Financial Liberalization and the Economic Crisis in Asia

Edited by Chung H. Lee

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Financial Liberalization and the Economic Crisis in Asia

In 1997, an economic crisis, the result of 'weak' domestic financial systems combined with volatile international capital movements brought about by the globalization of financial markets, took place in the so-called Asian miracle economies. These economies had been lauded for their rapid economic growth, resulting from sound economic policies. In this edited volume, a selection of internationally respected academics explore what brought about the crash and what developing countries can learn from the reform experiences in Asia.

Financial Liberalization and the Economic Crisis in Asia analyses how financial liberalization was undertaken in eight Asian countries – China, India, Indonesia, Japan, Malaysia, the Philippines, South Korea, and Thailand – and how it might be linked to the subsequent crises. The contributors discuss what the model for financial reform in each country was and how it was implemented. The book concludes that removing government intervention from financial markets does not by itself bring about a stable and efficient market-based financial system. Rather, they demonstrate that when financial reform is carried out without a coherent strategy, buffeted by pressures from various domestic as well as foreign interest groups, and without an appropriate infrastructure, financial crisis can result.

This topical study provides an insight into the complexity and difficulty involved in carrying out economic reform. It will appeal to students and researchers of the history of economic development as well as those interested in the Asian economies and the aftermath of the financial crisis.

Chung H. Lee is Professor of Economics at the University of Hawaii at Manoa and a former Senior Fellow at the East–West Center, Hawaii. He is a co-editor of *The Politics of Finance in Developing Countries* and *Financial Systems and Economic Policy in Developing Countries*.

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Contributors

Thomas F. Cargill is Professor of Economics, University of Nevada at Reno, USA.

Kok-Fay Chin is a member of the Faculty of Development Science at Universiti Kebangsaan Malaysia.

Yoon Je Cho is Professor and Director of the Graduate School of International Studies at Sogang University, Korea.

Maria Socorro Gochoco-Bautista is Rosa S. Alvero Professor of Economics, University of the Philippines at Diliman, Philippines.

K.S. Jomo is Professor of Economics, University of Malaya.

Nicholas R. Lardy is Senior Fellow, the Brookings Institution in Washington, DC, USA.

Chung H. Lee is Professor of Economics, University of Hawaii at Manoa, USA.

Anwar Nasution, former Acting Governor, Bank Indonesia, is Professor of Economics, University of Indonesia, Depok, Indonesia.

Bhanupong Nidhiprabha is Associate Professor, Faculty of Economics, Thammasat University, Thailand.

Rajendra R. Vaidya is Associate Professor, Indira Gandhi Institute of Development Research, Mumbai, India.

Series editor's preface

Institution building is a key element for a well-functioning free market economy and the state has an important role to play. That is an important lesson that we can learn from this excellent and very comprehensive book on financial liberalization and the Asian crises edited by Professor Chung Lee. It is perhaps not the first book on the Asian crises, but it gives us detailed case studies of the actual processes of financial liberalization in eight different Asian countries and a fresh perspective on how this made their financial system vulnerable to crisis. This is the key to understanding the Asian crises, if we presume that it was an unfortunate outcome of confluence of 'weak' domestic financial systems and volatile international capital movements.

In each of the case studies the influence of both the prevailing economic theories and powerful interest groups on the course of financial reform and its outcome are examined. Although the importance of institutional preconditions for financial liberalization have been well recognized in the literature before the crisis, the message does not seem to have filtered down to policymakers in a number of countries in Asia. Even if it had, they could not set up the preconditions in a timely manner as they lacked effective systems.

The country studies are written by some of the leading economic scholars and this makes the book not only a valuable contribution to understanding the Asian crises, but also an intellectual contribution to literature on financial liberalization, the influence of economic theories (right or wrong) on economic policies, and the political economy of economic reform.

We are proud to have it in our series jointly launched by the European Institute of Japanese Studies at Stockholm School of Economics and Routledge. The series focuses on the economic and business world of the East Asian region and in particular the driving forces, trends and developments in the cross-border flow of capital goods and technologies. The Asia-Pacific region is presenting the international business community with new bases of competition. The aim of the series is to provide sound analyses on these forces in a manner that will provide enlightenment and practical assistance to business executives and government officials as well as to policymakers.

This book addresses how the theories of financial liberalization have developed over time and how they have filtered down to policymakers, who actually implement

policies of reform under the pressure of various interest groups. These are processes that we need to understand to avoid crises in the future and to be able to build a better international financial architecture. This book is required reading not only for politicians, bureaucrats and economists but for anyone interested in sustainable development and the future of the world economy.

Marie Söderberg

Preface

The origin of this project lies in the Asian economic crisis of 1997–98, an unfortunate outcome of the confluence of 'weak' financial systems in Asia and volatile international capital movements brought about by the globalization of financial markets. Given that the crisis-afflicted countries in Asia had all carried out financial reforms of one sort or another in the years preceding the crisis, it was natural to ask whether there was any linkage between the manner in which financial systems were reformed in those countries and economic crisis.

In order to find out whether such a linkage did in fact exist and thus to learn whether the manner in which the financial system was reformed had anything to do with the crisis, a multi-country project was undertaken in 1999 at the East–West Center, Honolulu, Hawaii. Eight country papers were commissioned with the authors chosen on the basis of their deep insight into the financial systems of the countries investigated.

As part of the project two workshops were held at the East–West Center in 1999 to which both the authors and other experts in Asian financial systems were invited. The participants included, in addition to the authors, Muthiah Alagappa (East–West Center), Richard Baker (East–West Center), Brenda Bolletino (East–West Center), Edward K.Y. Chen (Lingnan University, Hong Kong), Tubagus Feridhanusetyawan (Center for Strategic and International Studies, Indonesia), Wee Beng Gan (Advisor and Senior Director, Monetary Authority of Singapore), Byron Gangnes (University of Hawaii at Manoa), Meheroo Jussawalla (East-West Center), Akira Kohsaka (Osaka School of International Public Policy, Osaka University), Jan Kregel (United Nations Conference on Trade and Development), Sang Hyop Lee (East–West Center), Manuel Montes (then Coordinator, Economics Studies Group, East–West Center and now at the Ford Foundation), Peter Montiel (Williams College), Charles Morrison (East–West Center), Sang Woo Nam (School of International Policy and Management, Korea Development Institute), S. Ghon Rhee (University of Hawaii at Manoa), Jane Skanderup (Pacific Forum, CSIS), Matha Tepepa (UNCTAD), Kang Wu (East–West Center), Ya-Hwei Yang (Chung-Hua Institution for Economic Research), Naoyuki Yoshino (Keio University, Tokyo), and Masaru Yoshitomi (Asian Development Bank Institute, Tokyo).

I am thankful to all these participants for making this project a success and especially to Manuel Montes, who, as the then coordinator of Economic Studies

Group at the East–West Center, helped initiate the project. My thanks also go to Thomas Cargill and Chris Grandy for their helpful comments and suggestions and Mary Abo, Richard Baker, Brenda Bolletino, Irene Cadelina, Jane Ho, Jane Smith Martin, and Lil Shimoda, all members of the East–West Center, for their assistance in bringing this project to fruition. Thanks are also due to Heidi Bagtazo and Grace McInnes, both at Routledge, and Marie Söderberg at the European Institute of Japanese Studies (EIJS), Stockholm School of Economics, for their help in getting the manuscript into print. Finally, the author is much indebted to Janis Togashi Kea for her excellent editorial work.

Thanks to the Swedish Foundation for International Cooperation in Research and Higher Education (STINT) I was able to carry out, in a most unharried manner, the final stage of my work for this project at the European Institute of Japanese Studies, Stockholm School of Economics. For all this I am grateful to my friend Magnus Blomström, the EIJS president, who among other things provided me with an office in his over-crowded institute so that I could finish the project in peace and quiet.

Introduction

Issues and findings

Chung H. Lee

Introduction

The Asian economic crisis of 1997–98 was an unfortunate outcome of confluence of 'weak' domestic financial systems in Asia and volatile international capital movements brought about by the globalization of financial markets (Dean 1998, Goldstein 1998, Montes 1998, Radelett and Sachs 1998). Given the technological advances in information and communications of the late twentieth century, globalization of financial markets was perhaps inevitable although its rapid progress since the 1980s was abetted by a widely accepted notion that free capital movements were better than less-than-free capital movements (Caprio 1998, Eichengreen 1998).[1] As it turns out, this notion – which is based on a simple extension to financial markets of the dictum that free trade in goods increases economic efficiency and thus improves economic welfare – requires many qualifiers to be valid. The Asian economies that suffered dearly from the crisis of 1997–98 were victims of this naive notion about free capital movement. We now know better: if a country is to benefit from free international capital movement it must have, *inter alia*, a sound and strong financial system that can deter panic capital movement and withstand systemic shocks from such a movement, if it is to occur.

What is ironic about the crisis of 1997–98 is that it took place in the so-called Asian miracle economies, which had been held up in numerous writings on Asia's economic success of the past forty-some years as an exemplary case of sound economic policies leading to rapid economic growth. As generally reported in those pre-crisis writings, the Asian economies all maintained sound macroeconomic policies and carried out financial liberalization, presumably removing government intervention and its distortionary effects from financial markets. Now these same economies are all accused of having 'weak' financial systems, if the following observation (Lim 1999: 80) is typical of the condemnation of the Asian financial systems that one reads about:

> Inadequate regulation, banking supervision, accounting standards, financial transparency, legal protection and accountability in corporate governance, combined with pervasive market imperfections, government interventions in business, and the common (and locally rational) practice of relying on political

> or personal relationships to advance and protect one's business ventures ('crony capitalism') all led to a high proportion of 'bad loans' and 'bad investments.'[2]

If the above quote is a correct portrayal of the true state of the Asian financial systems, one is led to wonder what the reforms presumably carried out in the name of financial liberalization in those economies in the years preceding the crisis had in fact accomplished. There are a number of views on this, some even arguing that financial liberalization was the wrong policy for the Asian economies.

According to Wade and Veneroso (1998), for example, financial liberalization in Asia was an inappropriate policy that only weakened a system that had served the region's economies well. As they see it, those economies had a unique financial system that was successful in mobilizing large amounts of savings and channeling them into productive investments. It was a system based on long-term financial relations, which some now call 'crony capitalism,' between firms and banks, with the government standing ready to support both of them in the event of a systemic shock. What financial liberalization had done in these economies was, they argue, to weaken this unique financial system by attempting to restructure it in the fashion of the Anglo-American system.

Kumar and Debroy (1999) likewise argue that financial liberalization in the Asian economies weakened the role of government in overseeing and supporting private enterprises, which was an integral component of their developmental strategy. In the absence of a government agency overseeing the strategies of individual firms and combining it with a broader sector or national strategy, firms over-expanded their capacity, engaging in unrelated and unwarranted diversification. Such expansion became the root cause of the crisis when the countries were faced with a demand slowdown in Japan, the emergence of massive excess capacity in some of their main export industries, a sharp decline in unit values, and rising interest rates that raised debt service obligations. Thus, according to Kumar and Debroy, the Asian crisis essentially represents a case of market failure and not of government failure.

There are others such as Hellman *et al.* (1997) who do not go as far as Wade and Veneroso or Kumar and Debroy in categorizing Asia's financial systems as unique, differing from the Anglo-American system. But they nevertheless argue that the standard financial liberalization policy is based on a naive acceptance of neoclassical *laissez-faire* ideas and is, therefore, inappropriate for many developing countries. For them, the right financial regime for the developing countries is 'financial restraint' – a system in which the government imposes some restrictions on financial transactions but the rents therefrom are captured by the financial and production sectors and not by the government.

Another view of financial liberalization and its possible linkage to the crisis in Asia is that while it was basically a correct policy, it was incorrectly implemented. For instance, according to Camdessus (1998), Managing Director of the International Monetary Fund, what weakened the Asian financial systems was an inappropriate or 'disorderly' manner of financial liberalization that did not pay enough attention to the proper phasing and sequencing of capital account liberalization. Masuyama

(1999) also argues that financial liberalization in Asia was carried out without due consideration for readiness and sequencing, adding that the policy was often undertaken under foreign pressure, influenced by liberalization ideology and the self-serving motives of foreign financial institutions. Likewise, Radelett and Sachs (1998) argue that financial liberalization in the crisis countries was carried out in a 'haphazard and partial' manner, making those economies vulnerable to a rapid reversal of international capital flows.

This debate over what the policy of financial liberalization has or has not done to the Asian financial systems raises questions about what the actual 'model' was that guided financial reforms in Asia and how they were actually implemented. These are the questions we need to address if we are to find out, as the debate points out, whether financial liberalization, as understood by economists and policymakers in Asia then, was a misguided policy or whether, even if it was a correct policy, it was inappropriately implemented.

Economic reform, whether it is for an entire economic system or even for the financial system, is not a simple task. For it to succeed, it needs to be based on sound economic theories and correctly carried out in accordance with its blueprint. Some of the recent experiences in economic reform suggest, however, that such may not have been the case in a number of instances. For instance, according to Stiglitz (1999), the reform policies prescribed for the transition economies of the former Soviet Union were based on a misunderstanding of the very foundations of the market economy. Furthermore, the Western economists advocating those policies failed, he argues, to take into account the fundamentals of reform processes as they lacked an understanding of the politics of reform in the transition economies.[3] A similar story can be told about Chile, which experienced a post-reform crisis when a 'dogmatic hands-off policy' was the guiding principle for financial liberalization in 1973–82 (Visser and van Herpt 1996).

Whether a similar mistake was made in the Asian economies is the subject matter of this volume. Following Stiglitz's analysis of the reform experiences of the transition economies, we offer two reasons why financial liberalization in Asia may have failed to deliver its promised result. The first is that financial reform in Asia may have been guided by a misunderstanding of what financial liberalization entailed and therefore how the financial system should be reformed. It is possible that in many of the Asian economies, financial liberalization may have been perceived and practiced as a simple mirror image of financial repression (Kaul 1999). Thus, financial liberalization may have been regarded merely as deregulation of interest rates, privatization of state-owned financial institutions and promotion of competition in financial markets, elimination of directed credit, and removal of foreign exchange controls. If these were in fact the guiding principles of financial liberalization, then we now know that the financial reforms in Asia were based on misunderstanding of what it takes to build a market-based financial system.

The second possible reason for the failure of the reforms is that even if the blueprint for reform was a correct one, its implementation may have strayed from its true course because of the pressures of various interest groups. For instance, according to Park (1998), the Western governments pressured the developing

countries to open their capital markets for foreign investment although they were aware that the accounting practices and disclosure requirements in the developing countries did not conform to the accepted standards and that the supervisory authorities in those countries did not enforce rules and regulations as tightly as they should.

The following section presents a brief review of the literature on financial liberalization up to the eve of the 1997–98 crisis to help the reader understand which ideas may possibly have guided economists and policymakers in Asia. It is then followed by a summary of what actually happened in financial reform in eight Asian countries selected for comparison. The chapter ends with concluding remarks.

Financial liberalization: from deregulation to institutional reform

Since 1973, when the seminal books by McKinnon and Shaw on finance and economic development were published, academic thinking on financial liberalization has gone through several rounds of revision, each round taking place more or less in the aftermath of a financial crisis. Through successive rounds our understanding of the scope of reforms necessary for creating a market-based financial system has progressed from that of simply removing government intervention in financial markets to that of establishing institutional preconditions for deregulated but efficient and stable financial markets.

Round 1: Deregulation

When McKinnon (1973) and Shaw (1973) published their respective books in 1973, it was a common practice in many developing countries to maintain artificially low interest rates on the belief that high interest rates were detrimental to economic growth. Thus the McKinnon-Shaw thesis that artificially low interest rates and the concomitant credit allocation by government, i.e. 'financial repression,' impede economic growth was a radical departure from the financial policy practiced in most of the developing countries at that time. Given the intuitive plausibility of the proposition that freeing interest rates from government control will increase savings and bring about an efficient allocation of credit and a higher rate of economic growth, the McKinnon-Shaw thesis had a powerful effect on the shaping of financial policy for economic development.

The first real-life test of the McKinnon-Shaw thesis came when Argentina, Chile, and Uruguay embarked upon the wholesale implementation of financial liberalization policies in the late 1970s. Unfortunately for those countries, the outcome of the reforms was not the sound and efficient market-based financial system that the thesis predicted. What emerged instead was '*de facto* public guarantees to depositors, lenders and borrowers, and no effective supervision and control (until it was too late) of the practices of financial intermediaries' (Diaz-Alejandro 1985: 1). With such financial systems in place, the three Latin American countries suffered skyrocketing interest rates, bankruptcy of many solvent firms, and an eventual financial crisis in 1982.

Round 2: Macroeconomic stability and imperfect financial markets

The disastrous consequence of the experiment in those three countries in South America, which later came to be known as the Southern Cone experiment, prompted research into the reasons for the failure in the 1980s and early 1990s (IMF 1983, Khan and Zahler 1985, Fry 1988, McKinnon 1991). An outcome of much soul searching on the part of the proponents of financial liberalization was a new consensus that the Southern Cone experiment was a failure not because the idea of financial liberalization *per se* was wrong, but rather because it was implemented in a macroeconomic environment unsuited for its success.

McKinnon (1988: 387–8) was one of the first to point out the importance of macroeconomic stability as a condition for successful outcome of financial liberalization. Fry (1988) also focused on the necessity of stable macroeconomic policy but added a sound regulatory framework as a precondition for successful financial liberalization. He was, however, cognizant of the difficulty of creating such a regulatory framework in the developing countries where human capital and knowledgeable auditors or supervisors were in short supply.

McKinnon (1991) gave perhaps the most comprehensive discussion of the correct sequencing of financial liberalization. While arguing that his initial policy prescriptions were not incorrect, he now added that there is a certain sequence of economic reform that should be followed if financial liberalization is to be successful. The first step of this sequence is the establishment of an appropriate macroeconomic policy, which includes fiscal control, balancing the government budget, privatizing state-owned enterprises, and ensuring an adequate internal revenue service for the purpose of tax collection.

The second step in the sequence is the liberalization of domestic financial markets by allowing interest rates to be determined freely by the market, freeing up onerous reserve requirements, and privatizing the banks. This step also includes the establishment of commercial law and the liberalization of domestic trade. McKinnon proposes that the privatization of banks may come near the end of this step because that can only occur after the proper re-capitalization of bad loans.

The third step is the liberalization of foreign exchange, which includes the liberalization of the exchange rate for current account transactions and the liberalization of tariffs, quotas, and other international trade restrictions. Only in the fourth and final step are international capital flows to be liberalized. So, while the goal of financial liberalization – i.e. the establishment of a market-based financial system – remained the same, the process necessary to achieve that goal was no longer simply that of doing away, in a big-bang fashion, with government intervention in financial markets. It was now regarded as a more complex process requiring a proper, step-by-step sequencing and macroeconomic stability as preconditions for its success (e.g. Cho and Khatkhate 1989, Lee 1991).[4]

Paralleling this progress in the literature on financial liberalization was a new development in the theoretical literature on financial markets due primarily to the contributions made by Joseph Stiglitz and his co-authors. Starting with the

basic premise that financial transactions are more severely constrained by asymmetric and imperfect information and costly contract enforcement than commodity transactions, Stiglitz (1989) argued that financial markets do not operate according to the textbook model of supply and demand. Instead, because of the problems of adverse selection, moral hazard, and contract enforcement – characteristics inherent in transactions in financial markets – credit- and equity-rationing may occur even in competitive financial markets that are free of government intervention. In other words, market failure is an inherent characteristic of financial markets.

Credit-rationing by banks – that is, the allocation of credit at interest rates below a market-clearing rate – may occur because of the asymmetry of information and the risk aversion of banks (Stiglitz and Weiss 1981). In other words, instead of making loans to those who are willing to pay the highest interest rate at which the market clears, banks may prefer to make loans to 'safe' borrowers at lower rates. Such a banking practice will exclude high-risk, high-return projects from banks' loan portfolios and, consequently, unless a country has a well-functioning equity market it will fail to establish some high-return projects. For many developing countries that lack a well-functioning equity market, financial liberalization may thus lead to an inefficient allocation of financial resources (Cho 1986).

But even if there is a well-functioning equity market there may be some rationing of funds, 'equity-rationing,' which limits raising capital in the equity market. Since with imperfect information the equity market will not be able to perfectly differentiate 'good' from 'bad' stocks, the market will generally discount the prices of the former (Stiglitz 1989). Unwilling to see their net worth decrease, 'good' firms will be reluctant to issue new shares and rely more on internal financing for capacity expansion or new projects. This is a less-than-optimum arrangement since with perfect information the firm would have gone to the equity market to raise additional capital.

The use of the equity market for raising funds is more limited in developing than in developed countries because the former generally have a less developed equity market than the latter and are subject to greater uncertainty, particularly where the political system is unstable. Furthermore, the small size of typical business enterprises in most developing countries implies greater difficulty in collecting, evaluating, and disseminating information, which poses problems for financial intermediaries. Small firms also lack the scale to maintain their own internal capital market capable of allocating funds efficiently among diverse sub-units. Yet even when firms are large, the relative weakness of regulatory institutions impedes full disclosure and adequate provision of information to the market.

Round 3: Institutional preconditions

New insights in the operation of financial markets led to a new round of debate on financial liberalization in the early 1990s with the focus now shifting from government to market failure. The general conclusion from this new round of debate was that the developing countries do not have the institutions necessary for

free-market policy and, furthermore, those institutions do not get established quickly and spontaneously. Its implication is clear: the institutions necessary for a market economy must be purposefully created prior to financial liberalization (Akyüz 1993, Villanueva and Mirakhor 1990, Caprio *et al.* 1994, Gertler and Rose 1996, Demirguc-Kunt and Detragiache 1998, Drees and Pazarbasioglu 1998, and Sikorski 1996).[5]

Such institution building requires government activism. Thus Villanueva and Mirakhor (1990) point to the importance of institutional reform prior to financial liberalization by calling for the development of financial 'infrastructure' such as adequate legal and accounting systems, credit appraisal and rating, and adequate channels for the flow of information. Likewise, Gertler and Rose (1996) propose that the government should pay attention to creating an efficient system of contract enforcement and creating a viable borrowing class. Thus they argue that financial liberalization should be coordinated with policies promoting growth and stability of the real sector, which would increase the creditworthiness of borrowers.

Increasing recognition of the importance of institutions such as the legal, supervisory and regulatory systems and the importance of building such institutions as a precondition for financial liberalization has led to the realization that institutions are a historical product and institution building cannot be done without taking into account a country's initial conditions. Thus a World Bank study (Caprio *et al.* 1994), investigating the relationship between financial and real sectors, the process of reform, and the effect of reform on the mobilization of savings and the efficiency of resource allocation, concludes that financial reform is not an all-or-nothing choice and cannot follow a rigid or unique sequence. Which strategy and sequencing a country adopts in reforming its financial system depends on its initial conditions and the speed of institution building. As a matter of fact, another World Bank study on financial reform concludes that, '. . . recommendations for any country's financial system need to be "tuned" to the institutions and culture of the country' (Caprio and Vittas 1997: 3).[6]

According to Caprio (1994), the outcome of financial reform depends on several initial conditions present in the economy when regulations are lifted. First, it depends on the overall net worth of banks and the initial mix of their assets at the time of reform. If the banks have low or no net worth prior to reform, their behavior under the new set of rules will likely be risky as it is in their interest to make high-risk loans to regain profitability. In contrast, if the banks have high net worth, they have the incentive to protect it by acting in a risk-averse way. The initial mix of assets in a bank is also important since once it is freed of former constraints, the bank would be inclined to make a portfolio shift in favor of the assets that have been discriminated against by former intervention. For example, if existing regulations hamper investment in the real estate sector, it is likely that the banks will diversify into that sector when those regulations are lifted.

Second, the success of financial reform depends on the initial stock of human capital as bankers need to have skills in risk assessment and the ability to gather information about new potential credit, if they are to make correct loan decisions. Third, the success of financial reform depends on the initial stock of information

capital, which in turn depends on the existence of audited financial statements, developed equity markets, and the level of acquisition of public and client-specific information. The fourth requirement for successful financial reform is the existence of a system of rules and procedures for the implementation of decisions within banks. As pointed out by Caprio (1994: 61), these requirements cannot be implemented overnight as their development requires time and diligence.

Caprio and Vittas (1997) acknowledge that financial reforms in the developing countries have been led to create a system that would mimic the one in the OECD countries. As they put it, 'the reformers virtually always take as given the goal, namely, to move their financial systems toward the general model that has been adopted in most OECD countries today' (p. 1). They warn, however, that such a model is premised on the existence of rich institutional environments and 'world-class' supervisory systems, which most of the developing countries lack. A developing country will have to develop its own financial system even if it is not as well developed and as sophisticated as that in the developed countries. There are no magic cures that 'would alone suffice to ensure a dynamic and efficient financial system in which all deposits are safe, all loans are performing, all good investment projects are financed, and all bad ones rejected' (p. 3). Whatever system a developing country may develop, it will have to be 'tuned' to the institutions and culture of that country. Harwood (1997) reaches a similar conclusion, arguing the necessity of paying attention to a country's unique political, economic, sociological, legal and institutional conditions in the development of its financial system.

This brief review of the literature on financial liberalization shows that there has been a progressive widening of the scope of financial liberalization in each of the successive rounds of debate on the topic, each round triggered by either the failure of financial liberalization in achieving its intended goals or new theoretical insights into the workings of financial markets. In the 1970s, the debate on financial liberalization focused on deregulation and the free-market determination of interest rates. In the 1980s, the debate focused on the proper sequencing of financial reform with a focus on macroeconomic stability as a precondition for successful financial liberalization. In the 1990s, the focus shifted to the institutions that are necessary for successful financial liberalization. In other words, even before the Asian crisis of 1997–98, serious writings on financial liberalization no longer took the text-book model of supply and demand as the norm for the financial market and no longer regarded financial liberalization as simply doing away with government intervention.

Summary of the country studies

The eight Asian countries selected for study of their experience in financial reform and the possible linkage to the crisis are Thailand, Indonesia, South Korea, Malaysia, the Philippines, Japan, China, and India. The first four countries suffered badly from the crisis whereas the last four escaped from the crisis with no significant effect on their economies. The following summarizes the varied experiences of the eight countries reported in the subsequent chapters.

Thailand

Financial liberalization in Thailand began in the early 1990s with the abolishment of interest rate ceilings and the gradual development of capital and bond markets. Also, as part of their financial liberalization efforts, Thailand accepted Article VIII of the IMF Agreements in May 1990, thus relaxing exchange controls and reducing restrictions on capital account transactions.

A consequence of these deregulatory measures was a rapid increase in capital inflows to Thailand. Between 1987–90, a few years preceding the capital account opening, and 1995–96 Thai banks' share of the country's net private foreign capital inflows increased from 14.7 to 49 per cent, more than a threefold increase in less than a decade. Foreign borrowing of the nonbank sector also increased from less than 2 per cent to 22 per cent over the same period. Interestingly enough, the share of foreign direct investment in Thailand decreased from 25 per cent to 8.5 per cent during the same period.

As part of financial liberalization, the Thai government established in 1993 the Bangkok International Banking Facilities (BIBFs) in the hope that Bangkok would become a regional banking center. The main function of BIBFs was supposedly that of raising funds overseas to finance trade and investment outside of Thailand. As Bhanupong Nidhiprabha points out, much of the money raised abroad was, however, channeled to borrowers inside Thailand for investment mostly in the nontraded goods sector.

Throughout the 1980s, Thailand experienced rapid economic and export growth and that growth nurtured the expectation that the country would enjoy continued economic prosperity. This optimism combined with credit from financial institutions created an asset market bubble, which was further fueled by huge inflows of foreign capital that followed capital account opening and the establishment of BIBFs.

Bhanupong argues that the opening of the capital account before the establishment of prudential regulations and the establishment of the BIBFs were a major policy blunder for Thailand. According to the author, local financial institutions in Thailand had limited capabilities for handling huge capital inflows, and the development of sound financial institutions, markets and policy instruments should have therefore preceded the opening of the capital account.

The IMF certainly influenced Thailand's decision to carry out financial liberalization. But, more important for that decision was, according to Bhanupong, the influence of a group of domestic players such as central and commercial bankers and independent think-tank economists who walked in and out of the public domain of regulatory agencies and private financial institutions. These central bankers and bankers-turned-finance ministers all shared the IMF ethos of free market ideology. If the policies they helped to implement are any evidence of their thinking on what constitutes financial liberalization, it appears that they had not been well informed of the more recent developments in the literature on financial liberalization.

Indonesia

Until Indonesia was engulfed in a crisis in 1997, various outward signs indicated a healthy economy with moderate inflation and interest rates and a relatively stable rupiah exchange rate, which are often cited as indicators of sound economic fundamentals. In reality, however, these were largely artificial phenomena created by implicit and explicit government subsidies and massive capital inflows that camouflaged an economy suffering from weak economic fundamentals, large external debts, and a fragile banking system.

The high rate of economic growth in the early 1990s was mostly associated with unproductive investments in 'strategic industries' and the nontraded goods sector. Those investments were largely financed by massive capital inflows that occurred in the wake of the banking sector reform in October 1988. The nation's total external debt as of March 1997 was US$135 billion, which was nearly triple the debt in 1989 and equivalent to 160 per cent of the annual GDP. The private sector owed over 60 per cent of the nation's debt, 90 per cent of it in short-term debt. Thus by 1997 Indonesia became highly vulnerable to currency crisis and, of course, that is exactly what happened when foreign lenders refused to roll over the country's huge short-term debt.

In Indonesia it was the 'technocrats,' the highly trained economists working in the Ministry of Finance and Planning Agency, who pushed for economic reform. With the support of the central bank and with little opposition from major interest groups in the country, these technocrats were able to carry out a number of economy-wide reforms. The general public also supported the reforms since they were seen as having favorable effects on inflation, employment and economic growth. Even politically powerful business groups in the highly protected sectors went along with the reforms, as they could now take advantage of liberalized capital markets and implicit guarantees on external borrowing and as they benefited from the privatization of state-owned enterprises, 'strategic industries', and public utilities.

According to Anwar Nasution, the 'technocrats' supported financial liberalization in the belief that a larger presence of foreign financial institutions would bring in more external savings as well as advanced technologies and expertise; improve the corporate culture; and improve the efficiency of the financial market through increased domestic competition. What actually happened was not, however, what they had expected. Instead, the reform brought about a rapid credit expansion and investments in 'strategic industries' and the nontraded sector. Increased competition from the new entrants placed pressure on the existing financial institutions to take on riskier projects when many of their credit officers did not have the expertise necessary for evaluating new sources of credit and market risks. As a result, many of the loans made by the banks went to investments in land, buildings, and other tangible goods that could be used as collateral.

Indonesia is a country with an adequate provision of prudential rules and regulations on the books, as it has adopted since 1991 many rules and regulations recommended by the Committee on Banking Regulation and Supervisory Practices under the auspices of the Bank for International Settlements (BIS). What the country

failed to do in a commensurate manner, however, was to strengthen its legal and accounting systems so that prudential regulations and supervision could be effectively enforced. Poor governance rooted in an unaccountable judiciary and a corrupt government bureaucracy also contributed to the ineffective implementation of whatever prudential rules and regulations the country had adopted since 1991.

Another factor that contributed to Indonesia's banking crisis was its failure to establish a proper exit policy to match the liberal entry policy introduced in 1988. Before the crisis there was no exit policy for state-owned banks: they were not allowed to go bust. As a matter of fact, even private banks were saved from bankruptcy if they happened to be owned by groups with the right political connection. The lack of exit policy encouraged moral hazard on the part of the banks and allowed them to accumulate nonperforming loans. Also contributing to the accumulation of nonperforming loans was government intervention in lending decisions of state-owned banks and finance companies, which continued in spite of financial reform.

Korea

In Korea, financial liberalization began in the early 1980s in a piecemeal manner and without a coherent strategy. Although a more serious attempt at reform was made in 1991, it was during the Kim Young Sam administration (1993–98) that the pace of financial deregulation accelerated. As a part of its effort to 'internationalize' the Korean economy, the government relaxed or abolished many of the restrictions on financial market and foreign exchange transactions. Its desire to make Korea the second Asian country to join the OECD also prompted the pace of financial deregulation to speed up.

According to Yoon Je Cho, in Korea almost every group, except the bureaucrats, who were averse to losing their control over financial institutions, was in favor of financial liberalization. For industrial firms, financial liberalization meant unlimited access to credit and a chance to establish their own financial institutions; for bankers, freedom from government intervention; and for politicians, a move away from an authoritarian government and a symbol of democratization. In spite of the widespread support for financial liberalization there was, however, no clear consensus on what financial liberalization constituted and how it should be implemented. In the event it was the push-and-pull of various interest groups, both domestic and foreign, and not a well thought-out strategy for a new financial system that determined the actual course of reform and its final outcome.

By 1997, financial reform in Korea had succeeded in eliminating almost completely the practice of direct intervention in credit allocation and government management of commercial banks. But in doing so it also weakened the government's capacity as a risk partner of the *chaebol* as well as the banks' monitoring role in corporate governance, while making it possible for the *chaebol* to increase their control over nonbank financial institutions and strengthening their internal capital market. In other words, financial liberalization weakened the 'government-*chaebol*-bank co-insurance' scheme that had worked well in bringing about rapid economic development in Korea.

By 1997, typical corporate firms in Korea were highly indebted, and in the case of some *chaebol* firms the leverage ratio even reached close to 500. Many of the *chaebols* were so large that it was impossible for any single financial institution to impose the necessary debt discipline on them, and it was in fact widely accepted that they would not be allowed to go bankrupt by the government. Obviously, this perception could not have been conducive to creating a sound banking or credit culture in Korea.

Yoon Je Cho argues that such structural problems should have been tackled before Korea began its financial liberalization. He rightly points out, however, that before the crisis many influential observers in Korea believed that financial liberalization would automatically solve many of the structural problems and would thus suffice in bringing about an efficient financial system.

Korea's financial crisis of 1997–98 was, in Cho's own words, a 'natural consequence of the financial liberalization that had been carried out in an economy with a highly leveraged corporate sector, poorly developed financial market infrastructure, inadequate corporate governance, and a poor credit culture.' He argues that since reforming the real sector is a difficult, time-consuming process Korea should have undertaken financial liberalization in a gradual manner in pace with reforms in the corporate sector and the regulatory regime. An alternative strategy would have been to accelerate the pace of reform in the real sector to keep up with the reforms undertaken in the financial sector. It is, however, doubtful that this strategy would have been any easier to implement.

The lesson that Cho draws from the Korean experience is that financial liberalization should be regarded as a process that takes time and involves much more than deregulating financial markets. In other words, the reform of a financial system should be undertaken over a period of time with careful attention paid to the economic structure of the country and the state of its financial market infrastructure and in conjunction with reforms carried out in other sectors of the economy.

Malaysia

Malaysia, compared with other developing countries, has a highly developed financial system with its history going all the way back to the British colonial era. Modeled after the Anglo-American system, Malaysian banks are restricted in their operation to accepting deposits, granting loans and other specified activities, and they are kept at an arm's length from corporate governance and management. But, beginning in the 1970s, the soundness of the Malaysian banking system was increasingly compromised by the Bumiputra policy that used financial policy as an instrument for inter-ethnic income redistribution.

Share trading in Malaysia goes as far back as the 1870s, but it was only in 1960, the year of the Malaysian Stock Exchange establishment, when serious public trading in stocks and shares began. Since then the stock market has become an important source of corporate finance and has superseded commercial banks as a source of corporate finance since the early 1990s. Much of the fund raised in the

equity market did not, however, go to new productive investments in the private sector as more than 50 per cent of it went into the acquisition of existing public sector assets that were being privatized.

In the early 1990s, the Malaysian government launched a financial market liberalization program in order to promote Malaysia as a major international financial center. To attract foreign capital, the government allowed foreign institutional investors to buy shares in Malaysian corporations while reducing the tax rate on their profits to 10 per cent. In response to these measures, large amounts of portfolio investment flowed into the country in the early and mid-1990s, and the stock market became almost like a gambling casino where a heady optimism and a frenzy of speculation over corporate takeovers fueled active trading.

Strengthening of the dollar from mid-1995 created a widespread sense that the ringgit, the Malaysian currency, which had been effectively pegged to the US dollar since the 1980s, became overvalued. So when the ringgit depreciated in mid-July 1997 it was not a totally unexpected event. What was, however, unexpected was the extent of the depreciation – not the generally expected RM2.7–2.8 to the dollar but to a rate as low as RM4.88 (in January 1998). As investors scrambled to get out of their position in ringgit, the stock market also fell severely, with the Kuala Lumpur Stock Exchange Index (KLCI) falling from 1,300 in February 1997 to 500 in January 1998. Kok-Fay Chin and K.S. Jomo argue that a correction in the currency and share markets was well overdue but it was the ill-considered official Malaysian responses that helped transform an inevitable correction into massive collapses in both markets.

Despite some erosion of financial governance from the mid-1980s, Malaysia was relatively safe from the danger of a reversal in short-term bank loans because of its tighter regulation of the financial sector than those of its neighboring countries. Instead what increased Malaysia's exposure to the shifting sentiments of international investors was the large amount of foreign portfolio investment that it had attracted into its stock market. The 1996 bull-run reversed, however, after February 1997 as the sentiment of international portfolio investors toward Malaysia soured. This change in sentiment was further reinforced by contemporaneous developments in the region, but the situation became worse due to inappropriate policy responses by the government and the contrarian rhetoric of the Malaysian Prime Minister.

The study by Chin and Jomo makes it clear that Malaysia was not ready to become a key financial center in Southeast Asia because it lacked a system of well-conceived prudential regulations that are necessary for managing much more volatile and greater portfolio investment inflows. Without such a system the country could not deal with the currency and financial crises that occurred with the sudden reversal of capital flows. Injudicious policy responses to the crises only helped turn them into a crisis of the real economy.

The Philippines

The Philippine financial system managed to survive the Asian financial crisis relatively unscathed due to a couple of factors. First, in the preceding three years

the central bank of the Philippines implemented various measures to strengthen its prudential framework and regulatory oversight over banks and to align domestic banking standards with international 'best practices.' It also made the banks achieve a high degree of capitalization. Second, compared with its neighbors, the surge in capital inflows to the Philippines came late and in relatively small amounts: in 1996 net foreign investment was only US$3.5 billion and in 1997 it actually fell to US$762 million.

The small amount of foreign capital inflow was in turn largely due to two factors that had negative effects on the inflow of foreign capital. One, affecting the demand side, was the external debt moratorium that had been in place since 1984 and had thus delayed access to foreign debt markets by the public and private sectors (the moratorium was only lifted in 1991). The other, affecting the supply side, was the country's relatively poor economic performance, which made the Philippines a less attractive place for foreign investment.

In the Philippines, interest rate deregulation began in 1980 when interest rate ceilings on various categories of savings and time deposits were lifted. Also beginning in 1990, the central bank began to dismantle various measures of control that had been introduced during the economic crisis of 1984–95 as well as other measures that had been put in place over the preceding four decades. But, as noted earlier, these measures of financial liberalization had very little to do with the relative immunity of the Philippine economy from the crisis of 1997–98. Furthermore, as emphasized by Maria Gochoco-Bautista, financial liberalization in the Philippines has failed to bring about a higher rate of economy growth because the limited nature of the reform left intact fundamental structural distortions in the economy.

In the Philippines, a long history of import substitution created a business elite whose power is deeply entrenched and whose interests run counter to greater market competition and liberalization. In spite of various measures of financial liberalization, the structure of the financial market has remained basically unchanged: the commercial banks are owned or controlled by large family-owned corporations, which rely on short-term bank loans for their working capital and for the financing of long-term investments.

The business elite behind these large family-owned corporations has influenced the outcome of financial liberalization and other reform programs to serve its own interests. In fact, financial liberalization has rather strengthened the monopoly power of the corporations that the elite controls with access to bank financing. Especially during the Marcos regime, many of the structural distortions in the economy were allowed to continue since they protected the interests of Marcos and the ruling elite, whose cooperation was sought by the United States to serve its larger geopolitical interests.

A result of the absence of genuine reforms in the economy was periodic balance-of-payments crises, which made the Philippine government and the ruling elite depend on external financing and aid, particularly from the IMF and the World Bank. Although democracy has returned to the Philippines with the demise of the Marcos regime, many of the structural weaknesses of the past still remain because of the government's inability to carry out reforms in the face of political opposition.

The experience of the Philippines shows that simply deregulating interest rates or liberalizing the foreign exchange market and opening the capital account do not necessarily improve market competition nor turn the industries that have long benefited from protected domestic markets into export industries.

Another consequence of the favored access to bank financing by large corporate groups is that it has made it possible for them to avoid financing in the equity market. This has allowed the owners of the groups to retain their corporate control, while insulating corporate management from the discipline of the equity market. With close ties to banks the large corporations have been able to maintain their monopoly power while burdening the economy with various distortions and consequent inefficiency.

Gochoco-Bautista argues that these ties will have to be broken if the Philippine economy is to become more competitive and efficient and if financial liberalization is to have a better chance of success than in the past. As she sees it, once the ties are broken the large corporations will be forced to observe better corporate governance since they will need to ensure access to loans from banks and to equity capital from the stock market. The banks will be also forced to monitor closely their clients since they will need to protect their own bottom lines.

Japan

In November 1997, the Hokkaido Takushoku Bank and Yamaichi Securities Company went bankrupt, followed by the failure of thirty financial institutions in 1998. Thomas Cargill attributes the failure of the first two financial institutions to accumulating stresses in the Japanese financial system resulting from the failure of its regulatory authorities to resolve the problem of nonperforming loans and a series of policy errors. In other words, Japan's economic and financial performance in late 1997 and through 1998 was an event unrelated to the Asian crisis of 1997–98.

Cargill argues that although Japan began financial liberalization in the mid-1970s, the reform remained incomplete with some of the key elements of the pre-liberalization financial regime remaining intact. Those elements, combined with an increased role for market forces after financial liberalization, led to excessive risk taking. This, in turn, brought about a bubble economy in the second half of the 1980s when the monetary policy turned expansive. According to the author, the fundamental structure of the Japanese financial regime would eventually have generated some type of economic and financial distress because of the unsustainable approach to financial liberalization adopted by Japan.

Japan's financial liberalization had very little to do with either a new market ideology or external pressure. Rather what brought it about was the pressure from domestic interest groups, and this explains to some extent why the financial system retained some of the key elements of the pre-liberalization regime. The elements that remained in spite of the reform include nontransparent regulation and supervision; the 'convoy system' for dealing with troubled financial institutions; pervasive government deposit guarantees; close linkages among politicians, financial

institutions, and regulatory authorities; and the postal savings system and the Fiscal Loan and Investment Program.

The incomplete liberalization has led, among others, to the unraveling of the main bank system that in the past served effectively in evaluating and monitoring risk. But there was no widely available financial disclosure framework that could substitute the main bank system in its evaluating and monitoring role. Furthermore, the development of the regulatory monitoring system lagged behind market developments, and administrative guidance could not keep pace with the fast-changing financial environment. It is the combination of enhanced market forces and incomplete and unbalanced liberalization that caused Japan's economic malaise. The same combination was responsible, according to Cargill, for the Asian crisis, although it was an event unrelated to Japan's problem.

What Japan needs to do to pull itself out of economic malaise is, according to the author, to complete its financial liberalization by doing away with the key elements of the pre-liberalization regime that it has retained. Japan has made significant progress in that direction but its future still remains uncertain.

China

China avoided the Asian financial crisis primarily because its financial system was relatively closed and semi-repressed with its currency inconvertible on the capital account. In addition, China had had an extraordinarily strong balance-of-payments position for years prior to the crisis, its external debt was modest relative to its official holdings of foreign exchange, and its short-term debt accounted for only 13 per cent of the total external debt. Yet China remains, according to Nicholas Lardy, vulnerable to a domestic banking crisis.

Despite financial reforms in China, its financial system remains semi-repressed: the interest rate structure is distorted, banks are subject to excessive taxation, and credit is allocated bureaucratically and mostly to state-owned enterprises. Banks and other financial institutions are in a weak financial condition because they have made most of their loans to state-owned enterprises at artificially low interest rates and have been a major source of government tax revenues. In fact, on the eve of the Asian financial crisis the taxes paid by the four largest state-owned banks accounted for about one-sixth of central government revenues.

Given that state-owned enterprises are the largest holders of bank loans, their poor financial conditions have serious implications for the stability and viability of China's financial system. The debt-to-equity ratio of the state-owned enterprises rose from 122 to 570 per cent between 1989 and 1995. This is a sign that most of the borrowed funds were not used to finance fixed investments but were used instead to pay wages and taxes and to finance growing inventories of unsold goods.

