policy stance, these direct costs to the state offered new and immediate avenues for further liberalization through new foreign bank entry and a reduction in the role of state banks. Singapore also took advantage of the crisis-affected regional environment to push through more liberal banking policies domestically.

Crises and their associated lender of last resort costs can shift the interests of the state from supporting statist-nationalist banking policies to introducing much more liberal ones. As with the case of Indonesia and earlier with the Philippines, they can help foment a collapse of the existing political system and state structure, leading to new ones that support a more open economy as part of their own institutional entrenchment. In contrast, Malaysia's crisis' crippling of local banks opened up new avenues for the Malaysian state to intervene with recovery funds to strengthen the state's control over the banking sector, bolstering the statist-nationalist NEP and precluding market-led liberalization. Crises create opportunities for both statist-nationalist paradigmatic defence, if the state can afford it, and liberalizing change, if the state wants it or has no choice but to accept it.

Finally, these four elements of the crises combined to create unique and powerful openings for external agents of banking policy liberalization/globalization to enter affected states' policy processes. Foreign banks keen to enter or expand their existing operations by buying into illiquid or insolvent local banks were the institutions most able to relieve the state's need to bail-out these banks. Concessional lenders were also the cheapest and often only source of external credit available to crisis-affected states. This greatly amplified these states' interests, even when supporting a statist-nationalist paradigm, in borrowing from these lenders, despite their ability to use conditionality as an effective tool to force liberalizing policy change. Tellingly, Malaysia rejected these lenders' advances, while the Thai and Indonesian financial authorities payed them off as quickly as possible to curtail their continuing influence. The crisis created these avenues. Yet, they lasted only as long as the crisis, while, as we saw earlier, strengthening the borrowing states' resolve never to place themselves in such a compromised position again.

Globalization through negotiation

In stark contrast, the 1982 inclusion of financial services in the General Agreement on Tariffs and Trade has been a gradual, globalizing change to the external environment of Third World states' banking policy. It has had a minimal effect on Southeast Asian states' banking policies so far, with only Thailand offering commitments during the Uruguay Round that were more liberal in nature

than their existing policies. It is hardly surprising that the Uruguay Round did not tempt member states to use its negotiations as a new avenue to pursue banking policy liberalization. The North–South conflict over financial services inclusion, then the modalities of negotiations, clearly shows the persistent lack of universal support for banking policy globalization. The fact that, prior to the Uruguay Round, six rounds of multilateral negotiations passed without discussing banking policy shows how strong protectionist interests are in banking, and how long banking policy was insulated from globalization. Tellingly, the Uruguay Round negotiations ended up with a compromise modality that allowed members with statist-nationalist banking policies, like the Malaysian state, to avoid liberalizing policy change; a loophole many developing members, including the Malaysian state, took advantage of.

More surprisingly, the Philippine state, despite unilateral liberalization, followed a similar defensive, minimalist approach to these negotiations, offering commitments that were substantially less liberal than existing policy. The reason for this counterintuitive outcome, where a state entrenching a technocratic, liberal paradigm ignored a new liberalizing avenue, stemmed from the adversarial, interconnected, and reiterative nature of multilateral trade negotiations. The reiterative nature of these negotiations means that any liberalizing commitment made during an ongoing round cannot be 'banked' for a future round, when new commitments will be demanded.

The interconnected nature of these rounds means that states wanting to protect illiberal policies in one area (rice for the Philippines and Indonesia) feel obliged to offer more generous, liberalizing commitments in other areas. This cross-sectoral, package-negotiating modality limits members' willingness to liberalize policy through the World Trade Organization in sectors they are unilaterally liberalizing, for fear that too rapid a multilateral liberalization of these policies in one round will reduce their bargaining leverage to protect 'sacred cow' illiberal policies in future rounds. In the present Doha Round, the Philippine negotiators can present existing policies, like the ability of a foreign bank to buy up to 60 per cent of a local bank, as new, liberalizing commitments in financial services. Similarly, Indonesia can present the much more open policy towards foreign bank purchases of local banks as a multilateral commitment. Then, it can trade off these 'new' commitments in banking to relieve pressure for the liberalization of rice imports.