The fiscal burden for restoring the health of the banking system is enormous. Lardy estimates it to amount to 25 per cent of the nation's GDP. This will be a significant burden on China's fiscal capability, given that consolidated government revenues in 1998 were only 12.4 per cent of GDP. Worse, the government debt has increased dramatically in recent years with the total sum of its debts reaching 20.5

per cent of GDP. Furthermore, it may not be possible to end the flow of new bad loans unless no new lending is made to unprofitable state-owned enterprises and unless the banks adopt a commercial credit culture.

The author concludes that China's immunity from the Asian crisis supports the view that premature capital account liberalization increases a country's vulnerability to currency crisis. But that does not mean, he argues, that the case of China supports the desirability of postponing financial liberalization. The current system is not sustainable, and the sooner more fundamental reforms are undertaken the stronger the Chinese financial system will be.

India

India is a country that has made numerous attempts to reform the financial system and open the capital account since 1991. It has made, however, little progress on that front, and it is ironically the lack of progress in capital account opening that helped India escape from the Asian crisis with relatively little damage to its economy.

India's economic policy regime has gone through three distinct phases. The first phase, 1951–84, was the era of planning when the state had strict control over resource allocation. The second phase, 1985–91, was a period of partial deregulation when the state retained a major role in resource allocation even though the private sector was given greater freedom in investment decisions. The third phase is the post-1991 period when resource allocation is primarily market-driven. Since 1991 there were two important reforms in India's financial sector – deregulation of interest rates and freeing of pricing restrictions on the new issues on the stock market. There has been, however, little change in the restrictions on banks' use of credit, and all of the major commercial banks are still owned by the government.

The banks in India are all burdened with nonperforming loans: about 18.7 per cent of their loans is classified as substandard, doubtful or a loss in 1996. This high ratio of nonperforming loans is a result of 'social control' imposed on state-owned banks in the years preceding 1991. It is too early yet to tell whether financial liberalization has improved the efficiency of banks and the quality of their loans. The public ownership of banks has created the appearance of their invulnerability to shocks, but as the fiscal health of the government deteriorates, its ability to bail out banks has come into question.

Two development banks in India – the Industrial Development Bank of India (IDBI) and the Industrial Credit and Investment Corporation of India (ICICI) – are not actually banks in the normal sense as they do not take deposits from the public and as they specialize in the provision of long-term loans. Both institutions have increased their liabilities in foreign currencies (12 per cent of total liabilities in 1998 for IDBI and 22 per cent for ICICI), while lending them to domestic firms with only rupee payoffs. Because of this currency mismatch the two development banks are now vulnerable to currency crisis.

Since the mid-1980s, the Indian government has tried to eliminate various subsidies and expand the tax base or implement tax reforms. But not having had much success in that endeavor the government has resorted to requiring the banks

to hold its debts at low interest rates in order to finance fiscal deficits. Such an arrangement would not have been possible if the banks had not been state-owned and had been free to make their own portfolio decisions. Thus recurring fiscal deficits have made the government reluctant to carry out financial liberalization.

Another factor that has impeded financial liberalization in India is the extremely powerful labor unions, which have successfully thwarted many moves toward the privatization of banks. The few cases of privatization that the government was able to carry through were done as piecemeal disinvestment of a small portion of government shareholdings. The sole objective of disinvestment appears to have been that of generating revenues for a cash-starved government. Consequently, privatization in India has had no significant effect on the basic character of public sector firms.

Banks are the weakest link in India's financial sector. The large number of nonperforming loans can put the entire economy under an enormous strain if the banks are faced with a crisis. Such a strain will arise, according to Rajendra R. Vaidya, if the government is forced to render budgetary support to weak banks with funds diverted from social welfare programs in health and education. Such a reallocation of resources will result in a severe social problem in a poverty-stricken economy like India.

Concluding remarks

One general conclusion that may be drawn from the studies reported in this volume is that financial deregulation does not by itself bring about a stable and efficient market-based financial system. When it is carried out without a coherent strategy, buffeted by pressures from various domestic as well as foreign interest groups, and without necessary institutions and financial market infrastructure, it can result in a financial crisis. As both the literature on financial liberalization and the Asian crisis make it clear, financial liberalization needs to have institutional preconditions and be tuned, as argued by Caprio and Vittas (1997), to the institutions and culture of the country if it is to be successful in creating a well-functioning market-based financial system.

The argument that there are institutional preconditions for financial liberalization comes as no surprise to anyone whose understanding of the workings of the market economy is not based solely on its simplistic representation typically found in economics textbooks. In fact, the importance of institutions in economic development has long been recognized, as these institutions impact the political, economic, and social interactions among individual actors and thus the path of economic development (North 1981, 1990, 1991; Platteau 2000; Williamson 1985).[7] It is also well known that while formal institutions such as constitutions, laws, and property rights may be established in a relatively short period of time, informal institutions such as sanctions, taboos, customs, traditions, and codes of conduct are culture-specific and slow to change. What makes carrying out economic reform difficult is that formal institutions being introduced in the country may not be always compatible with its informal institutions.

The importance of compatibility between formal and informal institutions for the former to be effective makes changing formal institutions a task that cannot be guided simply by some general theory, if there is any, or sheer imitation. This is basically a main conclusion that Lin and Nugent (1995: 2362) reach after an extensive survey of the literature on institutions and economic development:

> [M]ere transplantations of successful institutions from DCs to LDCs is, at best, unlikely to have the expected positive effects on performance, and, at worst, may have rather disastrous effects. Where to start and how to bring out the reforms in a country are questions that can be answered only with serious consideration of the country's existing institutional structure and human and physical endowments.

What this observation by Lin and Nugent suggests is that the imported institutions will have to be modified to fit in with indigenous informal institutions while, however difficult it might be, the indigenous institutions will also have to change to some extent to accommodate the transplanted institutions.

If it is the country's informal institutions that must change to make the transplanted formal institutions work effectively, the reform may take years, if not a generation. In fact, this is a conclusion reached by some observers of the Eastern and Central European reform experiences, which were based on the standard reform package prescribed by Western economists (Murrell 1995).[8] For instance, according to Brzeski (1994: 6):

> It will be years, in some cases decades, before the *Rechtsstaat* can create an environment favorable to private activities, especially those involving capital formation. Statutes can be altered easily enough; Western law teams stand by, keen to provide legal expertise. But it will take time for the complementary psychological, social, and cultural changes to take root. Perhaps only demography – a generational succession – can bring about those changes.

Thus what the dismantling of the central planning apparatus and the importing of Western formal institutions did in the transition economies was to create an 'institutional hiatus' in the absence of the informal institutions that were necessary for the effective functioning of the newly introduced formal institutions. In other words, in the transition economies there was neither central planning nor a functioning market economy, and the price of this institutional hiatus was a severe contraction in output and employment in those economies (Kozul-Wright and Rayment 1995, Ellman 1994).[9, 10]

As the country studies reported in this volume amply demonstrate, the Asian financial crisis is also a consequence of economic reform that was carried out before the necessary institutions were put in place.[11] As in the transition economies of the former Soviet Union, financial deregulation in Asia created an institutional hiatus, as it removed government regulation without putting in place institutions necessary for a market-based financial system.

Such an institutional hiatus was perhaps mostly clearly demonstrated in Korea. When restrictions and control measures were removed from the financial markets, neither the financial institutions nor the supervisory authorities were ready for the newly liberalized financial regime. Korean financial institutions had not developed expertise in credit analysis, risk management, and due diligence, and they had little experience in foreign exchange and securities trading and international banking in general. At the same time, the supervisory authorities were not monitoring and regulating the international financial activities of the banking sector as much as they should have because they were forced to overhaul the regulatory system hastily to make it more compatible with a liberalized system. In other words, what the Korean reformers failed to do was setting up a new system of prudential regulation and supervision necessary for safeguarding the stability and soundness of financial institutions (Park 1998).

The accounts of financial liberalization in the crisis countries reported in this volume suggest that it was more the so-called Washington Consensus and less the nuanced approach to financial reform that had been developing in academic circles in the 1990s that provided the intellectual rationale for financial reform in those countries. As a matter of fact, its influence continued even after the crisis when it dictated policy requirements to the crisis countries. As remarked by Bergsten (2000), 'It was the "Washington consensus" that guided the response of all those crucial actors and therefore dictated policy requirements to the crisis countries. The pictorial symbol was, of course, the colonial posture assumed by the Managing Director of the International Monetary Fund as the President of Indonesia, with the world's fourth-largest population, signed his *diktat*.'

The Washington Consensus, which began to emerge among the multilateral and other policy institutions centered in Washington DC in the early 1990s, was representative of the ideas focused on stable macroeconomic policy as the most important policy for economic development. As defined by Williamson (1994), this consisted of fiscal discipline, appropriate public expenditure priorities, tax reform, financial liberalization, appropriate exchange rate policy, trade liberalization, abolishment of barriers to foreign direct investment, privatization, deregulation, and property rights.

With regard to financial liberalization, Williamson very much followed the McKinnon-Shaw hypothesis – that is, to establish a financial regime in which interest rates are market-determined and credit allocation is free of government intervention. A testament to how strongly the Washington Consensus affected the thinking of some policymakers of the West can be found in Williamson's assertion that 'The Washington Consensus should become like democracy and human rights, a part of the basic core of ideas that we hold in common and do not need to debate endlessly' (1998: 111).

Strengthening the domestic financial system by building necessary national institutions is obviously a lesson that we all have learned from the Asian crisis if a developing country is to benefit from participating in global capital markets. But, what has also been made clear is that strengthening the domestic financial system will not be enough to reduce the likelihood of a future crisis because the price of

participating in global capital markets is a greater exposure to financial instability originating abroad. As long as capital can move freely between countries, financial markets know no borders and often make no distinction between a particular country that is suffering severe financial instability and the 'similar' countries that are not (Wyplosz 1999). As we now know, international financial markets reacted violently and indiscriminately to the financial crisis in Thailand, turning that into a region-wide crisis in Asia. That was clearly a case of one country's financial instability having a spillover effect on other countries' financial health and demonstrates the need for international coordination in maintaining financial stability. In other words, in this world of imperfect information financial stability is an international public good, which by its nature will be under-provided in the absence of international coordination.

It is, of course, in the interest of national authorities to require more transparent financial accounting, establish prudential regulation and supervision over their financial institutions, and maintain financial stability. If, however, such measures impose an additional cost to financial institutions and thus negatively affect their international competitiveness and profitability, the national authorities may lack the incentive to establish and enforce all the necessary prudential regulations and supervision. In that event, as remarked by Wyplosz (1999), there might be a 'race to the bottom' among the developing countries as they try to enhance the international competitiveness of their own national financial institutions. Prevention of such a race would call for international coordination.

It is by now well recognized that the multilateral institutions such as the IMF and the World Bank and the global arrangements such as the G-7 are not adequately structured to prevent future financial crises. New global arrangements will have to be established to prevent financial instability and manage crises in the event that they take place in spite of good efforts on the part of national authorities. Such arrangements would include transparency by both public and private institutions, surveillance over national macroeconomic and financial policies, rules for controlling capital flows, a global lender of last resort with the authority to create its own liquidity, and debt work-out procedures in international finance (Akyüz and Cornford 1999). These may, however, take years to be established, if ever, and for now the world may be better served if the developing countries are to take a gradual approach to capital account liberalization or even adopt market-friendly restrictions to capital flows.

If there is one important lesson that we have learned from the Asian crisis, it is that building a free-market economy – a goal to strive for – takes more than simply removing government intervention from markets. Clearly, misconceived and ill-executed government intervention should be removed to allow markets to operate more efficiently, but that will not suffice in promoting economic growth in the developing countries. Presence of appropriate institutions is a *sine qua non* of a well-functioning free market economy, and the state has an important role to play in establishing those institutions.

Notes

1 There were certainly dissenters from this view. For example, Felix (1995) argues in a paper published in 1995 that the containment of international capital mobility is a *sine qua non* for stable exchange rates and reasonable free trade.

2 Goldstein (1998) also identifies financial sector weaknesses as one of the causes of the Asian financial crisis. These weaknesses are over-extension and concentration of credit (in real estate and equities) and liquidity and currency mismatches. In addition, there is a long list of 'long-standing' weaknesses in banking and financial supervision. The list includes lax loan classification and provisioning practices, 'connected lending' (i.e. lending to bank directors, mangers, and their related businesses), excessive government ownership of banks and/or its involvement in bank operation, lack of independence of bank supervisors from political pressures for regulatory forbearance, poor public disclosure, and lack of transparency.

3 According to Stiglitz (1999), privatization in the transition economies of the former Soviet Union did not 'tame' political intrusion into market processes but provided an additional instrument by which special interests and political powers could maintain their power. As the country studies in this volume show, this also happened in some of the crisis countries in Asia as a result of financial liberalization.

4 In a survey of financial liberalization undertaken in the late 1970s and early 1980s in Asia (Indonesia, Korea, Malaysia, the Philippines, and Sri Lanka in Asia), Cho and Khatkhate (1989) found a mixed outcome of financial liberalization. They regard Korea, Malaysia, and Sri Lanka as successful cases judged in terms of the rate of growth and stability of the financial system, mobilization of savings, and the attainment of positive real interest rates; the Philippines as a failure; and Indonesia as a case of 'modest success.' The policy implication they draw from the survey is that financial liberalization should be carried out in a gradual manner with government playing the role of market-promotion. Although they acknowledge the desirability of financial liberalization, they also recognize that its modality, design, and phasing are no less important. They argue that before full liberalization is carried out, there should be in place well-functioning nonbank capital markets and that substantial progress in structural adjustment should have been made in trade, industry, and the legal system underlying the financial system as a whole. Until then, the government should carry out intervention in the financial markets in a diminishing degree spread over a period of time, deriving guidance from market-related indicators.

5 According to a post-crisis study of Asian financial systems, in East Asia the progress of institution building, which requires time and explicit effort, generally lagged behind financial liberalization (Masuyama 1999).

6 This obviously makes it difficult to know whether any particular reform is inappropriate or not until the country is actually afflicted by a crisis. In fact, in our review of the relevant literature published prior to the Asian crisis, we failed to find any mention of inappropriate or disorderly financial reform before the crisis. Rather, most of the pre-crisis studies give the impression that financial reform in Asia was cautiously and gradually undertaken, and in the right sequence. See, for example, Nam (1997), Chang and Pangestu (1997), and Yusof *et al.* (1997).

7 Although there is no clear consensus on the definition of institutions there appear to be, according to Nabli and Nugent (1989: 9), three basic characteristics that are common to most definitions of a social institution. These characteristics are: (1) the rules and constraints nature of institutions, (2) the ability of their rules and constraints to govern the relations among individuals and groups, and (3) their predictability in the sense that the rules and constraints are understood as being applicable in repeated and future situations.

8 The standard reform package consists of macroeconomic stabilization, the liberalization of domestic trade and prices, current account convertibility, privatization, the

creation of a social safety net, and the creation of the legal framework for a market economy.

9 According to Taylor (1994: 85), the blame for this institutional hiatus goes to the 'Bretton Woods institutions and their favored consultants': their policies have little to do with putting institutional prerequisites for modern capitalism in place.

10 Establishing new institutions means more than just creating new administrative bodies and passing new laws and regulations. For them to be effective in reducing transaction costs, there must be also 'institutional capital' – that is, the accumulated institution-specific human capital of both the individuals who operate an institution and those subject to this institution (Schmieding 1992).

11 In a paper written before the Asian crisis, Goldstein (1997) warned that any emerging market economy undertaking a pace of financial liberalization that proceeds much faster than the strengthening of banking supervision should be included in the likely list of future banking trouble spots. Furman and Stiglitz (1998: 15) also argue, writing after the Asian crisis, that '[r]apid financial liberalization without a commensurate strengthening of regulation and supervision contributed significantly to the crisis.'

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1 Premature liberalization and economic crisis in Thailand

Bhanupong Nidhiprabha

Introduction

The process of economic liberalization varies from country to country, depending on initial economic conditions, institutional factors, and political environment. Thailand has adopted an outward-oriented development strategy by eliminating export taxes and reducing import tariffs since the 1980s, but its trade liberalization is far from being complete. It was not until 1 January 2000 that Thailand reduced the tariff rates on certain imports from the ASEAN Free Trade Zone to a maximum of 5 per cent. In spite of tariff cuts there remain regulations that limit imports by requiring products to have at least 40 per cent local content to qualify for the rules of origin and thereby lower tariffs. Tariff rates on some imported raw materials are still kept at a high level.

In Thailand, financial liberalization began in earnest only in the early 1990s although at a faster pace than trade liberalization. The acceptance of Article VIII of the IMF Articles of Agreements was announced in 1990, when the Bank of Thailand was confident about the country's macroeconomic stability. Interest rate ceilings were abolished to enhance the allocative efficiency of savings and the capital account was opened, allowing free flow of trade and investment transactions. Underlying these policy developments was the idea that the economy would grow more rapidly with minimum public intervention and a greater reliance on market forces.

In spite of some costs involved in pursuing the goal of achieving high economic growth, the impact of the policy reforms on economic growth appear to have been favorable until the crash of 1997. The economy sustained a high growth rate for three decades, and this prosperity lulled Thai policymakers into complacency about the existing policies and institutional infrastructure. In 1996, however, external factors changed rapidly through volatility in international portfolio investment, wide fluctuations in the yen–dollar exchange rate, and a collapse in world trade and commodity prices. Given these changes, and especially the rapid and huge capital inflows, domestic macroeconomic policies (i.e. foreign exchange rates and monetary and fiscal policies) should have been changed and regulation and supervision of the financial sector should have been strengthened. The financial crisis in Thailand is a result of the failure to implement appropriate policies to deal

with the rapidly changing world economy in the 1990s and the policy response of the government that was either too late or too ineffective to halt the ongoing crisis.

Thailand's financial liberalization that relaxed capital control with the aim of establishing Bangkok as a financial center in the region was a major policy blunder. Taken in conjunction with the removal of interest rate ceilings at a time when the domestic economy was overheating and the world money market was awash with excess liquidity, the relaxation of capital control induced huge capital inflows. Even if the Bank of Thailand wanted to check the flow of capital it had no means doing so once the interest rates ceilings were removed. With hindsight it is clear that capital control relaxation should have been undertaken in a gradual manner in combination with greater flexibility in exchange rates and that the timing, speed, and sequencing of financial liberalization are critical ingredients of a successful outcome.

Macroeconomic stability is a necessary but not a sufficient condition for successful capital convertibility. Prudential financial regulations and supervision are its preconditions. Furthermore, given the trade-off between a strong financial system and competitive efficiency the number of firms in the financial sector may need to be limited to achieve a balance between efficiency and solvency. In addition, since changing the legal framework to establish good public and corporate governance is a lengthy process, the developing countries should take a gradual approach to financial liberalization. Abrupt liberalization can produce unexpected and undesirable consequences.

The chapter begins with a discussion of interest rate liberalization in Thailand and its outcome. It is followed by an analysis of capital account liberalization with a focus on the role of the Bangkok International Banking Facilities (BIBFs) and the timing of prudential regulations. The chapter then proceeds with an analysis of the political economy of financial liberalization and a discussion of the impact of capital inflows on the vulnerability of the Thai economy to economic crisis. It ends with some concluding remarks.

Interest rate liberalization in the 1990s

Thai commercial banks have always been the most important financial intermediaries in the country, mobilizing savings from households and extending credit to investors. The degree of financial deepening measured as the ratio of quasi-money and bank credit to gross domestic product (GDP) has increased over the past two decades. In recent years, however, the intermediation role of banks has become increasingly less important as capital and bond markets have emerged from a rudimentary stage in response to financial liberalization undertaken in the early 1990s. Household savings now include other financial assets besides bank deposits, and corporate borrowers, especially large ones, now have an additional source of funds in bond and equity markets at home as well as abroad.

Between 1982 and 1990, the rate of inflation in Thailand averaged 3.5 per cent while the ceilings on the rate of interest on time deposits stayed above the inflation rate. Consequently, real interest rates on bank deposits and loans stayed in the

positive zone even though their nominal rates were subject to ceilings. Positive real interest rates plus rapid economic growth, price stability, and a stable banking system contributed to financial deepening in Thailand even before the removal of interest rate ceilings, which was undertaken later than in some other countries.

Although ceilings were imposed on banks's lending as well as deposit rates, interbank short-term interest rates were freely determined by supply and demand – supply of reserves from surplus banks and demand from reserve-deficit banks. Gradually even the ceilings on bank interest rates were removed, beginning first with the ceilings on the rates of long-term deposits in March 1990 followed by those on short-term 'fixed' (i.e. time) deposits and savings deposits. Finally, in June 1992 ceilings were removed from all lending rates.

Prior to the interest rate liberalization, domestic interest rates adjusted infrequently in part because they were subject to ceilings, which the Bank of Thailand utilized as a monetary policy instrument. When those ceilings were removed, there was no sharp increase in interest rates since the market interest rates had been below the ceilings and the real interest rates had been positive. With the removal of the ceilings, however, domestic interest rates became more sensitive to movements in the world interest rates, adjusting quickly especially to changes in the US federal funds rate. As a consequence, the Bank of Thailand lost its control over domestic interest rates and found it exceedingly difficult to carry out its monetary policy.

Before 1992, large commercial banks were suspected of colluding on interest rates. The Thai Banker Association set the appropriate level of interest rates, making sure that there would be no cut-throat competition among member banks. The large banks acted as price leaders with smaller banks following them in setting their own interest rates. Interest rate liberalization changed all those practices, allowing each bank to set its own rates taking into account its cost structure and own market niche. In fact, in some cases small banks became leaders in the setting of interest rates.

It is commonly accepted that interest rate liberalization would reduce the spread between lending and borrowing rates. But what actually happened in Thailand was an increase in the spread between the prime lending rate or the Minimum Lending Rate (MLR) and the 'fixed' deposit rate from 2.5 percentage points in 1990 to 4.0 percentage points in 1991. It is possible that this large interest spread was due to the high cost of holding government bonds or large reserves for loan-loss provisions that the banks were required to hold. Such conditions did not, however, exist in the early 1990s, and the large spread was probably due to the lack of competition and inefficiencies in the Thai banking industry. In fact, large interest rate spreads produced a high rate of return on bank capital for many banks.

For interest rate liberalization to bring about an efficient resource allocation, it must be accompanied by a higher degree of competition. But for thirty years prior to the crisis, no new banks were established in Thailand. A probable reason for this was the belief that maintaining a sound banking system required protecting the existing banks' profitability. Thus the solvency of the banking system had its own cost in terms of efficiency, as represented by wide interest-rate spreads. The banks tried to maintain a constant spread between the prime lending rate and the 'fixed'

deposit rate (Figure 1.1). But after July 1997 they increased the spread because of the need to generate profits and retained earnings to make up for depleted capital funds caused by delinquent loans. This caused a public outcry with the banks being accused of aggravating economic hardships at a time of economic crisis, and the resulting public pressure and moral suasion from the central bank have brought down the rate spread since the third quarter of 1998.

It was proposed in 1995 that five new local bank licenses be granted in 1996 with each new bank being required to have at least 7.5 billion baht in paid-up capital. New foreign banking licenses were also to be issued as part of the commitment to the General Agreement on Tariffs and Trade (GATT) to open up the financial sector. It was hoped that the entry of new banks would break up the oligopolistic banking structure in Thailand. In the event, however, no new banking licenses were actually granted as some of the finance companies that were expected to obtain licenses went bankrupt after the July 1997 crisis. Moreover, there is now no need to issue new foreign banking licenses since after the crisis foreign banks are allowed to take over weak domestic banks.

During the liquidity shortage and the high interest rate episode of 1998, the Bank of Thailand re-introduced ceilings on deposit rates to prevent banks from competing for limited funds. As a result, the real deposit rate declined sharply, reaching a negative level in June 1998 (Figure 1.1). The rising inflation, stemming from large currency depreciation, caused the real return to turn negative, as the ceiling on the nominal deposit rate was set below the inflation rate. By mid-1998, however, the contractionary effect of devaluation began to have downward pressure on inflation, and as the recession deepened further with price deflation real interest rates began to rise despite the ceilings on interest rates. The rising real interest rates made it difficult for the central bank to stimulate the economy when such an action was needed to bring it out of recession.

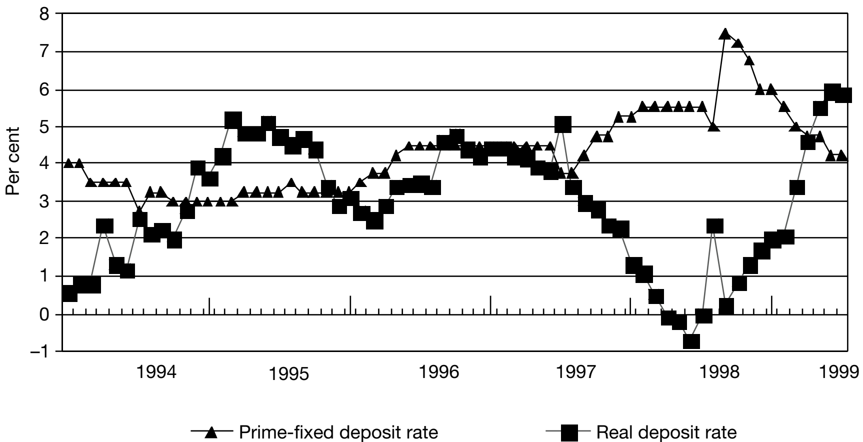

Figure 1.1 Spread between prime lending and fixed deposit rates and real deposit rate.

Capital account opening

In May 1990, Thailand agreed to Article VIII of the IMF Agreements, and relaxed foreign exchange controls and reduced restrictions on capital account transactions. Prior approval from the Bank of Thailand was no longer required for transferring capital in the form of dividends, principal and interest payments on foreign debts. The ceiling on the net position on foreign assets (net overbought) of commercial banks was raised from 20 to 25 per cent of capital funds, while the ceiling on net position on foreign liabilities (net oversold) was lifted from 15 to 20 per cent.

Other restrictions on foreign exchange transactions were also lifted. For example, a maximum of US$20,000 per person was allowed for travel overseas, a maximum of US$500,000 was allowed per individual for the repatriation of interest earnings and dividends, and restrictions on the transfer of money overseas for educational purpose were relaxed. Prior to liberalization, foreign stock market investors were required to wait two months before they could remit their earnings from the Thai stock market; however, after liberalization, remittance took only a few days. All of these changes made equity trading easier and set the stage for a stock market boom in Thailand.

In April 1991, the Bank of Thailand launched the second stage of liberalization on foreign exchange controls, including a more liberal outward transfer of investment funds, and provision for repatriation of dividends, sales proceeds, and profits from stock market transactions. Residents were permitted to open foreign currency accounts if the funds originated from abroad. Further liberalization measures on exchange controls were made in May 1992, allowing exporters to use foreign currency receipts to repay foreign debts without prior approval from the Bank of Thailand. Nonresidents were permitted to deposit foreign currencies received from Thai residents into foreign currency accounts. These measures encouraged dollarization in Thailand although it was limited due to the stability in the baht–dollar exchange rate, which prevailed until early 1997. In September 1992, commercial banks located in Vietnam and in countries bordering Thailand were allowed to withdraw baht from their accounts at commercial banks in Thailand. In April 1995, finance companies were allowed to issue bills of exchange to raise funds at home as well as from abroad. Thus both banks and finance companies were encouraged to seek funds from world capital markets.

A decade ago, Villanueva and Mirakhor (1990) warned that macroeconomic stability and a strengthened supervisory role of the central bank must be secured before embarking on financial deregulation if it is not to bring about adverse consequences by creating an unstable banking system. Unfortunately, capital account liberalization in Thailand was undertaken in haste before adequate prudential laws and regulations could be developed and put in place.

As Thailand embraced the ideology of free capital markets, substantial profits realizable from huge interest rate differentials induced a large influx of foreign capital, especially into its banking sector. As shown in Table 1.1, in 1987–90, a few years preceding the capital and exchange control relaxation, the banks' share of net private foreign capital inflows was only 14.7 per cent. This share increased to 49.3

per cent in 1995–96, more than a threefold increase in less than a decade. Foreign borrowing of the nonbank sector (i.e. 'other loans') also increased rapidly from 1.7 per cent to 15.6 per cent. In contrast, the share of foreign direct investment (FDI) in net private foreign capital inflows decreased from 25.1 per cent in 1987–90 to 5.8 per cent in 1995–96. The share of portfolio investment remained significant but nevertheless decreased from 24.2 per cent to 14.7 per cent during the same period.

The increasing reliance of Thai financial institutions on foreign funds is also shown in Table 1.2, where their funding structure for various years is compared. In 1990, domestic deposits accounted for close to 77 per cent of commercial bank liabilities but only 60 per cent in 1995–96, while commercial banks' share of foreign liabilities increased from 6.1 per cent to 22.6 per cent. Finance companies also increased their dependence on foreign funds, raising their share of foreign liabilities from 4.8 per cent in 1990 to 7.3 per cent in 1995–96.

Table 1.1 Composition of net private capital flows (as a percentage of total net private capital flows)

	1987–90	*1991–94*	*1995–96*	*1997–98**
Banks	14.7	41.7	49.3	47.4
Nonbanks	85.3	58.3	50.7	52.6
Direct investment	25.1	14.6	5.8	15.1
Other loans	1.7	1.9	15.6	16.6
Portfolio investment	24.2	15.6	14.7	7.6
Nonresident A/C	25.0	19.7	13.6	13.2

Sources: Bank of Thailand (various years).
*May 1998

Table 1.2 Funding structure of Thai financial institutions (percentage share)

	1990	*1991–94*	*1995–96*	*1997–99**
Commercial banks				
Deposits	76.9	72.0	59.9	61.6
Foreign liabilities	6.1	10.6	22.6	19.8
Liabilities to commercial banks & borrowing from other financial institutions	1.9	1.7	2.4	3.8
Capital accounts	6.2	6.9	7.9	11.9
Finance and financial & securities companies				
Borrowing from business	62.0	61.1	59.2	39.0
Foreign liabilities	4.8	5.9	7.3	5.5
Credits from commercial banks	7.5	7.8	8.7	8.0
Capital accounts	8.5	10.8	12.4	11.2

Sources: Bank of Thailand (various years).
*May 1999

Commercial banks' foreign liabilities in baht terms steadily increased from around 100 billion baht in January 1994, peaking at around 1,200 billion baht in January 1998, and outstripped the monetary base beginning in 1995 (Figure 1.2). Such a large, steady increase in capital inflows pumped a heavy dose of liquidity into the financial system and placed increasing pressure on the central bank to prevent excessive monetary growth.

Heavy dependence of Thai banks on foreign funds prior to the crisis can be attributed to the relaxation of capital controls. Although their capital funds gradually increased over the years, the increase was less than the increase in foreign liabilities. As is evident in the falling share of deposits from 1990 to 1996, the easy access to foreign funds seems to have reduced the incentives for banks to mobilize funds from domestic sources, increasing their reliance on foreign capital and their exposure and vulnerability to foreign exchange risks.

The value of foreign debt in baht terms jumped up dramatically as the baht plunged to its lowest level in January 1998, reducing the banks' net worth. Bank capital funds shrank since sharp currency depreciation was a shock to bank capital and this capital crunch caused bank credit growth to decline from 34.5 per cent in 1997 to −1.2 per cent in 1998.

The relaxation of capital controls also facilitated the inflow of short-term foreign capital into the nonbank private sector mainly in the form of portfolio investment, nonresident baht accounts, and other loans. This influx of capital significantly altered the composition of capital inflows to Thailand, with the share of foreign direct investment dwindling while short-term flows and portfolio investment increased (Figure 1.3). Short-term flows, however, declined sharply after the crisis, while foreign direct investment rose substantially in the aftermath of the massive currency depreciation.

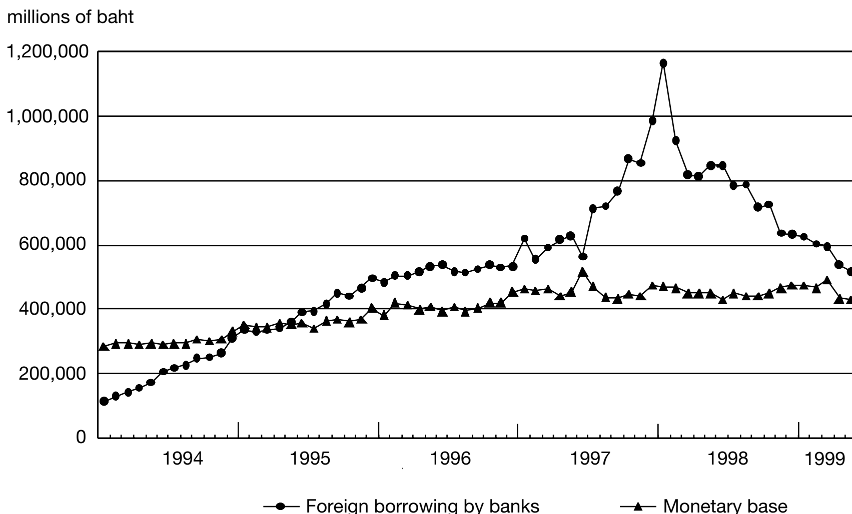

Figure 1.2 Bank foreign liabilities and monetary base.

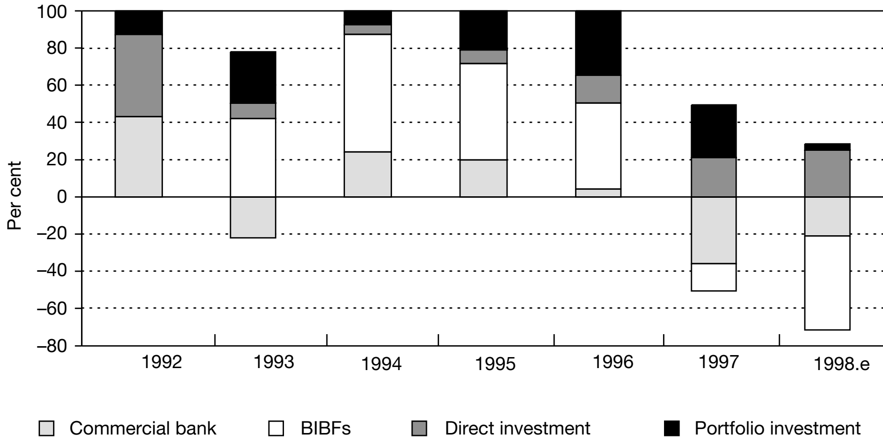

Figure 1.3 Structure of capital flows.

Establishment of the Bangkok International Banking Facilities

The real big opening of Thailand to foreign capital came with the establishment of the Bangkok International Banking Facilities (BIBFs) in March 1993. They were launched with great fanfare under the Chuan Administration with the aim of enhancing Thai financial institutions' capabilities to conduct international banking businesses. The BIBFs were to mobilize funds from overseas and extend credits only in foreign currencies. It was hoped that with the BIBFs the cost of foreign borrowing by Thai firms would be reduced. It was also hoped that they would serve as a financial gateway for neighboring countries including Myanmar and bring about an integrated financial system in the region. To accomplish these goals, the Thai government offered various tax incentives: the corporate income tax was reduced from 30 to 10 per cent; exemptions were provided for the sales tax, stamp duties, and permanent establishment tax; and the withholding tax rate on interest payments was reduced from 15 to 10 per cent for 'out-in' transactions.

BIBF licenses allowed their holders to borrow abroad in foreign currencies and then lend in foreign currencies at home ('out-in') or abroad ('out-out'). In essence, the 'out-out' BIBFs are banking services for nonresidents in foreign currencies, while 'out-in' BIBFs are banking services for domestic residents in foreign currencies only. In addition, BIBFs could guarantee any debts denominated in a foreign currency to nonresidents. They could also undertake foreign exchange transactions with nonresidents, and act as a party to loan syndication as well as a booking center for foreign currency loans.

The Thai central bank hoped that the BIBF banks would create 'out-out' business, where money raised abroad would be used to finance trade and investment outside Thailand. As it actually turns out, the size of 'out-in' lending was twice as

large as that of 'out-out' lending. This was due to the fact that interest rates were higher in Thailand – where a strong economy generated the expectation of high rates of return on investment – than in other countries in the region and thus larger profits were expected from 'out-in' lending.

As of March 1996, three years after the launching of the BIBFs, there were 42 BIBF banks – 12 belonging to Thai banks, 11 branches of foreign banks, and 19 foreign banks with no branches in Thailand. 'Out-in' lending amounted to US$28.7 billion, representing 16.3 per cent of the total domestic credit extended by the banking system, while 'out-out' lending was US$20 billion. In 1997, 'out-in' lending of BIBFs reached a peak, amounting to almost three times as large as Thailand's monetary base (Bank of Thailand 1996).

Thanks to their international networks that facilitated offshore borrowing, foreign BIBF units dominated the BIBFs. The main players of 'out-in' and 'out-out' businesses up to 1996 were foreign bank BIBF units with no branches in Thailand (these are included in 'other BIBF units' in Figures 1.4 and 1.5). Thai banks and foreign banks with full branches in Thailand accounted for a rather small portion of 'out-out' lending in 1994, 1995 and 1996.

Some of the borrowings by foreign affiliates in Thailand, which were previously classified as FDI inflows, were now booked under BIBFs and this 'rebooking' had the effect of causing a sharp decline in FDI especially in 1994. The rebooking was especially easier for Japanese affiliates since many Japanese affiliates and BIBFs belonged to the same Japanese conglomerates.

Both FDI and BIBF lending were highly concentrated in industry, real estate, construction, and financial institutions. Since many BIBFs made domestic long-term loans with overseas short-term credit, which they were confident would be renewed, Thailand's term maturity became increasingly mismatched as its borrowings from BIBFs increased.

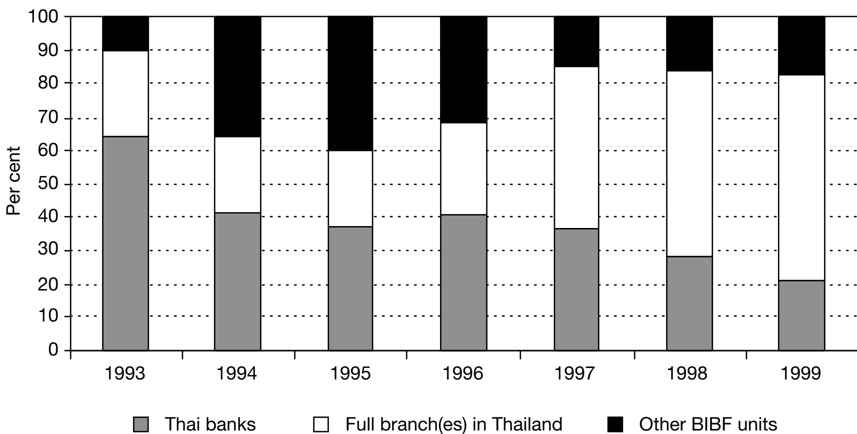

Figure 1.4 BIBF out-in loans.

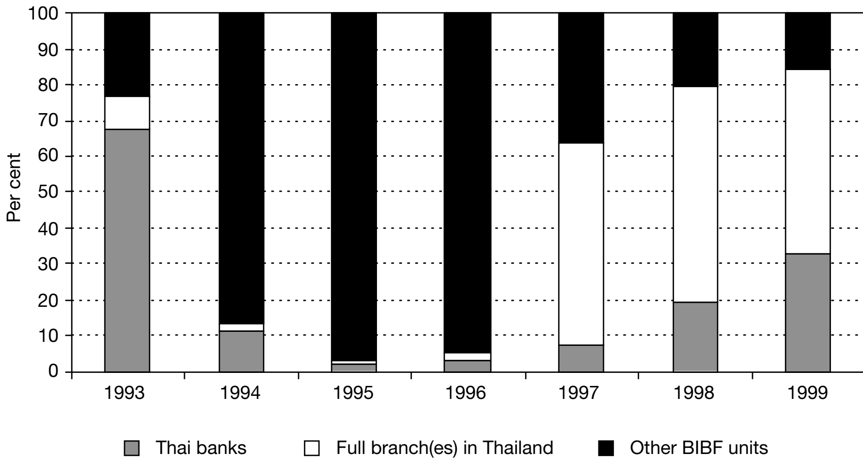

Figure 1.5 BIBF out-out loans.

Lending by BIBFs and commercial banks in foreign currencies was treated as 'foreign assets' since BIBFs were treated as part of Thailand's banking system. As a result, regulation on the maximum level of the net oversold position was less effective, allowing Thailand's short-term external debt to increase. The country's short-term external debt rose from US$18.9 billion in 1992 to US$41 billion in 1995, 58 per cent of which belonged to BIBFs. The share of short-term debt to total debt of BIBFs was 86 per cent in 1995 (Bank of Thailand 1996).

In August 1994, Thailand's International Banking Facilities were expanded beyond the Bangkok area into provinces with the granting of thirty-seven licenses of the Provincial International Banking Facilities (PIBFs). The offices of the PIBFs were to be located outside Bangkok and its vicinity, and their funding was to come from overseas. They were permitted to lend in baht as well as in foreign currencies. In March 1996, there were twenty-nine PIBFs in operation.

Although foreign capital inflows can make a positive contribution to economic growth, they can also inflict severe problems on a country especially when the inflows are large and sudden. Savings can be reduced as consumption expenditures increase with the relaxation of liquidity constraints. Furthermore, if capital inflows are in the nontraded goods sector, there will be a real appreciation, causing deterioration in the current account. 'Irrational exuberance' can bring about excessive investment in the nontrade sector, and it is not surprising that the sectors in Thailand that suffered most from the crisis were the real estate, construction, and service sectors.

The prospects of achieving a narrow spread between lending and deposit rates did not materialize with the establishment of BIBFs, and the government's wishful thinking that the 'out-in' business would promote exports and thus reduce the current account deficit did not come true. Instead, BIBFs worsened the deficit by

financing investments in the nontraded sector with their 'out-in' loans. In sum, it may be concluded that BIBFs raised the vulnerability of the Thai economy to crisis by increasing the risk exposure to currency and maturity mismatch, encouraging highly leveraged businesses, overborrowing in foreign currencies, expanding credit excessively to the nontrade sector, and shortening maturity of capital inflows.

Ill-timed prudential regulations

In June 1991, the reserve requirement was changed into a liquid asset requirement with the required ratio set at 7 per cent of deposits. Liquid assets included deposits at the Bank of Thailand, cash, and securities such as bonds issued by the government, the Bank of Thailand, and state enterprises. The Securities and Exchange Commission (SEC) was established in May 1992, after the launching of phase II of capital control relaxation. The Bank of Thailand also increased the minimum paid-up capital requirement for finance companies from 60 million to 100 million baht by July 1993 and to 150 million baht by July 1995.

In January 1993, the Bank of Thailand imposed the BIS capital adequacy ratio on commercial banks. The minimum capital-risk asset ratio was set at 7 per cent for domestic banks and a more favorable ratio of 6 per cent for foreign banks. This BIS standard was announced two months prior to the launching of BIBFs in March 1993. In December 1993, the adequacy ratio was raised to 7.5 per cent for domestic banks and 6.5 per cent for foreign banks.

The aforementioned prudential measures were undertaken step by step so as not to place too heavy a burden of adjustment on financial institutions. They are all good measures but are the kinds that should have been implemented before rather than after the capital control relaxation in 1990. The timing of the implementation was such that the measures could not prevent the overlending that took place in Thailand. The commercial banks tended to extend credit before raising capital funds, and a large number of them were not able to satisfy the prudential regulations.[1]

It was not until February 1994 that finance companies were subjected to the 25 per cent first-tier capital requirement on the overbought foreign exchange position and the 20 per cent requirement on the oversold position. Commercial banks were required to provide a minimum reserve of 50 per cent for questionable debts. This requirement was raised to 75 per cent in June 1994 and 100 per cent in December 1995. Commercial banks that operated BIBFs were required to provide reserves for questionable debts only in May 1995, suggesting that BIBF activities were given special treatment compared to local banking activities.

In April 1996, finance and securities companies were required to maintain liquidity reserves at 7 per cent of nonresident baht borrowing with maturity of less than one year, including promissory notes, the bill of exchange, and nonnegotiable certificates of deposit. The Bank of Thailand seems to have finally realized the danger of relying on short-term foreign capital, although there were very long recognition lags and decision lags in implementing policies to cope with capital inflows that were too large and too fast. In June 1996, the Bank stipulated that

commercial banks and BIBFs must also maintain cash reserves of 7 per cent of total short-term borrowing and deposits from abroad. Thus, until then, commercial banks received a special cost advantage in tapping foreign funds – a fact that suggests a pro-foreign capital bias on the part of the monetary authorities.

In 1995, realizing that a high degree of capital mobility and sudden surges in capital flows may not be desirable, the Bank of Thailand imposed capital control measures to restrict short-term capital inflows, interrupting capital account liberalization. To prevent banks from extending loans that require foreign borrowing, a maximum credit-to-deposit ratio was introduced, and the ceiling on the loan growth rate was set at 24 per cent in 1995, which then was lowered to 21 per cent in 1996. Other measures included provisioning reserves for 'out-in' loans of BIBFs, increasing the cash reserve requirement from 2 to 7 per cent for nonresident baht accounts, and raising the minimum requirement of loans from a half million baht to 2 million baht. All of these measures were not prohibitive; they simply raised the cost of foreign borrowing.

In July 1996, the Bank of Thailand was still busy issuing guidelines for the application of second-round BIBF licenses. The urge to establish Bangkok as a financial center was so strong that the Bank of Thailand did not foresee any danger in inducing foreign capital inflows. Nevertheless, as a precautionary measure, the Bank issued Financial Institutions Development Fund bonds, which could be used as part of liquid assets of commercial banks in case some of the banks were short of liquidity and required a fresh injection of funds.

In October 1996, the first-tier capital fund-to-risk asset ratio (CAR) of commercial banks was raised from 5.5 to 6 per cent and the CAR for finance companies was raised from 7 to 7.5 per cent. The latter was again raised to 8 per cent in January 1998. Starting in January 1997, commercial banks were required to submit a monthly report on real estate credit for large projects with outstanding credits exceeding 100 million baht. At the same time, the Bank of Thailand announced the approval of three domestic groups to set up new domestic banks. Ironically, some of the new banks-to-be were finance companies that were closed down in 1998. By March 1997, while defending the baht the Bank of Thailand required finance companies to submit reports on bills-of-exchange transactions. Commercial banks were required to set aside at least 15 per cent of their capital funds for substandard loans. For finance companies the requirement was 20 per cent. In June 1997, a month before the float, the Bank of Thailand requested that commercial banks not sell baht in offshore markets to prevent speculative attacks on the baht. Measures such as these confirm our contention that rules and regulations were introduced too late to have been of any use in preventing the crisis.

The experience of Thailand supports the observation made by Johnson (1998) that in many developing countries, local financial institutions have limited capabilities for assessing and managing risks related to huge capital inflows. They need to first develop sound financial institutions, markets, and policy instruments before they can durably liberalize capital account transactions. Until then, it may be necessary to maintain some restrictions on capital account transactions while developing prudential standards and appropriate supervisory arrangements.

In Thailand, once BIBFs' activities were in full swing the Bank of Thailand had lost its ability to control the money supply and, consequently, the burden of adjusting the money supply to capital surges fell on fiscal policy. Some part of capital inflows was absorbed by the public sector, contributing to a budget surplus that lasted for eight years preceding the crisis. The increase in public savings mitigated the rise in the monetary base but it reduced, at the same time, the amount of government bonds held by the Bank of Thailand. As a result, the Bank of Thailand could not carry out open market operation to the extent necessary to sterilize capital inflows. The Bank made some attempts to issue its own bonds but the amount issued was not significant enough to have much effect on liquidity.

The political economy of financial liberalization

In 1990, the Thailand Development Research Institute (TDRI), an independent think-tank, predicted that Thailand would repay all of its debt by 1992 and would graduate into a net creditor or a newly industrializing country like South Korea. It also predicted that the structure of capital inflows would be in the form of foreign direct and portfolio investment rather than foreign borrowing. Phaichitr Uathavikul, President of TDRI and former Finance Minister and executive officer of the World Bank, saw no obstacle to Thailand's becoming a net lender country, barring political interference that might create instability. According to Phaichitr, exchange control liberalization could fulfill Thailand's desire to become a commercial and financial center for the fast-growing region, and unrestricted access to the Thai market by foreign banks would bring about a competitive environment and advanced technology. Sanoh Unakul, former Governor of the Bank of Thailand, former Secretary General of the National Economic and Development Board, and chairman of TDRI in 1990, also argued that there was growing evidence of Thailand becoming the region's trade and financial center (*The Nation*, May 15, 1990).

When in 1990 the Bank of Thailand was holding talks on the strategy for liberalizing exchange controls with the IMF, the latter had been calling for the Thai government to liberalize exchange controls, arguing that the robust Thai economy would entail rapid exchange control liberalization. Chavalit Thanachanan, Governor of the Bank of Thailand, basically concurred, stating that exchange control liberalization would send a signal to the rest of the world that Thailand was ready to facilitate trade and financial flows and to join the club of sixty countries that had adopted exchange control liberalization. The US$12 billion level of international reserves was considered sufficiently large to relax foreign exchange control.[2]

In 1990, Prime Minister Chatichai Choonahavan argued for Thailand's compliance with the IMF rules of Article VIII by saying that Thailand was now financially mature and should thus meet the conditions under the Article. Pramual Sabhavasu, Finance Minister, also argued that the level of international reserves was sufficiently high since it covered five months of imports without any earnings from exports. According to Pramual, the announcement of the acceptance was a prelude to the upcoming 1991 IMF meeting of central bank governors in Bangkok (*The Nation*, 17 May, 1990).

The global trend toward financial liberalization and the globalization of financial markets prompted Thailand to accelerate the development of financial institutions to serve the increasingly sophisticated needs of international trade and investment. As director of the Bank of Thailand's supervision and development department in 1995, Thirachai Phuvanatnaranubala argued that Bangkok had a future as a leading international banking center in the region, replacing Hong Kong and Singapore. As he saw it, Hong Kong would be returned to China in 1997 and Singapore would be disadvantaged with rising operating costs. He thus pushed the Bank of Thailand to promote BIBFs' 'out-in' business in the form of loan syndication because it would serve, he contended, as a stepping-stone for expansion into their 'out-out' business once Thailand overcame its shortage of human resources (*The Nation*, 29 May, 1995).

Loans extended by BIBFs grew substantially from 200 billion baht in 1993 to 1.2 trillion baht in 1997, and peaked in 1997 at 1.88 trillion baht. At the end of 1999, the amount declined to just 600 billion baht, as the local interest rate declined to its lowest level in decades, resulting in the disappearance of the financial advantages of foreign borrowing through BIBFs.

Wade (1998) blamed the IMF for its pressure on developing countries to open the capital account without an adequate framework of regulation. In the case of Thailand, the IMF was in fact a major influence behind the push for financial liberalization and there was a trace of the Washington Treasury complex (Bhagwati 1998). But also important for Thailand's drive for financial liberalization was the consensus among domestic players such as central bankers, commercial bankers, and independent think-tank economists, who walked in and out between the public domain of regulatory agencies and private financial institutions. For example, Tarrin Nimmanahaeminda, Finance Minister under the Chuan Administration in 1993 and an advocate of the idea of establishing Bangkok as a financial center for the region, was once the president of Siam Commercial bank.

This network of influential players shared the IMF's ethos of free market ideology. Furthermore, the IMF gave them indirect support by providing the standby loan agreement in case of capital outflows after exchange control liberalization and thus encouraged the perception that nothing could go wrong with an open capital account. It should be noted, however, that the IMF influence alone was not sufficient to push for complete financial liberalization. Had central bankers and bankers-turned-finance ministers not subscribed to financial liberalization, the pace and shape of liberalization in Thailand would have produced a different outcome. There was also an environment of 'irrational exuberance' that was inflated by large accumulated international reserves and an unrealistic dream of becoming a financial center in the region.

Since the Finance Ministry controlled the number of foreign banks in Thailand, foreign banks that wished to enter the Thai market had to seek a BIBF license for full services. Given that there were large economic rents from having the license (tax privileges and the possibility of illegally siphoning money to offshore branches in locations like the Cayman Islands), there was keen competition for the license among foreign banks. This competition took the form of demonstrating their willingness to enter the Thai market by showing an impressive lending volume and thus resulted

in their excessive lending despite the low interest spread and high default risks. Thus it is not surprising that foreign banks' lending volume increased more rapidly than Thai banks.

Capital inflows and vunerability to economic crisis

Favorable events such as rapidly rising growth rates of exports and GDP generated the expectation of continued prosperity. Asset prices were bid up by the linear expectation of continued prosperity, and credit from financial institutions only added fuel to the bidding-up process to the extent that asset prices far exceeded their fundamental values. For instance, whereas in 1986 the share of bank credit allocated to real estate was only 3.8 per cent of total bank loans, it went up to 10.5 per cent in 1994 to decline slightly to 8.8 per cent in 1996 (Table 1.3).

Once psychological factors such as the herd instinct took over the sensibility of market participants, asset prices became highly overvalued. Greed and euphoria kept the level of 'paper profits' high. Capital control relaxation coincided with the boom in the real sector of the economy. Thus with the cheap funds they were able to obtain abroad financial institutions pumped credit and margin loans, fueling the bubble. What further weakened the financial fragility was that credit extension was concentrated in the nontrade sector. The open capital account also allowed large portfolio capital inflows from international investors who wished to diversify their portfolios, thus pushing up share prices further.[3]

Unlike foreign direct investment, which can be labeled 'cold money,' portfolio investment, other short-term loans, and nonresident baht deposits at Thai commercial banks are 'hot money.'[4] Realizing the high volatility of such money, the Bank of Thailand introduced certain measures to curtail its inflow in the second half of 1995. The measures adopted were, however, too lenient to preclude significantly the inflows of hot money, in particular, short-term borrowings by the nonbank private sector. Between 1995–96 and 1997–98 the share of portfolio investment in total private inflows nevertheless dropped from 14.7 per cent to 7.6 per cent while the share of nonresident baht decreased from 13.6 per cent to 13.2 per cent (Table 1.1).

The linear perception of market participants prevailed in the foreign exchange markets as well. To encourage the baht as a vehicle currency for regional trade and

Table 1.3 Lending structure of Thai commercial banks (percentage)

	1986	*1990*	*1994*	*1996*	*1998*
Manufacturing	22.8	25.1	24.2	27.1	30.7
Wholesale and retail trade	23.2	17.6	18.2	17.9	16.6
Real estate business	3.8	11.9	10.5	8.8	9.7
Personal consumption	8.8	10.6	12.7	12.6	11.3
Exports	1.8	1.1	0.9	0.8	3.3
Imports	4.1	2.0	1.5	1.8	3.7

Sources: Bank of Thailand (various years).

investment transactions, the value of the baht was maintained in line with the US dollar. After the 1984 devaluation the Bank of Thailand employed a basket of currencies to set the baht–dollar exchange rate on a daily basis. The weight of the dollar in the basket gradually increased from 52 per cent in January 1985 to 79 per cent in 1992 but was reduced secretly when the dollar subsequently gained strength in the world market (Warr and Nidhiprabha 1996).

This system of a basket of currencies brought about stability in the baht–dollar exchange rate, which in turn led to the perception that devaluation was unlikely as long as the level of international reserves was growing.[5] Furthermore, both domestic and international investors underestimated the possibility of devaluation since they believed that devaluation would be too costly for Thailand because of its large high US dollar-denominated debts. This underestimation was evidenced in the small yield spread between debentures issued by Thai property firms in international markets and US treasury bills.

Currency and maturity mismatches are a common cause of financial institutions' vulnerability to crisis. As reported in Table 1.4, the maturity structure of sources of funds for Thai commercial banks and finance companies shared the common feature of relying on short-term borrowing. In December 1996, commercial banks had 89 per cent of their domestic borrowing in maturity of less than 12 months, 47 per cent of their foreign borrowing in short-term maturity and 16 per cent in deposits from nonresidents. A similar pattern was found for the finance companies as of February 1997.

This precarious borrowing structure – largely short-term – was a sign of a financial distress to come when foreign lenders changed their perception about Thailand's country risks (Nixon and Walters 1999). When unfavorable events took place, public confidence in the strength of the Thai economy began to dwindle,[6] and investors began to realize that asset prices had been overvalued. As a matter of fact,

Table 1.4 Maturity structure of borrowing (percentage share)

	Commercial banks (December 1996)	*Finance companies (February 1997)*
Domestic borrowing		
Saving deposits	22	–
Call	3	23
Less than 3 months	60	51
3 to less than 12 months	3	15
12 months	11	5
More than 12 months	1	6
Foreign borrowing		
Foreign borrowing		
Short-term	47	46
Long-term	37	53
Deposits from nonresidents	16	–

Sources: Bank of Thailand (various years).

the stock market index in Thailand had been continuously declining since 1994 (Figure 1.6), way ahead of the collapse in real GDP in 1997, and the self-fulfilling prophecy would add to a sharp decline in the stock market as domestic investors overreacted to the declining prices.

During the bull market, foreign investors were leaders in the market with their net buying positions sending a buying signal to local investors. In contrast, during the bear market it was local investors who were the market leaders. They were the ones who lost confidence after the baht had hit its lowest level in January 1998, and it was they who initiated the large plunge in stock prices in 1998. Following domestic investors, panicky international investors also sold their shares and pushed down the stock index to its lowest level.

The boom and bust in the property sector in Thailand was closely related to the cyclical excess in bank lending. As Sachs *et al.* (1996) argue, lending booms and exchange rate overvaluation are some of the main culprits for financial crisis. The peak of the lending boom in real estate occurred between 1987 and 1990, when the growth rate of loan to the real estate sector rose faster than total credit expansion. As loans to this sector were monitored by the central bank, loans extended to the construction sector began to outpace total credit expansion. Lending to these sectors is likely to generate profit to banks and finance companies during boom years since their activities are pro-cyclical. The property-lending boom of finance companies continued even after the end of the boom years in the stock market in 1993, as if they expected that property prices would never collapse.

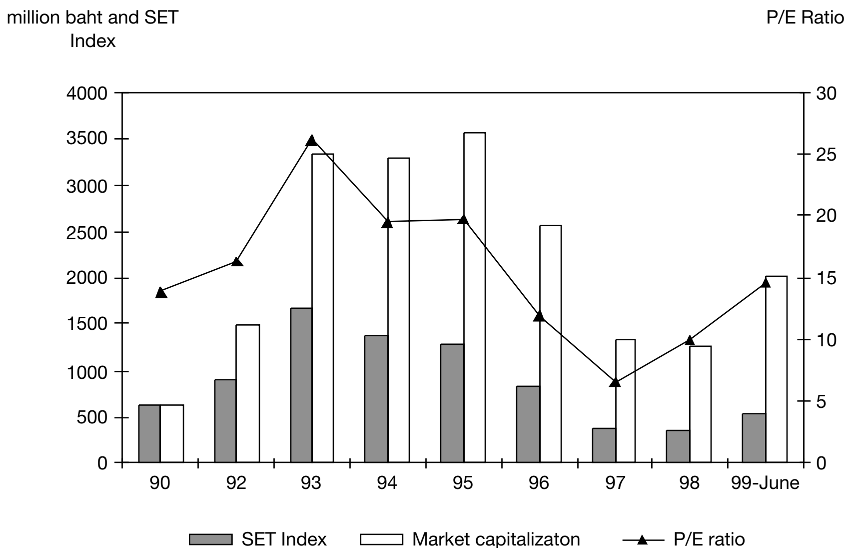

Figure 1.6 Asset price bubbles.

Concluding remarks

The rapid growth of exports and GDP that lasted throughout the 1980s and the first half of the 1990s generated expectations of continued prosperity in Thailand. Investors, expecting a continued increase in land and share prices into the future, bid up asset prices, and credit from financial institutions fueled this bidding-up process with funds obtained abroad after capital control relaxation.

Currency and maturity mismatches became pronounced: In December 1996 commercial banks' long-term domestic sources of funds – twelve months or longer – were only 12 per cent and the remainder of the funds came from sources of shorter maturity and their foreign long-term borrowing was 37 per cent, the rest being short-term foreign borrowing and deposits of nonresidents. The structure of borrowing of finance companies was similar: Only 11 per cent of their domestic borrowing was of maturity of twelve months or longer, and their long-term foreign borrowing was 46 per cent.

This precarious borrowing structure foretold a financial distress that would come when foreign lenders changed their perception about Thailand's country risks. In 1996, Moody's Investors Service downgraded three top Thai commercial banks because of their large short-term foreign currency debt. This prompted a decline in public confidence in the strength of the Thai economy, and in a self-fulfilling prophecy there was a sharp decline in the stock market with the overreaction of domestic investors.

Financial liberalization in Thailand, in particular capital control relaxation, was premature, as it was undertaken before adequate prudential rules and regulations for financial institutions had been established. The desire to establish Bangkok as the region's financial center in the absence of such regulatory infrastructure has proved to be disastrous and costly. Thailand was not ready for such a center since there was no effective mechanism for dealing with excessive capital inflows induced by offshore borrowing units created by BIBFs.

In Thailand, the bond market was not sufficiently developed to provide facilities for the monetary authorities to perform the sterilization of capital inflows. Furthermore, the Bank of Thailand could not invest its foreign exchange reserves in world capital markets because of the Central Banking Act, which prohibited such investment. Furthermore, what made the situation worse in Thailand was that the exchange rate of the baht was tied closely to the US dollar.

Capital account liberalization in Thailand was ill timed. Capital control was relaxed when interest rates in Thailand were high in comparison with those in world markets. The inflow of foreign capital was expected to lower domestic interest rates, and the expectation of declining interest rates led to the shortening of debt maturity. An overheated economy ensued with rising inflationary pressure and a widening current account deficit. The crisis could have been, however, avoided if the capital account had been opened gradually so as to allow time to create preventive measures that could protect the real economy against mismanagement in the financial sector. Such measures would have included a capital adequacy ratio, provisions for substandard loans, reserve requirement for banks' foreign borrowings, and effective bankruptcy and foreclosure laws.

If the motivation behind capital account opening was to promote economic growth by inducing foreign capital inflows, then Thailand could have achieved that objective by reducing capital impediments step by step without completely deregulating capital controls. As long as capital controls were of the kind that only affected the transaction cost (e.g. the bank's net foreign liability ratio) and did not prohibit capital inflows or impose quantitative limits, a large spread between domestic and foreign interest rates would have provided sufficient arbitrage incentives to capital flows. But by going for a big-bang liberalization instead the country risked a surge of unsustainable capital inflows especially when domestic interest rates were rising.

Premature liberalization of the capital account can increase vulnerability to crisis. Sequencing is important because liberalizing the capital account cannot be done without allowing market forces to determine the foreign exchange rate. Synchronization of the speed of liberalization must be made in the trade sector, money market, and foreign exchange market. Rapid relaxation of capital controls can lead to capital inflows that are too large and too fast, while the building of institutional infrastructure to cope with new problems is a slow, time-consuming process. Thailand's saga of capital account liberalization is a warning to be heeded seriously by advocates of capital convertibility.

Notes

1 Out of the total of fifteen Thai banks, three large banks were able to get capital injection from abroad while some foreign banks took over 75 per cent of the share of three small banks. Three medium-sized banks were nationalized while one was closed down.
2 The strength of the US dollar at 153 Japanese yen at that time also contributed to the ample amount of reserves for Thailand.
3 Large capital inflows can be observed at the peak of the bull market. The share of portfolio investment to total flows of net private capital rose from 1.9 per cent in 1991–94 to 15.6 per cent in two years prior to the crisis in 1997 (Table 1.1).
4 See Claessens, *et al.* (1995) for a discussion on the role of hot and cold money.
5 Thailand's international reserves averaged at $7.3 billion in 1985–90 and $28.5 billion in 1991–96, a period after capital control liberalization.
6 In 1996, Moody's Investors Service downgraded three top Thai commercial banks because of their large short-term foreign currency debts.

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2 Financial sector reform and Indonesia's economic crisis of 1997–98

Anwar Nasution

Introduction

The economic crisis that engulfed Indonesia in 1997–98 was a mixture of a banking and an external debt crisis. Many indebted firms were unable to repay their debts to local banks and international creditors because very high interest rates and a sharp devaluation of the rupiah together had significantly raised their foreign currency liabilities. Further contributing to their inability was a decline in their revenues in rupiah, a consequence of a domestic recession and a weak demand for their products in international markets. Financial conditions deteriorated also for banks, particularly for those banks that had received deposits and had made loans in US dollars.

The purpose of this chapter is to examine the financial sector reforms that had taken place since the 1980s and their possible links to the economic crisis that erupted in July 1997. The chapter begins with a brief discussion of pre-crisis macroeconomic policies and developments in Indonesia, followed by a description of the structure of the financial sector and reforms in that sector in the early 1990s. It then examines the problems faced by the financial industries prior to the crisis of 1997–98 and points out that the reforms were not accompanied by commensurate strengthening of the legal and accounting systems that is necessary for effective enforcement of prudential regulations and supervision. The remainder of the chapter discusses the exchange rate system and management and the instruments of monetary policy employed in Indonesia with the main conclusions of the chapter presented at the end.

Macroeconomic setting

In the mid-1990s the Indonesian economy was in need of structural adjustment: its economic fundamentals were weak, its external debts were large, and its banking system was fragile. Massive capital inflows since the early 1990s had caused bouts of domestic overheating, making it more difficult to manage the economy. As a result, rapid economic growth during this period was accompanied by rising domestic inflation, rising interest rates, and a widening current account deficit (Table 2.1).

Table 2.1 Macroeconomic indicators of Indonesia, 1989–99

	Annual Average												
	1980s	*1990s*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*[a]
Growth of real GDP (%)	6.6	5.2	7.6	9.0	8.9	7.2	7.3	7.5	8.1	8.0	4.6	–13.6	–4.1[d]
Traded goods[b]	na	5.8	na	8.5	9.3	4.5	6.2	9.5	8.5	9.1	5.2	–.4	–1.2
Nontraded goods[c]	na	4.0	na	6.4	5.3	7.8	6.7	6.5	7.9	7.3	4.5	–16.6	–6.0
Inflation (CPI, %)	8.5	16.4	6.3	9.5	9.5	4.9	9.8	9.2	8.6	6.5	11.6	77.6	10.6
Fiscal balance/GDP (%)	na	0.1	na	0.4	0.4	–0.4	–0.6	0.1	0.8	0.2	–0.2	na	na
Current acc't balance/GDP (%)	–1.2	–2.4	–0.5	–2.8	–3.7	–2.2	–1.6	–1.7	–3.6	–3.7	–2.7	0.1	10.9
Foreign reserve as % of:													
Imports	na	212.2	211.9	210.5	217.5	201.6	199.0	218.1	252.6	208.5	237.8	164.4	na
Short-term debt	na	na	na	na	na	na	na	na	na	na	170.0	150.0	80.0
External debt outstanding (US$ bil)	na	102.5	52.0	62.8	65.7	73.4	80.6	96.5	107.8	110.2	134.8	150.9	142.4
By recipients													
Public sector (%)	na	57.3	76.1	71.8	69.6	66.5	65.1	60.7	55.3	50.2	40.0	44.6	49.7
Private sector (%)	na	42.7	23.9	28.2	30.4	33.5	34.9	39.3	44.7	49.8	60.0	55.4	50.3
By debtors													
Banks (%)	na	18.6	6.4	14.8	17.1	23.4	27.6	21.7	20.9	16.5	17.7	12.9	13.4
Non-banks (%)	na	79.2	93.6	85.2	82.9	76.6	72.4	78.3	79.1	83.5	71.2	80.8	82.1
By maturity													
Short-term (%)	na	6.7	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.1	6.5	6.6
Long-term (%)	na	91.1	93.1	93.1	93.1	93.1	93.1	93.1	93.1	93.1	82.8	87.2	88.9
Index of export prices (1990=100)													
Oil	na	na	76.0	100.0	87.7	83.6	84.8	68.0	74.2	87.2	89.3	na	na
Non-oil	na	na	82.2	100.0	83.4	84.0	88.2	97.1	110.8	117.2	150.6	na	na

Sources: IMF (various years), Bank Indonesia (various years b), BPS (1999), and BIS (various years).

Notes: na = Not available.

a. Up to second quarter 1999.

b. Comprised of nonfood crops, forestry and fishery, mining and quarrying, and manufacturing industries.

c. Comprised of farm food crops, livestock and products, electricity, gas, and water supply, construction, trade, hotel, and restaurant, transportation and communication, financial, ownership and business, and services.

d. Calculated from data from the BIS.

Internal stability

The current account deficit, which had been less than 2 per cent of annual gross domestic product (GDP) in 1993 and 1994, rose to 3.6 per cent in 1995 and 3.7 per cent in 1996. This deterioration was in part due to higher investment, which as a percentage of GDP increased from 30.1 to 32.7 per cent between 1990 and 1996. The deficit was also due to an increase in consumption spending, as indicated by a slight decline in the national saving rate.[1] A part of foreign capital was also used to finance the rapid growth of 'off-budget expenditures,' government-sponsored projects, and 'bubble industries' in equity and real estate markets.

The high rate of economic growth in the early 1990s was mostly associated with government-sponsored projects and investments in the nontradables sector. Those projects included the 'strategic industries' controlled by Dr J. E. Habibie, Minister of Research and Technology (for example, the airplane manufacturing industry), infrastructure and petrochemical projects owned by politically well-connected groups, and the national car project[2] owned by Hutomo Mandala Putra, the favorite youngest son of President Suharto. This pattern of investment indicates that a large portion of foreign capital was invested in unproductive sectors in the economy. Moreover, the growth of non-oil exports during that period was mostly from industries such as electronics, sport shoes, and textiles and apparel, which relied the least on domestic inputs and were associated with firms from East Asia (mainly Japan, South Korea, and Taiwan). In contrast, industries that were owned domestically or relied heavily on domestic inputs fared poorly. Part of the problem was due to the quotas imposed on the export of palm oil and wood-based products.

The moderate inflation and interest rates and the relatively stable rupiah exchange rate that were often quoted as the leading indicators of sound economic fundamentals (in addition to high growth of GDP, rapid growth of non-oil exports and a significant reduction in the percentage of the population below the poverty line) were largely an artificial phenomenon. The government paid large implicit and explicit subsidies to control the prices of state-vended products and interest rates, and the massive capital inflows, which strengthened the external value of the rupiah, helped to keep inflation and interest rates in check.

Structure of external debt

The external debt of Indonesia grew rapidly following the economy-wide reform, particularly the banking sector reform in October 1988. Over 60 per cent of the external debt was owed by the private sector, of which nearly 90 per cent was of short-term maturity. As the rupiah depreciated steadily at 5 per cent a year, most of the debt was not hedged. After the crisis, the private sector debt was converted into public debt as domestic firms were protected from bankruptcy and external takeover.

The total external debt of Indonesia nearly doubled between 1989 and 1995. As of March 1997, the external debt amounted to US$135 billion, nearly triple the debt outstanding in 1989 and equivalent to 160 per cent of the country's annual

GDP or 215 per cent of exports in 1997 (Table 2.1). The debt service ratio in 1997 was about 33 per cent of total export value and the ratio of short-term private debt to foreign reserves rose to 1.7. These figures clearly show that by 1997 Indonesia had become heavily indebted and its economy was highly vulnerable to a currency crisis. Of course, that is exactly what happened when foreign lenders refused to roll over the country's huge short-term debt.[3]

Financial sector structure and recent reforms

Table 2.2 shows that, in terms of total assets and number of institutions and their branch offices, the core of Indonesia's financial sector is the banking system. Other financial institutions such as the equity market, leasing companies, insurance firms, and other financial institutions (including unit trusts, building societies, and housing bonds) have been growing rapidly, but they still constitute a relatively small segment of the financial system.

Another feature of Indonesia's banking system is that through networks of ownership and interlocking business and management, all of the domestic private banks in Indonesia have a close connection with large business conglomerates, which has allowed the latter to be highly leveraged. The collapse of a number of large conglomerates since 1990 is, however, a sign that the high-leverage financing, which may have been suitable in the era of subsidized interest rates and highly protected domestic markets, is no longer a viable strategy (Nasution 1995: 185–6).

Driving force behind the reforms

Financial sector reform was initiated in the early 1980s as an integral part of economy-wide liberalization. The scope and sequencing of the reforms were much wider and faster in Indonesia than in other ASEAN countries, which adopted a more gradual approach. The 'technocrats,' highly trained economists at the Ministry of Finance and Planning Agency, were the driving force behind the economic reform and were supported by Bank Indonesia, the country's central bank. Until May 1999 the central bank was governed by the Monetary Board, which decided on monetary policy. The Board members were cabinet ministers of the President's choice with the Minister of Finance serving as the chair.

The impetus for reform came from both internal and external developments. The import-substitution industrial policy, carried out in the 1960s and 1970s, had reached its limit, as shown by sluggish rates of economic growth in the early 1980s. Successive negative changes in the external terms of trade (particularly the drop in the prices of oil and natural gas) and the rise in international interest rates in the early 1980s, followed by a currency realignment in the mid-1980s, widened Indonesia's internal and external imbalances. Reviving economic growth and improving external creditworthiness required a change in development strategy to increase domestic savings and non-oil exports. Indonesia also made pre-emptive commitments to the ASEAN Free Trade Area (AFTA), the Asia Pacific Economic Cooperation (APEC) and the World Trade Organization (WTO) to open its financial sector. The

'technocrats' believed that an expanded presence of foreign financial institutions in the domestic economy would bring in not only external savings but also advanced technologies and expertise. They also believed that their presence would increase domestic competition and improve the corporate culture and have a positive effect on the efficiency of financial resource allocation.

In Indonesia there was no strong opposition to reform. The general public supported the reforms, which generally had beneficial effects on prices, employment and economic growth. Even politically well-connected business groups in the highly protected sectors of the economy went along with the reforms as they could now take advantage of a liberalized capital market and implicit guarantees on external borrowing as a *quid pro quo* for accepting the reforms. They also benefited from the privatization of state-owned enterprises and 'strategic industries' and the privatization of monopoly rights in public utilities such as toll roads, seaports and harbors, telecommunications, electric generating plants, and drinking water. In other words, deregulation in these sectors resulted in the transfer of monopoly rights from the state to the politically well-connected enterprises.

Banking reform in Indonesia was carried out in several stages. The interest rate ceiling was lifted in June 1983. Subsequent reforms significantly reduced the role of the central bank and commercial banks as development institutions and also scaled down the protection of domestic banks from foreign competition. The public sector (including state-owned enterprises) was allowed to place up to 50 per cent of its deposits outside state-owned banks, thus reducing the preferential treatment they had received over private banks.

Prior to the promulgation of the Bank Indonesia Law of 1999, the central bank was required to undertake quasi-fiscal operations. These included allocating subsidized credit to favored economic activities and development finance institutions through selective credit policies, subsidizing deposit insurance, bailing out insolvent financial institutions, and taking over the exchange rate and interest rate risks of offshore borrowings by favored groups of individuals and companies.

There are three aspects of the banking sector reform that have expanded the role of banks in mediating short-term capital inflows to Indonesia. First, the reform has removed the traditional boundaries between functional specializations for various types of banks including state-owned banks. Second, the reform has relaxed the requirements for domestic banks for dealing in foreign exchange transactions, opening overseas branches, and allowing a greater penetration of foreign banks in the domestic economy. Third, in November 1989, the ceilings on commercial banks' offshore borrowings were replaced with a system of net open position (NOP) and the limits for inflows of foreign direct investments were eliminated.

Scope and chronology of the reform

Since the early 1980s the reform of Indonesia's banking sector has removed the traditional functional specialization between various types of banks and major areas of specialization for state-owned banks (see Appendix 2.1 on page 71). The reform also did away with public development statutory agencies whose function was to

Table 2.2 Structure of the Indonesian financial sector, 1969–97

	Number of institutions 1969	1982	1988	1991	1994	1995	1996	1997
Bank Indonesia	1	1	1	1	1	1	1	1
Deposit money banks	179	118	111	195	240	240	237	238
State commercial banks	5	5	5	5	7	7	7	7
Private banks	126	70	63	129	166	165	162	160
Private forex banks	3	10	12	28	53	75	79	na
Private non-forex banks	123	60	51	101	113	90	83	na
Foreign banks	11	11	11	29	40	41	41	44
Development banks	25	29	29	29	27	27	27	27
Savings banks	12	3	3	3	–	–	–	–
Non-bank financial institutions	na	13	13	13	na	na	na	na
Insurance companies	na	83	106	145	150	159	163	171
Leasing companies	na	17	83	88	na	na	na	na
Other credit institutions	8,568	5,808	5,783	6,243	na	na	na	na
Total	8,748	6,040	6,097	6,725	386	396	401	410

	Share of assets (%) 1969	1982	1988	1991	1994	1995	1996	1997
Bank Indonesia	57.7	4.4	36.8	23.8	21.3	16.4	16.4	14.4
Deposit money banks	42.3	52.9	56.9	68.5	78.7	83.6	83.6	85.6
State commercial banks	30.3	37.9	34.5	30.2	30.4	33.4	30.4	32.1
Private banks	3.7	5.8	13.1	25.2	34.9	39.3	43.2	39.6
Private forex banks	na	3.6	2.8	5.2	6.9	na	na	na
Private non-forex banks	na	2.2	4.3	5.5	4.4	na	na	na
Foreign banks	4.3	3.6	2.8	5.2	6.9	8.2	7.7	12.0
Development banks	4.0	4.1	4.4	6.3	6.5	2.7	2.3	2.0
Savings banks	0.1	1.4	2.1	1.6	–	–	–	–
Nonbank financial institutions	na	2.5	2.7	2.1	na	na	na	na
Insurance companies	na	1.6	1.6	3.5	na	na	na	na

Leasing companies	na	0.4	1.5	1.8	na	na	na	na
Other credit institutions	na	0.3	0.6	0.4[a]	na	na	na	na
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total (Rp. trillion)	0.7	32.3	115.5	218.5	319.6	674.5	853.3	1,166.9
Memorandum items								
M1/GDP	0.07	0.09	0.1	0.12	0.14	0.12	0.12	0.13
M2/GDP	0.09	0.14	0.3	0.44	0.55	0.49	0.55	0.57
Total assets of fin. inst. (TAFI)/GDP	0.26	0.52	0.81	0.96	1.01	na	na	na
M2/TAFI	0.33	0.34	0.36	0.45	0.55	na	na	na

	Asset growth (%)				
	1970–82	*1983–8*	*1989–91*	*1992–4*	*1995–9*
Bank Indonesia	31.1	18.8	9.2	6.6	50.1
Deposit money banks	37.6	22.4	32.6	37.4	75.3
State commercial banks	36.6	19.7	20.7	16.7	64.7
Private banks	34.0	41.5	56.9	67.9	72.2
Private forex banks	na	36.1	64.9	75.7	na
Private non-forex banks	na	32.2	37.3	28.7	na
Foreign banks	32.6	16.8	55.4	44.6	149.3
Development banks	34.6	22.1	42.2	21.3	25.7
Savings banks	60.1	27.9	14.5	–	–
Nonbank financial institutions	na	22.3	14.9	na	na
Insurance companies	na	21.2	62.3	na	na
Leasing companies	na	45.4	33.6	na	na
Other credit institutions	na	33.4	15.9[b]	na	na
Total	34.2	21.2	21.3	29.0	73.0

Sources: Bank Indonesia (various years b, various years c), Cole and Slade (1992), Indonesia Department of Finance (1991a, 1991b).

Notes: na = Not available.

a. Dec. 1990.

b. Average 1989–90.

provide credit to targeted individuals and enterprises for investment in commerce, agriculture and industry.

As of March 1994, the banking system in Indonesia consisted of Bank Indonesia (the central bank), seven state-owned commercial banks, 163 national private commercial banks, 39 foreign banks, 27 commercial banks owned by provincial governments,[4] one Islamic bank (Bank Muamalat), 8,757 rural banks, 13 merchant banks and a number of money and foreign exchange brokers, all of which are regulated and supervised by Bank Indonesia. Sixty-seven of the commercial banks were licensed to deal in foreign exchange transactions. A number of private commercial banks are partly or wholly owned by Bank Indonesia. Ten of the foreign banks are full branches and were licensed between 1966 and 1970. There is no regulation concerning new entry of branches of foreign banks in Indonesia, but no new license has been issued since 1970.

The other 29 foreign banks are joint ventures with local institutions. The 1988 reform relaxed many restrictions on the entry and operation of foreign banks. Even then, prior to 1999, the mechanism by which foreign banks could enter the Indonesian market was through joint venture. To become a partner in a joint venture, the foreign bank was required to have a representative office in Jakarta, be reputable in the country of origin, and come from a country that had reciprocity agreements with Indonesia. The domestic partner must have been classified as being 'sound' for at least twenty of the last twenty-four months. The maximum equity share of the foreign partner in a joint venture bank was set at 85 per cent.

Financial repression

Control over deposit and lending rates and credit allocation was the essential element of financial repression in the past. This repression policy was carried out by Bank Indonesia and state-owned banks which acted as 'the agents of development.' It often resulted in low or negative real rates, discouraging savings, and brought about a misallocation of financial resources. It encouraged financial disintermediation, capital flight, and savings in the form of physical goods (land, jewelry, and durable goods) and was the principal root cause for corruption, collusion, and nepotism (KKN-*korupsi, kolusi dan nepotisme*) where the differential between the market interest rates and the official rates were shared. It turns out that much of the financial resources were allocated to nonproductive sectors and to family members and cronies of the then President Suharto who had been in power for over three decades between 1966 and 1998.

Despite policy reforms the credit policy in Indonesia remained segmented and pro-cyclical until 1999. The first step to reduce the scope of credit programs and to modify the system of credit allocation was introduced on 1 June 1983 with the elimination of credit ceilings and liberalization of deposit and lending interest rates. On 29 January 1990, the scope of the special credit program was significantly reduced to four areas: to farmers for working capital, to cooperatives for the financing of food purchase and productive activities, to Bulog – the National Logistic Agency – for financing the stocking of foods, and for investment financing in the

eastern part of Indonesia.[5] Since then, the interest rates charged for these special programs have been raised close to market rates and their insurance is voluntary with premiums based on market conditions.

Three new credit regulations, related to the system of credit allocation, were introduced in 1989–90. The first is implied in the legal lending limits (LLL) regulation, which restricts the aggregate amount of loans and advances to insiders, whether a single borrower (person or firm) or a group of borrowers. When the credit program from Bank Indonesia was available (until 1999), the LLL rule was not applicable to all forms of the subsidized credit program. The objective of the legal lending limits rule is to increase access to bank credits so as to inhibit the concentration of financial power, protect the interests of uninformed depositors, and prevent the misuse of funds by insiders. The second rule requires new joint-venture banks and the branches of foreign banks outside Jakarta to allocate at least 50 per cent of their loan portfolios to export-related activities. The third rule mandates domestic private and state-owned banks to allocate a minimum of 20 per cent of their loan portfolios to small-scale enterprises and cooperatives (*Kredit Usaha Kecil*) or KUK.[6]

Financial industry prior to the 1997 crisis

Since early 1991, Indonesia has adopted prudential rules and regulations as suggested by the Committee on Banking Regulation and Supervisory Practices under the auspices of the Bank for International Settlements (BIS). In line with BIS recommendations, the authorities raised the minimum initial paid-in capital for a new bank, set the capital adequacy ratio at 8 per cent and the loan-to-deposit ratio at 110 per cent, linked new loans to the level of deposits, and required the bank to provide reserves for all loans. Bank Indonesia even adopted a more restrictive CAMEL (capital adequacy, asset quality, management, earning, and liquidity) system to regulate and supervise banks.

These strict prudential rules and regulations were not, however, effectively implemented due to, as will be discussed further in the following section, structural weaknesses in the legal and accounting systems. Poor governance rooted in an unaccountable judiciary and a corrupt government bureaucracy also contributed to the ineffective implementation of prudential rules and regulations. For instance, four bank supervisors of Bank Indonesia were arrested in early August 1997 for allegedly receiving bribes while carrying out bank inspection during the 1993–96 period (*Jakarta Post* 1997). Such ineffective implementation of prudential rules and regulations resulted in a financial system with various structural weaknesses, as indicated in Table 2.3.

Lending spree

A combination of relaxed restrictions on financial institutions (such as banks and security companies), lowered reserve requirements (and gearing ratios), and greater access to offshore markets led to rapid credit expansion. Bank credit grew,

Table 2.3 Indicators of the banking sector, 1985–99

	1985	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*[d]
Number of banks	114	110	109	108	145	171	192	208	234	240	240	239	222	222	167
Private banks	69	65	64	63	88	109	129	144	161	166	165	164	144	130	80
State-owned banks[a]	5	5	5	5	5	7	7	7	7	7	7	7	7	7	19
Foreign banks & joint venture banks	11	11	11	11	23	28	29	30	39	40	41	41	44	58	41
Regional dev't banks	27	27	27	27	27	27	27	27	27	27	27	27	27	27	27
Loan-to-deposit ratio (%)	102.9	96.3	101.9	105.7	112.6	118.2	130.7	129.3	132.4	134.9	137.7	131.0	123.7	129.2	80.7
LGR minus GDPGR (%)	14.7	19.8	8.8	23.1	31.2	48.1	–9.9	7.7	6.9	5.7	4.0	4.7	12.1	45.5	–42.6
LGR minus IPGR (%)	29.0	20.8	35.9	34.4	44.2	61.4	9.0	25.9	22.4	16.0	23.1	22.5	16.2	45.1	na
NFL/TBL (%)	–20.0	–23.6	–18.2	–14.1	–10.6	0.9	0.7	2.2	4.9	5.8	3.8	2.8	5.2	2.6	6.4
M2/Multiplier[b]	3.4	3.4	3.8	5.0	5.4	6.7	7.7	7.0	7.8	7.4	8.0	7.5	7.6	7.7	8.2
M2/GDP (%)	na	na	na	na	na	43.0	43.6	46.4	44.0	45.7	49.0	54.2	56.9	58.3	na
Non-performing loans[c] (%)	na	na	na	na	na	na	9.2	na	14.2	12.1	10.4	8.8	14.0	49.2	39.0
Of which: bad debt (%)	na	na	na	na	na	na	1.7	na	3.3	4.0	3.3	2.9	2.3	23.4	28.5
Cash assets-to-deposit ratio (%)	15.9	13.3	12.4	14.5	11.1	6.5	13.7	3.2	2.6	2.5	2.6	4.7	5.8	8.2	7.5
Loans-to-assets ratio (%)	na	53.3	58.2	61.5	65.4	73.4	76.2	73.7	75.4	80.3	79.2	77.0	71.9	70.9	66.7
Credit in US$-to-total credit (%)	na	na	na	na	na	12.2	15.6	17.9	19.4	19.1	19.5	19.9	30.8	35.8	34.2
Dollar deposits-to-M2 (%)	na	na	na	na	na	20.6	21.2	20.8	21.7	21.7	19.8	19.5	31.1	24.8	21.3
EL/TL in US$ (%)	na	na	na	na	na	9.1	7.4	12.0	12.8	8.3	5.7	4.0	6.1	21.1	11.5

Sources: IMF (various years), Bank Indonesia (various years a).

Notes:
LGR = Loan growth rate.
GDPGR = GDP growth rate.
IPGR = Industrial production growth rate.
NFL = Net foreign liabilities.
TBL = Total bank liabilities.
EL = Excess liquidity.
TL = Total liquidity.

a. Including 12 banks taken over by the Indonesian Bank Restructuring Agency (IBRA) as of June 1999.
b. Ratio of M2 to reserve money.
c. As a percentage of total loans outstanding of commercial banks. Non-performing loans data tend to be underestimated. The decline of non-performing loans to 8.8 percent of total credit in 1996 was mainly due to the write-off of bad loans at state-owned commercial banks and private non-foreign exchange banks.
d. Data as of June 1999.

on average, by more than 20 per cent per year during the past two decades prior to the crisis in August 1997, a rate more than twice the annual rate of economic growth.

The presence of new entrants in a more competitive market environment may well have increased the pressure on financial institutions to engage in riskier activities. Yet many of the credit officers at these institutions, who were reared in the earlier controlled environment, did not have the expertise needed to evaluate new sources of credit and market risks. As a result, much of the bank lending went to financing investment in land, buildings, and other tangible goods that could serve as collateral in the collateral-based banking system of Indonesia.

Increasing bank liabilities with long maturity and currency mismatch

Part of the credit expansion was financed by foreign borrowings, which had been made easier by a combination of a liberal capital-account financial sector reform and advances in technology and information processing. The banks and their customers could now borrow abroad with relative ease when domestic interest rates were high. The commercial banks that had licenses to deal in foreign exchange transactions turned to short-term, foreign currency-denominated borrowing in the inter-bank market to fund longer-term bank loans. External borrowings of commercial banks rose rapidly from US$8.2 billion in 1994 to US$14.3 billion in 1997. Partly because of a historically stable and low rate of rupiah depreciation, a large portion of the external debt was not hedged. As discussed earlier, the perception of Indonesia as a stable country and one of the shining lights of the world economy generated massive capital inflows between 1989 and 1997.

The increasing dependency on external borrowings not only made the banks and their customers more vulnerable but it also made it more difficult to deal with the banking crisis. The risks of maturity mismatch were higher for unlisted banks that had no access to long-term sources of funding (bonds, shares, and other types of securities). The relatively high level of unhedged external borrowing and the traditionally high debt–equity ratio of the banking and corporate sector made it more difficult to impose tight monetary and austere fiscal policies that were required by stabilization programs.