WTO negotiations' adversarial, horse-trading environment, with powerful members pushing aggressively for rapid and comprehensive liberalization across many sectors, intensifies this fear of giving away too much too soon. This is especially true for small, weak members, like the Southeast Asian members with minimal agenda-setting powers and no effective walk out threat. If the United States walks out of a specific set of negotiations, this could end these negotiations and threaten the round as a whole. If Malaysia, the Philippines, Thailand, Singapore or even Indonesia (the world's fourth most populous country) walk out, the negotiations and the round would continue, while these states would sacrifice the right to benefit from the most-favoured nation clause. This negotiating modality

favours shallow, cross-sectoral over deeper, sector-specific liberalization. While supra-sectoral paradigms determine and limit banking policy choices domestically, as in the case of Malaysia, the supra-sectoral negotiating modality of the WTO determines and limits the speed and scope of banking policy reform through multilateral negotiation.

While this limits multilateral trade talks' ability to deliver rapid banking policy globalization, unlike crises, the inclusion of financial services in multilateral trade negotiations cannot serve to reaffirm statist-nationalist paradigms and their banking policies. The cumulative effect of repeated rounds, where members must make new liberalizing banking policy commitments or risk losses in other sectoral negotiations, establishes a permanent, growing pressure for more liberal and open banking policies. Immediately after the limited liberalizing success of the Uruguay Round, powerful market and state actors from members pushing for rapid, comprehensive banking policy commitments labelled it as a top negotiating priority for the Doha Round and beyond (Vastine 1997).

A similar story unfolds with bilateral trade deal negotiations, if one of the partners is a major global financial power. Bilateral negotiations between the United States and Singapore leading to the signing of a free trade agreement have reflected this. American negotiators pushed hard and successfully for preferential access to Singapore's protected banking sector. Since then, Australian and Japanese negotiators have used the review periods of their own bilateral trade deals with Singapore to push for similar treatment as that given to American banks. Southeast Asian states, apart from Singapore, have been slow to join the global rush for bilateral trade deals, especially North–South ones. Yet, this is changing. Bilateral trade deals may prove to be the most effective form for liberalization through negotiation, and may continue and even become stronger if the multilateral process fails.

Globalization through technology

As with crises, technological advances are primarily a market-based force for globalization that can change the institutional nature of banking sectors protected by statist-nationalist banking policies. The spread of foreign bank or foreign controlled joint venture automated teller machines across Indonesia, Thailand and Singapore is the clearest visible sign of this technological change and its liberalizing power. As with crises, states' ability to choose how to respond to these technological advances provides them opportunities to mediate their use in ways that support dominant paradigms and their banking policies, either statist-nationalist or liberal ones. Like multilateral trade negotiations, these technological advances are a permanent and growing part of the external environment that will increasingly undermine statist-nationalist banking policies' effectiveness, and aggravate the incoherence between eroding banking policy means and enduring statist-nationalist policy ends.

The Malaysian state's defensive responses to these technological advances signify how the regulatory power of states over the application of technology can

bolster statist-nationalist banking policies; i.e. reverse globalization. By legally limiting the use of territorially-bound technological advances to local banks, the Malaysian state transformed them from a natural competitive advantage for foreign banks to a policy-created one for local banks. Other advances like the global automated teller machine networks and internet banking are less dependent on Malaysian legal codes and cannot be so easily tamed to support the NEP's statist-nationalist banking policy status quo. The 2001 Financial Sector Masterplan calls for a gradual reduction in the technological favouritism towards local banks, though.

By providing a legal level playing field, the Philippine and Indonesian states have allowed these advances to remain as a competitive advantage for foreign banks, and used this to push local banks to invest more heavily in technology. As with the Asian financial crisis, Malaysia supported the statist-nationalist NEP by intervening to control and redirect market forces spawned by technology. As with the Asian financial crisis, the Philippine state supported its technocratic, liberal paradigm by allowing these market forces free play, and relying on their competitive impulses to change local bank behaviour.