Weak financial positions of banks and no exit policy

Although Indonesia enjoyed a relatively high rate of economic growth of more than 6 per cent a year since the 1970s, its national banks seem to have accumulated an increasing amount of nonperforming loans (NPLs). Information on NPLs is sketchy but they were reported to amount to 9 per cent of the total outstanding loan portfolio in mid-1997 (Figure 2.1). This figure does not fully convey the seriousness of the NPL problem since the authorities allowed the banks to roll over unpaid matured loans. That is, the practice of classifying loans by repayment performance rather than collectability has masked the seriousness of the NPL problem.

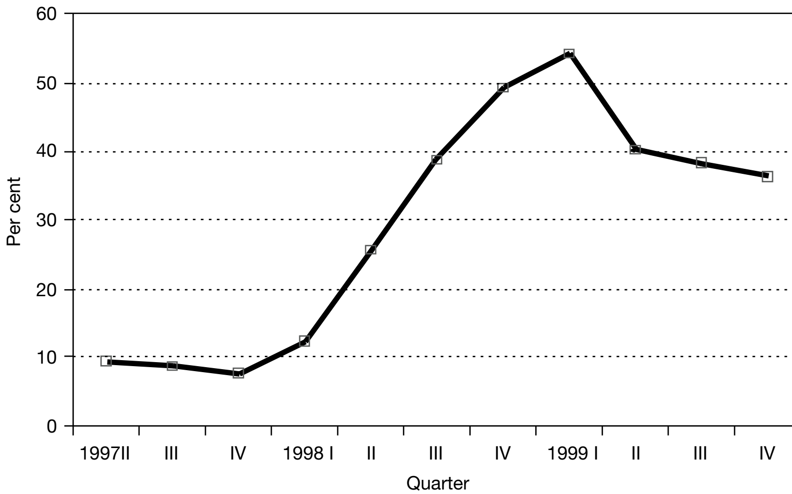

Figure 2.1 Development of nonperforming loans (NPL), 1997–99.
Source: Bank Indonesia (various years a).

The negative net worth problems were likely to be more severe at state-owned banks and non-bank *devisas*, which in the past were the main provider of subsidized credit during the long era of financial repression. They were also the main victims of erratic government policies, such as the shifting of public deposits to the central bank.

The liberal entry policy introduced in 1988 was not accompanied by a proper exit policy. Prior to the banking crisis in 1997, Indonesia did not allow state-owned banks to go bust as the state always stood by these undercapitalized banks. To prop them up in an emergency, the government injected public sector deposits into the financially distressed banks. In addition, Bank Indonesia provided them with low-interest and risk-free liquidity support. The same facilities were also made available for ailing private banks, including those that were not solvent but were owned by politically well-connected groups.

Internal problems of state-owned banks

Because state-owned banks were protected from closure on constitutional grounds and had their losses covered by the public budget, they tended to have fewer incentives to innovate, to quickly identify problem loans at an early stage, and to control costs. Furthermore, these banks suffered from greater political intrusion in almost all aspects of bank operations, including personnel and technology policies. They were also more likely to have recourse to public financing of bailouts.

In the past period of financial repression, loan decisions of state-owned banks were subject to explicit or implicit government direction. All too often, borrowers' creditworthiness did not receive sufficient weight in credit decisions and, in fact,

loans served as a vehicle for extending government assistance to particular industries or a handful of politically well-connected business groups. These groups of large companies – the conglomerates – controlled a large part of GDP and a vast range of mainly rent-seeking activities. In sum, the banking sector reform that had been carried out in Indonesia did not end government intervention in lending decisions of state-owned banks and finance companies.

Overstaffing and overextended branch networks were also more prevalent among state-owned banks and finance companies. This is partly because during the regime of financial repression public financial institutions operated like a government agency, as their task was mainly focused on managing the government credit program and related financial services. As the risks of state-owned banks were assumed by the state, their loan officers did not develop lending skills (including risk appraisal). State-owned banks, whose origin goes back to the colonial days, carried on with the tradition of financing foreign trade and related activities, the nature of which is totally different from that of manufacturing and modern service industries. These banks, therefore, did not have any expertise to function as 'agents of development' by mobilizing savings, upgrading skills and technologies, and nurturing entrepreneurs.

Underdeveloped legal and accounting system[7]

The need to overhaul the antiquated legal and accounting system in Indonesia was evident for a long time prior to the outburst of the financial crisis in 1997. The numerous cases of failures and incidents of fraud that occurred among banks (such as PT Bank Umum Majapahit, PT Bank Duta, PT Bank Putera Sampurna, and PT Bank Summa) and nonfinancial companies (including PT Bentoel and PT Mantrust) in the 1980s and early 1990s indicated the need for reform. Information provided by the substandard accounting and provisioning rules were not very reliable as a guide for early warning signals on the financial positions of the banks.

Weak legal system

As the basis for securing contracts and credit transactions is unclear in Indonesia's weak legal system, delinquent debtors enjoy strong protection. At present there is no reliable information system covering land registration, property and security, or credit information. Hypothecation is recognized only for removable assets and ships but not for a wide range of assets. Pledges are possible but require physical possession, which is impractical. The transfer of ownership and the mortgage of land (at present the most important form of asset and collateral) are extremely difficult, and obtaining title documents is a time-consuming and costly procedure.

The existing company law in Indonesia is based on the antiquated twenty-one rudimentary provisions of the commercial code established in 1847. A limited liability company requires approval from the Ministry of Justice, which is a time-consuming and often costly procedure. Flexibility and mobility are limited as companies can be formed only for specific purposes and for definite time periods. Voting rights are archaic and minority shareholders have little protection. The laws

and procedures on exit and bankruptcy are unclear and untested because of the weakness of the court system.

Under Indonesian law, disputes of commercial interests, including disputes with government agencies and state-owned enterprises, can be solved by arbitration. Arbitration provides a much cheaper and more reliable way of settling disputes than the lengthy court system, as technical specialists can settle them quickly and fairly in arbitration. Arbitration proceedings follow procedures similar to those in the Civil Procedure Court, and the format of the arbitral award is simple and must be rendered within six months of submission. Services of an arbitration board, Badan Arbitrase Nasional (BANI), which was established in Jakarta in 1977 by the Indonesian Chamber of Commerce, are however seldom utilized.

Unreliable accounting system

While existing corporate and tax laws in Indonesia require that 'adequate financial records' be kept, they do not impose accounting requirements and standards to ensure financial disclosure. Indonesia has adopted internationally acknowledged prudential rules and regulations: banks are required to file audited financial statements to Bank Indonesia and to publish them quarterly, and public companies are mandated by the Capital Market Agency (Bapepam) to provide and publish regularly audited financial statements. For internal use, financial statements of state-owned companies (including banks) are audited periodically by the Agency for Control of Finance and Development (BPKP) and the reports are submitted to line and supervising ministries. The State Auditory Agency, Badan Pemeriksa Keuangan (BPK), audits the public entities, and the Ministry of Finance issues licenses to public accountants. Nevertheless, during the long period of financial repression of the past, the main priority of the banks was to run the subsidized and low-risk credit programs. As a result, bank supervisions and examinations to check implementation of prudential rules and regulations were not a top priority. Inadequate enforcement of prudential rules and regulations allowed violation of legal lending limits and creditworthiness criteria.

Public accountants must be graduates of accounting from state universities or recognized private universities and must have acquired three years of experience. However, there are no requirements to pass additional rigorous examinations in accounting theory and practice, auditing practice, and commercial laws before being licensed. There is an Association of Indonesian Accountants (Ikatan Akuntan Indonesia-IAI), which has the responsibility for setting the framework of accounting principles, auditing standards, and codes of ethics for accountants. The association, however, has neither the statutory right nor the resources to conduct accountancy examinations or to enforce accounting standards. On a joint venture basis, foreign accounting firms can penetrate domestic markets, but only a locally licensed accountant is authorized to sign audit reports.

Foreign exchange system and exchange rate management

In contrast to the sequence of economic liberalization as suggested by economic theory, Indonesia first liberalized its capital account in October 1966, devaluing a basic exchange rate and setting up a second, floating rate. It then allowed free capital movements with a unified exchange rate pegged to the US dollar in 1970 (Cole and Slade 1996). These measures were taken long before Indonesia deregulated its current account and domestic commodity, labor and assets markets in the second half of the 1980s. This reverse sequence of liberalization did not, however, cause a major problem since Indonesia had then tamed its inflation and obtained support from the international community to finance its budget and current account deficits and since its private sector had, until the mid-1980s, a very limited access to international financial markets due to lack of information.

The exchange rate system was further relaxed with a devaluation and unification of the exchange rate in April 1970. Since then Indonesia has obtained the IMF Article 8 status with a relatively liberal exchange rate system. Under this system, there is no surrender requirement for export proceeds and there are no taxes or subsidies on the purchase or sale of foreign exchange. Foreign nationals and Indonesian citizens are free to open accounts in either rupiah or foreign currencies with all bank *devisas*, which are authorized to deal in foreign exchange transactions. These banks are free to extend credits in foreign currencies with a 15 per cent withholding tax on interest earnings.

Foreign exchange exposure

In general, the financial sector reforms have replaced complicated direct controls or ceilings on foreign borrowings of the financial institutions with a more rational system of daily net open position (NOP). In Indonesia, the NOP is set at 20 per cent of the capital of the bank and 25 per cent to a single borrower and that borrower's group of companies. In reality, however, this rule has hardly been enforced.

To encourage inward foreign investment a special effective exchange rate was made available to domestic borrowers by providing explicit subsidies on the exchange rate from January 1979 to December 1991. This foreign exchange subsidy was extended through the exchange rate swap facility at Bank Indonesia. Under this facility, the central bank provided forward cover to foreign borrowing contracts or swaps, at the then prevailing exchange rate, to banks and non-bank financial institutions as well as for their customers who had a foreign currency liability. Although they paid a swap premium, those who could obtain the swap facility received a subsidy because the premium was set below the level of the realized depreciation of the rupiah. This subsidy obviously had the effect of encouraging foreign borrowing although the size of the subsidy depended on the choice of interest rates used to calculate the interest rate differential. In reality, the swap facility was also used for liquidity purpose by the financial institutions either to secure funds for their own use or to hedge or even speculate against a declining rupiah.

In the beginning, Bank Indonesia set the amount of the swaps and allocated the premiums through a non-market mechanism. Although the ceiling was abolished in October 1986 with Bank Indonesia allowing the swap premium to be determined by market forces, in reality the swap premium remained subsidized until December 1991. The subsidy came about because of the time lag in either an upward adjustment of the swap premium or a nominal depreciation of the rupiah, or a combination of both. Beginning in December 1991 Bank Indonesia, on average, set the swap premium above the market rate. This further induced speculation on the rupiah.

Control on short-term external borrowings

Despite liberalization in the capital account, the authorities in Indonesia had taken a number of measures to limit the size and affect the structure of capital inflows by resorting to controls on certain types of transactions and class of customers. In October 1991, they re-imposed special quantitative ceilings on offshore borrowing of the public sector at large, including state-owned enterprises. The ceilings were also applied to offshore borrowings of the private sector that relied on public entities for their bankability. Control was implemented through Bank Indonesia's regulations, which set the ceiling on commercial foreign borrowings by itself, state-owned banks, private-owned foreign exchange banks, and state-owned and private companies for the five fiscal years ending in 1995/96 (Nasution 1996a). Bank Indonesia established a queuing system to obtain and use the ceilings and abolished the implicit subsidy on the premium of the exchange rate swap facility. The queuing system allowed authorities to set the size and timing of the capital inflows and to check their terms and conditions as well as their uses. The banks were fined for failing to report external borrowings and for exceeding their ceilings and NOP requirement. Effective 1 April 1997, at least 80 per cent of the offshore borrowings must be channeled to export-related activities.

Exchange rate management

The exchange rate affects resource allocation, as it is the single most important relative price in an open economy. Monetary transmission in such an economy operates through exchange rate effects on net exports and interest rate effects on financial portfolios. Exchange rate policy in Indonesia includes devaluation, speed-up depreciation, a widening intervention band, and raising transaction costs in foreign exchange markets. The exchange rate policy has traditionally been used in combination with other policies mainly to remove distortions in the domestic economy and to promote international competitiveness. In fact, an active exchange rate policy was an integral part of the 'outward-looking' or export-oriented development strategy of this region.

To offset the 'Dutch disease' effect of the oil boom, the Indonesian authorities devalued the rupiah by 50 per cent against the US dollar in November 1978. At the same time, the authorities replaced the US dollar as its external anchor with an undisclosed basket of major currencies and moved to a managed floating exchange

rate system. The rupiah was further devalued by 40 per cent in June 1983 and by another 31 per cent in September 1986. In a normal situation, the authorities targeted depreciation of the rupiah against the dollar between 3 to 5 per cent a year. Bank Indonesia intervened in the foreign exchange market by buying and selling the rupiah in an intervention band around the central rate.

To allow market forces a greater role in setting the exchange rate, Bank Indonesia widened the intervention band six times since 1992 and to 6 per cent in September 1996. In theory, this greater exchange rate flexibility introduces uncertainty that may well discourage part of the purely speculative capital flows and allows a higher degree of freedom for monetary authorities to exercise control over monetary aggregates. As it allows a temporary slight appreciation of the rupiah, the policy is supposed to reduce the need for sterilization of surges in capital flows.

The adjusting factors of the active management of exchange rate policy have been raising the domestic inflation rate and interest rates. The pressures pushing up the rate of inflation in Indonesia have been partly suppressed by the government's policies to narrow the budget deficit, subsidize the prices of state-vended products,[8] control wages, and adopt a more vigorous trade liberalization program. Trade and financial sector policy reforms and the productivity gains generated by the economy-wide reforms and increasing market competition helped to relax the supply constraint and check the inflationary pressures and upward pressures on interest rates.

Partly because of the surge in capital inflows, the rupiah appreciated slightly between 1990 and 1996, which helped to reduce inflation and interest rates. The currency appreciation, however, eroded external competitiveness of the economy, distorted savings and investment decisions, and squandered the scarce savings upon unproductive investment projects. As pointed out earlier, the massive capital inflows were also used for the financing of expansion in the nontraded sector and private consumption expenditures.

Until June 1997, Indonesia defended the external value of the rupiah against successive major speculative attacks by depleting external reserves. The strategy, however, had to be abandoned eventually because of the limited resources under the command of the central bank, Bank Indonesia. To defend the external reserve position, on 14 August 1997 the Indonesian authorities abandoned the currency exchange band system and moved to the present free float system. This allowed the rupiah to depreciate and raised both interest rates and the rate of inflation.

The sharp increase in interest rates and devaluation of the domestic currency deteriorated bank and firm balance sheets because of their high leverage strategy with the high debt–equity ratio. The substantial fall in the external value of the domestic currency rapidly raised the cost of renewing or rolling over the short-term foreign borrowings in real terms. The indebtedness of domestic banks and firms rose and their net worth fell.

Instruments of monetary policy

Despite the reforms, the government retained some direct non-market policy instruments to pursue its industrial policy. These instruments, which were targeted

to either interest rates or quantities of credit through regulations that were widely used in Indonesia, were mainly aimed at the balance sheets of commercial banks. But, as noted earlier, the government employed these instruments mainly for channeling credit to particular classes of customers and even to specific individual borrowers, and not for correcting market failures relating to monopolies, externalities, and public goods.

The authorities also used indirect monetary policy instruments for quasi-fiscal operations. In general, these instruments are targeted at the balance sheet of the central bank and operate through the money market by influencing the underlying demand and supply conditions. They are also called market-based instruments as they generally influence the supply of bank reserves through banks and non-bank financial institutions at market-related prices on a voluntary basis. The direct and indirect monetary instruments that have been used in Indonesia are listed in Table 2.4.

One characteristic of market-based monetary policy is its generality, which in principle affects all market participants equally. For example, the price level and interest rates are important signals for all market participants to freely adjust their asset and liability positions according to their own objectives. The generality principle, however, does not necessarily proscribe direct guidelines since in reality the market is imperfect and not all market participants are in similar positions. As will be discussed later, the shifting of public sector deposits only affects the public sector.

Discount window

Particularly during the time of crisis, Bank Indonesia used the discount window or credit liquidity as an instrument for undertaking quasi-fiscal operations in helping financially distressed banks. Introduced in February 1984, there are now two types of the rediscount window employed by Bank Indonesia. The first facility is designed to facilitate the day-to-day reserve management of financial institutions. The second

Table 2.4 Monetary policy instruments in Indonesia

Direct	*Indirect*
1. Interest rate controls	1. Reserve requirement
2. Credit ceilings (by economic sector, class of customer and bank)	2. Rediscount window
3. Rediscount quota (by economic sector, class of customer and bank)	3. Lombard (overdraft) window
4. Ceilings on foreign borrowings (banks, public sector and private companies)	4. Public sector (including SOEs) deposits
5. Moral suasion	5. Credit auctions
	6. Net open position
	7. Foreign exchange swap
	8. Open market operations

window is intended to promote long-term lending by offering temporary relief to banks that face risks associated with maturity mismatch between assets and liabilities. The maximum duration of the first facility is three working days and the second is 90 days. At the time of crisis in 1997, Bank Indonesia injected massive credit liquidity with an extended or even open-ended duration. As this was regarded as inadequate, the authorities provided a blanket guarantee to all liabilities of banks to third parties.

Open market operations

The massive injection of liquidity credit in the third quarter of 1997, which was intended to revive financially distressed banks, was partially sterilized by open market operations (OMO).[9] These operations drove up interest rates to exorbitant levels, over 60 per cent per annum in 1997. Until that time, open market operations in Indonesia were not related to fiscal operation, namely, that of assisting debt management and government borrowing from domestic sources and influencing the debt position of the government. This is because the market for the more than Rp.530 trillion worth of government bonds for a re-capitalization program is yet to be developed.[10]

Up until the present, OMO has been used mainly for pursuing the objectives of monetary policy – namely to (a) influence interest rates through the setting of prices and yields of monetary instruments; (b) influence the availability of the reserve base of commercial banks and thereby their capability to make loans and create deposits and money supply; and (c) provide seasonal or other finance for commercial banks.

The capacity of Bank Indonesia to conduct OMO is relatively limited. In general, both the quantity and types of assets that the central bank holds are relatively small – the bank employs two instruments, Sertifikat Bank Indonesia (SBI) and Surat Berharga Pasar Uang (SBPU).[11] In addition, due to a combination of a long history of political and economic instability and relatively weak market infrastructure, the size and depth of the market for securities in Indonesia are still relatively narrow and shallow. The small number of buyers and sellers limit the ease with which transactions can be put through without undue fluctuation in security prices.

Table 2.5 shows the leading role of SBI in the money market. Two discretionary policy measures were used to increase the size of SBI held by commercial banks. The first required state-owned enterprises to convert their deposits at commercial banks into SBI. The second measure, introduced in October 1988, required commercial banks to temporarily hold in SBI the excess reserve created by a reduction in reserve requirements from 8 per cent to 2 per cent. (See the section on shifting of public sector deposits on page 68 below for the effect of such measures on the money supply.)

The last three columns in Table 2.5 indicate the increasing importance of SBI and SBPU as instruments of monetary policy as they can affect the capability of commercial banks to make loans and create demand deposits. This is shown in the increasing amount of these instruments as a percentage of assets, excess reserve, and total deposits of the commercial banks. The SBPU market has grown rapidly since 1991. To ease the contraction of liquidity resulting from the shifting of public

Table 2.5 Development of SBI and SBPU, 1985–98

End of period		*SBI & SBPU as % of:* *SBI held by commercial banks*	*SBPU sold in the market*	*Total SBI and SBPU*	*Role of SBI in total market instrument*	*Deposit money bank assets*	*Excess reserves*	*Total deposits* [a]
1987	Dec.[b]	275	–	275	100.0	0.6	14.5	1.0
1988	Dec.[c]	1,254	–	1,254	100.0	2.0	102.7	3.5
1989	Mar.	444	–	444	100.0	0.7	29.1	1.2
	June	2,156	–	2,156	100.0	2.9	211.8	5.3
	Sept.	2,483	–	2,483	100.0	3.0	243.7	5.5
	Dec.	2,886	–	2,886	100.0	3.1	163.0	5.6
1990	Mar.	2,216	253	2,469	89.8	2.4	129.8	4.4
	June	2,061	–	2,061	100.0	1.8	157.4	3.3
	Sept.	1,412	–	1,412	100.0	1.1	139.5	2.1
	Dec.	1,529	–	1,529	100.0	1.2	99.9	2.0
1991	Mar.[d]	9,414	6,782	16,196	58.1	12.0	1,025.7	22.5
	June	11,994	7,739	19,733	60.8	13.6	1,590.1	25.0
	Sept.	11,410	4,995	16,405	69.6	11.6	1,321.9	19.5
	Dec.	10,942	4,342	15,284	71.6	10.0	1,131.3	17.0
1992	Mar.	11,239	4,196	15,435	72.8	9.8	716.2	17.2
	June	15,542	2,808	18,350	84.7	10.9	1,766.1	18.9
	Sept.	17,982	1,995	19,977	90.0	11.3	1,584.2	19.4
	Dec.	20,599	2,820	23,419	88.0	12.8	1,476.6	21.8
1993	Mar.	23,010	2,619	25,629	89.8	13.5	1,122.1	23.2
	June	18,730	1,511	20,241	92.5	10.4	1,184.4	18.0
	Sept.	18,663	1,624	20,287	92.0	9.8	1,049.6	16.5
	Dec.	23,433	1,395	24,828	94.4	11.6	1,133.8	19.5
1994	Mar.	19,771	2,734	22,505	87.9	10.3	1,338.8	16.9
	June	15,237	3,341	18,578	82.0	8.4	1,635.5	13.6
	Sept.	14,090	3,373	17,463	80.7	7.5	1,505.4	12.0

	Dec.	15,052	3,842	18,894	79.7	7.6	1,764.1	12.1
1995	Mar.	11,172	4,137	15,309	73.0	6.1	1,089.6	9.4
	June	11,005	4,128	15,133	72.7	5.7	1,414.3	8.8
	Sept.	10,509	2,165	12,674	82.9	4.4	1,212.8	6.8
	Dec.	11,851	4,205	16,056	73.8	5.2	1,222.8	7.5
1996	Mar.	10,818	2,580	13,398	80.7	4.2	329.1	6.0
	June	12,460	1,218	13,678	91.1	4.0	403.1	5.7
	Sept.	11,469	1,339	12,808	89.5	3.6	340.9	5.1
	Dec.	18,553	171	18,724	99.1	4.8	395.9	6.6
1997	Mar.	20,996	2,670	23,666	88.7	5.9	446.7	8.7
	June	17,329	2,126	19,455	89.1	4.6	382.3	6.7
	Sept.	16,864	21	16,885	99.9	3.5	402.4	5.5
	Dec.	7,034	3,455	10,489	67.1	2.0	220.7	3.2
1998	Mar.	16,925	4,090	21,015	80.5	2.8	404.8	5.1
	June	48,011	146	48,157	99.7	4.7	727.7	9.3
	Sept.	48,726	227	48,953	99.5	5.5	514.9	9.7
	Dec.	42,765	1,019	43,784	97.7	5.7	350.2	8.2
1999	Mar.	48,914	1,018	49,932	98.0	8.4	376.7	9.0
	June	63,879	1,018	64,897	98.4	11.6	611.0	11.4
	Sept.	73,202	1,018	74,220	98.6	9.7	738.0	12.3
	Dec.	62,899	0	62,899	100.0	7.7	399.8	10.7

Source: Bank Indonesia (various years b).

Notes:
- a. Consist of demand deposits, time deposits, and foreign currency deposits.
- b. The first Sumarlin shock in June 1987.
- c. Reduction in banks' reserve requirement held temporarily in SBI.
- d. The second Sumarlin shock in February 1991.

sector deposits to the central bank, Bank Indonesia injected liquidity into the economy by buying SPBU from commercial banks.

Costs and benefits of using central bank securities as a primary instrument for OMO

The use of central bank securities like SBI as a monetary instrument in OMO has both advantages and disadvantages. The advantages include concentration of OMO on monetary policy objectives and separation of OMO from fiscal policy or debt management and government borrowing. This strengthens the operational autonomy of the central bank, particularly when the Treasury is unwilling to accept the rise in interest rates that may increase the burden of government debt repayments. In addition, SBI is a flexible monetary instrument as it is a debt instrument issued by the central bank, which is totally independent in setting the issuance, auction system, counterparts, maturities, and settlement rules.

There are two disadvantages in using the central bank securities as a monetary instrument in OMO. The first is that the central bank's debt instruments are created solely to absorb liquidity. Their issuance is not aimed at fostering the development of financial markets because the volume of issue of central bank securities is small relative to the size of debt instruments issued by other economic agents (central and local governments, business firms, and households). There are many reasons for this. One reason is that unlike other economic agents, the central bank has the exclusive right to issue money and does not need to raise money by issuing debt instruments and selling them to the general public. Another reason is that as the monetary authority the central bank is well equipped with other instruments to affect liquidity. These include reserve requirements and access to credit facilities at the central bank, setting foreign exchange power of the commercial banks, and currency devaluation. Moreover, through various types of instruments at its disposal the central bank can affect interest rates.

The second disadvantage is that the issuance of SBI is costly and may thus have a significant negative impact on the profit and loss account of the central bank. The financial cost is a positive function of the volume of the issuance and the interest rates. The income of the central bank comes from seigniorage ('taxes' from inflation) and reserve requirement, fees, and interest rates received from lending operations and operations in foreign exchange market. The lender-of-last-resort function was shifted in January 1998 from Bank Indonesia, the central bank, to the public budget through a newly established institution, the Indonesian Banks Restructuring Agency (IBRA).

Shifting of public sector deposits

Shifting of public sector deposits from commercial banks to the central bank has been used intensively in Indonesia. Popularly known as 'the Sumarlin shocks,' after the Minister of Finance Sumarlin who issued the order, the measure has been introduced twice, in June 1987 and February 1991, to drain liquidity or sterilize

monetary expansion following surges in capital inflow. A similar measure was introduced in August 1997 to moderate the effect of the financial crisis. The shifting of deposits is similar in effect to an increase in the reserve requirement to 100 per cent and thus brings about a monetary contraction. It can be thus used effectively as a monetary policy instrument, particularly when OMO is neither feasible nor efficient.

There are, of course, many differences between such a transfer and a normal OMO. First, shifting public deposits between commercial banks and the central bank is basically an administrative decision and not a market-based policy. Periodic uses of such policy have resulted in large and unforeseen changes in the cash base of commercial banks and thereby have introduced an element of great uncertainty in their operations. Given this uncertainty, commercial banks cannot make long-term portfolio decisions, including lending policies, based on public sector deposits held with them.

Second, the shifting of deposits has a discriminatory tax effect on state-owned commercial banks. In Indonesia, prior to October 1988, all public sector funds (including those of state-owned enterprises) were required to be deposited only at the seven state-owned commercial banks. Since then the public sector has been allowed to deposit a maximum of 50 per cent of their funds at private commercial banks. Each province has its own development bank, acting as the treasury agent for its owner and as the depository of funds for the provincial and local government. Thus the transfer of public sector deposits from state-owned commercial banks, and not from others, to the central bank acts like a tax on the first group of banks but not on the second. The state-owned commercial banks did not only lose liquidity from the Sumarlin shocks but they also had to reduce the amount of their loans outstanding. Third, the interest cost of such a transfer is much less than the cost of normal sterilization using government bonds or debt instruments issued by business firms, as the interest rates on these debt instruments are higher than that of SBI.

Conclusion

In Indonesia, reform in the banking sector began in June 1983 with the relaxation of interest rate controls and the elimination of sectoral credit allocation. The scope of the reform was much wider and its speed much faster than reform in the real sector of the economy which also began in the early 1980s. A more drastic reform in the banking sector was introduced in October 1988 although new prudential rules and regulations were announced two years later. The 1988 reform removed special purpose development banks, reduced protection on domestic banks from foreign competition, and reduced special market preferences for state-controlled financial institutions. The reform introduced since the crisis under the IMF program includes reform of the central bank, merger of state-owned commercial banks, and closure of some private commercial banks.

In contrast to the sequence of economic liberalization suggested by economic theory, Indonesia first liberalized its capital account in October 1966, long before it deregulated its current account and domestic commodity, labor, and assets

markets in the second half of the 1980s. Nevertheless, the reverse sequence of liberalization did not cause a major problem since Indonesia had already tamed inflation and obtained support from the international community to help finance its budget and current account deficits.

In spite of the reforms, the prudential rules and regulations were not strictly enforced mainly due to weaknesses in the legal and accounting system. Moreover, bank supervision was focused more on the regulatory and procedural aspects of the supervisory functions than on making sure that the prudential rules and regulations were being followed. Financial disclosure was weak as a result of weakness in implementing accounting requirements and standards and in the training of public accountants. Furthermore, Indonesia suffered from the colonial legacy of having a weak basis for securing contract and credit transactions, and unclear laws and procedures on exit and bankruptcy.

The broad-based economic reforms encouraged massive inflows of capital with short-term maturity as banks and the corporate sector in Indonesia were allowed to borrow abroad to finance their domestic operations. The massive capital inflows led to an appreciation of the external value of the rupiah, which in turn reduced the external competitiveness of domestic firms and induced resources to move towards the nontraded goods sector. Excessive investment in construction and land-based industry and government-sponsored unproductive projects also resulted.

The transition towards a more competitive environment and stricter rules and regulations is very difficult for Indonesia's banking system. The problems are not limited only to state-owned banks which are traditionally undercapitalized and have inherited a larger portion of low-yield, non-performing assets from the past credit program. The number of closures among private banks and their clients has also been rising because of a combination of high interest rates, a sharp depreciation of the rupiah, and a recession in the domestic economy.

The fragility of the banking system has limited the strictness of monetary policy and austerity of fiscal policy. The tight liquidity, high interest rates, and wide spreads between deposit and lending interest rates have pushed the banking industry and corporate sector to bankruptcy. The extra burden of paying the coupon of government bonds for refinancing the banking system has relaxed the support for fiscal austerity.

Appendix 2.1 Reform in the commercial banking industry, 1969–99

Policy measures	*Before reform*	*After reform*	*Date*
I. Competitive measures			
1. Entry of new banks			
a. Private banks	Moratorium since 1970	Permitted	Oct. 1988
b. Islamic share principle banks	None	Permitted in a broad manner	May 1999
c. Foreign banks	Moratorium since 1970	Permitted to enter as joint venture, limited in numbers	Oct. 1988
		Permitted to enter as joint venture, no number limit	Jan. 1998
2. Branching power			
a. Domestic branches			
i. Private banks	Restricted[a]	Permitted to sound banks	Oct. 1988
		May have Islamic share principle branches	May 1999
ii. Islamic share principle banks	None	Permitted to sound banks	May 1999
		Not allowed to have conventional branches	May 1999
iii. Foreign banks	Restricted to Jakarta	Permitted to seven cities (later Batam)	Oct. 1988
		Unlimited	Jan. 1998
iv. Bank Perkreditan Rakyat			
– Conventional BPRs	Restricted	Restricted to the same province with head office	May 1999
– Islamic share principle BPRs	None	Restricted to the same province with head office	May 1999
b. Branches abroad			
i. Private banks	None	Permitted after 24-month period of being foreign exchange bank	May 1999
ii. Islamic share principle banks	None	Permitted after 24-month period of being foreign exchange bank	May 1999
3. Conversion of type of bank			
a. Private banks	None	Permitted to convert into Islamic share principle banks	May 1999
b. Bank Perkreditan Rakyat			
i. Conventional BPRs	None	Permitted to convert into Islamic share principle BPRs	May 1999

Policy measures	Before reform	After reform	Date
4. Foreign exchange license			
i. Private banks	Restricted[a]	Eligible for sound banks	Oct. 1988
		Eligible for sound banks	Sept. 1995
ii. Islamic share principle banks	None	Eligible for sound banks	May 1999
5. Type of loans			
a. State banks	Mainly the extended subsidized credit programs, as set and refinanced by Bank Indonesia	The scope and coverage of the subsidized credit programs were reduced	June 1983 Jan. 27, 1990
b. Private banks	Free to set	20% of total credit must be extended to small business[b]	Oct. 1988
		22.5% of total credit must be extended to small business[b]	April 1997
c. Islamic share principle banks	Free to set	Free to set	May 1999
d. Foreign banks	Free to set	50% of total credit must be extended to export-related activities	Oct. 1988
e. Bank Perkreditan Rakyat			
– Conventional BPRs	Free to set	Small and medium entrepreneur credit (KPKM)[c]	Oct. 1998
– Islamic share principle BPRs	None	Free to set according to the principles	May 1999
6. Types of saving and deposit schemes			
a. State banks	Set by Bank Indonesia	Free to set	June 1, 1983
b. Private banks	Free to set	Free to set	June 1, 1983
c. Islamic share principle banks	None	Free to set	May 1999
d. Foreign banks	Free to set	Free to set	June 1, 1983
e. Bank Perkreditan Rakyat			
– Conventional BPRs	Free to set	Free to set	Oct. 1998
– Islamic share principle BPRs	None	Free to set according to the principles	May 1999
7. Deposits of the public sector	Restricted to state banks	Restricted to state banks	Oct. 1988
8. Deposits of state enterprises	Restricted to state banks	Up to 50% with private banks	Oct. 1988

9. Deposit rates			
a. State banks	Set by Bank Indonesia	Free to set	June 1, 1983
		Tied to SBI discount rate, max. 25% higher	Feb. 1998
b. Private banks	Free to set	Free to set	
		Tied to SBI discount rate, maximum 25% higher	Feb. 1998
c. Foreign banks	Free to set	Free to set	
		Tied to SBI discount rate, maximum 25% higher	Feb. 1998
10. Loan rates			
a. State banks	Controlled by Bank Indonesia	Free to set	June 1, 1983
b. Private banks	Free to set	Free to set	
c. Foreign banks	Free to set	Free to set	
11. Credit ceilings			
a. State banks	Set by Bank Indonesia	Eliminated	June 1, 1983
b. Private banks	Set by Bank Indonesia	Eliminated	June 1, 1983
c. Foreign banks	Set by Bank Indonesia	Eliminated	June 1, 1983
12. Loan restriction	Not regulated	Prohibited to land provision and land usage of the real estate developer	July 1997
13. Foreign exchange power (limited to licensed banks)	Subjected to ceilings set by Bank Indonesia	Net open position[d]	Nov.1989
		30% of bank capital	March 1997
14. Reserve requirements	15% of deposits (differentiated between banks)	2% of deposits	Oct. 1988
		3% of deposits	Dec. 1995
		5% of deposits	April 1997
15. Gift and presents	Not regulated	Allowing banks to give gift and presents to their customers 1% of interest payment	Feb. 1998
16. Foreign exchange purchasing tax	Not regulated	Imposing tax on foreign exchange purchasing	March 1999
		Releasing tax on foreign exchange purchasing	March 1999
17. Electronic local clearing	Not regulated	All banks in the local clearing area	Aug. 1998

Policy measures	*Before reform*	*After reform*	*Date*
18. Entry to new activities			Dec. 1988[e]
a. Leasing	Not regulated	Subsidiary	
b. Venture capital	Not regulated	Subsidiary	
c. Securities trading	Not regulated	Not for own account, not as broker/dealer	
d. Factoring	Not regulated	Directly	
e. Consumer finance	Not regulated	Directly	
f. Credit cards	Not regulated	Directly	
g. Underwriting shares[f]	–	Prohibited	
h. Custodian	Not regulated	Approval required for capital market[g]	Otherwise can do as
i. Trustee and guarantor	Not regulated	Approval required for capital market[h]	part of usual activities
j. Securities Administrative Agency	Not regulated	Prohibited	
k. Investment manager	Not regulated	Subsidiary	
l. Derivative transaction	Not regulated	By permission of Bank Indonesia	Feb. 1996
m. Auction institution	Not regulated	Directly, either foreign or joint	July 1997
n. Swap and forward facilities	Not regulated	Applicable to banks with foreign exchange license	Oct. 1997
19. Stock market foreign purchasing	49% of primary market shares	100% of primary market shares	May 1999
20. Share ownership	49%, either local or foreign individual or institution	99%, either local or foreign individual or institution	May 1999
II. Prudential measures			
1. Capital requirements			
a. General banks			
i. Private banks	–	Rp. 10 billion	Oct. 1988
		Rp. 50 billion	Oct. 1992
		Rp. 1 trillion	Feb. 1998[i]
		Rp. 150 billion or less	June 1998[k]
		Rp. 3 trillion	May 1999

ii. Joint venture banks (minimum 15% of Indonesian ownership)	–	Rp. 50 billion		Oct. 1988
		Rp. 100 billion		Oct. 1992
		Rp. 1 trillion		Feb. 1998[i]
		Rp. 150 billion or less		June 1998[k]
		Rp. 3 trillion		May 1999
iii. Islamic share principle banks		Rp. 3 trillion		May 1999
iv. Foreign branch		Rp. 3 trillion		May 1999
b. Bank Perkreditan Rakyat		Rp. 50 million		Oct. 1988
		Rp. 1 trillion		Feb. 1998i
		Rp. 150 billion or less		June 1998k
i. Conventional BPRs				
– Jakarta and peripheral		Rp. 2 billion		May 1999
– Province capital		Rp. 1 billion		May 1999
– Other sites		Rp. 500 million		May 1999
ii. Islamic share principle BPRs				
– Jakarta and peripheral		Rp. 2 billion		May 1999
– Province capital		Rp. 1 billion		May 1999
– Other sites		Rp. 500 million		May 1999
2. Legal lending limit	None	1. Old credit: (% of bank capital)		
		Individual	Group	May 29, 1993
		20%	50%	May 29, 1993
		20%	50%	Dec. 1995
		20%	50%	March 1997
		2. New credit		
		Individual	Group	
		20%	20%	March 1997
		30%	30%	Jan. 1999
3. Loan-to-deposit ratio	None	110 per cent		Feb. 1991[g]

Policy measures	*Before reform*	*After reform*	*Date*
4. Capital adequacy ratio	None	(% of risk weighted assets) 5% by March 1992 7% by March 1993 8% by December 1993[h] 4% by December 1998[j]	Feb. 1991
5. Working capital			
a. Islamic share principle branches of private conventional banks			
– Jakarta and peripheral	None	Rp. 2 billion	May 1999
– Other sites	None	Rp. 1 billion	May 1999
6. Net open position	None	25% of capital	March 1989
7. Accounting standard			
i. Private banks	None	Standardized – *Standar Khusus Akuntansi Perbankan Indonesia (SKAPI)* – Accounting Standard for Indonesian Banks	Jan. 1, 1993
ii. Islamic share principle banks	None	Accounting Standard for Indonesian Banks	May 1999
8. Measures of the soundness of banks			
a. State banks	None	Weighted average of prudential measures	May 1997
b. Private banks	None	Weighted average of prudential measures	May 1997
c. Bank Perkreditan Rakyat	None	Weighted average of prudential measures	May 1997
9. Rules of banks merge, consolidation and acquisition			
a. Private banks	None	The rules and steps of banks merge	May 1999
	None	Allowed to merge with Islamic share principle banks to be a new Islamic principle bank or to have Islamic share principle branches	May 1999
b. Islamic share principle banks	None	The rules and steps of banks merge	May 1999

c. Bank Perkreditan Rakyat			
i. Conventional BPRs	None	The rules and steps of banks merge	May 1999
	None	Allowed to merge with Islamic share principle BPRs to be a new Islamic principle BPR	May 1999
ii. Islamic share principle BPRs	None	The rules and steps of banks merge	May 1999
10. Rules of bank suspension and liquidation			
a. Private banks	None	The rules and steps of banks closure	May 1999
b. Islamic share principle banks	None	The rules and steps of banks closure	May 1999
c. Foreign banks	None	The rules and steps of banks closure	May 1999
d. Bank Perkreditan Rakyat			
– Conventional BPRs	None	The rules and steps of banks closure	May 1999
– Islamic share principle BPRs	None	The rules and steps of banks closure	May 1999
11. Government's warranty			
a. Payment obligation of private banks	None	Sanction to the unobeyed party	March 1998
b. Deposits and interbank call money	None	No more than acquired interest rate	May 1998
12. Recapitalization program	None	Obliged to banks with CAR lower than 4%	Sept. 1998
13. Bad debt restructuring	None	Funding creation and debt elimination, incl. lending-capital conversion and 99% foreign ownership	Nov. 1998

III. Money market: Reintroduced in February 1984, SBI is the most important money market instrument at present. On June 1, 1993, the auction system of SBI changed from 'cut-off rate' (COR) to 'stop-out rate' (SOR). The private sector commercial paper (SBPU) introduced in Jan. 1985. In May 1999, the government issued bonds to help recapitalized banks. There are three types of bonds:

a. Bond with floating rate, tied to three-month SBI rate.
b. Bond with fixed rate.
c. Indexed bond with 3% interest rate.

Policy measures	*Before reform*	*After reform*	*Date*
IV. Transparency and accountability of reporting and management			
1. To improve banking supervision by (i) standardizing accounting and reporting system; (ii) requiring commercial bank to submit detailed business plans to the central bank and banning person involved in fraudulent transactions or defaulted on significant loans from becoming shareholders, executives or member of the Board of Commisioners of banks			Jan. 1995
2. Banks are required to (i) submit detailed credit plan to Bank Indonesia and those with uncollectibles amounted to 7.5% of total credit or more are required to submit credit recovery plans; (ii) standardized internal audit system; (iii) adopt standardize information system technology;			March 1995
(iv) improve the financial report; to include the detail on the items calculated on exchange rates value			Sept. 1995
(v) submit and announce annual financial report			Dec. 1998
3. The criteria of persons who may not be involved in bank management			Jan. 1995
4. The easing of bad debtors from the bank's confidentiality criteria to encourage announcement of bad debtors			Nov. 1998
5. The criteria and limitation of members of the Board of Directors and the Board of Commisioners, such as: (i) family relativity; (ii) shares ownership of other companies; (iii) occupancy in other companies			May 1999
V. Special supervisory institution			
IBRA (Indonesian Banking Restructuring Agency) established in March 1998, to help the recovery of management, fund availability for all banks, and the merge among banks. IBRA itself endorsed by the parliament in Oct. 1998.			

Sources: Government of Indonesia (1988a, 1988b, 1990, 1991), Banking Law Number 7 (1992), Banking Regulation (May 29, 1993), Nasution (1983), Cole and Slade (1991), Chang and Pangestu (1992), Bank Indonesia (various years b, various years c), *Indocommercial* magazine, and *Kompas*.

Notes:
a. Permitted in principle, but economic and social requirements made it prohibited in practice.
b. Since May 29, 1993, can be channeled through other banks and BPRs.
c. KPKM is the abbreviationof Kredit Pengusaha Kecil dan Menengah (small and medium entrepreneurs' credit).
d. Overseas borrowing for public sector is subject to ceilings set by TKPLLN (Coordinating Team for Management of Commercial Offshore Loans) since Oct. 1991.
e. Items (g) to (j) are subject to Ministry of Finance's Decision No. 1548 of December 4, 1990.
f. Be able to underwrite bonds and other debt instruments.
g. Since May 29, 1993, own capital is included in the denominator.
h. The regulation is intended to be fulfilled in December 1999, to be Rp.2 trillion in December 2000, and Rp.3 trillion in December 2003.
i. On November 12, 1998, this schedule was extended to December 1998. The banks are obliged to fulfill the 8 per cent CAR limit in December 1999 and 10 per cent in December 2000.
j. The capital requirement changed under the above CAR conditions.

Notes

1 In Indonesia, public sector savings, the main component of national savings, are closely linked to changes in the prices of oil and natural gas in the world market. Oil and gas contributed to around 20 per cent of GDP and 33 per cent of government revenue in 1997.

2 The national car policy, promulgated in Presidential Instruction No. 2/1996, gave 'pioneer' status to PT Timor Putra Nasional. The exclusive status exempts the company from paying 65 per cent maximum import duties for car spare parts and 35 per cent maximum import duty and luxury goods sale tax that make up over 60 per cent of the cost of car production in Indonesia. While completing its own production and assembling capacity in Indonesia, the company was allowed to import the first 45,000 units of built-up cars from Kia Motors of Korea. To boost the sales of cars, the public sector was required to buy cars from that company. In return, the company promised to manufacture in stages the national car with the use of local components, beginning at 20 per cent in the first year of operation, over 40 per cent in the second year, and over 60 per cent in the third year. Fully backed by the Government and Bank Indonesia, a consortium of four state-owned banks and twelve private domestic banks extended a US$960 million credit to the company for car production and assembly. Hutomo Mandala Putra and the Kia Motor Company of South Korea jointly owned PT Timor Putra Nasional.

3 The World Bank considers a debt-to-GNP ratio of less than 48 per cent as low risk, 40 to 80 per cent as medium risk, and over 80 per cent as high risk. In terms of the ratio of total debt service to exports, the World Bank considers 18 per cent as the 'warning' threshold.

4 Each provincial government has one rural development bank (RDB). In reality, the RDBs only operate as a fiscal agent for their owners.

5 At the end of 1990, concessionary credit was also made available for *Badan Penyangga dan Pemasaran Cengkeh* to finance its clove buffer stock. (Clove is the main ingredient of clove cigarettes.) The recipient of this credit was a consortium of private traders who had powerful political backing (i.e. Hutomo Mandala Putra) and had been granted exclusive rights to operate a buffer stock for that agriculture product.

6 The subsidized credit program, refinanced by Bank Indonesia's liquidity credit and credit denominated in foreign currencies, was excluded from the calculation of the 20 per cent credit designated for the small-scale business sector (KUK). The May 1993 regulation raised the maximum size of KUK per customer from Rp.200 million to Rp.250 million and allowed banks to use other financial institutions (including the BPR) to channel their mandatory KUK credit.

7 A number of the ideas in this section are drawn from Nasution (1995).

8 The authorities in Indonesia control prices of staple foods (such as rice, sugar, and wheat flour), building materials (such as Portland cement), energy (such as electricity and petroleum products) and services (such as fares for land, sea, and air transportation and school tuition). In comparison, the government of Singapore controls prices and rents of public housing.

9 Open market operations refer to the purchase and sale of specified assets by the central bank to influence the prices and yields (or interest rates) of these assets and the cash base of the banking system.

10 Until 1999, there were no government securities issued in the domestic market as the public budget deficit had been financed by external debt, preferably at concessionary terms from official sources. This policy prohibited the government from issuing Treasury bills or other debt instruments in domestic markets. The policy was changed in 1999 as the government issued Treasury bonds for financing the bank's restructuring program. Secondary market for government bonds began to develop in February 2000.

11 Sertifikat Bank Indonesia (SBI) are central bank certificates, and Surat Berharga Pasar Uang (SBPU) are promissory notes issued by banks and non-bank financial institutions in connection with inter-bank borrowing and bills of exchange issued by third parties and endorsed by eligible financial institutions.

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3 The political economy of financial liberalization and the crisis in South Korea

*Yoon Je Cho**

Overview

South Korea (henceforth Korea) faced a severe currency crisis in November 1997 that culminated in a sharp economic contraction in 1998. This currency crisis was not caused by the reversal of foreign portfolio investment, but was instead caused by the refusal of foreign creditors to roll over their short-term credit to Korean commercial banks and merchant banking companies (MBCs). There were a number of factors behind this rapid erosion in foreign creditors' confidence in the Korean banking sector, including the contagion effect from other East Asian economies; however, the most critical factor was the rapid increase in nonperforming assets of Korean banks. In Korea, unlike in the case of many other developing countries, the rapid increase in nonperforming assets was not caused by the burst of an asset bubble, but rather by a widespread debt problem in the corporate sector, in particular, that of the large *chaebol*.[1] In fact, between January and October of 1997, six of the largest thirty Korean *chaebol* went bankrupt.

Until the crisis, rapid expansion of the Korean economy as well as its corporate sector was based on the expansion of debt intermediation with firms operating with a highly leveraged financial structure. This highly leveraged financial structure could be sustained only so long as the government functioned as the corporate sector's risk partner. With its control over credit allocation, the government could intervene whenever it was necessary to save the highly indebted, troubled corporate firms. But once the government relaxed its control over the financial sector – a result of financial liberalization – its role as a risk partner was also weakened.

A financial crisis is not simply brought about by insolvency of a single enterprise or financial institution. Insolvency can and does persist for years without causing a crisis. This was what had happened many times in Korea prior to 1997. What was different in 1997 was that, because of a changed financial market environment brought about by financial liberalization, the Korean government could no longer contain the insolvency of several troubled firms by forcing financial institutions to roll over their credit. Another difference was that domestic firms and financial institutions had accumulated a large amount of short-term, private foreign debt, and the country suddenly faced a liquidity problem when foreign lenders refused to roll over the maturing debt. The government had neither the power to control the

behavior of foreign lenders nor the ability to print foreign exchange, whereas it could print the domestic currency to prevent domestic runs.

By the early 1990s, Korea had become the eleventh-largest economy in the world and could no longer resist joining the trends of globalization in finance. Recognition of this reality led to the Korean government initiating financial liberalization in the 1990s. However, what the government failed to recognize was that for financial liberalization to succeed it had to be accompanied by a fundamental change in Korea's economic structure – a structure that required government intervention in the credit market to forestall crisis.

Corporate firms in Korea typically had a very high leverage ratio, reaching close to 500 per cent in the case of some large *chaebol*. What made the situation worse was that the *chaebol* were too large in size for any single financial institution even to attempt imposing the necessary debt discipline on them. As a matter of fact, the total debt of some of the large *chaebol* was larger than the assets of Korea's largest bank. The insolvency of any such *chaebol* would have triggered a systemic crisis for the entire banking sector, requiring large-scale government intervention using public funds.

Ironically, this situation – the importance of large, over-leveraged *chaebol* in the Korean economy – cultivated the view in business and financial circles that because of their importance in the economy the government would not be able to afford to let the *chaebol* go bankrupt and would, therefore, guarantee their loans. Banks thus blindly extended credit to large *chaebol* without carrying out rigorous credit analysis or requiring adequate corporate governance. Such practices were not conducive to creating the banking or credit culture in Korea, and the lack of it was a fundamental problem ailing the country's banking sector when Korea faced a major crisis in 1997.

This sorry state of Korea's banking sector was a legacy of the manner in which the banks had been used by the government since the 1960s to promote rapid economic development. They had functioned less as financial intermediaries – as they do in a typical Western-style, market-based economy – but more as a channel through which the government allocated credit in pursuit of its development objectives (Huh 1999).[2]

Bank supervision in Korea did not function properly either, as it was concerned more with whether the banks complied with official guidelines on credit allocation or interest rate ceilings than with whether a bank had excessive risk exposure to a single borrower or industry. Although the supervisory authorities knew that certain banks had excessive exposure to some *chaebol* or firms, they were in effect unable to demand corrective actions, since such actions, if in fact they had been carried out, could trigger their bankruptcy, possibly causing economy-wide problems. Making decisions of this magnitude was not, therefore, something that a single bank manager or even the head of the supervisory authorities would have dared to make. It was a decision that would have been made only with the approval of the President and the support of powerful politicians.

In Korea, there was compartmentalization of supervisory authorities between the Ministry of Finance and the Bank of Korea, creating rivalry and lack of coordination between the two and, worse, a big lacuna in regulatory oversight.

Furthermore, given that it was the government that essentially directed banks to extend credit to select industries or firms or to provide rescue loans, neither of the two supervisory authorities could enforce prudential regulations in a strict manner without at the same time contravening government directives.

With hindsight, it is clear that these basic structural problems should have been tackled before or in tandem with financial liberalization. But in those days, many influential observers in Korea believed that financial liberalization itself would automatically solve many of these problems, which they saw as consequences of government intervention. Although it was generally agreed that some changes were needed in the financial sector, there was no agreement on what these changes should be and what the changes would bring about. Many observers, including academics and journalists, believed that an efficient financial system would automatically emerge once the government stopped intervening in the financial market. In other words, they believed that financial liberalization would suffice in correcting most of the problems ailing the Korean financial sector.

For many industrial firms, their interest in financial liberalization was motivated by their own parochial concern. For them it meant unlimited access to credit, allowing them to borrow as much as they desired at low interest rates. They also thought that financial liberalization would give them freedom to establish their own financial institutions. To bankers, financial liberalization meant that they would be free from any government intervention, including prudential regulations as well as credit allocation for development purposes. For politicians, financial liberalization was a move away from an authoritarian government and a symbol of democratization and, as such, something that could command support from every quarter in the nation (perhaps with the exception of the bureaucracy) and foreign governments.

It was in this atmosphere – imbued with the ideas that good things, whether parochial or general, would be brought about by financial liberalization – that the Korean government initiated the process of financial liberalization. But what actually determined the course of reform and its outcome was not a well thought out strategy but the push and pull from various domestic sectoral interests and pressures from the outside world. The reform, as a consequence, was a reactive process that responded to wherever pressure was the greatest, and what came out of this process was a corporate financial structure that turned out to be a root cause for extensive bankruptcies in 1997.

In a sense, the deep financial crisis that the Korean economy faced in 1997 was an inevitable consequence of financial liberalization carried out in an economy with a highly leveraged corporate sector, poorly developed financial market infrastructure, inadequate corporate governance, and a poor credit culture. In other words, the Korean economic structure was not adequately prepared for implementing financial liberalization at the speed that it had. What is ironic is that since the crisis the Korean financial system has reverted back to the old system in which the government owns and controls the banks. The only difference is that the government is now using the system for the purpose of restructuring the corporate sector rather than promoting rapid economic development.

One lesson that may be learned from the Korean experience is that financial liberalization is not something that can be undertaken apart and separately from reforms in the real sector of the economy. Given the slowness and difficulty of carrying out a reform in the real sector, Korea would have been better off if it had adopted a more gradual approach to financial liberalization, keeping pace with the slow pace of reform in the corporate sector and the regulatory regime. Alternatively, Korea should have implemented real sector reform much faster and in tandem with financial sector reform.

Korea's experience in financial liberalization suggests, as do the experiences of many other countries that have carried out financial reform, that financial liberalization is not an event but is a process that should be carefully framed in full cognizance of the economic structure of a country, reforms in other sectors of the economy, and the extent of development of the financial market infrastructure such as accounting practice, credit analysis and rating, supervisory capacity, etc. If it is not carried out in this manner, financial liberalization could intensify whatever distortions there are in the real sector and make the overall economy more vulnerable to crisis.

This chapter first examines how financial liberalization in Korea changed the structure of its financial market and its corporate sector's financing pattern. It then analyzes the political economic aspect of financial liberalization in Korea – why it took the particular path that it took and why the country eventually ended up with a severe financial crisis. The chapter ends with a discussion of lessons to be drawn from the Korean experience in financial liberalization.

Financial liberalization and changes in the financial market structure[3]

In Korea, financial reform or liberalization began in the early 1980s but was carried out in a piecemeal manner without a coherent strategy.[4] Although a more serious attempt at reform began in 1991 with the announcement of a four-stage interest rate deregulation plan, it was not until the inauguration of the Kim Young-Sam administration (1993–98) when the pace of deregulation was accelerated in an attempt to expedite the 'globalization' of the Korean economy. With the announcement of the Blueprint for Financial Liberalization and Market Opening in July 1993 and the Foreign Exchange Reform Plan in December 1994, many of the restrictions on financial markets and foreign exchange transactions were relaxed or abolished. The government's desire to become a member of the Organization for Economic Co-operation and Development (OECD) by the end of 1996 was an additional factor that prompted the pace of financial deregulation in Korea.

Unbalanced approach to financial liberalization

When the interest rate liberalization plan was first announced in 1991, the order of liberalization was guided by the following principles: from long-term to short-term interest rates, from securities market rates to bank interest rates, and from large-sum instruments to small-sum instruments. The plan that the government finally arrived

at did not, however, show that it was guided by a clear set of principles (see Appendix 3.1 on page 99). Moreover, the plan was not fully followed and, as a result, what came out of the reform process deviated significantly from the plan.

Interest rates on short-term bills such as commercial papers (CPs), for example, were officially deregulated in 1991 although it was only in 1993–94 that the actual deregulation took place. Interest rates on bank loans (except those on policy-based loans supported by the rediscount window of the central bank) were not fully deregulated until 1996 even though officially they were to be completely liberalized by November 1993. In fact, the actual movements of bank loan rates (the prime rate) demonstrate that the government exercised its influence on the setting of interest rates through moral suasion or administrative guidance. Such indirect control also continued on the setting of interest rates on time deposits of less than one-year maturity until mid-1996 in spite of the fact that they were officially to be deregulated by July 1995. Corporate bond rates were likewise officially deregulated in 1991 but were, nevertheless, indirectly controlled until mid-1997 with restrictions imposed on the volume to be issued.[5]

A consequence of such haphazard interest rate deregulation was the emergence of abnormalities. For example, interest rates on three-month CPs exceeded those on three-year corporate bonds for most of 1994–97 (Cho 1999).

Shift of funds to the short-term market

The haphazard liberalization of interest rates caused a rapid shift of funds toward the short-term CP market in 1991–96. As shown in Table 3.1, the annual growth rate of CPs was 26.4 per cent while the rates of growth of corporate bonds and bank loans were 18.8 and 16.2 per cent, respectively.

Accordingly, the source of corporate financing shifted rapidly toward the short-term commercial paper market. Table 3.2 reports changes in the financing pattern of the corporate sector for 1990–97. As shown in the table, the share of CPs in total corporate financing increased rapidly between 1993 and 1996; for example, the share averaged at 2.5 per cent in 1990–92, rose to an average of 13.1 per cent for 1993–96, and peaked at 17.5 per cent in 1996. This rapid increase in CPs facilitated the financing of corporate expansion because they were financial instruments readily accepted by finance and investment companies (FICs) and MBCs for resale to individual or institutional investors.

Table 3.1 Growth of financial markets

Financial indicators	*Avg. annual growth rate, 1991–96 (%)*
Commercial paper	26.4
Corporate bonds	18.8
Bank loans	16.2
M3	20.8

Source: Bank of Korea (various years).

Table 3.2 Financing pattern of the corporate sector (percentage)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Total financing	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Direct financing	42.4	37.9	41.4	52.9	38.1	48.1	47.2	37.1
CPs	3.7	–3.8	7.6	13.9	4.9	16.1	17.5	4.1
Bonds	21.5	24.2	12.1	14.5	14.2	15.3	17.9	22.9
Stocks	11.8	11.5	13.1	14.7	14.8	14.4	10.9	7.7
Indirect financing	38.4	41.8	36.3	31.4	44.5	31.8	29.1	37.9
Banks	15.8	19.8	15.1	13.1	20.7	14.9	15.2	12.9
Nonbanks	22.6	22.0	21.1	18.3	23.8	17.0	13.9	24.3
Overseas borrowing	6.4	4.1	7.1	1.5	6.6	8.4	10.4	6.1
Other[a]	12.8	16.1	15.3	14.2	10.8	11.7	13.2	18.9

Source: Bank of Korea (various years).
Note: a. Includes inter-firm credit.

Since the interest rates on short-term bank deposits were kept under control while the rates on other instruments were deregulated, the banks experienced a shift in their liabilities from short-term to long-term deposits and certificates of deposit (CDs). Thus, between 1991 and 1996, long-term deposits and CDs grew at an average annual rate of 17.7 and 22.0 per cent respectively, while short-term deposits grew only at 9.9 per cent (Table 3.3).

On the asset side of the banks, a significant change took place in their securities investments. Until 1993, the government required that funds in bank trust accounts be invested in long-term securities such as government securities and corporate bonds or be lent to firms. In 1993, the government deregulated this portfolio restriction under the pressure of the banking community and allowed trust funds to be invested in CPs. It also raised the ceiling on the share of securities investments in the total asset portfolio of the trust account from 40 to 60 per cent. This change resulted in a sharp increase in the share of corporate bonds, CPs, and other securities in trust accounts from 46.9 to 66.2 per cent between 1991 and 1997 (Table 3.4).

This increase was mostly in the bank holdings of CPs that they purchased with trust account funds. As far as most depositors were concerned, there was no difference between a time deposit account and a trust account at a bank since both were at the same bank.[6] Thus when the banks offered higher interest rates on the trust account, depositors simply transferred their funds from the low-yield deposit account to the trust account. The banks then used these funds to purchase corporate short-term CPs, which were then used by corporations to finance their long-term risky investments.

In sum, the unbalanced deregulation of interest rates between bank deposits and trust account instruments and between banks and the CP market brought about a substantial shift of funds toward trust accounts of banks and the CP market. This shift, in turn, had the effect of reducing the amount of loans that were subject to prudential regulation. For instance, bank loans from the general account were subject to a regulation that limited the amount of loans to a single borrower, whereas the same loans from the trust account were not subject to a similar regulation.

Table 3.3 Growth in bank liabilities

	Avg. annual growth rate, 1991–96 (%)
Deposits	
Short-term	9.9
Long-term	17.7
CDs	22.0
Money in trust	27.4
Foreign liabilities	26.9

Source: Bank of Korea (various years).

Table 3.4 Share of securities holdings in bank assets

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Bank accounts							
100 million won	167,487	186,934	231,157	305,283	413,800	510,688	719,347
%	12.2	12.3	13.9	15.2	15.9	16.4	17.1
Trust accounts							
100 million won	149,755	216,873	405,512	586,667	879,180	1,059,753	1,245,216
%	46.9	46.8	59.8	61.2	64.0	65.2	66.2

Source: Office of Banking Supervision (various years).

A consequence of this supervisory loophole and the asymmetric liberalization between bank deposits and trust account instruments and between banks and the CP market was an increase in the amount of funds being channeled, through the intermediation of trust accounts, into the short-term CP market.

Financial market opening

Korea's approach to liberalizing foreign capital flows was a cautious one. The gap between domestic and foreign interest rates was substantial and there was a strong latent corporate demand for cheap foreign capital. Concerned with the possibility of massive capital inflows that could destabilize the domestic macroeconomic environment, Korea took a gradual approach to capital account liberalization.

Starting in 1994, when the government decided to join the OECD, it accelerated the pace of capital account opening by, among others, raising the limit on foreign investment in the domestic stock market and relaxing control over short-term trade-related borrowing and the issuance of Korean corporate securities in the foreign capital market and offshore borrowing (Cho 1999). Although the government maintained strict control over foreign investment in government securities and corporate bonds issued in the domestic market, it imposed no significant restriction on foreign borrowings by banks and MBCs, especially their short-term borrowings.[7] The result was a dramatic increase in the inflow of short-term foreign capital,

responding to the strong investment demand of the corporate sector when the economy entered a boom in 1994.

The number of financial institutions dealing in foreign currency-denominated instruments increased rapidly. Between 1994 and 1996, a total of twenty-four finance companies, which had been restricted from dealing in foreign exchange transactions, were transformed into MBCs, thus increasing the number of participants in the international financial market. During the same period, twenty-eight branches of Korean banks were established abroad. The newly licensed MBCs, which lacked experience in foreign exchange transactions, also rushed abroad for borrowing and lending business, borrowing short term (because interest rates were lower abroad) and lending long term, thus creating a significant maturity mismatch between foreign assets and liabilities.

This rapid growth in foreign currency-denominated assets and the recognition of the potential danger arising from maturity mismatch prompted some debate in Korea on the adequacy of its supervisory system. No serious attempt was made, however, to reform the system until June 1997 when the Office of Bank Supervision introduced a guideline for the liquidity ratio, and it was only after the crisis of 1997–98 that the Ministry of Finance and Economy, which had supervisory authority over MBCs, made any serious attempt to deal with the problems (Shin and Hahm 1999).

As it turns out, the lack of prudential regulations over MBCs' foreign currency transactions was only one of the numerous problems relating to their operation. There were no basic regulations such as a capital adequacy ratio for MBCs, and the monitoring function of the Ministry of Finance and Economy (MOFE) was extremely poor. Indeed, after the crisis, several MBCs were found to have engaged in fraudulent operation (Shin and Hahm 1999).

With the entry of MBCs into the international capital market, competition in the foreign currency lending business at home intensified. To be able to compete

Table 3.5 Composition of foreign debt (US$100 million)

	1992	*1993*	*1994*	*1995*	*1996*	*1997*
Public sector	56	38	36	30	24	180
Long-term (%)	100	100	100	100	100	100
Short-term (%)	0	0	0	0	0	0
Corporate sector	137	156	200	261	356	423
Long-term (%)	47	50	45	40	38	42
Short-term (%)	53	50	55	60	62	58
Financial sector	235	244	333	493	667	605
Long-term (%)	52	53	42	40	41	56
Short-term (%)	48	47	58)	60	59	44
Total foreign debt	428	439	568	784	1047	1208
Long-term (%)	57	56	47	42	42	58
Short-term (%)	43	44	53	58	58	42
Total foreign debt/gross national product (%)	14	13	15	17	22	28

Source: Ministry of Finance (various years).

with these new players in the foreign currency-lending business, commercial banks lobbied hard to reduce the minimum ratio of their long-term liability. In 1994, they succeeded in having this ratio reduced from 60 per cent to 40 per cent. A consequence of this reduction was a rapid increase in foreign debt, especially its short-term component, starting in 1994[8] (Table 3.5). It is this 'short-termization' of the foreign debt structure, which developed along with the 'short-termization' of the domestic financial structure, that made the Korean economy increasingly vulnerable to a currency crisis.

Impact on the corporate financial structure

Financial liberalization in Korea has also brought about significant changes in the corporate financial structure. With the opening of the capital account, domestic firms now gained easier access to foreign capital. It was, however, mainly the largest five *chaebol*[9] that had already established their reputation in the world market that took advantage of the deregulation in issuing bonds and equities in the foreign capital market. Although smaller *chaebol* (6th–30th ranked *chaebol*) as well as other corporate firms could also borrow more easily from abroad, they could do so mainly through the intermediation of banks or merchant banks since they did not have well-established global reputation. Nevertheless, the ratio of total debt to assets of the entire corporate sector increased slightly from 67.6 to 72.1 per cent between 1990 and 1996 (Figure 3.1).

Given their well-established reputation abroad, the big five *chaebol* increased, starting in 1993–94, their borrowings from abroad by issuing long-term convertible bonds, thereby lengthening the average maturity of their debts. But the debt structure for other firms without such reputation deteriorated since they had to rely on the domestic financial market that was becoming increasingly short-term oriented (Figure 3.2).

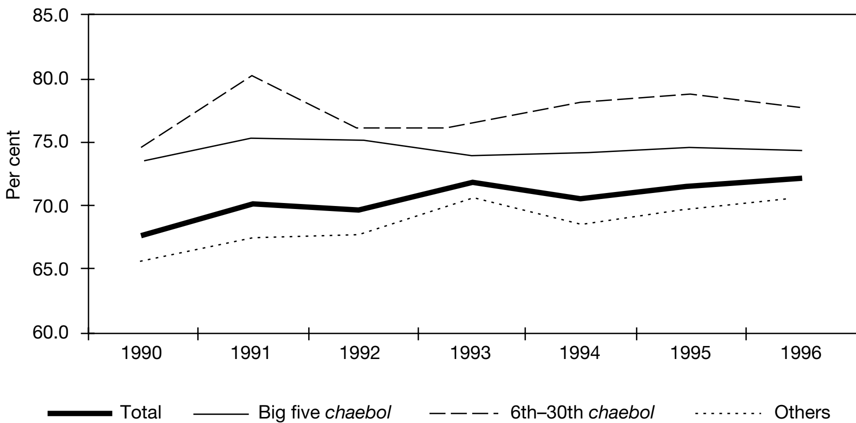

Figure 3.1 Debt/asset ratio of Korean firms.

Source: Korea Information Services.

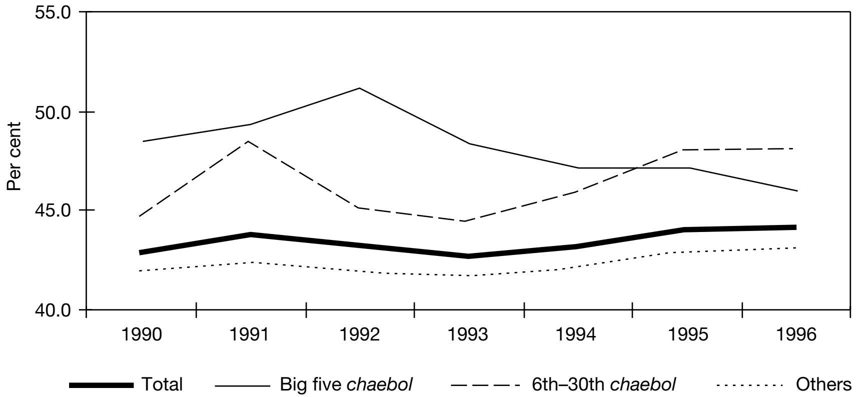

Figure 3.2 Ratio of short-term debt to assets of Korean firms.
Sources: Korea Investors Service; Kis-Fas database.

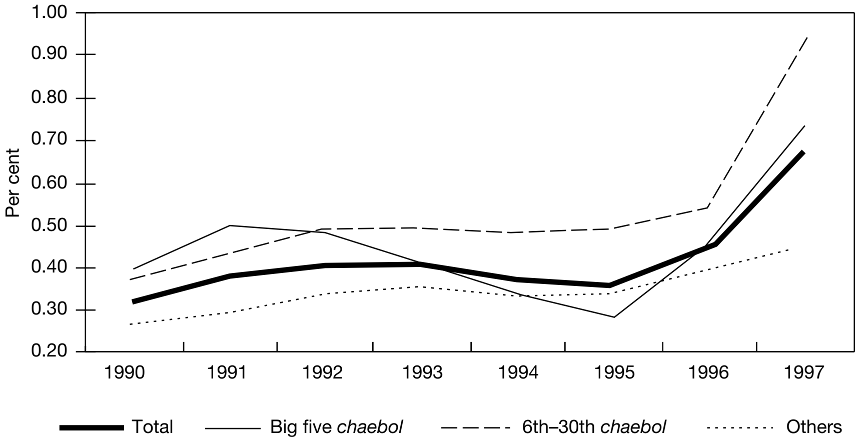

Figure 3.3 Debt-service capacity.[a]
Sources: Korea Investors Service; Kis-Fas database.
Note a. Ratio of interest payments to earnings before interest rate and tax payments.

The debt-service capacity of a firm is closely related to the domestic business cycle, deteriorating in a recession while improving in a boom. This relationship is shown for three categories of firms (the top five *chaebol*, the next twenty-five *chaebol*, and others) in Figure 3.3, where the ratio of interest rate payments to total earnings before interest rate and tax payments (EBIT) – an inverse proxy of the debt service capacity – is measured on the vertical axis. The Korean economy was in a recession in 1991–93 but began recovering in the middle of 1993. It then entered a boom in 1993–95 but fell into a recession in late 1995.

What is clearly demonstrated in Figure 3.3 is that starting in 1996, the first full year of recession, the debt-service capacity deteriorated rapidly, worse than during the 1990–92 recession, for all categories of firms.

Among the three groups of firms, the debt service capacity was the worst for the 6th–30th *chaebol* groups. Their debt-service capacity hardly improved even during the boom years of 1993–95 because they had borrowed heavily in the domestic high-cost, short-term debt market (i.e. CPs) and had over-expanded their production capacity. The recession in 1996 and a rapid deterioration in their debt-service capacity forced many of these firms to go bankrupt which, in turn, had a snowballing effect on the nonperforming loans of banks as well as nonbank financial institutions (NBFIs).

Political economy of financial liberalization

What accounts for the unbalanced manner in which financial market liberalization was undertaken in Korea? As it turned out, what ultimately determined the outcome of financial liberalization in Korea was not a coherent vision for a market-based financial system, but pressures from internal as well as external interest groups. In other words, financial liberalization was a reactive process responding to internal and external pressures and not a process implementing a carefully designed reform in tandem with reforms in other sectors (including the corporate and labor sector) and the development of a prudential financial market infrastructure that includes a credit-rating capacity and bank supervision.

The Korean government had long appreciated the adverse effects of financial repression and attempted financial liberalization starting in the early 1980s. However, several factors prevented full-scale liberalization. First, the high debt ratio that reached above 300–400 per cent for most large corporations made them highly vulnerable to external shocks. Given this highly leveraged debt structure, there was the danger that full financial liberalization would accentuate financial instability whenever there was an economic downturn. In other words, given the high corporate debt ratio and its possible implication for economic stability, the government's hands with regard to financial liberalization were tied.

Second, the government itself was not fully committed to the idea of financial liberalization as it still regarded the use of the banking system as a vehicle – a necessary tool – for achieving policy objectives such as supporting small and medium-sized enterprises and establishing strategic industries.

Third, many influential government officials were not fully convinced that a free financial market would be stable and efficient but, perhaps more importantly, they were not ready to give up their power to control the financial market.

Fourth, as *chaebol* became the dominant players in the Korean economy by the 1980s and acquired a significant degree of control over the financial system through their ownership of many of the nonbanking financial institutions, there was the fear that financial liberalization would only result in enhancing *chaebol* dominance in the financial market and the economy.

These factors made the Korean government's commitment to financial liberalization a reluctant one, even though it recognized that full financial liberalization was

something that would have to be carried out eventually. The pressure for financial liberalization was increasing, however, in both the internal and external circles as the powerful *chaebol* saw the advantage of having easy access to the global capital market and as foreign financial interests saw profitable opportunities in investing in the booming Korean economy. Under such unyielding pressures, the government finally undertook financial liberalization, giving in where pressure was strong and holding back where it was not. To better understand this haphazard financial liberalization, we need to take a careful look at one of the most important relationships in the Korean political economy – the government–bank–*chaebol* relationship and how this relationship has changed over time.

From the 1960s to the late 1980s: an authoritarian government and financial repression

Until 1987, Korean politics was characterized by authoritarianism backed by the military. The authoritarian government, not having the mandate of the people, needed to bribe intellectuals, political opponents, and journalists in order to keep them silent and obtain their cooperation. The money for such expenses was obtained in large part from *chaebol*, which the government in effect controlled through its power to allocate bank credit, determine entry into new financial and industrial activities, and carry out tax investigations. For *chaebol*, donations to the political power were an insurance premium for securing a stable line of credit, for being allowed to expand into new areas of business, and for being leniently treated in tax investigations. In this way, the government and business established a symbiotic relationship.

Chaebol continued their expansion into many new business areas with a highly leveraged financial structure. The banks extended credit without making rigorous credit analysis in the expectation that the government would bail them out if the loans they had made went sour. This system was effective in encouraging *chaebol* to venture into many new areas such as automobiles, petrochemicals, ships, steel, and semiconductors with an aggressive international marketing strategy. When these same firms ran into financial difficulties due to, for instance, a global economic recession, the government basically bailed them out. This system served the Korean economy well, contributing to its rapid industrialization when the country lacked a long-term, risk capital market (Cho and Hellman 1993, Lee 1992). It did not, however, help the banks develop the credit culture that is a foundation for a market-based financial system.

In managing such a financial system, the government had several instruments. The Bank of Korea (BOK), the central bank, was directly under the Ministry of Finance, while commercial banks, even though they were privatized in the early 1980s, were *de facto* under the control of the government. Although the government did not have a single share of the banks it could exercise control over them by appointing their managers, as there were no controlling private shareholders. The government also indirectly controlled the securities market through its control over the volume of new issues. It also controlled capital movements with its control over foreign exchange transactions.

From the late 1980s to 1997: political democratization and financial liberalization

The system described above continued more or less into the early 1990s, albeit in a weakened form from the late 1980s when political democratization began in Korea. The revision of the Constitution in 1987 brought back the system of popular vote in presidential election, and finally for the first time since 1961, a civilian, Kim Young-Sam, was elected president of the Republic of Korea.

President Kim's administration (1993–98) launched a campaign of 'deregulation' and 'globalization.' As the first president without a military background, President Kim wanted to distinguish his administration from previous ones by further deregulating markets and strengthening democratization. Another goal of his administration was for Korea to become the second Asian member of the OECD during his term in office. This motivation helped accelerate the pace of financial deregulation, including the opening of the financial market starting in 1993–94. The government reduced intervention in credit allocation and in the management of commercial banks.

Although the MOF's direct intervention in credit allocation and in the management of commercial banks was almost completely eliminated, intervention by powerful political figures remained, since the appointment of the presidents of commercial banks could still be vetoed by powerful political figures such as key party members or close associates of the President. In other words, political intervention was not removed from the financial markets although government intervention was formally and officially eliminated during the Kim administration.

The government carried out other measures of financial liberalization in the 1990s. In certain cases, however, financial deregulation was blindly pursued – for example, the elimination of asset restriction and a reduction in the reporting requirements for banks and NBFIs that had been established for prudential purposes. In addition, pressures from foreign governments and international organizations led to relaxation of entry barriers. *Chaebol* also lobbied strongly for relaxation of entry restrictions and, as a result, they were able to increase their control over NBFIs. Once the *chaebol* had acquired control over NBFIs, they lobbied for the dismantling of business restrictions on NBFIs so that they could offer new financial instruments. From early on, NBFIs were less restricted in setting interest rates and in managing assets as compared to commercial banks. Furthermore, they were free from directed credit programs. Although there were interest rate ceilings imposed on their deposits and loans, these restrictions were less strictly applied for NBFIs than to bank deposits and loans. Because of this regulatory imbalance, NBFIs could grow faster than commercial banks during the 1980s. This imbalance in the regulatory regime was, in part, due to the fact that the banks did not lobby as strongly as NBFIs for deregulation of their business. This was, in turn, due to the fact that there were no large private owners of bank shares who could gain from such deregulation.

As was to be expected, deregulation of short-term money market instruments, which were the main business of some of the NBFIs, progressed faster than deregulation of commercial bank business. Later when the banks, facing stiff competition

from NBFIs in what used to be exclusively their areas of business and suffering deteriorating profits, requested an expansion of their own business boundaries, the authorities responded by further reducing restrictions on their trust account business.[10]

Political democratization changed the way policies were made and implemented in Korea. The new government, led by a civilian president, could no longer dictate economic polices at its choosing. In this changed environment and faced with opposition from various interest groups, the government failed to carry out reforms in a timely manner. Real sector reforms, which should have preceded or at least accompanied the reforms in the financial sector, were not carried out. The government's attempts to reform the labor market and corporate governance were frustrated by strong opposition from labor unions and *chaebol* – the two most powerful interest groups in the new politically democratized Korea. *Chaebol*, through their control and influence over public media, frustrated government attempts to introduce new rules that they regarded as being against their own interest. In contrast, financial deregulation faced relatively little opposition, except from bureaucrats; as a result, it progressed more rapidly than reforms in any other sector of the economy.

The pace of financial liberalization accelerated after 1993, but not enough attention was paid to enhancing the supervisory role of the government. In fact, what happened during the drive for 'deregulation' was a diminution in this role of government since there was little recognition of the difference between prudential regulation and economic regulations. Deregulation, whatever it might be, was welcome and was to be carried out.

Another factor that interrupted the strengthening of supervision was the fragmentation of supervisory authorities and lack of effective coordination among them. Supervision of banks was the responsibility of the Office of Banking Supervision (OBS) affiliated with the Bank of Korea, whereas the supervision of most of the NBFIs was the responsibility of the MOF.[11] Even in bank supervision there was fragmentation of authorities: the banking account was subject to supervision by the OBS whereas the trust account was subject to supervision directly by the MOF.

The MOF did not have the manpower and expertise to carry out proper supervision of financial institutions, but it was reluctant to delegate the supervisory functions to the BOK. But, even if they had been transferred to the BOK, nothing fundamental would have been changed, since banking supervision in Korea had had to do more with the examination of banks' compliance with the list of credit allocation guidelines set by the government and less with the assessment of their risk exposure and the prevention of excessive risk-taking. Classification of nonperforming assets was also lax and not up to international standards.

Another reason for the unbalanced liberalization was the role of the MOF (MOFE since 1996[12]). Since the MOF was responsible for controlling the money supply and achieving high economic growth, it often had to compromise between the two conflicting goals. Since the late 1970s a target for M2 was set annually, which the monetary authorities were expected to follow closely. The Minister of

Finance served as the chairman of the Monetary Policy Board of the BOK and the Governor of the BOK served as the vice-chairman of the Board until February 1998. Thus the ultimate responsibility of monetary policy was with the MOF and not with the BOK. When it became difficult to keep M2 on target in 1993 because of an increase in long-term time deposits, the government liberalized the CP market completely.[13] This was done presumably to achieve the dual objectives of boosting the economy and keeping the target for M2, which did not include CPs in its measurement.

Industrial firms also supported the liberalization of the CP market since banks normally required detailed project plans before making loans to large projects, whereas the underwriters of CPs (the short-term financial companies or merchant banking companies) did not require such plans as long as they received an eligible rating from credit-rating agencies. CP market liberalization thus made corporate borrowers happy because they could more easily finance their projects without strict monitoring by their creditors. As it turned out, the credit agencies' rating system in Korea was not as strict and reliable as that in the United States (Cho 1999) with the result that many projects that would not be financed in the United States were financed in Korea (see Appendix 3.2 on page 101).

While being pressured to carry out financial liberalization, the authorities did not pay sufficient attention to the strengthening of the financial market infrastructure necessary for the sound operation of a market-based financial system. Financial supervisory capacity was not strengthened; poor accounting and disclosure standards were left intact; and the credit rating capacity was not enhanced. Fragmented financial supervisory authorities and lack of human skills also contributed to the inadequate provision of supervisory functions. Attempts were made to consolidate the supervisory agencies and to create a central bank independent of government intervention, but these efforts met with no success because of the bureaucratic power struggle between the MOFE and the BOK. It was only after the crisis that the government succeeded in carrying out some of the necessary reforms.

There were, however, limits to what the supervisory authorities could have done even if they had been consolidated and thus had been made more powerful. Most of the large firms in Korea were highly leveraged, and there was a common perception that large *chaebol* would not be allowed to fail because of their strategic position in the national economy. Thus, even though many large *chaebol* were expanding into new industries such as automobile and steel with a highly leveraged financial structure, the supervisory authorities could not require banks and other financial institutions to deny or reduce loans to these firms. They were afraid to do so since the denial of loans to those firms could immediately lead to their bankruptcy and the *chaebol* to which they belonged. The size of borrowers was already too large for the banks to exercise prudential loan portfolio management, and all they could do was to hope either that the investments by their borrowers would turn out to be a success or that the government would bail them out in the event the projects failed. In a sense, in an economy where the average corporate debt ratio was higher than 400 or 500 per cent and the indebted firms occupied a strategic position in the economy, the banks had become a hostage to the indebted firms.[14]

Financial liberalization in Korea weakened the government–*chaebol*–bank co-insurance scheme while increasing the control of *chaebol* over NBFIs. This strengthened *chaebol*'s internal capital market while further weakening the monitoring role of financial institutions in corporate governance. It also had the effect of weakening the government's capacity as an effective risk partner of the corporate firms when the economy turned downward.

In 1996, Korea suffered a large terms-of-trade shock and an economic recession, and many of the highly leveraged and over-expanded firms fell deeply into illiquidity, if not insolvency. Unlike in the past, the government was unable to help stop the financially troubled firms from going into bankruptcy. Six of the largest thirty *chaebol* went bankrupt in 1997 – a harbinger of a currency crisis that would shake the foundation of the Korean economy in November 1997.

In the matter of exchange rate policies, the government was also constrained by several concerns. Korea had a managed floating system and did not peg exchange rate to the US dollar as other East Asian countries did in the 1990s. But the exchange rate remained inflexible and overvalued during the most of the 1990s until the eve of the crisis. There were several reasons for that. First, capital inflows following the financial opening propped up the exchange rate despite an expanding current account deficit. Second, Korea had a large current account surplus in the second half of the 1980s in the wake of a sharp yen depreciation and became subject to increasing pressure from the US government to appreciate the Korean currency. In fact, throughout the 1990s (until the crisis) the Korean government was mindful that a significant won depreciation might cause trade disputes with the United States. Third, the government tried to achieve an inflation target that it officially set and announced every year, and keeping the exchange rate stable helped achieve this objective. The polls consistently showed that for the general public a low rate of inflation was the most important measure of the government's economic performance, and political leaders thus demanded that the government put the highest priority on price stability.

Under these circumstances the government was reluctant to allow the currency to depreciate to any significant degree although the deteriorating terms of trade and balance of payment position warranted such a measure. The exchange rate thus remained inflexible in spite of the increased volatility of capital flows and external shocks after the financial market opening.

After the crisis (1998–99)

In 1998, during the midst of the crisis, Korea began a radical financial restructuring. Out of a total of twenty-six banks, five were liquidated and four were merged. Out of a total of thirty MBCs, sixteen were closed, one was merged with another, and one suspended its business. Numerous financial institutions had their licenses revoked or suspended. In addition, the government allocated about 90 trillion won (by December 1999), equivalent to 20 per cent of Korea's gross national product, to purchase nonperforming assets and recapitalize the remaining financial institutions. For banks whose capital base had eroded, the government injected new

capital and has become the major shareholder, strengthening its control over the banking sector. Thus, ironically, the consequence of these measures was the revival of the old relationship between banks and the government – the relationship that financial liberalization was meant to sever. That is, as in the days before financial liberalization, the government now owns most of the major commercial banks although it has now used its control over these banks for corporate restructuring and not for rapid economic growth.

Since the crisis of 1997–98, the government has attempted to carry out major economic reforms such as introducing transparency in business transactions, an arm's-length relationship between banks and firms, international standards of accounting and loan classification, and improved corporate governance. Whether it will succeed in doing so, given the highly indebted and powerful corporate sector, remains yet to be seen.

Concluding remarks

Before the 1997–98 crisis, many people in Korea as well as abroad advocated financial liberalization as a way, if not the only way, of improving the efficiency of Korea's financial system. Korea's experience in financial liberalization, however, suggests that an efficient market-based financial system is not something that can be created by simply removing state intervention from the financial market. It has clearly demonstrated that there is a limit to how far financial liberalization can be carried out in an economy where the corporate sector is highly leveraged, supervisory capacity is weak, good corporate governance is absent, and the financial market infrastructure is underdeveloped. Financial liberalization in such a setting could instead expand reckless investments by the corporate sector, aggravate its financial structure, and intensify the vulnerability of the entire economy to the business cycle.

In Korea, the importance of proper sequencing of economic reform might not have been fully understood. But even if it had been, the political economy of reform in Korea would have made a properly sequenced implementation of reform difficult, if not impossible, as real sector reforms were strongly opposed by Korea's two powerful interest groups – *chaebol* and labor unions. The former were opposed to the strengthening of the rules for fair trade and the adoption of good corporate governance and disclosure standards for corporate accounting, while the latter were opposed to labor market reforms that would have made the labor market more efficient and flexible. Furthermore, there was no pressure from either multilateral institutions or the United States for real sector reforms. In contrast, there was significant pressure for financial liberalization from the international financial community and the United States, while there was little domestic political resistance except from bureaucrats.

It is now clear that financial liberalization in Korea was not carried out under the guidance of a clear vision and a well-laid-out strategy but was instead driven by political pressure. Restrictive regulations were removed in the areas where the pressure was strong, while they were kept in the areas where pressure was weak or

absent. Sometimes it was driven by the political campaign of 'deregulation' and an obsession with the 'number' of the regulations eliminated. The consequence of such haphazard financial liberalization was a financial system that was distorted and unbalanced among its various component parts. This further weakened the financial structure of the corporate sector and made it more vulnerable to external shock.

The Korean experience suggests that financial liberalization cannot be successfully carried out without real sector reforms. It requires, among others, reform in corporate governance and the development of relevant infrastructure such as credit rating, supervisory capacity, and reliable accounting disclosure practices. It also requires a clear vision and a careful strategy that is backed by strong political determination.

Appendix 3.1 Four-stage liberalization of interest rates

		Measures
First stage		**Implemented in November 1991**
	Deposits	*Bank: CD, large denomination RPs, commercial bills & trade bills, time deposits with maturity of three years (new) *Nonbank: large denomination CPs, time deposits with maturity of at least three years, time deposits of mutual savings & finance companies with maturity of at least two years, etc.
	Loans	*Bank: overdrafts, discounts on commercial paper apart from loans assisted by BOK rediscounts, overdue loans *Nonbank: discounts on commercial bills of trust, mutual savings & finance companies, insurance, discounts on CPs & trade bills of investment finance corporation, etc.
	Bonds	Corporate bonds with maturity of at least two years
Second stage		**Implemented in November 1993**
	Deposits	*Bank: time deposits with maturity of at least two years, installment-type deposits with maturity of at least three years such as installment savings, mutual installments, etc. *NBFIs: time deposits with maturity of at least two years, installment-type deposits with maturity of at least three years such as installment savings, mutual installments, etc. *Mutual savings & finance companies: time deposits with maturity of at least one year and installment savings with maturity of at least two years, etc.
	Loans	*All loans of banks and nonbank financial institutions except policy loans
	Bonds	Corporate bonds with maturity of less than two years, financial debentures, government & public bonds; minimum maturity of CPs was reduced to two months
Third stage		**Partially implemented in July 1994**
	Deposits	*Shortened the minimum maturity of CP (from 91days to 60 days) and allowed the issue of bank cover bills
		Partially implemented in December 1994
		*Time deposits with maturity of less than two years and installment savings with maturity of two years or less than three years

Appendix 3.1 (continued)

		Measures
	Loans	*Liberalized the interest rate of loans with an aggregate credit ceiling system of BOK to the extent of prime rate
		Partially implemented in July 1995
	Deposits	*Time deposits with maturity of six months or less than one year and installment savings with maturity of one year or less than two years; expanded short-term marketable products liberalization (shortened the minimum maturity and lowered the minimum issue denomination)
	Loans	*The interest rate of loans with an aggregate credit ceiling system of BOK
		Full implementation in November 1995
	Deposits	*Time deposits with maturity of less than six months and installment savings with maturity of less than one year, etc.; preferential savings & company savings with maturity of at least three months; expanded short-term marketable products liberalization (lowered the minimum issue pars)
Fourth stage		**Implemented in July 1997**
	Banks	Savings deposits, preferential savings with maturity of less than three months and MMDA; company savings with maturity of less than three months and MMDA
	Merchant banks	Bills issued with maturity of less than one month
	Investment trust	Trust-type securities savings
	Mutual savings	Passbooks
	Mutual credits & credit unions	Preferential time & savings deposits with maturity of less than three months
	Community credit co-operatives	*Deregulated the maturity of short-term marketable products (CD, RP, CP, etc.), the minimum denomination, repurchasing fee of trust companies, interest rate of time deposits with maturity, etc.