Together these three forces of globalization challenge statist-nationalist paradigms and their derived banking policies on many different fronts, simultaneously raising the costs of these policies to the state, offering new avenues for consistent external pressure, and undermining the effectiveness of the policies themselves. So far, these three globalizing forces have offered Third World states strong incentives to support liberalizing banking policy reform predicated on the entrenchment of liberal paradigms. At the same time, these forces have provided select contrary opportunities for strong states to reconfigure their statist-nationalist paradigms to enhance them. Globalization has been a universal disciplining force, but one that still leaves room for state mediation and banking policy divergence.

The permanent, structural nature of these three globalizing elements of banking policy's external environment, though, means that pressures for banking policy liberalization will build and intertwine. The Philippine state's earlier shift in line with the new environment highlighted its high level of exposure to its external environment and the traumatizing power of crises, as did Thailand and Indonesia' experience during the 1997–1998 crisis. The rising costs the Malaysian state has had to shoulder to maintain the NEP's banking policies is further proof of the power of globalization's domestic ramifications. In all cases, the states' divergent responses to banking policy globalization featured disciplining reforms in favour of market forces.

The most noticeable banking policy similarity has been the common state desire to strengthen local banks through consolidation. In all five cases, states have sacrificed the interests of small bank owners in their mediation of globalization, after providing small banks (with the exception of Singapore) decades of policy support. Both foreign banks, if allowed to participate in the consolidation exercise, and large local banks support consolidation, making it an easier policy change to push. Globalization here sacrifices the interests of the small for those of the large, a phenomenon that weakens states' ability to hand out bank licences

to broaden and solidify patrimonial support bases. Historically, the increase in the number of small local banks was intimately linked with this political strategy. Southeast Asian states' responses to banking sector globalization in the decade under study have been far from identical, yet all now have fewer small banks and a larger and expanding role for foreign banks, underlining globalization's disciplining power and states' continuing ability to mediate this power.

The impact of these three changes on Southeast Asian banking policy and banking markets over the decade under study means that the future will likely see no significant return to a stronger commitment to the statist-nationalist status quo. Rather, it will be a question of continued slow and politically challenging policy liberalization and a growing presence of foreign banks. As we have seen with each state's post-crisis banking policy planning, their authorities have realized this and are each slowly working to further open up their banking sectors, while hoping that their largest local banks can become more than nationally competitive.

Regionalism mediated

The impact of the decade of banking policies under study on the ties that link the countries of Southeast Asia together is more ambivalent than the impact of globalization on its banking policies. In many ways, it was much easier and more persuasive to talk about Southeast Asia as an economic region before this decade than after. From 1985 to1994, the focus on Southeast Asia was on its industrial policies favourable to foreign direct investment in export manufacturing and the place of the regional economies in global production networks. These networks helped link the countries of the region more closely together, with Singapore acting as the regional hub. They also linked these countries to the global economy in a mutually beneficial manner. Among ASEAN's first economic agreements were agreements to try to strengthen regional industrial policy coordination, and servicing the automotive production chain segments in Southeast Asia was a key driver of the push in the 1980s and early 1990s for an ASEAN free trade area.

In the first part of the decade under study here, these links and the regional order they helped create were strengthened by the influx of global investment capital, along with continued high levels of foreign direct investment for export manufacturing. The early 1990s were the golden years for those seeing Southeast Asia as a dynamic and coherent region backed by a globally relevant regional organization, ASEAN. First, in the early 1990s, the Philippines stopped being the odd man out in Southeast Asia, as it had recovered finally from the end of the Marcos era and the debt crisis and had joined its neighbours on their high growth trajectory, strengthening the claims for Southeast Asia to be treated as a single region and a uniquely successful one in the Third World. This long-running and now regionally consistent boom also emboldened the countries of the region, making them more willing to consider regional initiatives.

Second, Singapore's and Malaysia's policy decision in this boom period to actively promote foreign direct investment outflows to neighbouring countries strengthened the ties that bound maritime (and increasingly all of) Southeast Asia

together, even before banking sectors were opened up (see Table 1.2). A Malaysian holding firm took control of the previously state-owned Philippine steel company National Steel Corporation in the Philippines, while Singapore banks also took early advantage of the Philippine banking sector liberalization. These policies and the gradual liberalization of investment rules in Southeast Asia made the region more economically coherent, and helped reinforce the order of Singapore, and to a lesser extent Malaysia, as the wealthier capital-exporting countries and the other regional countries as capital importers (in terms of foreign direct investment and portfolio capital, if not the movement of deposits and personal wealth).