Appendix 3.2 Credibility of credit rating agencies in Korea*

An analysis of the record of credit rating of the two credit rating agencies in Korea on the 40 bankrupt companies in 1997 suggests that Korean rating agencies were much more lax and unreliable, compared to their counterparts in advanced economies. A comparison of their ratings with ratings by a U.S. company, Standard & Poors in 1995 is given below.

Credit rating: A comparison between domestic agencies and S&P

Domestic agencies' 1997	*Average 1996*	*1995*		*Standard & Poors 1995*
8.4%	8.2%	6.4%	AAA	1.2%
17.9%	22.0%	21.1%	AA	5.4%
31.1%	33.8%	32.5%	A	16.2%
40.6%	35.9%	40.0%	BBB	19.5%
0.4%	0.2%	0	BB	26.1%
1.3%	0	0	B	28.6%
0.3%	0	0	CCC	1.1%

Sources: Korea Investors Service, Kis-Fas database.

While the ratings from A1 to A3 make up about 65 per cent in Korea, the equivalent ratings from AAA to A are only 22 per cent in the US. A rating of 'B' is a minimum requirement for issuing CPs in Korea, and companies that received a B or above were 98 per cent in 1997, while companies rated BBB (the equivalent rating to the Korean rating) or above were only 42 per cent in the US. The rating of AAA, which is the highest rating for securities, was conferred to only 1.2 per cent of total listed companies in the U.S., while A1 companies made up about 8 per cent in Korea in 1997. Ratings on forty companies during 1991–97 that went bankrupt during 1997–98 were also examined. During that period, there was almost no change in the ratings and no difference between the two agencies. Even in the year of financial distress, 1997, there were only two rating adjustments for Korean firms.

* The source of the information contained in Appendix 3.2 is Cho (1999).

Notes

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1 See Cho (1998a, 1998b) for a detailed discussion of structural problems that caused the widespread insolvency of firms.

2 A more formal elaboration of this can be found in the framework of Diamond (1984) where a bank (financial intermediary) comes into being due to its comparative advantage as a delegate monitor over individual lenders. An intuitive definition of credit culture is

'a set of generally accepted business practices in which, for example, debts are normally honored and the value of assets can be and is consistently evaluated' (Truman 1995).

3 For more detailed analysis on this subject, see Cho (1999).

4 See Cho (1998b) for more on the major financial reform experiences of Korea during the last three and a half decades.

5 The government allowed the Securities Association to determine who would be able to issue the bonds, the overall amount of which was guided by the government. Usually the Securities Association allocated the amount among applicants. The reason why the government was so concerned with the level of corporate bond yield was because it was the most observable market rate.

6 Korea had not had deposit insurance scheme until the end of 1996. But depositors believed that there was an implicit guarantee by the government not only on deposits but also on trust account at the banks.

7 A broad limit of long-term borrowings was guided by the balance-of-payment projection (or target) of the year.

8 See Cho (1998c) for detailed analyses of the development of the maturity mismatch problem.

9 They are Hyundai, Samsung, Daewoo, Lucky-Goldstar (LG), and Sunkyung (SK).

10 Korean banks were involved in the trust business since the early 1980s, which in practice is equivalent to securities investment and trust business. As the banks were losing their market shares in the 1980s and suffered from low profitability due to heavy government regulations, they were allowed to engage in the trust business to increase their profitability. Loans from trust accounts were allowed higher interest rates than loans from banking accounts even though they were essentially the same and were from the same bank.

11 However, the head of the OBS had to report to the Minister of Finance. The BOK did not have independence not only in monetary policies but also in bank supervision.

12 The MOFE was established at the end of 1995 by merging the former Economic Planning Board (EPB) and the Ministry of Finance (MOF). In Korea, the EPB was a senior ministry among economic ministries and responsible for the coordination of economic policy and for deciding the direction of macroeconomic policy. Now the MOFE is responsible for the overall economic management and performance and has authority over the budget, tax, monetary and financial policies, and coordination of domestic and international economic policies.

13 They also deregulated bank trust accounts to allow purchase of CPs. Bank trust accounts are not included in M2.

14 This challenge remains valid after the crisis.

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4 From financial liberalization to crisis in Malaysia

Kok-Fay Chin and K.S. Jomo

Introduction

Together with several other economies in Southeast Asia, Malaysia experienced a currency crisis from mid-1997 that, in turn, precipitated a financial crisis and eventually led to a severe recession in 1998 after almost a decade of rapid economic growth and industrialization. Once considered by the World Bank (1993) as an impressive example of successful development, the Malaysian economy was transformed from an economic 'miracle' into a 'debacle' from mid-1997.

There are many competing explanations for this unprecedented crisis. Many popular accounts, especially in the Western-dominated international media, have portrayed the crisis as primarily one of crony capitalism (Jomo 1999). Others have focused on the vulnerability of the national financial systems in the region with growing international financial liberalization (e.g. Jomo 1998a). Some observers have also highlighted the large current account deficits, largely financed by capital account surplus, that Thailand and Malaysia had during most of the early and mid-1990s.

Immediately following the onset of the crisis, many observers assumed that the crisis was due to poor macroeconomic management, as suggested by the second-generation theories of currency crisis. Except for large current account deficits and worsening savings-investment gaps, Malaysia's macroeconomic fundamentals were generally sound prior to the crisis (Table 4.1). Over the previous decade, Malaysia had enjoyed rapid growth, stable inflation, falling unemployment and fiscal surpluses. As such, these theories, which focused on public sector debt as they related to fiscal deficits, were also clearly irrelevant for explaining the financial crisis in Malaysia.

Once it was clear that the region's macroeconomic balances were not seriously awry, various commentators, including US Federal Reserve Board Chairman Alan Greenspan, began to focus on alleged cronyism and its supposed consequences as the new explanation for the crises. Nebulous catchall terms – such as cronyism and Asian values as well as business practices – seemed to provide ready-made explanations for the crises. Differences in organizations, relations, practices, and norms that had previously been credited with the East Asian miracle by some commentators were now condemned as the sources of the financial debacle.

Table 4.1 Selected macroeconomic indicators, 1991–97 (percentage)

Year	*Growth in real GDP*	*Inflation*	*Unemployment rate*	*Fiscal balances (as a share of GDP)*	*Current account (as a share of GDP)*
1991	8.7	4.4	4.0	–2.0	–9.2
1992	7.8	4.7	3.7	–0.8	–3.8
1993	8.3	3.6	3.0	0.2	–4.8
1994	9.2	3.7	2.9	2.3	–6.3
1995	9.5	3.4	2.8	0.9	–8.5
1996	8.6	3.5	2.6	0.7	–4.9
1997	7.7	2.7	2.6	2.4	–5.1

Source: Bank Negara Malaysia, *Annual Report*, 1996 and 1998 issues.

Popular versions of the political economy of rent seeking were readily invoked and deployed in the post-crisis discourse as if to explain all, while in fact, often explaining nothing.

A popular explanation of the East Asian crisis emphasizes corruption and cronyism, as well as lack of transparency. This diagnosis, however, fails to provide a satisfactory explanation as to why the crisis, which started in Thailand, spread to the rest of the region so quickly, leading to massive disruption of the region's economies. So-called 'crony capitalism,' which has presumably existed for some time, fails to explain how Malaysia sustained rapid growth for four decades after independence in 1957 without experiencing an earlier financial crisis of comparable magnitude. More importantly, as pointed out by UNCTAD (1998), this explanation also ignores the similarities of the Asian crisis with the financial crises in developed and other developing economies, which had been occurring with increasing frequency since the late 1970s.

Despite ongoing debates about the significance of macroeconomic fundamentals and crony capitalism as causes of the East Asian economic crises, there is now little disagreement that they began as currency and financial crises. It will be argued here that the currency and financial crises in Malaysia became a crisis of the real economy mainly due to the government's policy responses and partly due to financial market demands and the IMF. Related work (Montes 1998, Jomo 1998b) shows that the crises have been due to the undermining of the previous systems of international and national economic governance due to deregulation and other developments associated with financial liberalization and globalization. In other words, the erosion of effective financial governance at both the international and national levels created conditions that led to the crises.

Malaysia has practiced selective state intervention that is motivated by non-developmental considerations (Jomo *et al.* 1997). Such intervention – now often cited as evidence of 'crony capitalism' – bears some responsibility for the crisis in Malaysia. More importantly, non-developmental considerations have influenced government policy responses in ways that have undoubtedly exacerbated the crisis. In other words, while 'crony capitalism' does not explain the origins of the crisis, except in so far as

crony financial interests were responsible for the financial policies from the mid-1990s that led to the crisis, it certainly exacerbated the crisis in Malaysia.

It is worthwhile emphasizing at the outset that Malaysia's experience differs in at least four respects from those of other East Asian economies that were hit by the crisis. First, although prudential regulation and supervision had weakened with growing financial liberalization, especially since the mid-1980s, the situation in Malaysia was not as bad as elsewhere in the region. Second, although the Malaysian banking system contributed to asset price inflation by making loans for property and share purchases, Malaysian banks and corporations were allowed far less access to foreign borrowings than their counterparts in other crisis economies in the region. Unlike in the other economies, foreign bank loans did not figure as significantly in the Malaysian crisis; instead, capital market flows, especially those into and out of the stock market, figured more prominently. Third, as a consequence of its reduced exposure to private bank borrowings from abroad, Malaysia was not in a situation of having to go cap in hand to the International Monetary Fund (IMF) or to others for emergency international credit facilities. Fourth, for most of the second half of 1997, and again from mid-1998, the Malaysian authorities deliberately pursued unconventional measures in response to the deteriorating situation, with rather mixed results.

To trace the roots of the currency and financial crises in Malaysia, we begin with a discussion of financial developments in the country prior to the crisis before considering the broader macroeconomic situation.[1] Given the dominance of the banking system and the growing importance of the stock market, our discussion will concentrate mainly on banking and stock market developments to give insights into the structure of Malaysia's financial system. Analysis of the characteristics of financial developments and reforms in the years leading to the crisis will shed light on how financial interests and liberalization have undermined effective financial governance, both at the international and national levels, causing greater vulnerability of the system to crisis.

We show in this chapter how financial interests favored certain policies, including selective financial liberalization, which led to increased lending for unproductive purposes, asset price inflation, massive reversible short-term capital inflows and an overvalued currency.

Development of the financial system

Although Malaysia's financial system was relatively developed during the British colonial era and in the early post-independence period compared to other developing countries, it played a limited role in financial intermediation, the main function of banking services being that of facilitating trade. Banks mainly provided funds for agency houses, which dominated the exports of the country's primary commodities (tin and rubber) as well as the imports of consumer and capital goods.[2] Financing was thus essentially short term and self-liquidating as it was mostly in the form of bills of exchange, letters of credit, overdrafts and trust receipt facilities, which normally did not exceed 180 days in maturity and was repaid as soon as the goods concerned were received or exported (Hing 1987: 421).

Conscious efforts to develop the financial system only began after the establishment of the Central Bank of Malaya, which was renamed Bank Negara Malaysia (BNM) after the formation of Malaysia in September 1963. Since then, the financial system has been restructured, reorganized, and reshaped to meet the increasing investment needs of the growing economy. It has certainly become much deeper, broader, and more diverse, with a host of institutional developments taking place over the decades.

The banking system in Malaysia, which has always been the core of the financial system, consists of not only monetary institutions (comprising BNM and commercial banks including Bank Islam) but also non-monetary financial institutions, including finance companies and merchant banks. The turn of the decade also saw aggressive promotion and rapid growth of the capital market. In recent years, the government has adopted several measures to promote a venture capital market in order to facilitate the mobilization of financial resources for technology development in the manufacturing sector.[3]

The data in Table 4.2 reflect growing monetization and financial deepening in Malaysia. The M2/GNP ratio increased from 0.46 in 1975 to 0.70 in 1985, and subsequently to 1.11 in 1997, reflecting rapid monetization in the country. This is also reflected in the sharp increase of the M2/M1 ratio, from 2.3 in 1975 to 3.71 in 1985 and to 4.61 in 1997. The increasing monetization of the economy has been accompanied by further deepening of Malaysia's financial system. The M3/GDP ratio in 1997 was more than double its value in 1980, although the transaction demand for M1 relative to GDP remained fairly stable over the period.

Table 4.2 Monetization and financial deepening, 1975–97

	1975	*1980*	*1985*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*[a]
M1/GNP	0.20	0.19	0.19	0.22	0.22	0.22	0.27	0.26	0.25	0.25	0.24
M2/GNP	0.46	0.54	0.70	0.76	0.78	0.81	0.89	0.89	0.96	0.98	1.11
M2/M1	2.30	2.87	3.71	3.46	3.57	3.77	3.35	3.45	3.83	3.85	4.61
Currency/M1	0.51	0.49	0.46	0.41	0.41	0.40	0.32	0.34	0.34	0.31	0.34

Source: Bank Negara Malaysia, *Quarterly Economic Bulletin*, various issues.
Note: a. Bank Negara Malaysia estimates.

The banking system

Generally, differences between financial systems have been the result of interactions of a number of factors that have exerted influence over a long period of time (Rybczynski 1984: 280–2). The evolution of different financial systems can be traced back to the political, social, and economic history of the countries concerned. Being a former British colony and greatly influenced by trends in the United Kingdom and the United States since independence, the Malaysian financial system has exhibited many features of the Anglo-American model, which restricts banking activities to accepting deposits, granting loans, and other specified activities.

During the early postcolonial period, loans advanced for general commerce remained high, reaching 42 per cent of total loans of the commercial banking system, while those advanced to agriculture and manufacturing were low, amounting to less than 20 per cent. Even in 1960, loans for general commerce constituted about 25 per cent of all loans of the financial system while those for manufacturing and agriculture were less than 15 per cent (Table 4.3). As Ho (1990: 2) commented: 'Banks concentrated on discounting of trade bills, providing the letters of credit and checking the creditworthiness of traders and merchants. In this sense, they were nothing more than foreign outfits to process trade papers and to act as insurers for merchants.'

The turn of the last decade saw two important developments with enormous implications for the future development of Malaysia's financial system. In 1989, the Banking and Financial Institutions Act (BAFIA) was passed by Parliament, with vast implications for governance of the financial system. Soon after, the Kuala Lumpur Stock Exchange (KLSE) broke off from its Siamese twin, the Stock Exchange of Singapore (SES), paving the way for its subsequent rapid growth.

Despite the relatively recent rapid growth of the securities market in Malaysia (first established in the early 1960s by the Malaysian Industrial Development Finance), the banking system had long remained the main source of funds for the private sector in both absolute and relative terms. But being fashioned after the Anglo-American model, banks in Malaysia are kept at an arm's length from corporate governance and management. They also tend to be conservative, mainly extending loans on the basis of collateral, rather than project viability. As noted by Hing (1987: 422): 'These policies . . . impose on industry a similarly cautious and short-term view of investment, profitability and profit allocation, and inhibit long-term or high-risk industrial investment.'

Under the Banking (Control of Acquisition and Holding of Shares) Regulations of 1968,[4] a domestic bank could only invest up to 10 per cent of its paid-up capital and reserves (or 10 per cent of the net working funds in the case of a foreign bank) in trustee shares. In aggregate, a domestic bank was not permitted to hold shares of companies that owned more than 25 per cent of the bank's paid-up capital and reserves, while a foreign bank was not permitted to invest in such shares in excess of 25 per cent of its net working funds (BNM *Annual Report 1989*: 101).

Table 4.3 Direction of loans and advances of the financial system by sector, 1960–92 (percentage share)

Sector	*1960*	*1970*	*1980*	*1988*	*1990*	*1992*
Manufacturing	7.9	15.5	19.9	16.5	19.0	18.4
Agriculture	5.6	23.0	8.4	5.8	4.9	4.1
General commerce	24.7	13.7	18.0	12.5	10.1	8.2
Broad property[a]	15.7	13.1	27.6	34.5	27.9	28.3

Source: Bank Negara Malaysia, *Annual Report*, 1989 and 1994 issues.
Note: a. Comprises construction, real estate and housing.

Apart from historical accidents, many institutional arrangements and developments in the financial system have been due to the regulatory framework, which has evolved over the decades. Commercial banks – the oldest established financial intermediaries – have remained the largest institutions within the banking system, with total assets worth RM362 billion or 57.5 per cent of the total assets of the banking system in 1996 (BNM *Annual Report 1997*: 85). Their significance has been due to their roles as retail deposit takers as well as providers of current accounts. They provide financing in the forms of overdrafts, trade bills, and term loans. This traditional pattern of lending has, however, changed significantly over time, as reflected by the declining share of general commerce in total loans and advances since independence (Table 4.4). Another positive development in the evolution of commercial bank lending has been increased term lending, lengthening the average maturity period for credit. There was a decline in the use of overdrafts for short-term financing – from 37.2 per cent of total loans and advances in 1978 to 29.7 per cent by the end of 1990 (Zainal *et al.* 1994: 307). This can partly be attributed to the BNM urging commercial banks to emphasize term lending in view of the rising demand for long-term credit with rapid industrialization and economic growth.

The 1965 establishment of Bank Bumiputra, the first state-owned commercial bank in Malaysia, marked the beginning of active direct government intervention in finance. Following a resolution of the First Bumiputra Economic Congress in 1965, the state-owned bank was set up in 1966 to provide commercial loans to Malay entrepreneurs. The government became a major shareholder of Malayan Banking in 1969 after a run on the bank in 1966. By 1976, when the then United Malayan Banking Corporation (UMBC)[5] came under government control, the government dominated the banking system, owning the three largest commercial banks in the country.

Table 4.4 Commercial bank lending and advances to selected sectors, 1960–96 (percentage share)

	Manufacturing	*Agriculture*	*General commerce*	*Broad property*[a]
1960	10.4	7.2	42.2	3.7
1965	15.3	8.5	37.1	7.3
1970	19.8	10.2	32.1	8.8
1975	19.6	7.5	26.6	18.9
1980	22.3	7.9	22.1	25.4
1985	17.5	6.0	17.9	34.7
1990	23.2	5.2	14.4	18.1
1991	23.8	4.5	12.6	28.8
1992	23.4	4.3	11.9	32.0
1993	22.5	3.4	11.4	31.6
1994	23.0	2.5	10.8	29.3
1995	23.3	2.1	10.5	29.3
1996	21.0	2.0	9.8	30.3

Sources: Lee (1987: 312–13); BNM *Annual Report*, 1992 and 1997 issues.
Note: a. Comprises construction, real estate and housing.

These state-owned banks were used to facilitate implementation of the New Economic Policy (NEP), introduced in 1970, especially for redistribution as well as the heavy industrialization program that the government launched in 1981. The state-controlled joint venture with foreign capital began to invest in heavy industries such as Perwaja Steel and Proton (Perusahaan Otomobil Nasional Berhad). These state-sponsored corporations have received loans at subsidized interest rates.

The first half of the 1980s saw many abuses by the directors and staff of banks and finance companies in lending operations. Some major Bumiputra-controlled conglomerates emerged then, mostly under the patronage of powerful politicians, with soft loans from state-owned banks and the award of major projects and lucrative licenses as well as other business opportunities including privatization (Gomez 1994: 9).[6] The ownership of financial institutions and top corporations by the government and by state-owned enterprises and, later, the privatization of some of them served to encourage such developments. Huge loans could be obtained without going through proper procedures, and were often given for speculative get-rich-quick schemes, rather than for productive investments.

Meanwhile, many major corporate groups controlled by non-Bumiputras, mainly ethnic Chinese and Indians, have also grown due to political patronage, arising from close ties with powerful, often, Malay politicians (Gomez and Jomo 1997). During the height of implementation of the ethnic redistributive New Economic Policy, many Chinese capitalists minimized their vulnerability to long-term risks by moving capital abroad, mainly from the mid-1970s until the late 1980s (Jomo 1990). Within the country, many preferred short-term investments in construction, commercial property, and residential housing at the expense of longer-term investments such as those in manufacturing.

The 1980s saw the mushrooming of poorly regulated deposit-taking cooperatives (DTCs) with weak capital bases engaging in speculative and unproductive investments, as well as connected lending to or investments in subsidiaries and related companies. Taking advantage of the more liberal interest rate regime and lax regulation, most of these DTCs, which were already insolvent due to hidden losses from heavy investments in shares and property, offered higher deposit rates and attractive commission for their staff to attract deposits. This created the illusion of high liquidity and disguised the rapid deterioration of their actual asset position (BNM *Annual Report 1987*: 129). By the mid-1980s, twenty-four ailing DTCs had collapsed, involving over 522,000 depositors and total deposits of RM1.5 billion (Sheng 1989: 22). As pointed out by Hino (1998: 7), 'the presence of small institutions came to pose systemic risks, not only because of the large number of such institutions that failed, but also because these weaker institutions had attracted larger shares of banking system deposits.'

After the DTC scandal, as well as the stock and property market crashes from the mid-1980s, the Banking and Financial Institutions Act (BAFIA) was passed by Parliament in 1989, with vast implications for governance of the financial system. For example, effective 1 September 1989 it broadened the scope of permissible investments by commercial banks. They were now allowed to invest in Malaysian Airline System Berhad (MAS), the Malaysian International Shipping Corporation

(MISC), other approved 'blue-chip' shares, and shares of manufacturing companies and property trusts, subject to prescribed limits (for details, see BNM *Annual Report 1989*: 101, Lee 1992: 281).

Malaysia has had restrictions on the entry of and branching by foreign banks, but on 1 October 1990, the government created an international offshore financial center (IOFC) on the island of Labuan. To make this financial center comparable to some of the 'best' IOFCs around the world, a relatively liberal regulatory environment was established on the island. For example, exchange rate control regulations pertaining to offshore business activities were made very liberal; and preferential tax treatment for income, profits, dividends, and interest earned from offshore business activities was offered.[7] By the end of December 1993, twenty-one banks held Ministry of Finance licenses to conduct offshore banking activities in Labuan (BNM *Annual Report 1994*: 46).

Some of the previous efforts to deregulate the Malaysian financial system encouraged the proliferation of unproductive investments in, for example, the property sector. Following the liberalization of interest rates in October 1978,[8] there was a property boom, reflecting the banking sector's preference for making collateralized loans with high rates of return rather than for productive long-term investments. In fact, as shown in Table 4.5, the share of bank credit to the property sector rose from 8.8 per cent in 1966–70 to 33.5 per cent in 1986–90, before declining slightly to 30.5 per cent in 1992–96.

This huge increase in property-related lending – which reflected the greater profitability of real estate investments – contrasts with the relatively modest importance of building and construction in GDP. Loans by the banking system for consumption credit also rose, together with loans for purchases of stocks and shares. Bank lending to the stock market began only in the late 1970s and averaged 3.8 per cent during 1992–96. As a result, the share of bank credit to the manufacturing sector rose modestly, while the proportion of lending to agriculture actually declined during the same period, despite a sharp increase in the manufacturing sector's share of GDP and agriculture's continued, albeit more modest, growth.

Malaysian banks tend to be conservative, mainly extending loans on the basis of collateral rather than project viability (Hing 1987). This emphasis on loan

Table 4.5 Distribution of bank credit for select purposes, 1966–96 (percentage)

	Manufacturing	*Property*[a]	*Shares*	*Agriculture*
1966–70	2.6	8.8	–9.2	–
1971–75	8.5	17.0	–	8.6
1976–80	18.8	22.5	1.8b	7.1
1981–85	21.1	32.0	1.8	6.5
1986–90	20.1	33.5	2.4	5.6
1990–96	22.6	30.5	3.8	2.9

Sources: BNM *Quarterly Economic Bulletin* and *Annual Report*, various issues.

Notes: a. Property includes loans for building, construction, real estate and housing.
b. 1979–80.

security has favored loans to the real property sector and for share purchases and consumption rather than production when the property and stock markets have been bullish. Only about a quarter of Malaysian commercial bank lending went to manufacturing, agriculture, and other productive activities (Tables 4.4 and 4.5). This modest share for productive investments is likely to be even smaller for foreign borrowings, most of which have been collateralized with assets such as real property and stocks. The lack of incentives for Malaysian bankers to favor long-term lending for productive investments is one reason for the limited development of Malaysian manufacturing capabilities, especially in non-resource-based export-oriented industries, which are dominated by foreign investors. Export-oriented manufacturing only accounts for a very small percentage of total outstanding loans extended by commercial banks. With the exception of export credit and some relatively minor financial institutions, there is little evidence that the government has used financial policy as an instrument for promoting industry (Chin and Jomo 2000, Chin 2000).

A BNM survey of private investment in Malaysia found that the lack of bank credit to the manufacturing sector caused firms to increasingly rely on internally generated funds. On average, surveyed firms financed 52 to 66 per cent of their capital expenditure from internally generated funds during 1986–90, while bank financing accounted for only about 10–14 per cent. Although banks still provided a larger share of external finance than the capital market (ranging from 1 to 8 per cent), this probably reflected the less-developed state of the capital market relative to the banking system at that time. Company size was also found to be an important determinant of access to credit, with larger companies enjoying, on average, lower credit costs. This could be due to the fact that financial institutions imposed less stringent requirements for loans to larger companies since they had better track records and reputations than did smaller companies (Zainal *et al.* 1994: 313). This 'discrimination' was more pronounced during the recession of 1985–86, when the average cost of credit for large companies was almost 11 per cent lower than for small and medium-sized enterprises.

In the mid-1990s, well before the crisis, the BNM attempted to consolidate Malaysian banks in anticipation of further financial liberalization. A new two-tier regulatory system, which sought to provide incentives for smaller banks to re-capitalize and merge, was introduced in December 1994. To qualify for tier-one status, which allows a bank the privilege of handling certain lucrative types of transactions (such as opening foreign currency accounts), banks had to have an equity base of at least RM500 million.

Banks in Malaysia have been heavily used by the state with the New Economic Policy. With increasing Bumiputra dominance of the Malaysian banking system from the 1970s, financial restraint was used primarily to ensure bank profitability. As Bumiputras advanced their interests in the financial sector, competition was limited in some areas, especially from foreign banks, in order to enhance rents for bank owners. However, other policies encouraged wasteful competition in the banking sector that eroded some of these rents. For example, lucrative banking margins fostered too many bank branches competing for limited business in many

areas, resulting in socially wasteful duplication and limiting scale economies in the provision of banking services (Chin and Jomo 2000).

The almost singular preoccupation with inter-ethnic economic redistribution has compromised the purpose, nature, and quality of state intervention generally, and of financial policy in particular. In other words, financial policy in Malaysia has been used more as an instrument for inter-ethnic economic redistribution and other related public policies, and less as an instrument for promoting long-term productive investments, especially in non-resource-based export-oriented manufacturing.

It should be pointed out, however, that it was not the New Economic Policy, with all its consequences for banking, which caused the recent financial problems culminating in the crisis. Rather, the roots of the crisis can be traced to inappropriate and improperly sequenced liberalization of the Malaysian banking system. Malaysia should have been much more prudent in deregulating the domestic financial sector. With appropriate deregulation as well as continued prudential regulation (e.g. regulation of capital flows to constrain their exit), Malaysia may have been able to mitigate some of the worst excesses that contributed to the recent crisis.

Stock market development[9]

Since the late 1980s, promotion of stock markets all over the world by the International Finance Corporation (IFC) of the World Bank has resulted in the growing significance of equity finance and stock markets in the Southeast Asian region, especially in Malaysia with its British colonial heritage. The split between the Kuala Lumpur Stock Exchange and the Stock Exchange of Singapore at the end of the 1980s gave momentum to the growth of the stock market in Malaysia. The 1992 passage of the Securities Act and the subsequent establishment of the Securities Commission (SC) gave further impetus to stock market growth in Malaysia.

Share trading in Malaysia began as early as the 1870s, involving British companies dealing primarily in rubber, tin, and international trade. Public trading of stocks and shares was not undertaken until May 1960 when the Malayan Stock Exchange was established (Drake 1969: 210, Zeti 1989: 90–1). The exchange was renamed the Stock Exchange of Malaysia in 1964 after the formation of Malaysia on 14 September 1963. It was later renamed the Stock Exchange of Malaysia and Singapore after the separation of Singapore from Malaysia in 1965, but it continued to operate as a unified stock exchange with separate trading rooms in Kuala Lumpur and Singapore (Zeti 1989: 92). In 1990, the stock market in Kuala Lumpur broke off from its twin, paving the way for its subsequent rapid expansion.

As noted by Singh (1995: 27), contemporary stock market development in many developing countries has not been a spontaneous response to market forces, but rather, governments have played a major role in the expansion of these markets. This is particularly true of Malaysia. Between September 1961 and June 1964, the embryonic stock market enjoyed a boom (Drake 1975), but in 1965, it turned bearish,[10] plagued by the existence of counterfeit shares. From 1968, however, under the supervision of the Capital Issues Committee (CIC) and with the

government requirement that companies granted pioneer status tax relief must go public, there was marked growth in new market issues (Zeti 1989: 97).

With the promulgation of the NEP in 1970, redistribution, especially along inter-ethnic lines, became the most important government public policy priority. Since 1976, firms issuing shares to the public have had to offer 30 per cent of their equity to Bumiputras. The Foreign Investment Committee (FIC) has become an important government body to monitor and influence non-Bumiputra and foreign-owned corporations to restructure their equity to comply with the NEP's ownership regulations. Together with the FIC, the CIC sets the prices of shares issued by local Chinese and foreign firms to Malay interests, including special government-financed trust agencies and investment funds for Bumiputras.

The prices were usually set below market prices[11] to ensure positive returns for these special investment funds to accelerate capital accumulation and speed up acquisition of corporate assets on behalf of Bumiputras. Ariff *et al.* (1993) argued that excessive under-pricing of Malaysia's initial public offerings (IPOs) was mainly due to government intervention in price setting, and not merely the consequence of asymmetric information, a winner's curse, or *ex ante* uncertainty or seasoning.[12] Excessive under-pricing of new issues has meant good prospects for capital gains through immediate sale in the market after successful subscription allocation, resulting in the over-subscription of new issues (Table 4.6). As a result of the significant under-pricing of IPOs, particularly in the case of the KLSE Second Board[13] new listings (Securities Commission 1996: 73), the over-subscription of Second Board IPOs grew rapidly, almost catching up with those of the Main Board, which generally have been hovering around 50 times IPOs. In addition, the possibility of making quick tax-exempt capital gains encouraged even more to subscribe to new shares (Ng 1989: 44).

The stock market has grown with considerable support from the government and from those who have sought to use the stock market and publicly listed firms to capture various types of rents and secure better access to relatively cheap funds (Chin and Jomo 2000). In August 1985, the Finance Minister allowed banks to give up to 100 per cent loan support for share purchases, despite persistent warnings from

Table 4.6 Over-subscription rates of new listings, 1989–96

Year	*Main Board*	*Second Board*
1989	56.3	14.6
1990	52.5	20.1
1991	33.6	25.2
1992	15.9	13.7
1993	41.2	34.5
1994	46.7	32.5
1995	60.8	46.3
1996*	76.8	56.7

Source: Securities Commission (1996).
Note: *First quarter.

Bank Negara Malaysia against giving out loans for share speculation (Khor 1987: 101). The increased availability of such credit must have boosted share trading and stock prices as well as to increase bank vulnerability to asset price deflations (e.g. in 1986, 1994 and 1997–98). The minister also directed government-controlled investment institutions, such as the Employees Provident Fund, to invest in stocks. The privatization of state-owned enterprises further contributed to the growth of the stock market, especially in the early and mid-1990s. The substantial funds raised by the capital market since 1990 can be partly attributed to the government's privatization program, which has undoubtedly deepened Malaysian's stock market considerably.

The Malaysian stock market increased in relative significance as a source of corporate finance, particularly at the expense of domestic and foreign bank loans, and emerged as a more important source of funds than commercial banks from the early 1990s. Table 4.7 shows that the early 1990s saw some financial disintermediation with commercial bank deposits' share of savings declining from 23 per cent in 1990 to 16 per cent in 1994, and the KLSE's share rising from 48 per cent to 62 per cent over the same period. Table 4.8 shows that the stock market became more important as a source of funds, while the share of bank loans as a proportion of total funds raised by the private sector declined correspondingly. Specifically, the share of equity market financing of total funds raised by the private sector rose significantly from 9 per cent during 1980–85 to 19 per cent during 1990–96, while the bank loans' share dropped correspondingly from 67 per cent to 51 per cent. During the same period, the additional funds raised through share issues since 1993 are reflected in increased stock market capitalization, especially in terms of share volume.

Although the Malaysian stock market has emerged as a more important source of funds than commercial banks since 1990, the funds mobilized during the stock

Table 4.7 Classification of deposits by financial institutions, 1990–96 (percentage share[a])

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*
Commercial banks[b]	22.8	23.1	20.1	13.4	16.1	17.3	16.1
Finance companies[b]	10.4	10.6	8.5	5.3	6.2	6.3	5.7
National Savings Bank[c]	1.0	0.9	0.8	0.5	0.6	0.5	0.5
Employees Provident Fund	16.9	16.0	13.4	8.1	10.3	10.5	9.2
Life insurance companies	0.6	0.6	0.5	0.3	0.4	0.5	0.4
Unit trust funds	na	na	3.4	3.1	4.4	4.7	4.7
KL Stock Exchange	48.2	48.8	53.3	69.4	62.1	60.2	63.4

Sources: *Banker's Journal Malaysia* (1995, 33); BNM, *Annual Report 1997*; Ministry of Finance (1996, 1997); and Kuala Lumpur Stock Exchange (1997).

Notes: na = Not available.

a. Allow for +/– 3% variation.
b. Figures do not include Negotiable Certificates of Deposits (NCDs) issued and Repurchase Agreements (Repos).
c. Figures consist of 'amount standing to credit of depositors' plus 'Premium Savings Certificates depositors.'

Table 4.8 Funds raised by the private sector[a] (percentage share)

	1980–85	*1990–96*
Bank loans	67	51
Private debt securities	1	13
Equity	9	19
EPF[b]	–	3
Foreign borrowing	23	14

Source: BNM *Annual Report 1997* (Chart IX.2).

Notes: a. Excludes loans to individuals and CAGAMAS (National Mortgage Corporation) papers.

b. Direct equity financing.

market boom did not all go to productive investments; more than 50 per cent of the total funds raised in the equity market through IPOs in 1990–96 went to privatized projects (BNM *Annual Report 1997*: 149). In other words, with privatization, capital resources that might otherwise have been invested in expanding productive capacity in the private sector have been diverted into acquiring or transferring existing public sector assets (Jomo 1995: 51). Moreover, the state revenue from privatization, which could have been used for productive purposes, was much less than it could have been because the public sector assets were disposed of at a substantial discount (Bank Negara Malaysia 1999: 323).

By 1993, the Malaysian stock market had gained a reputation as being a kind of casino, with active trading fueled by heady optimism, sudden interest from foreign institutional investors, and a frenzy of speculation about corporate takeovers (*Asian Wall Street Journal* 1996). The KLSE Composite Index (KLCI) almost doubled to 1,275 points before crashing to 971 points in the following year, while market capitalization as a proportion of GDP rose more than twofold from the year before. The volume of shares traded jumped by more than 450 per cent and rose by more than 650 per cent in value terms to reach RM387 billion in 1993.

Since 1993, the increased funds raised through rights issues are reflected in the expansion of existing stocks or capitalization. Table 4.9 shows that much of the funds raised from the equity market in 1996 was from rights issues, which mobilized 43 per cent of the total funds raised during 1993–97, while initial public offers only accounted for 31 per cent.

The growth of the Malaysian stock market was extraordinary by regional standards, with KLSE capitalization more than double annual GNP by 1996 (Table 4.10). While total capital inflows into Malaysia were not extraordinarily high as compared to Thailand and Indonesia, a much higher proportion of its inflows went into the stock market rather than being intermediated through the banking system.

The swelling equity flows were partly due to the gradual liberalization of financial markets and regulations. The government announced an 18-point financial market liberalization program to enhance Malaysia's position as a major international financial center. One strategy was to attract more foreign institutional investors by

Table 4.9 New share issues in the Kuala Lumpur Stock Exchange, 1992–97[a]

	1992		*1993*		*1994*		*1995*		*1996*		*1997*	
	Rm mil	*%*	*Rm mil*	*%*	*Rm mil*	*%*	*Rm mil*	*%*	*Rm mil*	*%*	*Rm mil*	*%*
Initial public offers	5,415.8	59	912.7	26.6	2,972.9	35.0	4,175.0	36	4,099.2	26	4,781.0	26
Rights issues	3,437.8	37	1,176.9	34.3	3,436.7	41.0	5,240.2	46	5,268.5	33	8,524.9	46
Special issues[b]	300.4	3.3	684.2	19.9	1,249.4	15.0	875.5	7.7	2,002.3	13	1,818.8	10
Private placements[c]	27.5	0.3	658.8	19.2	798.9	9.4	1,146.9	10	4,554.4	29	3,233.6	18
Preference shares	–	–	–	–	–	–	–	–	–	–	–	–
Total	9,181.5	100	3,432.6	100	8,457.9	100	11,437.6	100	15,924.4	100	18,358.3	100

Sources: Bank Negara Malaysia *Annual Report* (1997: 249; 1998: 290).

Notes: a. Excludes funds raised by the exercise of employee share options schemes, transferable subscription rights, warrants and irredeemable convertible unsecured loans stocks.

b. Issues to Bumiputra investors and selected investors.

c. Including restricted-offer-for-sale.

Table 4.10 Financial development indicators, 1996 (US$ billion and as percentage share of GDP[a])

	Credit[b]		*Money*[c]		*Stocks*[d]		*Capital inflows*[e]	
	$ bil	*% of GDP*[a]	*$ bil*	*% of GDP*[a]	*$ bil*	*% of GDP*[a]	*$ bil*	*% of GDP*[a]
Indonesia	123.9	55.0	94.9	42.0	43.5	19.0	10.8	4.8
Philippines	40.5	49.0	36.1	43.0	31.3	38.0	7.7	9.3
Malaysia	92.2	93.5	67.1	68.0	223.5	227.0	9.5	9.6
Thailand	185.0	100.0	130.3	70.0	142.0	77.0	19.5	10.5

Sources: IMF (1998: November issue), National Economic and Development Authority (1997), *Euromoney* (1996: 84).

Notes: a. Calculated according to the following exchange rates and GDP values:

	1996 GDP (billions in local currency)	Exchange rate (per US$, end 1996)
Indonesia	532.631	2383
Philippines	2,171.9	26.288
Malaysia	249.503	2.529
Thailand	2,689.6	25.343

b. Claims on private sector held by deposit money banks, end 1996.
c. Quasi-money.
d. Stock market capitalization, Dec. 1995.
e. Net inflows of capital: financial and capital account of the balance of payments, 1996.

allowing fund managers to buy more equity in Malaysian corporations and to reduce the tax rate on their profits to 10 per cent. Table 4.11 reports the withholding tax rates for dividends and long-term capital gains that selected emerging markets offered to US-based institutional investors, as well as restrictions on foreign ownership of listed stocks in 1996. Malaysia is clearly the most liberalized market. With greater access to the Malaysian stock market as well as reduction or removal of capital gains and dividends withholding taxes, interests of international investors in the Malaysian stock market grew rapidly, inducing enormous foreign portfolio investment inflows.

According to some stock market analysts, by early 1997, one-quarter of the stock in the Kuala Lumpur Stock Exchange was in foreign hands with another quarter held by Malaysian institutions and the rest constituting 'retail trade' by individuals. While most Malaysian shareholders only operate within the Malaysian stock market, foreign institutional investors see the Malaysian market as only one of many different types of financial markets in a global financial system that includes many national markets; i.e. the global financial system is hardly a market of equals. Although always in the minority, foreign investment institutions 'made' the stock markets in the region, shifting their assets among securities markets as well as among different types of financial investment options all over the world. In the face of limited transparency, the regional nature of their presence, the nature of fund managers' incentives and remuneration, and the short-term investment horizons, foreign financial institutions were much more prone to herd behavior and contributed most to the regional spread of contagion. To quote Mansor (1995: 10):

Although only about 20 percent of daily market activity has been attributed to foreign funds, the influence of foreign funds is more than their share of the volume of activity, as they are generally considered market leaders. Their presence is crucial to lending credibility and international standing, which are important elements in raising future capital, locally and overseas.

Origins of the currency crisis

The Malaysian economic boom from the late 1980s was helped by the significant depreciation of the ringgit against the US dollar from late 1985. Meanwhile, the Japanese yen, and then the Korean won, the new Taiwanese dollar and the Singapore dollar all appreciated against the US dollar, and hence, even more against the ringgit. High growth was sustained for almost a decade – during most of this period, fiscal balances were in order, monetary expansion was not excessive and inflation was generally under control. Nevertheless, there were some potential problems.

Despite the claim by the central bank that the ringgit had been pegged to a basket of currencies of Malaysia's major trading partners, for all intents and purposes it had in effect been pegged to the US dollar at least since the 1980s. This unofficial peg offered certain advantages, especially the semblance of stability – including low inflation – that was so desired by financial interests. With the depreciation of the US dollar against the yen and other East Asian currencies between 1985 and 1995, the Southeast Asian currencies depreciated as well, making their products more competitive in the world markets. In this context, the 1990 and then the 1994 devaluations of China's renminbi placed greater competitive pressure on the emerging second-tier or second-generation Southeast Asian newly industrializing countries (NICs), including Malaysia. But the reversal of this decade-long currency depreciation from mid-1995, when the US dollar began to appreciate against the

Table 4.11 Barriers to portfolio investments in selected emerging stock markets, 1996

Country	*Withholding taxes*		*Foreign investment ceiling for listed stocks*
	Dividends (%)	*Long-term capital gains (%)*	
Malaysia	0.0	0.0	100% in general
Indonesia	20.0	0.1	49% in general; 85% for securities companies
Philippines[a]	15.0	0.5	40% in general; 30% for banks
Thailand	10.0	0.0	10–49% depending on company by-laws
India	20.0	10.0	24% in general
Korea[b]	16.5	0.0	20% in general; 15% for KEPCO and POSCO
Taiwan	35.0	0.0	25% in general

Source: IFC (1997).

Notes: a. Transactions tax in lieu of a capital gains tax.

b. Rates are for funds in which US investments total more than 25%. Tax rates shown include 10% resident tax applied to base rates.

yen, then implied declining cost competitiveness of the region. Capital inflows renewed but they were sterilized with complicated consequences.

There was a widespread consensus that the ringgit had become overvalued as a result of being pegged to the US dollar as the latter strengthened significantly from mid-1995.[14] Hence, the ringgit was expected to depreciate to around RM2.7–2.8 against the US dollar,[15] the supposed equilibrium exchange rate that was based on calculations that took account of purchasing power parity and other relevant factors. However, from mid-July 1997, the Malaysian ringgit fell far more precipitously, reaching RM4.88 to the US dollar in early January 1998, its lowest level ever; this represented a collapse by almost half within less than half a year from a high of RM2.47 in July 1997. The stock market fell more severely, with the main Kuala Lumpur Stock Exchange Composite Index (KLCI) dropping to less than 500 in January 1998 from almost 1,300 in February 1997.

This sudden and massive collapse of the ringgit – politely referred to in the financial community as 'overshooting' – by much more than the anticipated 'correction' of RM2.7–2.8 raised serious questions about the very nature of the international monetary system. Other international, regional, and domestic speculators also contributed to the collapse by reacting in their own self-interest to perceived and anticipated market trends rather than as part of some conspiracy as claimed by Malaysian Prime Minister Mahathir. As investors scrambled to get out of positions in the ringgit and other regional currencies, the currencies fell further and, with them, the stock and other markets. With financial liberalization, fund managers had an almost infinite variety of investment options to choose from, and could move their funds much more easily than ever before, especially with the capital account convertibility Malaysia and other crisis-affected countries in the region had prided themselves on. The operations and magnitude of hedge fund operations and other currency speculation undoubtedly exacerbated these phenomena, with disastrous cumulative consequences.

Financial fragility and crisis

The Malaysian currency and financial crises since mid-1997 can be traced to financial liberalization and its consequent undermining of national monetary and financial regulation. The ringgit's virtual peg to the US dollar encouraged huge foreign capital inflows, which served to finance the persistent current account deficit. Thus, foreign savings supplemented the already high domestic savings rate (40 per cent in 1996) to raise the investment rate to 45 per cent, which contributed to an asset price bubble involving shares and real property.