Finally, the rush of foreign portfolio investment into maritime Southeast Asia reinforced the idea of Southeast Asia as a single coherent economic region in a new and more dangerous manner. With the growth of local stock markets and offshore banking interest, global firms quickly extended their presence from Singapore to other parts of Southeast Asia, with Singapore becoming both a regional headquarters for manufacturing and increasingly for financial and other services. As Southeast Asian bourses and borrowers found out quickly, foreign portfolio investment and offshore bank lending is much more fleeting than export manufacturing foreign direct investment. This increase in foreign investor interest in the booming economies of Southeast Asia beyond Singapore at roughly the same time helped trigger a positive demonstration/contagion effect, where growth and dynamism in one regional country encouraged investors to look more at this country's regional peers.

If the first part of the decade under study helped deepen the idea of maritime Southeast Asia as an increasingly coherent and attractive economic region with a predictable order, with Singapore at the top followed by Malaysia and then Thailand and Indonesia with the Philippines still behind but making up ground. The Asian financial crisis and its aftermath seriously undercut this construct. From the Plaza Accord of 1985 to the Asian financial crisis, the idea of Southeast Asia as an economic and political region grew in political support within an increasingly confident geographical region, and gained more credence and acceptance globally, both diplomatically and among international investors.

From the onset of the financial crisis in mid-1997 until today, this image and its internal and external supports have been under challenge. The crisis and its aftermath, which we are still living through today in Indonesia and Thailand certainly, had effects that strengthened Southeast Asia as an economic and political region and those that weakened it. However, clearly the balance of effect lies on the weakening side of this ledger.

Strengthening effects

The most powerful of these was that the crisis-inspired liberalization of banking policy in affected countries opened them up for the first time to increased foreign investment and even foreign control of local banks. As we have seen in the

previous chapters, Singaporean and Malaysian banks were some of the most active in buying into Indonesia, Thailand and the Philippines. Particularly, Singapore banks now really are Southeast Asian players, with significant stakes in their neighbours, both for the Singaporean banks and for Singapore's neighbours. As we have seen with the political backlash in Thailand over Singaporean investment in firms owned by then Prime Minister Thaksin, investment from wealthy neighbours can be especially politically fraught. The opening up of crisis-affected banking sectors to foreign investment also reinforced the existing regional order, as Singaporean firms were by far the largest regional investors, followed by Malaysian banks which expanded in the Philippines and bought into Indonesia. There was certainly no movement the other way.

ASEAN, which had its thirtieth anniversary in 1997, was widely criticized from within Southeast Asia and outside (often quite unfairly) as having failed its members and as a regional body during the crisis. Yet, the shock of the crisis deepened ASEAN's fear of irrelevance, and Southeast Asian countries' fear of Chinese economic competition. This has led from 1997 to an upsurge in ASEAN activity, rhetorical and beyond, to strengthen the institution and accelerate its economic integration efforts. At the height of the crisis, there was even talk about adopting the Singapore dollar as a regional currency, talk that never went down too well in the city state. Today, ASEAN, reflecting the European Union benchmark of regionalism, has completed a free trade area and a regional charter. Growing perceptions of ASEAN's declining relevance has helped spur a countervailing increase in ASEAN activity and ambition. ASEAN's newer members from continental Southeast Asia, largely insulated from the crisis, are less keen with this upsurge in activity and ambition than its original maritime members.

Weakening effects

Ranged against these two strengthening effects that are still present today are at least four weakening ones. First, the crisis itself was both larger and smaller than maritime Southeast Asia. Within Southeast Asia, Singapore, and to a lesser extent the Philippines, largely ducked the crisis and its contagion effect, as did Vietnam, Southeast Asia's new rising economy. At the same time, the crisis extended beyond the confines of Southeast Asia, when the Northeast Asian (relative to Southeast Asian economies) economic giant South Korea fell victim.

The crisis' uneven spread within maritime Southeast Asia helped reinforce the economic and psychological distance between wealthy, First World Singapore, and its suffering neighbours, while also reigniting anti-Singaporean feeling in some quarters. This widening of perceptions was no better caught then when President Soeharto's replacement, President Habibie referred publicly in 1998 to Singapore as a 'little red dot'. Soon after the crisis, Singapore began to actively pursue extra-regional bilateral trade deals as well.

The extension of the crisis beyond Southeast Asia to South Korea turned it from a regional financial crisis in the developing world, akin to Latin America's recent history, to a globally significant crisis including one of the world's largest trading

economies and a member of the OECD. This of course attracted much more global interest and action, but framed the crisis as an Asian one with East versus West dimensions, much more so than if it had stayed cordoned off in developing Southeast Asia. Since the crisis, East Asian regionalism and the idea of East Asia as a coherent and distinct economic region not well represented in the Western-dominated global order has received a significant boost, and has become more dynamic and exciting than Southeast Asian regionalism. Regional financial cooperation has been stronger at the East Asian level through the ASEAN+3 and EMEAP processes than at the Southeast Asian level through ASEAN. The financial crisis, along with the rise of China as an East Asian leader, may sound the surpassing of Southeast Asian regionalism by the wider phenomenon of East Asian regionalism, with financial cooperation as the first stalking horse and bilateral trade agreements between Northeast and Southeast Asian economies as the second.

Second, if the Asian financial crisis and its continuing legacy have helped elevate China to the status of East Asian leader, it has also helped either topple – or at least distract – Indonesia from being the leader of Southeast Asia. Indonesia is by far the largest country in Southeast Asia, and Southeast Asian political regionalism has always centred around Indonesia, and particularly President Soeharto (ASEAN's strongest supporter and, for many years, Southeast Asia's most senior and respected leader). Yet, as we clearly saw in Chapter 3, the crisis quickly toppled Soeharto and his New Order regime, and sent Indonesia on a self absorbing democratization process. Indonesia today, as a government and polity as a whole, is still largely inward looking, rebuilding itself in a new more legitimate manner. Thailand's political system is also still deeply involved in the challenges thrown up by the Asian financial crisis and the coming to power of Prime Minister Thaksin.

Third, the crisis itself showed the downside, for both international investors and the governments and populations of Southeast Asian countries, of a close regional association. As soon as the crisis spread from Thailand, Thailand's neighbours complained of the unfairness of the supposed 'contagion' (not demonstration) effect among ill-informed international financial markets, and attempted to differentiate themselves from Thailand. Philippine officials and commentators happily focussed on this theme of differentiation as it painted the Philippines, for the first time in decades, in a positive comparative light economically.

Finally, and most speculatively, the crisis and the long recovery period for the worst hit countries significantly diluted global interest in Southeast Asia as an economic or political region, with many shifting their focus to China and India. Not only has academic and diplomatic interest shifted, but so has foreign direct investment in export manufacturing, the first driver of Southeast Asian economic regionalism and global attention. While the comparative sizes and late international integration of the Chinese and Indian economies would have meant that global attention would have naturally drifted north from Southeast Asia, the crisis and its long aftermath accelerated and deepened this process.

This last chapter has attempted to show how banking reform in Southeast Asia from 1994 to 2004 has had much wider impacts than those simply on the

individual economies of maritime Southeast Asia. Global changes to banking have been the primary drivers of the reforms undertaken in this decade, while the differences in banking reform approaches taken by the five states can tell us much about the nature, power and limits of globalization. Without a doubt, the financial crisis, greatly aided by the prior opening up of regional economies to offshore borrowing, was the most definitive source of banking policy reform and purveyor of the new global era in banking.

The ramifications of these reforms and the crisis have also been great for Southeast Asia as a region and as a regional ideal. While the previous decade defined by export manufacturing and industry policy brought the region closer together and to greater global prominence, 1994–2004 and its focus on banking policy and reform has weakened the region and undercut its place in the world.