As elsewhere in the Southeast Asian region, besides encouraging portfolio investments and bank borrowings from abroad, the unofficial peg also became a target for currency speculators as regional currencies appreciated with the US dollar despite adverse consequences for export competitiveness and growth. Meanwhile, financial liberalization had also opened up lucrative opportunities for taking advantage of anticipated changes in foreign exchange rates, thus accelerating and exacerbating the collapse of the region's currencies and share markets. All this,

together with ill-considered official Malaysian responses, transformed the inevitable 'correction' of the overvalued ringgit into massive collapses of both the ringgit and the KLCI as panic set in, exacerbated by 'herd' behavior and 'contagion.'

It was noted earlier that increased liberalization of the financial sector reduced the franchise value of the banking sector, which is crucial for inducing banks to effectively monitor and manage the risk in their loan portfolios (Hellmann *et al.* 1997).[16] Although banking licenses were not granted to foreign banks after 1974 and various restrictions have been imposed on them, the franchise value of large Malaysian banks has declined. The share of deposits in the ten largest banks declined from about 84 per cent to 77 per cent of the total between 1975 and 1990, while their share of total assets fell from 80 per cent to 72 per cent over the same period (Zainal *et al.* 1994: 303–5).[17] Thus, banks experienced disintermediation on both sides of their balance sheets. In the absence of strong institutional arrangements for effective prudential regulation and supervision to realign incentives, the erosion of franchise value further distorted the banks' risk-taking behavior, exacerbating moral hazard problems and hence the fragility of the banking system.[18]

High loan exposure to asset price inflation

Notwithstanding its efforts to improve the regulatory and supervisory systems, the BNM was ineffective in checking the growing fragility of the financial sector, particularly due to trends in bank lending. Despite several warnings by the BNM and the growth in non-performing loans after the property market collapse of 1986, banks continued to lend to the property sector. In 1986, these loans accounted for 55 per cent of all new loans, compared to 32 per cent in 1980 (Zainal *et al.*1994: 309). When the property and stock markets collapsed following the recession in the mid-1980s, many banks were in serious trouble, as a large percentage of property-based loans became non-performing. Such a big overhang of non-performing loans in the banking system – reaching almost 30 per cent at its apex – required substantial provisions for interest in suspense and bad debts. The banking crisis in the late-1980s was short-lived due to rapidly improving external conditions and manufacturing expansion following selective deregulation and other new incentives attracting foreign direct investment from the late 1980s, which contributed to the revival of the stock and property markets. Despite adopting the Banking and Financial Institutions Act (BAFIA) in 1989, Malaysian policymakers did not seem to insist on more prudent lending practices, perhaps due to the speed of the late 1980s' recovery. Moreover, in the face of greater competition to lend in the more liberalized and competitive market, banks preferred financing real estate and share purchases, as long as such loans were collateralized. Thus, exposure to property and share purchases grew quickly in the early and mid-1990s as in the preceding decade, with property and stock prices rising rapidly. The easy availability of such credit encouraged over-investment in non-tradable, in turn, aggravating current account deficits (with greater imports but no corresponding exports) and fueling asset price bubbles.

Thus, the economic boom from the late 1980s was increasingly being built on some shaky and unsustainable foundations. Meanwhile, economic growth in

Malaysia became increasingly heavily reliant on foreign resources, both capital and labor. Foreign direct investment significantly supplemented domestic investment, accounting for 19 per cent[19] of gross fixed capital formation on average during 1990–96.[20] With more intense competition from lower-cost exporters, especially China,[21] as well as rising production costs, Malaysia's future economic progress could no longer be secured by continued reliance on its strategy of offering cheap labor and lowering other production costs through 'competitive' currency devaluation. Inappropriate investments in human resources and infrastructure continued to limit the development of greater industrial and technological capabilities in the country. Inappropriate financial policy also continued to limit the commitment[22] on the part of financial institutions to provide long-term resources for manufacturing, let alone for more innovative and higher technology-based activities requiring longer gestation periods (Chin 2000).

Build-up of private external debt

Foreign savings supplemented the already high domestic saving rates in the region to further accelerate the rate of capital accumulation, albeit in increasingly 'unproductive' activities owing to the foreign domination of most internationally competitive industries in the region. Malaysia's savings-investment gap, which was 5 per cent of GNP in 1997, lay behind the current account deficit, which had exceeded RM12 billion since 1994.

Before the 1990s, the savings–investment gap had mainly been bridged by foreign direct investment (FDI), though high FDI and foreign debt have, in turn, caused growing investment income outflows abroad. In the early and mid-1990s, however, the current account deficit was increasingly covered by short-term capital inflows. A great deal of portfolio investment went into the stock market in 1992–93, and again, from 1995 until early 1997, with adverse consequences following their sudden and hasty exit each time. Many post-crisis confidence restoration measures actually seek to induce such short-term inflows once again, and, when successful, will be expected to finance current account deficits as before.

Some companies and banks in Malaysia also borrowed heavily from abroad, thus supplementing investment inflows (Tables 4.12 and 4.13). According to Bank Negara,[23] commercial banks' net foreign liabilities increased by almost 150 per cent in eighteen months from RM10.3 billion at the end of 1995 to RM25.2 billion in June 1997, while their net external reserves position deteriorated from −RM5.3 billion to −RM17.7 billion over the same eighteen-month period! Thanks to stricter central bank supervision, a smaller proportion of Malaysian foreign borrowings were of a short-term nature[24] compared to Thailand and Indonesia, and a greater proportion was hedged, owing to the lower costs of hedging for Malaysian borrowers.

Ironically, stock exchange listing in Malaysia has been an important means for accessing more bank borrowings on better terms, rather than for raising funds on the stock market itself. The establishment of the Labuan International Offshore Financial Center (IOFC) also facilitated greater Malaysian access to international

Table 4.12 External short-term debt outstanding of the banking and non-bank private sector outstanding[a], 1988–97 (RM million)

	Banking sector	*Non-bank private sector*
1988	2,464	na
1989	3,343	na
1990	4,415	na
1991	7,171	na
1992	13,157	na
1993	17,320	na
1994	9,840	4,404
1995	11,293	4,911
1996	17,648	8,098
1997	32,665	11,322

Source: BNM, *Quarterly Economic Bulletin*, various issues.
Note: a. Short-term debt refers to debt with tenure of one year and less.

Table 4.13 Lending by BIS-reporting banks to selected Asian economies by sector (cumulative as of end-June 1997)

	S. Korea	*Thailand*	*Indonesia*	*Malaysia*
Total borrowings	103.4	69.4	58.7	28.8
Banks (US$ bil)	67.3	26.1	12.4	10.5
%	65.1	37.6	21.1	36.5
Private nonbank (US$ bil)	31.7	41.3	39.7	16.5
%	30.6	59.5	67.6	57.3
Government (US$ bil)	4.4	12.0	6.5	1.9
%	4.3	17.3	11.1	6.6

Source: Jomo (1998a: 32).

funds on less transparent terms. According to the Cash Balance of Payments Reporting System of the BNM, net international funds sourced from the Labuan IOFC increased from RM69 million in 1991 to RM7.441 billion in 1996. On the supply side, intense competition among 'debt-pushing' Japanese and continental European banks (which were attracted by the comparatively higher interest rates available for dollarized loans to the region) further eased access to foreign funds. These and other financial liberalization reforms as well as the growth of 'private banking' and 'relationship banking' in the region weakened the scope and efficacy of national-level prudential regulation. On the demand side, more Malaysian corporations seeking lower financing costs began to tap funds from abroad.

As a result, in recent years, there has been a surge in private sector borrowings from abroad (Table 4.12). The non-bank private sector in Malaysia was the major recipient of international bank loans, accounting for more than half of all foreign borrowings by the end of June 1997, though Malaysian private sector external debt exposure was both absolutely and relatively less than in Thailand, Indonesia, and

South Korea (Table 4.13). Foreign borrowings of almost ninety of Malaysia's largest listed and KLCI-indexed companies have been estimated at around RM35 billion, with the three largest borrowers – Malaysian Airline System Berhad, Tenaga Nasional Berhad, and Telekom Malaysia Berhad[25] – alone accounting for three-quarters of this foreign corporate debt.

Thus, Malaysia's medium- and long-term debt as a percentage of net external reserves rose from 102 per cent at the end of 1994 to 176 per cent in June 1997, a dramatic increase in about two-and-a-half years, having declined after the mid-1980s crisis (Jomo 1990). These capital inflows, both equity investments and bank borrowings, helped finance the current account deficits due to the growing proportion of non-tradable being produced in Malaysia, much of which involved (infrastructure as well as property) construction activity. Although these capital inflows were 'sterilized' to minimize currency appreciation as well as consumer price inflation, they fueled asset price inflation, mainly involving real estate and share prices.[26]

Insofar as such investments did not contribute directly to export earnings, they aggravated the current account deficit and contributed to the problem of currency mismatch. Term mismatch also became a serious problem as a high proportion of foreign borrowings were of short-term maturity (Table 4.14), but were often deployed on medium- to long-term bases.

Surge in portfolio investment inflows

More than other emerging markets in the region, Malaysia experienced an unprecedented surge in portfolio investment inflows in the early and mid-1990s, attributable to various push and pull factors.[27] Active government encouragement of such foreign portfolio investments succeeded in attracting massive inflows seeking to maximize the capital gains in the bullish Malaysian stock market (Table 4.15). During 1991–95, when net foreign portfolio investment averaged 5.1 per cent of GDP, portfolio investments accounted for 88 per cent of identified gross capital inflows (Ong 1998: 222–3). In 1993 and 1994, the portfolio investment inflows alone surpassed GDP in current market prices, reaching US$67 billion and US$87 billion, respectively.

Table 4.14 Maturity distribution of lending by BIS-reporting banks to selected Asian economies, 1996 (US$ million)

	All loans			*Under 1 year*			*1–2 years*		
	June 1996	*Dec. 1996*	*June 1997*	*June 1996*	*Dec. 1996*	*June 1997*	*June 1996*	*Dec. 1996*	*June 1997*
South Korea	88,027	99,953	103,432	62,332	67,506	70,182	3,438	4,107	4,139
Thailand	69,409	70,147	69,382	47,834	45,702	45,567	4,083	4,829	4,592
Indonesia	49,306	55,523	58,726	29,587	34,248	34,661	3,473	3,589	3,541
Malaysia	20,100	22,234	28,820	9,991	11,178	16,268	834	721	615

Source: Jomo (1998a: xvi).

Table 4.15 Annual capital inflows by major category, 1989–95 (as a share of GDP, percentage)

	1989	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*
Net capital inflows	3.5	4.2	11.9	15.2	16.8	1.6	8.5
Official development finance	–2.4	–2.4	–0.5	–1.4	0.6	0.3	2.7
Foreign direct investment	4.4	5.4	8.5	9.0	7.8	6.0	4.7
Commercial bank funds	1.1	2.0	2.8	6.3	6.6	–7.0	0.1
Portfolio equity	na	na	–1.5	5.6	14.5	5.7	1.2

Source: Ong (1998: 222).
Note: na = Not available.

Encouraging foreign financial institutions to invest in the Malaysian stock market inevitably made the national economy much more vulnerable to international macroeconomic fluctuations as well as capital flight, and rendered the tasks of exchange rate management and controlling inflation much more difficult. The huge short-term capital inflows proved to be destabilizing as they involved closer links between two inherently unstable markets – the stock and currency markets. The central bank was reported to have incurred high costs in trying to maintain tight monetary policy by neutralizing the potentially destabilizing inflows of foreign speculative funds.[28] After a sudden exodus of such money in early 1994, temporary controls aimed at limiting portfolio inflows were put in place. They were, however, removed by mid-year once speculative pressures on the ringgit declined.

Speculation and contagion

It did not take very long for contagion from the Asian financial crisis – usually dated from the floating of the Thai baht on 2 July 1997 – to spread to Malaysia. With the baht down, currency speculators turned their sights on other economies in the region that had similarly vulnerable quasi-pegs to the US dollar. Also anticipating a glut in the property market due to rapid over-expansion in recent years, and noting the decline of the KLCI after February 1997, the reversal of portfolio investment funds and its high exposure to short-term foreign borrowings (albeit relatively less than its crisis-hit neighbors in the region), speculative attacks on the pegged ringgit began to mount as net portfolio capital outflows began to accelerate. The BNM, which initially put up a spirited defense of the ringgit, finally gave up currency support operations after hefty losses of several billion US dollars. The ringgit fell beginning in mid-July 1997, eventually reaching RM4.88 to the US dollar in early January 1998 – collapsing by almost half in six months from a high of RM2.47 in July 1997. The stock market dropped more severely, with the KLCI dropping to 262 on 1 September 1998 from almost 1,300 in the first quarter of 1997.

Nevertheless, Malaysia was relatively better off than its neighbors that were devastated by the crisis. Although weakened in recent years, especially due to financial liberalization, prudential regulation remained better in Malaysia than in most other countries in the region, with the exception of Singapore, and thus saving

Malaysia from some of the worst excesses witnessed elsewhere in the region. Lower domestic interest rates also limited the extent of foreign borrowings, most of which were hedged, owing to the relatively lower costs of hedging in Malaysia.

Conclusion and policy implications

As Lee argues in the introductory chapter of this volume, economic thinking about the appropriate role of finance in promoting economic development was profoundly influenced by the 1973 McKinnon-Shaw critique of so-called financial repression. This critique contrasted with earlier work by Gurley and Shaw (1960), which seemed to support a pro-active role for government in promoting bank intermediation to allocate savings for developmental purposes. The critique of financial repression was soon translated into policy, especially with the resurgence of 'neo-liberal, free-market' conservatism in the Anglophone world, boosted by the political ascendance of Margaret Thatcher in Britain (1979) and Ronald Reagan in the United States (1980). Foreign and domestic advocates of financial liberalization promised increased savings and investments, net capital inflows from abroad, and higher economic growth. With the debt crisis of the early and mid-1980s, debt-strapped governments in Latin America, Africa, Eastern Europe, and elsewhere were soon obliged to accept and implement various conditionalities that accompanied debt relief packages. Thus, international financial institutions were able to promote, if not impose, policies advancing domestic as well as international financial liberalization.

Although the resolution of the debt crisis generally protected the interests of the international banks, the protracted negotiations and losses incurred served to discourage international bank lending to the developing country governments. Instead, such banks found new customers in the burgeoning private sectors of the developing world, especially in East Asia. The new economic policy orthodoxy favored lending to the private sector ostensibly to avoid a recurrence of the 1980s' international debt crisis. Meanwhile, the Bank for International Settlements (BIS) imposed more onerous lending conditions, which served to discourage long-term lending and resulted in greater short-term lending (for periods of less than a year), rendering such loan flows much more easily reversible. The willingness of international banks to seemingly indefinitely roll over such loans in good times encouraged a false sense of confidence in the continued availability of such lending, encouraging many borrowers to invest or lend long term with these seemingly perpetually available funds.

From the late 1980s, the Bretton Woods financial institutions began actively promoting the internationalization of capital markets in a big way. In particular, the International Finance Corporation (IFC), a World Bank subsidiary, encouraged investment in the 'newly emerging markets' of the developing countries and transitional economies. Mutual funds, hedge funds, and other institutional and even individual investors were keen to invest in the rapidly growing economies of East Asia, where growth performances contrasted favorably with the prolonged slow growth, if not recessions, of the advanced industrial economies of the North and elsewhere.

New conditions in Southeast Asia also contributed to financial liberalization in the region. Unlike Japan, South Korea and Taiwan – where indigenous entrepreneurs and technological capabilities had developed – transnational corporations from the North controlled much of the internationally competitive export-oriented industries in Southeast Asia. This was especially true of Malaysia, which was second only to Singapore in terms of the contribution of foreign direct investment to gross domestic capital formation, especially in the manufacturing sector. Consequently, domestic capital tended to dominate non-industrial sectors, including finance. While domestic financial interests were generally opposed to full-blown international financial liberalization for obvious reasons, they were keen to profit from the availability of cheaper funds from external sources as well as inflation of the value of financial and other assets due to foreign portfolio investment inflows.

Despite some erosion of financial governance in Malaysia from the mid-1980s, the tighter regulation of the financial sector in Malaysia, compared to its neighbors, rendered it less vulnerable to the reversal of short-term bank lending. However, earlier Malaysian success in attracting foreign portfolio capital inflows to its stock market rendered it more vulnerable on a different front. Hence, unlike Thailand, Indonesia, and South Korea, the crisis in Malaysia was not primarily exacerbated by vulnerability to short-term foreign bank borrowings. Instead, the greater vulnerability of its relatively much larger stock market to international investor sentiment proved to be its Achilles' heel. The 1996 bull-run had already been reversed after February 1997 as international portfolio investor sentiment toward Malaysia began to sour. This change in sentiments was further reinforced by contemporary regional developments, especially after the mid-July 1997 collapse of the Malaysian ringgit's unsustainable dollar peg. Investor sentiments were further undermined by inappropriate policy responses as well as the Malaysian prime minister's contrarian rhetoric, but ill-informed negative international perceptions of the region as a whole probably wreaked the most havoc by causing investor herd panic, resulting in sudden and massive capital flights and thus serving as the principal vectors of regional contagion.

The recent financial crisis points to the importance of prudentially managing risk in the financial system, as failing to do so, as shown in Malaysia, enhanced the vulnerability of the financial system. While financial restraint can promote banks' commitment to act as long-run agents as well as enhance their capability to cope with risks, this has not been the case in Malaysia. Financial restraint in Malaysia has primarily sought to ensure bank profitability, especially with increasing ethnic Bumiputra dominance of the Malaysian banking system from the 1970s. In other words, financial restraint has been used to advance inter-ethnic economic redistribution and other related public policies, rather than to favor long-term productive investments, especially in non-resource-based export-oriented manufacturing, with financial liberalization exacerbating most of these trends.

An important lesson from the East Asian crisis is that prudential regulation by the government is necessary to manage the trade-off between the competitive efficiency of markets and the security of the banking system (Park 1994: 21, Chowdhury and Islam 1993: 144). As Stiglitz (1999) pointed out, developing countries should be

encouraged to find the appropriate regulatory structures or governance systems to manage the incentives and constraints which affect financial institutions' exposure to and ability to cope with risk to engage in rapid financial market liberalization, especially massive cross-border capital flows.[29] Furthermore, he makes the point that the requirements of good risk management in developing countries may differ markedly from those for developed countries, since the former generally face larger risks, lack well-developed information system flows, and typically have weaker risk management capacities. Building such financial infrastructures in developing countries should be a precondition for appropriate and properly sequenced financial liberalization.

Careful analysis of the pre-crisis financial reforms and developments suggests that the crisis can be traced to financial liberalization and the consequent undermining of effective financial regulation both at international and national levels. Liberalization of the domestic financial system – including the elimination of interest rate controls and credit allocation, which thus allowed market forces to work – before putting in place the strong institutions needed for effective prudential regulation and supervision led to moral hazard problems. Promoting securities markets before an effective and mature banking system was well established diminished the franchise value of the banking system, resulting in increased risk-taking and aggravating banking system fragility.

Stock market promotion from the late 1980s, which not only enabled free international movements of capital but even encouraged foreign financial institutions to invest in the stock market, made the Malaysian economy more vulnerable to external shocks, especially capital flight, and rendered the tasks of exchange rate management and inflation control more difficult. Unlike the banking crisis of the late 1980s, which was brought on by a prolonged world recession that began in the West in the early 1980s, the crisis of 1997–98 was precipitated by the massive withdrawal of funds in the turbulent financial market. In its enthusiasm to establish the country as yet another key financial center in Southeast Asia, Malaysia did not develop any well-conceived prudential regulatory instruments to manage the more volatile and greater portfolio investment inflows, notwithstanding some temporary controls aimed at discouraging portfolio flows in 1994. Malaysia was thus ill equipped to deal with the currency and financial crises and, with injudicious policy responses to the crises, managed to turn the situation into a crisis of the real economy (Jomo 1998b).

Notes

1. For a critical review of how the currency and financial crises in Malaysia became a crisis of the real economy, see Jomo (1998b).
2. For a brief historical review of the development of commercial banks in Malaya and later Malaysia, see Lee (1990: Ch. 4).
3. For details, see Chin (2000).
4. Initially, these regulations were imposed on commercial banks but were later extended to merchant banks beginning in 1979.
5. Known as the Sime Bank after the takeover by the Sime Darby group, it was subsequently acquired by RHB Bank.

6 Bumiputra refers to the 'indigenous' population of Malaysia, mainly comprising the Malays of Peninsular Malaysia.
7 For details, see BNM *Annual Report 1994*: 46–7.
8 Except for interest rates on loans to priority sectors.
9 Part of this section draws from Chin (1999).
10 There was only one public issue in 1965 (Drake 1975).
11 Some examples are provided in Jesudason (1989: 26, endnote 31).
12 One may disagree by arguing that shares which are issued at their intrinsic values can be bid up by an overly optimistic market, leading us to wrongly interpret demand pressures as under-pricing. However, demand pressure at or after listing may push prices above their intrinsic values in the short run, as prices of new issues decline in the longer run after demand pressure subsides.
13 As the minimum paid-up capital of companies to be listed on the KLSE Main Board is not less than RM50 million, the KLSE Second Board was launched in 1988 to enable smaller companies (with minimum paid-up capital of RM10 million but less than RM50 million) to tap additional funds through public listings.
14 For example, the yen fell from less than ¥80 to the US dollar in mid-1995 to over ¥120 by mid-1997, while the deutschmark had floated against the US dollar before mid-1997.
15 Information obtained from personal communication with Tan Eu Chye.
16 As discussed in Hellmann *et al.* (1997), an important aspect of the franchise value is that it creates long-run equity that cannot be appropriated in the short run since banks have an ongoing interest to stay in business. Thus, franchise value creates incentive and commitment for banks to act as long-run agents, to effectively monitor firms they finance, and to manage the risk of their portfolio of loans.
17 A similar declining trend over the same period was also observed for the three and five largest banks (Zainal *et al.* 1994: 305).
18 In examining the empirical relationship between banking crisis and financial liberalization, Demirgüç-Kunt and Detragiache (1998) show that the adverse impact of financial liberalization on banking sector fragility is stronger where the institutions needed for the correct functioning of financial markets are not well established.
19 Computed from Table 2 in UNCTAD and ICC (1998).
20 The share of foreign direct investment in gross capital formation in Malaysia was exceptionally high, not only rising from 10.7 per cent during the period 1980–90 (Rasiah 1998), but also rising much higher than in other Asian countries affected by the crisis (i.e. South Korea, Thailand, Indonesia, and the Philippines), where the ratio never surpassed 10 per cent (UNCTAD and ICC 1998: Table 2). Foreign direct investment also accounts for very significant export shares, particularly in electrical and electronic industries, reaching more than half of manufacturing exports and more than 40 per cent of total exports (UNCTAD and ICC 1998).
21 Bhattacharya, Ghosh and Jansen present evidence that recent growth of China's market shares of its top ten manufactured exports was associated with small declines in the Malaysian market shares for these products as well as Thailand (World Bank 1998: 23).
22 Commitment here refers to the financial institutions' willingness to assume a major role in industrial finance, promoting longer time horizons, rather than mainly lending short-term working capital.
23 With financial liberalization, it is likely that official measures of such flows underestimate the actual extent of these borrowings.
24 According to the BIS (*Asian Wall Street Journal* 1998: 6), 56 per cent of Malaysian foreign borrowings from commercial banks were short-term in nature. This figure differs from the one reported by the Malaysian central bank, according to which only 30 per cent of all foreign borrowings were short-term in nature with another 9 per cent due in the following year (39 per cent in all).

25 Malaysian Airline System, once privatized, has been recently renationalized. The other two were corporatized with the majority of shares still owned by the state.
26 Some commentators claim that the resultant property price bubble has its roots in Japanese-type or more generically East Asian culture, norms, and relationships which compromise relations between the state and the private sector as well as among businesses, invariably involving welfare-reducing, if not downright debilitating, rent-seeking behavior. In so far as such relations are believed to exclude outsiders, their elimination is believed to contribute to a leveling of the playing field and to bringing about an inevitable convergence towards supposedly Anglo-American style arms-length market relations.
27 See Akyüz (1995) and Griffith-Jones (1997).
28 For further details, see BNM *Annual Report 1993*. For instance, the BNM had to absorb large interest payments for issuing bonds to mop up extra liquidity in the financial system.
29 Stiglitz calls this approach to effective financial regulation, from the perspective of risk management, the Dynamic Portfolio Approach.

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5 Financial liberalization and economic reform

The Philippine experience

*Maria Socorro Gochoco-Bautista**

Introduction

The historic lackadaisical performance of the Philippine economy is due to several structural weaknesses such as low factor productivity, a low saving rate, and inadequate investments in areas such as human capital and physical infrastructure, which various reform programs over several decades have been unable to surmount. In a sense, the persistence of these structural weaknesses reflects the poor quality of the reform process itself; not necessarily because the technical design of the reform programs has been flawed, but perhaps because the political economy aspects of the reform process have not been conducive to better outcomes. Indeed, one view is that Philippine economic development has been constrained to a great degree by weaknesses of political development. Specifically, according to this view, the Philippines suffers from a weak, patrimonial state with little capacity to undertake basic tasks because of the presence of a predatory oligarchy (Hutchcroft 1998).

This study attempts to understand the factors that have influenced the process and outcomes of economic reforms in the Philippines by taking a close examination of the reform in the Philippine financial sector. The story that emerges is the following.

The economy of the Philippines has long been and still remains inward-oriented owing to the long history of import substitution. This history has created a business elite whose interests are deeply entrenched and run counter to greater market competition and liberalization. Most of the core businesses of the elites are in protected sectors. Economic reforms under several administrations have usually been overwhelmed by opposition from these oligarchic interests who have long been used to rent-seeking behavior through alliances with those in power. In many cases, such reforms failed to achieve the purposes for which they were intended because in the presence of a weak state, they were simply transformed into new ways of dividing spoils among the privileged few rather than creating wealth for the entire nation, a kind of capitalism that has been called 'booty' capitalism (Hutchcroft 1998).

The weak capacity of the state banking regulatory authorities is all too apparent in their failure to consistently pursue reforms and prevent the corruption of reform programs by failing to resist political pressures from vested interests. The experience

of the Philippines shows that simply deregulating interest rates or liberalizing the foreign exchange market and opening the capital account do not necessarily improve market efficiency nor change the orientation of industries from an inward-looking to an outward-looking one. In spite of various measures of financial liberalization that have been undertaken in the Philippines the market structure of its financial sector has remained basically the same: it is oligopolistic, lacking competition, and commercial banks are still owned or controlled by large family-owned corporations (Appendix 5.1 on page 151). The business elites behind these large family-owned corporations have influenced the outcome of financial liberalization and other reform programs to serve their own interests. Given an oligopolistic banking market structure, interest rate deregulation has simply allowed interest rate spreads to widen and banks to reap even more abnormal profits despite their inefficiency. A close relationship between the banking and nonbanking corporate sectors has also allowed corporate borrowers to rely on short-term bank loans for their working capital and for the financing of long-term investments (Saldana 1999). Higher interest rates following deregulation have prevented potential competitors of big business access to affordable bank credit.

Foreign exchange market liberalization likewise represented new opportunities for banks to source foreign funds cheaply for re-lending locally at very high interest rates, without much regard for currency and default risks, given the official assurances that the currency would remain stable as had been its history. Big business corporations also saw opportunities to tap global financial markets directly for financing, again being able to avail themselves of a special privilege not realistically available to smaller firms.

During the Marcos regime, many of the inefficiencies in the economy were allowed to continue because they protected the interests of Marcos and the ruling elite, whose cooperation was sought by the United States to serve its larger geopolitical interests. The absence of genuine reforms in the economy resulted in periodic balance-of-payments crises that made the country and the ruling elite depend on external financing and aid, particularly from the International Monetary Fund (IMF) and the World Bank that ended up providing support to the Marcos and the oligarchs. The return of democracy after the demise of the Marcos regime did not totally erase the structural weaknesses of the past as political challenges limited the ability of government to pursue the needed reforms.

If it is to have a better chance of success in the future, the Philippine economy must be made to become more competitive and efficient by opening up the economy and breaking the collusive ties that bind vested interest groups. Correct timing and having the right preconditions in place, such as an appropriate regulatory and supervisory framework for financial institutions, are also important for reform programs to yield the expected benefits. Given its flawed economic development strategy of the past, the design of an appropriate alternative in today's world is a major challenge for the Philippines.

Macroeconomic conditions

In 1997, despite the occurrence of the Asian crisis beginning in the third quarter, real gross domestic product (GDP) of the Philippines grew by 5.2 per cent (Table 5.1). But even this positive growth rate was insufficient to bring back its per capita GDP to the level in 1981.[1]

Even a positive rate of economic growth does not tell the whole story as it masks the sources of growth and inherent structural weaknesses. Manufacturing growth, in particular, fell from 6.77 per cent in 1995 to 5.58 the following year. This decline occurred prior to the *de facto* devaluation of the peso on 11 July 1997 and was most noticeable in industries such as textiles, garments, rubber, metals and metal products, and transport equipment.[2] Some of these industries are highly labor-intensive and their decline was of major concern, particularly because of its effect on employment. The decline in manufacturing growth continued through 1997, and by 1998, manufacturing growth actually shrank by 1.1 per cent. As a result, the share of manufacturing in GDP and total employment declined relative to the previous decade, with the country experiencing a phenomenon known as 'de-industrialization.'[3]

Philippine exports are not well diversified, consisting largely of a few products such as semiconductors and transport equipment. These exports have, however, very few linkages in the economy as they rely heavily on imported inputs. Export growth began to decline steeply in 1995, dropping to 12 per cent per annum from 19.8 per cent a year earlier. Garment exports, the second-largest group of exports, have been declining by 4 per cent annually since 1995 (Saldana 1999: 94).

After experiencing trade deficits amounting to about 12 per cent of GDP for several years preceding the Asian crisis, the Philippines made a reversal of the trend in 1997 with a sharp depreciation of the peso to an end-of-period level of P39.98 in 1997 from P26.29 in 1996. Imports declined, narrowing the trade deficit, while export growth remained strong at 17 per cent despite the Asian crisis (60 per cent of Philippine exports were destined for countries outside of Asia).

Portfolio investments in the Philippines dropped beginning in 1997 as capital was withdrawn broadly from Asia. Net foreign direct investment declined dramatically to US$762 million in 1997 from US$3.517 billion in 1996. Further peso depreciation was prevented by massive remittances by overseas workers and positive external developments towards the fourth quarter of 1998 (such as the strong performance of the US economy and the strength of the Chinese yuan).

The peso depreciation led to an increase in the foreign debt-to-GDP ratio from 50 per cent in 1996 to about 75 per cent in 1997. Nevertheless, because of the improved export performance, the ratio of debt service to exports of goods and services remained at 11.7 per cent. The government has maintained a debt maturity profile of 5.5 years on foreign debt, limiting short-term debt to trade financing. It has also maintained the average maturity of public sector debt to 21.5 years.

The government adopted an expansionary fiscal policy in order to address a slowdown in private sector activities. Its budget deficit of P49.98 billion in 1998, equivalent to 1.8 per cent of gross national product in 1998, exceeded slightly the

Table 5.1 Macroeconomic indicators

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
GDP growth (in per cent)	3.04	–0.58	0.34	2.12	4.39	4.68	5.85	5.19	–0.59	3.41	4.01
Export growth (in per cent)	1.86	6.27	4.28	6.22	19.79	12.04	15.40	17.15	–21.03	3.62	17.68
Import growth (in per cent)	10.04	–1.12	8.69	11.50	14.50	16.02	16.74	13.49	–14.70	–2.80	4.00
Manufacturing growth (in per cent)	2.66	–0.44	–1.73	0.75	5.01	6.77	5.58	4.22	–1.13	1.59	5.61
Peso/$ rate, (end of period)	28.00	26.65	25.10	27.70	24.42	26.21	26.29	39.98	39.06	40.31	49.40
Consolidated public sector deficit/GDP	–4.73	–2.08	–1.92	–1.76	–0.50	–0.22	0.34	–0.99	–3.11	–3.45	–4.28
Foreign debt/GDP (in per cent)	77.86	67.03	59.58	66.76	55.85	54.14	50.68	74.84	69.74	70.70	77.87
Net foreign direct investments (million $)	480	654	737	812	1558	1609	3517	762	1672	1345	
Short term capital (million $)	19	349	660	–148	1002	–56	540	495	–1521	–4617	
Capital and financial account (million $)	1776	1878	1849	2820	4547	3393	11075	6593	956	–814	

Source: Bangko Sentral ng Pilipinas.

target of P49 billion agreed upon with the IMF. The consolidated public sector deficit, which includes government owned and controlled corporations, worsened in 1998 from having a small surplus in 1996.

The large depreciation of the peso in 1997 and the subsequent tightening of liquidity adversely affected both the corporate and financial sectors, slowing down the rate of economic growth.

Bank profitability declined dramatically in 1998, and the return on equity (ROE) dropped to 6.6 per cent at the end of 1998 from 16.34 per cent in 1996 and 12.42 per cent in 1997 (Guinigundo 1999: 4). Within the corporate sector, the subsector of large firms was the most severely affected by the Asian crisis with its ROE declining to 3.8 per cent in 1997, compared to the lowest prior record of 12.5 per cent in 1995 (Saldana 1999: 12).

Despite structural weaknesses in the Philippine economy, its financial system managed to survive the Asian financial crisis of 1997–98 relatively unscathed. This is due to a couple of factors. First, over the previous three years, the central bank implemented various measures to strengthen its prudential framework and regulatory oversight over banks and to align domestic banking standards with international 'best practices.' In particular, the banking system achieved a high degree of capitalization, which stood at 17.3 per cent in March 1998 (Saldana 1999: 96).

Second, the Philippines has a relatively low level of financial intermediation with a ratio of loan to GDP of less than 65 per cent, and the surge in capital inflows came late in comparison with other countries in Asia and in relatively smaller amounts (Goldman Sachs 1999: 17). Thus the financial system was not highly dependent on external capital. This was, in large part, due to the fact that the external debt moratorium, which had been imposed in 1984, was lifted only in 1991, delaying access to foreign debt markets by the public and private sectors. An additional factor contributing to the small amount of foreign capital inflows is the fact that the Philippines had had relatively poor economic performance, especially in comparison with its neighboring countries. In 1996, it received net foreign investment flows of only US$3.5 billion and a much smaller sum of US$762 million in 1997 (Saldana 1999: 96).

Financial liberalization and changes in the financial system

Financial reforms

Financial reforms in the Philippines began in 1971 upon recommendations made by the Joint IMF-Central Bank Banking Survey Commission, and in 1972–93 a number of amendments were incorporated into the General Banking Act and the Central Bank Act (Valenzuela 1989: 6). The pursuit of economic growth as part of the central bank's responsibilities and the prohibition on new banks were removed, and foreign banks were allowed equity participation in domestic banks and the creation of offshore banking units.

Minimum capital requirements were instituted to reduce the functional separation among banks of different types. Commercial banks were now allowed to engage in quasi-banking operations, while thrift banks were given permission to offer demand deposits, conduct trust operations, and institute NOW accounts. They were also given access to the central bank's discount window.

The beginning of the 1980s was an inauspicious period for the Philippines. The second oil shock of 1979 brought to an end the easy foreign financing that had fueled debt-driven growth in the 1970s. The massive foreign borrowings of the 1970s could not be rolled over, and the collapse of the commercial paper market in 1981 marked the beginning of a major Philippine financial crisis. The central bank rehabilitated weakened banks and imposed a moratorium on various aspects of bank competition. Capital requirements were reduced from 10 per cent in 1973 to as low as 6 per cent after 1980 (Intal and Llanto 1998: 8). In 1983, when the assassination of Benigno Aquino and the ensuing political crisis prompted massive capital flight, a moratorium on external debt payments was imposed.

Beginning in 1980, reforms covering the restructuring of the banking system and interest rates were undertaken based on the recommendations of the IMF-IBRD Survey in 1979 (Lamberte 1993: 232–5). These reforms began before the crisis of 1981, but the crisis made their swift implementation both imperative and difficult.

Interest rate deregulation began in 1980 with the lifting of ceilings on various categories of savings and time deposits and loans of over two years of maturity. Remaining interest rate ceilings on short-term loans were removed at the beginning of 1983.

The rediscounting facility of the central bank was overhauled in 1985 (Lamberte and Llanto 1995: 246) The central bank set one discounting rate aligned with the market rate for all eligible papers instead of having several preferential rates, and set the rediscounting value equal to 80 per cent of the original loan. The rediscount rate was aligned with the Manila Reference Rate, a weighted average of rates on promissory notes and time deposits with a 90-day maturity of a sample set of banks. Interest rates on remaining special credit programs of the government were likewise aligned with market rates.

The outcome of the overhaul of the rediscount rate was to effectively shut off a source of cheap funds for banks. Until then, the commercial banks had relied on borrowings from the central bank for about a quarter of their funds (Intal and Llanto 1998: 16). Rural banks, in particular, had borrowed liberally from the central bank's discount window and had functioned as a conduit for cheap government funds. This had a negative effect on deposit mobilization and prudential lending by rural banks, leading to mounting nonperforming loans in the late 1970s. With the reforms, the central bank discount window was closed to rural banks, and many became insolvent. Although a special rehabilitation program for those banks was undertaken, it proved largely ineffective in addressing the inherent weaknesses in the system.

One reform measure adopted to reduce fragmentation in the financial system and improve the availability of medium- to long-term funds to the industrial sector was the adoption of the modified universal banking concept. The Universal Banking

Reform Law was legislated under Batas Pambansa Nos 61 to 67 dated 1 April 1980 and implemented by Circular Nos 739 to 742 dated 10 July 1980 (Valenzuela 1989: 7). The law enabled commercial banks to engage in near-banking functions: they could now perform investment banking functions and engage in allied and non-allied financial undertakings, and wholly own nonfinancial business enterprises as well as other types of financial institutions. These measures were expected to increase competition in the banking system (Valenzuela 1989: 7).

The adoption of universal banking and the increase in minimum capital requirements had the effect of encouraging bank mergers and consolidations. This, combined with restrictions on bank branching and entry into the banking system, increased the market power of incumbents, hampering competition and market contestability, and in fact increased the level of concentration in the banking industry (Saldana 1984). In 1995, for example, the concentration ratio of the five largest domestic commercial banks relative to all domestic commercial banks in terms of assets amounted to 52.2 per cent (Hutchcroft 1998: 262). In other words, five banks hold more than half of all bank assets. Likewise, in terms of total deposits, the share of the five largest banks increased to 52 per cent in 1990 from 31 per cent in 1981. The Herfindahl concentration index almost doubled from 0.044 to 0.074 in the same period (Lamberte and Llanto 1995: 255).

Many of the Philippines' large family-owned business groups own a commercial bank directly or indirectly through the companies they control. Since much of corporate financing depends on intermediation by banks, a business group that owns a commercial bank is able to improve and maintain access to loans at favorable terms. The major interests of these family-owned business groups are in industries that primarily serve domestic markets and that tend to be highly protected; these industries include manufacturing, real estate, construction, and banking (Saldana 1999: 34).

Beginning in 1990, the central bank began to dismantle slowly the controls that had been set up over the preceding four decades and also during the economic crisis of 1984–85. The moratorium on the entry of new domestic banks was lifted in 1990. Bank branching regulations were revised in 1991, introducing the auctioning of franchises for bank branches; this had the effect of sharply increasing the number of commercial bank branches. By 1993, banks were allowed to set up branches anywhere as long as capital adequacy, liquidity, profitability, and soundness of management standards were met although the designation of 'over-banked' areas is still in the books of the central bank (Paderanga 1996: 7). In 1994, the entry of foreign banks was liberalized, although it was limited to only ten banks and to specified modes.

The outcome of dismantling controls and easing bank branching and entry was as expected. The ratio of total deposits to GNP increased from 38 per cent in 1982 to 43 and 53 per cent in 1993 and 1995, respectively. Banks slowly began to source more funds through deposit mobilization. As a result, the ratio of total deposits to gross savings increased from a range of 33–5 per cent in 1988–92 to an average of 54 per cent in 1993–95 – a sign of increasing financialization of savings (Intal and Llanto 1998: 17).

The beneficial outcome of interest rate deregulation was, however, mitigated to some extent by lack of competition that existed in the banking sector. In fact, deposits of the five largest banks as a share of total deposits of the banking system increased to 52 per cent in 1990 from 30 per cent in 1980 (Lamberte 1993: 242). The banks continued to maintain a large spread with low interest rates on deposits, which were in part due to lack of competition in the banking system (Lamberte 1993: 236). These suggest that financial reforms undertaken since 1990 have done little to improve the efficiency of financial intermediation.

Supervision and regulation

Regulatory authorities have long been unable to exercise their power independently of certain vested interests despite various reform programs. Furthermore, there is not much evidence that the basic regulatory and supervisory framework has improved beyond the legal consolidation of supervision based on functions rather than types of banks and in a manner keeping pace with rapid financial developments.

There have been some changes insofar as bank supervision and examination are concerned. On the chartering of banks and branches, the concept of 'economic service area,' which counted the number of banks in a geographical area, was introduced. It replaced the 10-meter rule of the 1960s, which required banks to be physically located at least 10 meters apart from one another. Unfortunately, both of these concepts illustrate the lack of appreciation for the more relevant concepts of competition and market contestability.

The managing of problem banks was done through an intensive care system and what was called the favorite banks list (Valenzuela 1989: 7). The central bank was not impartial in its supervisory function and a bank's success or failure largely depended on whether it was favored or not by those in official positions. These policies may have made it difficult for the central bank in its capacity as the regulator and supervisor of banks to maintain an arm's-length relationship with banks and prevent the problems of moral hazard. As a consequence, the decision as to which troubled banks were to survive and be allowed to remain in business was made more by bank regulators and less by the market. A case in point is the glaring difference in the way that Republic Bank and Overseas Bank of Manila were treated after the owners of the banks plundered them through lending to related enterprises: Republic Bank, whose owner was close to government officials, was bailed out while Overseas Bank was allowed to fail and its owner was jailed (Hutchcroft 1998: 90–100).

In the 1980s, some aspects of the support structure for bank examination were strengthened. The central liability files and central information files were started in 1983 to assist field examiners on the classification of loans to large borrowers and the identification of loans to bank directors, officers, stockholders, and related interests (DOSRI) and loans linked to corporations. The concept of comptrollership as a conditionality for granting emergency loans by the central bank was introduced in 1984. The CAMEL rating system was introduced after 1983.[4] A pilot group to audit the computer system of banks was started in 1986.

In spite of these measures, the financial system in the 1980s had some serious deficiencies; the emergence of the Philippine financial crisis in 1981 only made these deficiencies more evident. The supervision of banks was weak and encouraged loose banking practices. There was no significant improvement in the regulatory and supervisory framework, and no changes were made in the rules governing the treatment of overdue loans, the provisioning of debt, and examination of deposit transactions by central bank examiners (Intal and Llanto 1998: 9).

There was supervisory and regulatory fragmentation as well. For instance, the central bank had jurisdiction over quasi-banks and monitored transactions on a 'with recourse' basis, while the Securities and Exchange Commission supervised other participants and monitored transactions on a 'without recourse' basis. This fragmentation, which meant that there were no uniform supervisory rules over money market operations, enabled quasi-banks to circumvent central bank regulations.

The 1970s was a period during which economic growth was driven primarily by foreign debt that the regime managed to wangle from abroad to keep the economy afloat. The central bank was the key conduit in the disbursement of large quantities of foreign loans and other instruments of selective credit in the late 1970s and early 1980s. In particular, a favored bank could enter into a foreign exchange swap with the central bank in which a foreign loan could be converted into a peso loan for re-lending at high interest rates to local borrowers while the bank is charged a very low interest rate on the loan by the central bank. In fact, it was surprising that the central bank did not seem to bother to charge an interest rate even sufficient to cover the foreign exchange risk premium or the difference between the foreign and domestic interest rate. Apparently, the central bank was more concerned with being able to access foreign funds covertly through commercial banks. Hence, while this turned out to be a great way to make money in a relatively risk-free way for the favored banks, the central bank later became saddled with losses from such swap agreements. Given the favoritism and abuse that accompanied such selective credit privileges, rules regarding DOSRI lending were effectively relaxed by 1980.

Substantial DOSRI lending was encouraged by the high interest rate regime, promoting debt-financed investments, political accommodation in lending, and weak enforcement of DOSRI regulations. This problem was particularly acute in the case of government banks such as the Philippine National Bank (PNB) and the Development Bank of the Philippines (DBP), which accounted for nearly 50 per cent of all banking assets. These banks were plagued with poor internal controls, politically motivated loans, the takeover of troubled corporations, and the sharp devaluation of the peso. By 1985, both PNB and DBP were insolvent, and their nonperforming loans amounting to US$105 billion and their non-government deposit liabilities were transferred to the national government (Lamberte 1993: 234).