Notes

Chapter 1

1 Lee Kuan Yew, the founder of modern Singapore, sets out the case for Asian Values and their political economic superiority in a 1994 interview with Fareed Zakaria: 'Culture is destiny: a conversation with Lee Kuan Yew', *Foreign Affairs*, 1994, 73(2): 109–118.

Chapter 2

1 The United States economy is the prime example of 'disintermediation' and its erosion of banks' traditional markets. In the late 1990s, banks accounted for only slightly over one quarter of all corporate credit in the United States. For all other major First World economies, banks' shares were over half (White 1998).
2 A very clear example of bank looting from the Philippines is the Orient Bank saga. In February 1998, Orient Bank declared a banking holiday and, after inspecting its loan portfolio, *Bangko Sentral ng Pilipinas* discovered that 5.8 billion of its 6.1 billion pesos in non-performing loans were connected to the other business interests of Orient Bank's controlling shareholder (Milo 2000). Akerlof and Romer (1993) provide case-studies of looting during the Chilean bank meltdown and the US Savings and Loan debacle of the early 1980s.
3 One of the major supervisory stumbling blocks is the lack of legal protection for central bank supervisors in many countries, and the ability of wealthy bank owners to use the court system and the threat of legal action to stymie supervisory efforts (Delston 2000).
4 Knight (1998) notes that from 1991 to 1996, fifty-two developing members accepted the IMF's Article VIII, with three-quarters fully opening their capital accounts by the end of 1996. Williamson and Mahar (1998) note that in 1998, 80 Third World members adhered to Article VIII.
5 The IMF monitored that 133 of 181 members suffered severe banking instability from 1984 to 1999, many members more than once (Llewellyn 1999).
6 Jeffrey Sachs (1989) pithily notes that any state needing such a seal clearly identifies itself as a credit risk.
7 The anti-inclusion block had earlier embraced an integrated approach to the inclusion of financial services, when they successfully bargained for the inclusion of the Multi-Fiber Agreement discussions in the Uruguay Round as the *quid pro quo* for the inclusion of financial services (Key 1997). The Multi-Fiber Agreement was a multilateral protectionist agreement limiting Third World clothing and textile exports.
8 The higher levels of technological penetration in developed countries suggest these advances may have had more impact than in less interconnected developing countries. Yet, wealth is usually more heavily concentrated in the Third World in nodes in major cities that are often as 'well wired' as the First World.

Chapter 3

1 Tim Huxley's 2003 Adelphi Paper entitled *Disintegrating Indonesia? Implications for Regional Security* (Huxley 2003) is good example of these fears – fears that the New Order used to justify its long non-democratic rule.
2 World Bank (1998) *Indonesia in Crisis: A Microeconomic Update*, Washington, DC, cited in Paul Kelly (2006) *Howard's Decade*, Sydney: Lowy Institute for International Policy, 2006, p. 34.
3 The 1999 second edition of this book does a good job in looking at what happened to the Indonesian economy from 1996 to 1998.
4 According to banking sources in Singapore, Indonesians placed more money in Singapore banks during the crisis and left it there for much longer than any other crisis-hit country.
5 BIES 1 argues these moves undermined local banks' balance sheets and ability to deal with the currency crisis, helping to turn it into a banking crisis.
6 Soeharto's middle son, Bambang Trihatmodjo, owned 25 per cent of Bank Andromeda. Bank Alfa had been controlled by the Salim Group's Liem Sioe Liong before.
7 The feud between President Wahid and Governor Sabirin shows that this insulation, while much greater than before, was not absolute.
8 This bidding process was not without its controversies as Standard Chartered Bank had put in a higher bid than Farallon (Mapes 2002). Standard Chartered had failed earlier in its bid to buy Bank Bali.
9 See Chapter 5 for details on Malaysia's Bank of Commerce and its links to the Malaysian state.

Chapter 4

1 It strikes me that the regional response to the crisis starting in Thailand and then spreading by contagion to the rest of maritime Southeast Asia is a good proxy measure of regional sentiment. I have always been surprised that the other crisis-hit countries and governments did not blame Thailand more as the 'cause of the crisis', even simply to divert attention from their own national shortcomings. Despite it being a regional crisis, almost all the blame was sheeted home to the forces of globalization.
2 Union Bank and Laem Thong were taken over by the FIDF in August 1998. Nakornthon was taken over in July 1999.
3 The FIDF did transfer the known bad assets of the Bangkok Bank of Commerce first to a special asset management corporation. There was no such easing of pain for the merger with First Bangkok Commercial.
4 The blanket guarantee for creditors was abolished in 2003.
5 As we will see in Chapter 6 when looking at the Philippines, ABN-Amro and the Development Bank of Singapore took very similar steps in the Philippines to reduce their presence there after boosting it significantly during the crisis.

Chapter 5

1 Dr Mahathir's 1970 book *The Malay Dilemma* forthrightly sets out the justification for this and the mechanisms through which it should be achieved.
2 Hamilton-Hart (1999) estimates that the state controlled 64 per cent of financial assets in 1984.
3 Questioning liberal economic assumptions, local banks avoided resident foreign multinationals, despite their dominant role in the export sector and their large demand for locally-sourced credit. According to foreign bankers interviewed in Malaysia and the Philippines, local banks avoid this market segment because foreign multinationals

demand a much higher level of service from their banking providers than local firms, especially in terms of processing speed. Small, weakly capitalized banks often prefer to stay small and inefficient, increasing the opportunity costs of regulatory forbearance.

4 The two different figures come from the fact that often investors, especially institutional and state ones, and controlling shareholders, hold large blocks of shares but do not actively trade them, meaning that only a portion of a stock market's capitalization is actively traded. A low percentage of traded shares increases market volatility, hurting all shares and investors, especially index-tracking funds.
5 EON, *Edaran Otomobil Nasional,* is the car distribution and financing arm of Proton, the state-owned car manufacturer favoured by high tariff walls.
6 Sorsa (1997), in her survey article on Uruguay Round commitments in financial services, noted that in 1994 Malaysian banks' average return on capital was second highest only to Thailand in Southeast Asia. Backing this up, in Asiaweek's 2000 list of the top 500 Asian banks, Malaysian banks on the list accounted for 1.15 per cent of list assets, but 6.28 per cent of profits.
7 It is important to note that these controls and the Prime Minister's railings against foreign investors carefully avoided undermining Malaysia's openness to foreign direct investment in the export-manufacturing sector. Capital controls targeted short-term capital outflows not profit repatriation or capital inflows, the stock and trade of foreign direct investment.
8 This information comes from an interview with a former Bank Utama employee interviewed in Malaysia in June 2001.

Chapter 6

1 Just before the crisis, real interest rates were up to 12 percentage points lower for large local firms borrowing overseas than borrowing locally, while the peso-dollar rate was very stable (Elek and Wilson 1999).
2 Felipe Miranda of the University of the Philippines noted to me how in a 1996 poll over half of the respondents claimed to have voted for Ramos in 1992, more than double the actual number who did vote for him.
3 In 1998, when I hunted for the cheapest, most flexible car loan in Metro Manila, the Development Bank of Singapore offered the best terms, closely followed by other new foreign entrants. They also approved the loan within 24 hours, exemplifying the new competitive pressures and consumer opportunities the 1994 law unleashed.
4 This section borrows heavily from (Cook 2003).
5 The Philippines status as the main regional exporter of labour also provides a thick layer of economic insulation, through steady and large inflows of remittances estimated at over US$6 billion a year.
6 Thrift or savings banks operate under a more limited banking licence than commercial banks due to their lower paid-up capital requirements.
7 The World Bank loan prohibited the Philippine state from participating in this capital call, facilitating Lucio Tan's control of the Philippine National Bank (Arpon *et al.* 2000).

Chapter 7

1 In 1998, to help local bank owners out, this was altered to 10 per cent Tier-1 capital and 2 per cent Tier-2 capital.
2 Qualifying foreign banks were also permitted to provide customers services relating to the Central Provident Fund's investment scheme and the supplementary retirement scheme and accept Central Provident Fund Fixed Deposits. The Central Provident Fund is Singapore's state-based pension system. In January 2007 it had 3.12 million members and a total member balance of 129 billion Singapore dollars.

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