In the latter part of the 1980s, the central bank introduced measures to strengthen prudential regulation, including improvements in commercial banks' reporting requirements and specific guidelines for asset valuation and loan-loss provisions, and measures to curb insider abuse. For example, DOSRI loans were not to exceed

outstanding deposits and the book value of paid-in capital of the borrowing bank officer in the lending bank at any time (Intal and Llanto 1998: 10). Nevertheless, the recent experience of Orient Bank, a small commercial bank, which had made approximately 85 per cent of its loans to the bank owner and subsequently became insolvent, shows how ineffectively the rules on DOSRI lending are implemented even today. Orient Bank was, nevertheless, able to obtain an emergency loan of an unknown amount from the central bank even though such a loan is legally allowed only in the case of a temporary liquidity problem and not in the case of insolvency. The monetary authorities are suspected to have turned a blind eye to the mismanagement of Orient Bank, as its top official was once the head of the central bank's department of bank supervision.

Defending the peso

The central bank introduced currency swaps and blocked peso accounts in 1983 and 1984 in order to continue its defense of the peso and induce exchange rate stability. There were nevertheless devaluations in 1983 and 1984, which raised the peso-dollar rate from 11 to 18 pesos to the US dollar. To control the resulting inflation that soared to 50 per cent in 1984, the central bank began mopping up liquidity by selling high-yield instruments called 'Jobo' bills. Interest rates skyrocketed to as high as 40 per cent in 1984 from 14.5 per cent a year before, and the banks experienced premature terminations of deposit accounts as people withdrew funds to purchase the high-yield central bank instruments. Outstanding loans of the banking sector fell by 17 per cent between 1984 and 1985, and the economy was plunged into a deep recession in 1984–85 although inflation was brought under control (Bautista 1992: 13). By February 1986, a new government was in place.

The outcome of the central bank's defense of the peso, particularly in 1983, was extremely costly to the economy, including large losses for the central bank. Between 1983 and 1986, these losses hampered the central bank's ability to conduct monetary policy. By the end of 1986, the balance on these 'suspense accounts' amounted to close to P170 billion and had counterpart liabilities of a corresponding amount (Paderanga 1996: 2).[5] The servicing of these liabilities implied a continuous injection of money into the economy. Under the IMF stabilization program with monetary targets, these injections of money had to be mopped up with the flotation of treasury bills, the proceeds of which were immediately deposited with the central bank. The resulting high interest rates on treasury bills discouraged banks from extending loans to the private sector since they could easily earn more on treasury bills.

Liberalizing access to international capital markets

The Philippines made a re-entry into international capital markets with a series of Paris Club debt rescheduling beginning in 1985 and the implementation of a debt-to-equity program beginning in 1986. Only in the early 1990s was the country able to float bonds and some international equity issues, and it has yet to return to an investment grade credit rating by international credit rating agencies.

While the foreign exchange market remained highly regulated throughout the 1970s and 1980s, the central bank began relaxing some foreign capital controls in 1979, allowing domestic residents to obtain dollar loans from the foreign currency deposit units of banks (FCDUs). Finally, in 1992 the foreign exchange market was liberalized, eliminating restrictions on current account transactions and greatly diminishing restrictions on inward and outward movements of capital. Foreign exchange earners are now allowed to retain all of their foreign exchange earnings, and exporters are allowed 90 days instead of 60 days to remit their foreign exchange receipts to authorized banks. Exporters can also take out loans from FCDUs and there is no limit on the purchase of foreign exchange. Full and immediate repatriation of funds without central bank approval is allowed for foreign investments duly registered with the central bank or a custodian bank. The procedures for registering foreign investments were simplified, and the prohibition on on-floor foreign exchange trading was lifted (Intal and Llanto 1998: 13).

Adequate strengthening of bank supervision and regulation did not, however, precede liberalization of the foreign exchange market. The central bank, for example, was largely in the dark as to what financial derivatives are and how to regulate their trading. Regulations regarding such derivatives were issued only after their introduction in the market. The result of inadequate supervision, coupled with an overvalued peso, was over-borrowing from abroad by financial institutions with little regard for currency risk and maturity mismatch. Beginning in 1993, the corporate sector also showed signs of over-borrowing and declining productivity of investments, albeit not to the same extent as in other Asian countries (Saldana 1999: 1).

Before foreign exchange market liberalization in 1992, the banks in the Philippines reaped huge profits by investing in high-yield but riskless government securities. Interest rates in the Philippines were high relative to those in developed countries and even to those in ASEAN countries with the exception of Indonesia.[6] The liberalization opened another opportunity for banks to make huge profits as they could now source funds from abroad at lower rates and re-lend the funds locally at higher rates. Given the long history of exchange rate stability prior to the Asian crisis and the not-too-implicit policy of maintaining the peso-dollar rate, (the peso–dollar rate stayed at about 26 pesos to the US dollar in 1994–96), the banks became overly confident that the peso would not depreciate as officials had promised. Consequently, they largely neglected currency risks and most of their foreign currency borrowings were not hedged.[7]

Even if the banks had wanted to hedge their foreign currency borrowings they would not have been able to do so because hedging instruments are lacking and there is no forward exchange market. The only exception is the belatedly introduced, central bank's Currency Risk Protection System (CRPP) – a forward swap arrangement in which the difference in the exchange rate at maturity from that stated in the contract is paid by the central bank to the buyer in pesos. Although this program is in principle open to anyone, it aims to cover the foreign exchange needs of certain industries deemed essential, such as the oil companies. Some have also commented that the cost of such forward cover is very high, presumably since the central bank has vivid memories of its past losses from such swaps.

Predictably, surges of capital inflows followed the liberalization of the foreign exchange market. Total foreign exchange liabilities of private domestic banks increased from a paltry US$715 million in 1990 to US$5.031 billion in 1996, with the largest increase occurring in 1995–96 – an almost threefold increase from US$1.741 billion to US$5.031 billion (Bangko Sentral ng Pilipinas, various years). The total foreign exchange liabilities of private nonbank institutions also increased from US$3.23 billion in 1990 to US$9.112 billion in 1996. The share of foreign currency loans and discounts in the total assets of the banking system increased from 53 per cent in 1995 to 103 per cent in 1996, indicating that much of the funds sourced abroad were being re-lent locally. In the wake of the real appreciation of the peso, the government encouraged direct and indirect exporters to borrow dollar loans from FCDUs to help them reduce their interest cost and retain international competitiveness. According to a study of bank portfolios, dollar loans amounted to about US$3.6 billion – 30 per cent of banks' total loan portfolio of US$12 billion (Deutsche Morgan Grenfell 1998: 18). Evidently, many of these were not hedged and much of the cheap money went to the stock market and the real estate sector, fueling asset bubbles. The bubbles burst in July 1997 when capital made a rapid exit.

Effects on financial markets and the corporate sector by the time of the Asian crisis

Financial liberalization in the Philippines has not changed the structure of its banking sector and thus has done little to increase market competition and efficiency. Philippine banks have a low level of efficiency, spending US$3.75 for every US$100 to run their business when banks in Hong Kong and Singapore spend US$1.15 and Korean banks spend US$2.75. The spread between deposit and lending rates for the Philippine banks is relatively large although it decreased to 4.7 per cent in mid-1998 from more than 5 per cent in 1997 as a result of moral suasion by the central bank. The spread is only 2.7 percent for Malaysia, 1.8 per cent for Indonesia, 2.9 per cent for Singapore, and 1.1 per cent for the Republic of Korea (Basilio 1999: 30). The overhead cost as a ratio of total assets is also relatively high for Philippine banks – 4.4 per cent in 1988–95 in comparison with an average of 1.8 per cent for seven Asian economies (Asian Development Bank 1998: 23). In spite of their inefficiency, Philippine banks were able to earn excessive profits due to lack of competition in the banking sector. In 1988–95, for instance, their ratio of net profits to total assets was 2 per cent while the average ratio for seven Asian economies was only 1.8 per cent.[8]

Financial liberalization has nevertheless changed the business environment for large banks. While in the past big family-owned businesses were traditionally the main clients of large banks, with financial liberalization they could now raise funds easily through an initial public offering (IPO) of stocks or the floating of bonds in the global financial market. With their traditional clientele turning abroad for funds and with interest rates going down on government securities (as a result of a small budgetary surplus in 1994), the large banks were forced to look for new clients.

They started competing for clients with mid-sized and thrift banks, which mainly catered to retail lending such as car financing, housing loans, and credit cards.

Several features of the Philippine financial system that existed on the eve of the Asian crisis worked to attenuate the effect of the Asian crisis. First, the banks had a relatively strong capital position as a result of the raising of capital requirements in the years preceding the crisis; this allowed them to better absorb loan losses. Second, the surge in capital inflows occurred relatively late and in relatively small amounts in the Philippines as compared with other countries in Asia. Third, the historic lack of competition in the banking industry, which was not affected by financial liberalization, allowed the banks to maintain large spreads and earn profits despite their inefficiency. The banks' high profits, despite periodic boom and bust cycles in the economy, can also be attributed to their ability to earn high rates by purchasing treasury bills and by lending mostly to large family-owned corporate groups in protected industries (Saldana 1999: 25).

There are also several features of the Philippine corporate sector that reduced the damage that the Asian crisis might have inflicted on the Philippine economy. First, because of the delayed access to foreign currency debt markets (the debt moratorium was lifted only in 1991) and because of the experience gained from the external debt crisis in the 1980s, the corporate sector was able to access foreign currency debt markets only in small, measured steps. Furthermore, for several years preceding the Asian crisis, debt financing was minimal since the corporate sector had had five years of good profits and fresh equity could be raised through initial public offerings in the stock market (Saldana 1999: 1).

Second, the corporate sector managed their borrowing risks relatively well by largely avoiding the imprudent use of debts for risky investments. The leverage ratio, measured by the ratio of total liabilities to assets, ranged from about 50 per cent to 69 per cent in 1988–97, corresponding to a debt-to-equity ratio of 2.2 (Saldana 1999: 7). This range is high by developed-country standards but compares favorably with those in other Asian countries. While the leverage ratio increased in 1997 from the previous year for different-sized corporate subsectors, the increases were neither too different from the historical average nor significantly different across different-sized subsectors. For example, the leverage ratio of the large-sized subsector increased from 58 to 67 per cent between 1996 and 1997, but this is not very different from the historical average for 1988–97 of 60 per cent (Saldana 1999: 7).

Third, between 1988 and 1997 there appears to have been a prudent relationship between debt and equity financing for corporations regardless of their ownership type (Saldana 1999: 10). During the volatile and high-inflation years of 1973–91, corporations financed their investments primarily through internally generated funds, shareholder equity, and moderate amounts of short-term debt. Between 1993 and 1996, lending rates were declining and inflation rates were lower, and many corporations raised new equity through initial public offerings in the stock market. Even then, foreign portfolio investments remained small and, as a result, the adverse effects of the reversal of capital flows during the Asian crisis were mitigated.

Political economy of financial liberalization

Economic development strategy and the role of business elites and external actors

For most of its post-World War II years, the Philippines carried out a 'managed development' strategy that featured state ownership of business, 'crony capitalism,' state-sanctioned monopolies, and heavy subsidies. Another important element of the past is the strategy of import substitution via an overvalued currency, high tariffs and heavy government intervention, which created a local business elite in protected industries. The few who had access to scarce foreign exchange had the benefit of importing capital at subsidized prices and were thus able to transform themselves from simple traders into a new industrial elite. This policy of import substitution led to the emergence of an imported capital-intensive manufacturing sector, which continues today.

When foreign currency was no longer rationed and the exchange rate was decontrolled in the 1960s, this business elite sought to ensure the maintenance of an overvalued, stable peso–dollar rate because it served to reduce the foreign exchange risk and effectively subsidized imports. They also opposed tariff reduction and trade liberalization. Being profitable under protection, they did not see the need to make new investment to modernize and expand manufacturing capacity. Industries such as sugar refining and textiles are examples of the protected industries that are floundering today.

Unlike its ASEAN neighbors, the Philippines has the unique experience of having been under the tutelage of the World Bank–IMF for almost four decades. The important role of external players in sustaining the economy and the state regimes cannot be ignored.

Throughout the 1970s and 1980s, this 'managed development' strategy, which prevented any meaningful reforms from taking place and resulted in the Philippine economy lagging behind its dynamic neighbors in East Asia, was maintained because it benefited Marcos and his cronies. This strategy was tolerated by the United States – and, by extension, the World Bank–IMF – not because they wanted the Philippines to remain backward, but because a serious push for major reforms could have destabilized the delicate balance of power within the Philippines and placed American interests, both economic and military, in peril. The US bases hosted by the Philippines were strategically important to the United States and were used by Marcos as a bargaining chip to extract resources from the Americans and the multilateral institutions. The periodic balance-of-payments crises during the Marcos regime kept him dependent on American aid and loans through these multilateral organizations.[9] Hence, the interests of both Marcos and his cronies, and US geopolitical interests were served to maintain the status quo.

The deep recession and a political crisis in the early 1980s were something of a watershed in the history of economic policymaking in the Philippines. There were several reasons for this. First, the assassination of Aquino in 1983, so soon after the financial crisis of 1981, triggered political and economic shockwaves. People began to question the ability of Marcos to maintain control, given the brazenness of

Aquino's assassination and the well-known fact that Marcos was seriously ill at the time. There were doubts as to who really was in charge, and many began to consider a post-Marcos scenario. Second, the crisis was costly in terms of a decline in economic growth and, furthermore, the painful orthodox stabilization measures of the IMF resulted in negative rates of growth in 1984 and 1985 that were the first in the postwar history of the country. There began to be a great deal of disaffection among the business elites who became less favored than Marcos' closest elite business friends or 'cronies.' Some of these individuals were jailed and others had their business empires taken over by the cronies. Many of these disaffected business elites supported the 1986 EDSA revolution and Mrs Aquino. When Mrs Aquino became president in 1986, it was time for the Philippines to start afresh.

The return of democracy, the pursuit of reforms, and ghosts of the past

Along with a change in the political regime in 1986 was a shift towards allowing more market-based forces to be operative in the economy. One of the first actions of Mrs Aquino as president was to order the dismantling of state monopolies in such industries as sugar and coconut, which were held by Marcos cronies. Also, as part of its financial rehabilitation programs agreed upon with the World Bank–IMF, the government privatized various loss-making government-owned corporations. The government's ability to push for deeper reforms was severely hampered because of at least seven coup attempts.

In spite of reforms, the return of a democratic form of government did not erase overnight the weaknesses and structures inherited from the past. Given the historic institutional weakness of the state, a return to democracy may allow for a curtailment in the obstructionist role of the state in the economy, but not necessarily raise its capacity to achieve constructive tasks (Hutchcroft 1998: 3). Dismantling monopolies and privatizing government-owned corporations are far easier types of reforms to undertake than, say, installing a tax system that is able to effectively generate revenues for government. It is difficult to pursue the kinds of reforms that change the inward orientation of the economy to an outward one. Past policies of peso overvaluation, tariff protection, and a bias for capital-intensive methods of production led to a high degree of concentration in the corporate sector, dominance in certain industries, and a business orientation geared towards serving the domestic rather than foreign markets.

The high interest rate policy that was used to defend the peso at an overvalued level worked in the interest of banks as they could earn high rates on riskless government securities. It also served the interests of large corporate groups by preventing potential competitors from affording bank finance. Such a high interest rate policy was typically part of orthodox stabilization policies under IMF programs, in which the government agreed to follow a tight monetary policy to control inflation and reduce balance-of-payments deficits. Hence, the methods imposed by the IMF to stabilize the domestic economy also served the interests of banks and protected the business elite.

What is also evident is that in spite of the reforms, the incentive structure remained biased against exportables – a situation very much unlike those in the East Asian countries both before and after these countries liberalized their financial markets. Even in the 1980s, the Board of Investments, despite the political changes and the shift towards reliance on markets, granted tax incentives to and retained the bias in favor of capital-intensive industries serving the domestic market.

Interest rate deregulation

Interest rate deregulation in the Philippines resulted in higher interest rates as it did in South Korea and Taiwan, but it did not correct the incentive structure bias against exports that had existed prior to financial liberalization and, in fact, the liberalization may have worsened the bias. This is perhaps one of the reasons why the outcome of interest rate liberalization in the Philippines was different from that of South Korea and Taiwan. One could even argue that the design of the Philippine interest rate liberalization program, specifically its objectives, was somewhat technically flawed.

How this came to be can be gleaned from history. As early as 1969, for example, Gerardo Sicat, who was one of the leading 'technocrats' of the Marcos regime, wrote a paper arguing the relevance to the Philippines of South Korea's and Taiwan's financial liberalization experience in the mid-1960s (Sicat 1969: 34). He cited the fact that the deregulation of interest rates in those two economies raised interest rates and increased savings from households and institutional investors.

Sicat did not, however, embrace the idea that the liberalization of interest rates would mean that purely market forces would dictate the allocation of scarce capital resources. While he spoke of the interest rate policy adopted by South Korea and Taiwan as a 'model of rational pricing for a major economic resource,' he also noted the use of subsidized interest rates to promote exports in those economies (Sicat 1969: 34 and 38).

At the time, academic economists in the Philippines did not consider this latter aspect of interest rate liberalization in South Korea and Taiwan.[10] They were more concerned with raising the level of financial savings by removing controls over interest rates. In any case, interest rate deregulation in an oligopolistic banking sector, in conjunction with a policy of defending an overvalued exchange rate and the IMF-imposed stabilization programs, had the effect of keeping lending rates high and deposit rates low. Financialization of savings increased only much later when bank entry and branching policy were liberalized beginning in 1990. Even then, the Philippines has remained a country with the lowest savings-to-GDP ratio in East Asia and its ASEAN 5 neighbors – a mere 19 per cent.

Sicat points out that this failure of financial liberalization in the Philippines to discriminate between export industries and import-substitute industries also applies to the Philippine experience with respect to the foreign exchange decontrol. When foreign exchange controls were lifted in South Korea and Taiwan, their currencies were allowed to depreciate. This is unlike the Philippine experience in which the central bank sought to maintain the peso at an overvalued level. Furthermore,

import controls in the two East Asian economies, especially those on consumer goods, remained in effect even after exchange rate decontrol. South Korea used its list of restricted imports as a bargaining chip in trade negotiations to secure more open markets for its exports. In the Philippines, whatever positive effect the lifting of foreign exchange controls might have had on exports was nullified by the structure of tariffs that restored the bias against exports to the level that had existed during the period of foreign exchange control. Again, the lobby by the business elite to maintain the system of protection undermined the liberalization efforts.

In other words, whether one looks at financial deregulation or trade and foreign exchange liberalization, one is forced to conclude that reforms in the Philippines did not change the incentive structure that had been biased against exports. As a matter of fact, financial liberalization may have resulted in a more pronounced anti-export bias since it allowed the protected, large bank-owning business corporations in import-substituting industries favored access to bank financing to the exclusion of other borrowers in the country. Likewise, the financialization of savings occurred belatedly because the banking industry was protected when interest rates were deregulated.

Lagging exports and large imports required by the protected domestic industries gave rise to periodic balance-of-payments crises. Shortages in foreign currency interrupted the importation of capital and raw materials needed by the protected domestic industries and made it difficult for the authorities to maintain the peso at an overvalued level. Such difficulties, in turn, made the country dependent on foreign actors such as the IMF for bailout loans that came with harsh conditionalities.

It is clear from the foregoing discussion that certain structural weaknesses, such as inadequate regulatory supervision of the financial sector, the lack of competition in the financial and real sectors of the economy, the low saving rate, the anti-export bias, and other structural problems were never adequately resolved by the various reform programs undertaken over the years.

Conclusion

The long history of import substitution in the Philippines has created a business elite and a political regime whose deeply entrenched interests run counter to greater market competition and liberalization. The Philippine state is weak and patrimonial and has little capacity to undertake basic tasks because of a predatory oligarchy that has dominated the economy. These oligarchic interests, supported by the United States that has its own geopolitical interests, have favored the maintenance of the status quo in the Philippine economy. As a consequence, the Philippines has experienced a long period of lackadaisical economic performance and recurrent balance-of-payments crises.

The return of a democratic form of government did not erase overnight the weaknesses and structures inherited from the past. Past policies of peso overvaluation, tariff protection, and a bias toward capital-intensive methods of production led to a high degree of concentration in the corporate sector, oligopolistic industries, and a business orientation geared towards serving the domestic market.

The ownership by large family-owned corporate groups of commercial banks facilitated their access to financial resources, which were largely channeled through banks. This access gave them an added advantage over potential competitors and strengthened their position in the industries already dominated by them.

Financial liberalization in the Philippines did not bring about the theoretically expected results because it was undertaken in the presence of many significant distortions in the economy. The regulatory authorities have been unable to exercise their powers independently of vested interests. The experience of the Philippines shows that simply deregulating interest rates or liberalizing the foreign exchange market and opening the capital account do not necessarily promote market competition nor change the orientation of industries from an inward-looking to an outward-looking one. Whatever reforms might have been undertaken in the Philippines, none has corrected the anti-export bias in its incentive structure. As a matter of fact, financial liberalization may have resulted in a more pronounced anti-export bias by allowing the large family-owned corporate groups in protected import-substitute industries favored access to bank financing locally and abroad.

Deregulating interest rates without ensuring market contestability in the banking industry through entry allowed commercial banks to raise lending rates while keeping deposit rates low. This prevented access to bank financing by potential competitors to large family-owned corporations and exacerbated the problem of the general lack of competition in the economy. Furthermore, the favored access to bank financing by large corporate groups made it easy for them to avoid going to the equity markets. This has allowed the owners to retain their ownership control while insulating corporate management from harsh judgments of the equity markets. In other words, the close ties between large corporations and banks and their ties to those in political power are what have perpetuated monopolies and the resulting inefficiencies in the Philippine economy. Breaking these ties and raising the capacity of the state to undertake even its most basic tasks are critical if the Philippine economy is to become more competitive and efficient, and if financial liberalization is to have a better chance of success than in the past.

Breaking the close linkages among the elite business interests will not only contribute to market contestability in the corporate sector, but will also provide banks with an incentive to closely monitor their clients. Banks would have the incentive to supervise corporate borrowers as they would need to protect their own bottom lines, while corporations would be motivated to observe good corporate governance in order to ensure access to loans from banks and equity capital from capital markets.

Liberalization of the foreign exchange market in the Philippines did not lead to greater market competition and efficiency as well. It was really only banks and large corporations that could access funds in international capital markets, and this selective access further enhanced their advantage over other players in the economy. Taking advantage of an overvalued currency and low interest rates abroad, banks and corporations borrowed heavily from abroad for investments in the nontradeables sector.

Correct timing and having the right preconditions in place are important for reform programs to succeed. When financial reforms are pursued at a time of crisis,

as was the case in the Philippines in the early 1980s, they are hampered by more urgent measures of containing the crisis: regulatory forbearance such as reducing capital requirements and a moratorium on certain aspects of bank competition such as bank entry and branching. Such inconsistencies in reform programs are less likely to arise if they are carried out in good times when there is more elbow room to take on difficult reforms and put in place some safety nets to cushion the pain.

One of the most important lessons one may draw from comparing the liberalization experiences of the Philippines with those of other countries in Asia, such as South Korea and Taiwan, appears to be that openness to international competition is key to achieving economic efficiency and rapid economic growth. In other words, there is really no substitute for the disciplining power of international markets in surmounting the opposition of well-entrenched business elites to meaningful economic reforms and making the economy efficient and resilient. If the Philippine economy is to grow and prosper in the globalizing world of today, it must make a fundamental shift in its policy orientation toward a more outward-looking orientation.

There are also new challenges to be faced in a more open, global economy. Given the flawed economic development strategy of the past, the design of an appropriate alternative in today's world is a major challenge. The conduct of appropriate monetary policy is less clear in a world where the high international mobility of capital makes independent monetary policy difficult, if not impossible. The central bank's role as the lender of last resort is also challenged because the liquidity injected to maintain financial sector stability can be easily converted into assets abroad. The design of an appropriate regulatory and supervisory structure capable of 'globalized' supervision that correctly assesses risks is important to ensure that the financial system and the economy are resilient to shocks.

Appendix 5.1 Aggregate and average sales per company of selected groups of companies by industry category, main firm and affiliate banks, 1997

Corporate group	*Size class*[1]	*Main firm*	*Affiliate bank*[2]
Eduardo Cojuangco	Large	San Miguel Corporation	UCPB
Lopez Family Group	Large	MERALCO	PCIBank
Ayala Corp. Group	Medium	Ayala Corporation	BPI
George Ty	Medium	Toyota Motors	Metrobank/ Global Bank
Jojn Gokongwei	Medium	Robinson	PCIBank
Henry Sy	Large	Shoe Mart	Banco de Oro
Lucio Tan	Large	Philippine Air Lines	Allied Bank
Ramon Cojuangco Family Group	Large	Philippine Long Distance Telephone	Bank of Commerce
Del Rosario/ Phinma Group	Medium	Phinma	Asian Bank
Zuelig Group	Large	Zuelig Pharmaceutical	
First Pacific/Metro Pacific Group	Medium	Metro Pacific	PDCP Bank
Aboitiz Family Group	Medium	William Gothong and Aboitiz	Union Bank

Appendix 5.1 (continued)

Jose Concepcion/ RFM Group	Medium	Swift Foods/RFM	Consumer Bank (savings bank)
Alfonso Yuchengco	Medium	House of Investment	RCBC
Andres Soriano Family Group	Medium	Anscor	Asian Bank
George Go	Medium	Equitable Card Network Inc.	Equitable Banking Corp.
Wilfred Uytengsu/ Gen. Milling Group	Medium	Alaska Milk Corporation	
David M. Consunji	Medium	DM Consunji Inc.	
Jolibee Foods	Medium	Jolibee Foods Corporation	
Luis Lorenzo Family Group	Small	Lapanday Holdings Corp.	
Alcantara Family Group	Small	Alson Cement	
Bienvenido Tantoco	Medium	Rustans	
Elena Lim	Medium	Solid Group	
Andrew Gotianum	Small	Filinvest	East-West Bank
Brimo Family Group	Medium	Philex Mining	International
Exchange Bank			
Andrew Tan	Medium	Megaworld Properties	
J.P. Enrile. JAKA Group	Small	Jaka Investment Corporation	
Jaime Gow	Small	Uniwide Corporation	Ecology Bank (savings bank)
Guoco Group	Small	Guoco Ceramics	Dao Heng Bank
Jose Go	Small	Ever Gotesco	Orient Bank
Jardine Davies	Medium	Republic Cement	
Gerardo Lanuza	Small	PhilReality	International Exchange Bank
Alfredo C. Ramos	Medium	National Bookstore	International Exchange Bank
Gaisano Family Group	Small	Gaisano Department Store	Philbanking Corp.
Felipe Yap	Small	Lepanto Consolidated Mining	
Felipe F. Cruz	Small	F.F. Cruz & Co. Inc.	
Jose Luis Santiago	Small	PT&T Corp.	
Keppel Group	Small	Kepphil Shipyard Inc.	Keppel-Monte Bank
Robert John Sobrepeña/Fil-Estate Group			

Source: Saldana (1999: 33).

Notes: a. Recent developments have included the mergers of very large banks such as PCIBank and Equitable Bank, and BPI and Far East Bank.

b. Definition of Size class: Large = sales greater than 4.48 billion; medium = sales of 1.65–4.48 billion; small = sales of less than 1.65 billion.

c. Commercial bank, except when otherwise indicated.

Notes

* I acknowledge the support provided by the East–West Center.

1 This discussion on the macroeconomic conditions in the Philippines in the aftermath of the Asian crisis is drawn from Asian Development Bank (1999) using data in Table 1.

2 See de Dios *et al*. 1997: 3.

3 This term arose in the literature in the context of the effects of real appreciation of domestic currencies in Latin America as a result of portfolio inflows.

5 CAMEL stands for Capital adequacy, Asset quality, Management, Earnings, and Liquidity.

5 Suspense accounts are an accounting entry in the balance sheet of the central bank created by amendments to the Central Bank Charter via Presidential decree. In effect, the central bank was allowed to book its unrecognized losses under its assets.

6 In 1996, for example, the average Treasury bill rate was 12.4 per cent compared with about 6.4 per cent in Malaysia and 0.90 per cent in Singapore for securities of comparable maturities. In the Philippines, the Treasury bill rate is basically the rate on the 31-day Treasury bill as this is the most actively traded type. At this level, the yield on a 31-day Philippine Treasury bill is much higher than that on long-term US bonds.

7 Indeed the previous central bank governor was quoted at the time as saying that he would resign from his post before he would allow the peso to be devalued.

8 Asian Development Bank (1998: 23) citing a study of Stijn Claessens and Tom Glaessner. The six other economies studied were Hong Kong, India, Indonesia, Malaysia, South Korea, and Thailand.

9 A common joke attributed to the Americans at the time was that, 'Marcos may be an S.O.B., but he's our S.O.B.'

10 See the studies cited in Tan (1980).

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6 Japan, the Asian crisis, and financial liberalization

Thomas F. Cargill

Japan and the Asian crisis

This chapter considers the sharp economic and financial decline in the Japanese economy in the late 1990s in the context of the Asian crisis in 1997 and 1998[1] and focuses on the relationship between Japan's economic and financial distress and the Asian crisis, and lessons both Japan and other Asian economies can draw from the crisis.

Japan's economic and financial distress and the Asian crisis are noteworthy events by any reasonable standard. They involve countries that collectively represent a major component of the world economy in terms of trade and finance, and they involve two of the world's larger countries in terms of GDP (Japan, and to a lesser extent, South Korea). Collectively, the Asian countries exhibited unprecedented growth prior to the crisis. Their economic performance was so remarkable that a World Bank study (1993) referred to economic growth in the region as nothing less than an 'Asian miracle.'

The timing of Japan's decline and the Asian crisis suggests they were causally related. The Asian crisis started in the spring of 1997 in Indonesia and Thailand, spread to other Asian counties, and culminated with the near collapse of the South Korean economy in late 1997. The crisis was manifested in capital flight, currency depreciation, insolvent financial institutions, declining output, and an apparent inability of government policy to reverse the decline. The Japanese economy also declined significantly in the latter part of 1997 and, by 1998, came close to a deflationary-downward spiral with increasing numbers of insolvent financial institutions and an apparent inability of government policy to reverse the decline reminiscent of the 1930s. In fact, the failure of monetary policy to stimulate the economy since 1997 has rekindled the debate over 'liquidity traps' and monetary policy (Krugman 1999). In November 1997, Hokkaido Takushoku Bank and Yamaichi Securities Company, two large financial institutions, failed and in 1998, the Long Term Credit Bank and Nippon Credit Bank, also two large institutions, were declared insolvent and nationalized. Numerous smaller financial institutions failed in 1997 and 1998. Real GDP from 1991 to 1995 was virtually stagnant and while the economy appeared to recover in late 1995 and 1996, the economy abruptly declined in the fourth quarter of 1997 and declined in each quarter of

1998. Real GDP recovered in 1999 and 2000; however, the economy declined again in late 2000. Real GDP was projected to decline in 2001.

Japan and other Asian countries share certain economic institutions, and this commonality suggests a causal relationship between Japan's problems and the Asian crisis. Many of the economic institutions of the Asian countries were influenced by Japan because it had been the first industrial economy in the region and was the first to achieve the 'Asian miracle' status. Japan thus offered a guide to other Asian countries wishing to duplicate Japan's economic success.

Although the timing of the two events and the shared economic institutions suggest a causal relationship between Japan's problems and the Asian crisis, the two events were largely independent of each other. The thesis of this chapter is that Japan's problems in 1997 and for the remainder of the 1990s were independent of the Asian crisis, which in turn was due to forces independent of Japan's economic and financial distress. In a general sense, the Asian crisis and Japan's problems were both the outcome of a conflict between market forces and an unbalanced and incomplete liberalization process. The fundamental structure of the Japanese financial regime and of other financial regimes based on the Japanese model would eventually have generated some type of economic and financial distress. That is, the approach to liberalization adopted by Japan and the other Asian countries was not sustainable and events like the sharp decline in Japan and the Asian crisis in 1997 and 1998, while not directly related to each other, were the outcome of a partial and incomplete liberalization process.

Relations between Japan's economic and financial distress and the Asian crisis

Japan's economic and financial distress started in 1991 and 1992, well before the Asian crisis. Mattione (2000) refers to Japan as exhibiting the 'world's slowest crisis' while most would agree that the Asian crisis was one of the speediest. The Japanese economy was virtually stagnant in the first half of the 1990s, burdened with nonperforming loans and increasing numbers of insolvent small financial institutions. Despite Japan's relative importance in the region, Japan's problems were not a meaningful cause of the Asian crisis. The countries involved in the Asian crisis – Thailand, Indonesia, Malaysia, and Korea, for example – exhibited robust economic and financial development in the first half of the 1990s while Japan stagnated. Thus, their problems in late 1997 and 1998 cannot easily be attributed to the economic and financial distress in Japan. Likewise, Japan did not experience the same degree of recovery that appears to be taking place in the majority of the other Asian countries (Table 6.1). Japan's real GDP growth in 1999 was barely positive at 0.8 per cent, increasing to 1.5 per cent in 2000; however, the economy began to decline in late 2000 and reached a business cycle peak October 2000. Real GDP is projected to decline in 2001. Other Asian economies exhibited much higher growth rates in 1999 and 2000.

The immediate causes of the Asian crisis were the large amounts of external debt denominated in external currency, inadequate international reserves to credibly

Table 6.1 Real GDP growth of Japan and other Asian economies, 1998–2000 (percentage)

	1998	*1999*	*2000*
Japan	–1.1	0.8	1.5
China	7.8	7.1	8.0
Korea	–6.7	10.7	8.8
Hong Kong	–5.3	3.0	10.5
Singapore	0.1	5.9	9.9
Thailand	–10.8	4.2	4.4
Indonesia	–13.1	0.8	4.8
Malaysia	–7.5	6.1	8.3
Philippines	–0.6	3.4	4.0

Source: Bank of Japan (2001) and International Monetary Fund (2001).

prevent depreciation of the currency, and government policy influenced by the International Monetary Fund. These factors were not issues for Japan. While it was an important member of the International Monetary Fund, Japan was not very sensitive to Fund influence to adopt austerity programs, as were other Asian countries. Throughout the 1990s Japan had no meaningful external debt and possessed large amounts of international reserve assets accumulated after over two decades of large current account surpluses. In fact, in 1985 Japan became the largest creditor nation in the world. Japan did not experience the capital flight or currency depreciation in 1996 and 1997 common to those countries involved in the Asian crisis. The yen had been depreciating since 1995, but began to appreciate in mid-1998 and continued to appreciate for the remainder of the 1990s. While the trade and current account surpluses declined from the early 1990s to mid-1996, both surpluses increased at the end of 1997 and remained high through the end of the decade.

The sharp decline in real GDP in the fourth quarter of 1997 was the outcome of a fiscal policy error exacerbated by the failure of Hokkaido Takushoku Bank and Yamaichi Securities Company, events largely independent of the Asian crisis. The failure of Hokkaido Takushoku and Yamaichi Securities can be explained by accumulating stresses in the financial system resulting from the failure of regulatory authorities to resolve the nonperforming loan problem and a series of policy errors made by regulatory, fiscal, and monetary authorities.

The absence of a causal relationship between the two events, however, does not imply the lack of any relationship between Japan's economic and financial distress and the Asian crisis. Three relationships are worth noting.

First, the Asian crisis adversely impacted Japan through trade and financial relationships in the region, but only in the sense that the impact of the Asian crisis on Japan made a long-standing problem worse than it would have been in its absence. Exports to Asian countries declined and Japanese financial institutions found their nonperforming loan problem increase to the extent that they held debt against other Asian countries.

Second, the Asian crisis, in part, was due to an unwillingness of Asian governments to adapt their domestic financial structures to the increasing role of market forces and

internationalization of finance. In this respect, Japan and the other Asian economies shared a common financial regime with Japan serving as a model to a large extent. Many Asian economies adopted Japan's bank-finance model, nontransparency, and pervasive government-deposit guarantees; while there were significant differences between the Asian financial systems,[2] the similarities with Japan were significant. The key characteristics of these structures ensured problems once market forces came to play an important role in the domestic financial system.

Third, the Asian crisis was initiated by currency flight as the market responded to unsustainable domestic financial policies of large holdings of nonperforming loans and heavy reliance on short-term borrowing in the international markets. No such currency flight occurred in Japan. Nonetheless, international market forces played a role in revealing weaknesses in Japan's financial system and policies in the form of a 'Japan premium' required by Japanese banks that borrowed in the overnight dollar market (Figure 6.1). The high Japan premium, however, had been an issue in 1995 well before the Asian crisis. Japan and the other Asian countries thus shared a common susceptibility to market forces as each country achieved a degree of liberalization, but continued to rely on key elements of the old financial regimes.

The following sections of this chapter discuss the liberalization process in Japan through 1989, the accumulation of economic and financial distress in Japan during the 1990s, problems facing Japan as the new century begins, and lessons from both Japan's problems and the Asian crisis. The discussion emphasizes the view that Japan's distress was firmly in place prior to the Asian crisis, that the sharp Japanese downturn in 1997 was the result of internal rather than external shocks, but that there are, at the same time, general lessons that emerge from both events. A concluding section places the Japanese experience in the context of the Asian crisis.

Financial liberalization in Japan:[3,4] catalysts, process, accomplishments, and problems from 1976 to 1989

The official recognition of the *gensaki* or repurchase market in government bonds in 1976 is generally regarded as the start of an official policy to liberalize the financial system. The *gensaki* market had been an informal market since the late 1960s, unofficially permitted by the Ministry of Finance. During the subsequent decade and a half (1976–89), the Ministry of Finance implemented a gradual and administratively directed financial liberalization process. This section discusses three issues relating to this liberalization process – the characteristics of the pre-liberalization structure of finance, the forces that initiated the liberalization process, and the accomplishments and the inherent contradictions in the liberalization process that set the stage for the economic and financial distress that dominated Japan in the 1990s.

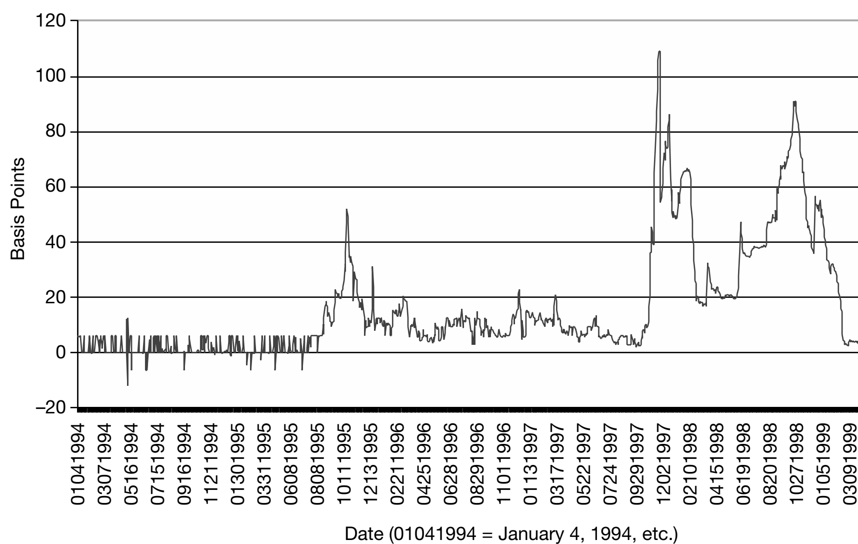

Figure 6.1 Japan premium, 4 January 1994–30 April 1999.
Source: Ito and Hasada (2000).

Pre-liberalization financial regime

Japan's financial and monetary system evolved after the 1868 Meiji Restoration as part of the country's overall effort to industrialize and become a major industrial and military power. The financial and monetary system evolved slowly, but from the start it exhibited well-defined trends that evolved into the financial and monetary system that characterized Japan in the 1950s and 1960s. The evolution of the system was influenced most significantly by the banking collapse in 1927, war mobilization and war in the 1930s and first half of the 1940s, and adjustment to peacetime conditions by the early 1950s. The system reached full maturity by the early 1950s, but in many respects, represented a continuation of pre-war trends (Hamada and Horiuchi 1987). Japan's pre-liberalization financial and monetary system can be characterized by four considerations.

First, the regime was designed to ensure that the financial system supported the goals of reindustrialization, high household saving, export-led economic growth, and international isolation. This was accomplished by a segmented bank-finance model in which both private and government banks played a major role, and money and capital markets played an insignificant role in the flow of funds from households to the corporate sector. Interest rates with the exception of the interbank and *gensaki* rates were administered, financial regulation and supervision were nontransparent, and soundness was maintained by an explicit policy of no failures of financial institutions or markets. The no-failure policy was implemented by extensive and implicit government deposit guarantees, regulation designed to limit market forces, and nontransparency that permitted a policy of mutual support or 'convoy'

approach in which the stronger institutions were required at the direction of the Ministry of Finance to support weaker institutions.

Second, the financial regime was successful by any reasonable measure of performance. Japan emerged from complete devastation in 1945 to being the second-largest economy in the world by the mid-1970s and the largest creditor nation in the world by 1985. This was accomplished with a high degree of macroeconomic and financial stability. The entire period from 1950 to 1989 was marked by only one period of economic and financial instability. In the early 1970s, Japan's inflation rate reached 30 per cent as a result of excessively easy monetary policy designed to limit yen appreciation and maintain high rates of real growth. The Bank of Japan in 1973 restricted monetary growth and adopted price stability as the primary policy target. The oil price shock in 1973 and restrictive monetary policy together generated a sharp recession, but the Bank of Japan maintained its focus on price stability. Price stability was achieved by 1975 and Japan returned to a sustained, but lower, noninflationary growth path as well as embarking on a general process of liberalization.[5]

Third, the success of Japan elevated the Japanese financial regime to model status for other Asian countries wishing to repeat Japan's economic performance. Asian countries adopted various aspects of the Japanese system, especially the bank-finance framework, and like Japan, the 'Asian miracle' was attributed to the particular approach to finance adopted by Asian countries. Korea adopted the Japanese model to the greatest extent.

Fourth, the success of the Japanese financial regime and other financial regimes modeled after Japan, depended on a narrow set of conditions that were not sustainable. The regime depended on the ability to limit market forces, limit the channels of finance, and impose administrative controls over institutions and markets. The regime required international isolation to limit competition, a national consensus on the goals of the economy, and high rates of economic growth to placate those excluded from the financial system or limited to low financial asset returns. High rates of growth also reduced incentives to innovate and circumvent binding regulations and sustained the soundness of financial institutions to offset less-than-efficient credit allocation policies. These conditions, however, were unlikely to exist over long periods since the very success of the system to support economic growth and increase Japan's market share in the world economy ensured that competitive and market forces could not be restrained indefinitely.

Political economy of financial liberalization

A schematic outline of the evolution of financial change in Japan starting in 1976 and ending in 2001 is presented in Appendix 6.1 on page 180. The adoption of an official liberalization policy in 1976 can be accounted for by three reasons.

First and most important, the shift to a slower natural growth path after 1973 changed the flow of fund relationship between the corporate and government sectors (Table 6.2). These new relationships provided incentives for the most important sectors in Japan to support liberalization as part of a *quid pro quo* arrangement

Table 6.2 Surplus or deficit positions of major nonfinancial sectors, 1954–74 and 1975–85 (percentage of GNP)

	Personal	*Corporate*	*Central gov't*	*Public corp. & local gov't*	*Total gov't*	*Rest of world*
1954–74	8.6	–7.1	0.7	–2.4	–1.7	–0.3
1975–85	10.3	–2.6	–3.7	–3.3	–7.0	–1.0

Source: Cargill and Royama (1988: Table 2.6).

between banks, corporations, securities companies, and the Ministry of Finance (Feldman 1986). The central government sector before 1973 ran small deficits or surpluses and corporations ran large deficits. The central government could not issue general deficit bonds without annual approval (Article 4 of the Fiscal Law); however, in 1965 political leaders adopted a more flexible attitude toward deficit bond issues. Despite the ability to issue deficit bonds, the Ministry of Finance and the Liberal Democratic Party were fiscally conservative because of the economic instability caused by large government deficits and their adverse effect on the economy immediately after the end of World War II. During the high-growth period from 1950–70, the corporate sector needed to support rapid rates of investment and thus operated with excess demand for funds from the banking system. In the slower-growth environment starting in the early 1970s, corporations found themselves with increased liquidity since they were no longer required to hold large compensating balances with banks to maintain their 'customer relationship.' Corporations then became an advocate for enhanced portfolio diversification powers and new financial assets (domestic and international) as a channel for financial investment.

The central government experienced large deficits as the economy slowed. Government expenditures increased to offset the adverse effects of the oil price shock and tax revenues declined in the slower-growth environment. The Ministry of Finance now had to finance large deficits in the absence of a bond market. In the past, small deficits were financed by selling bonds to a 'captured syndicate' of banks and securities companies who were willing to absorb the bonds at above-market prices. They were willing to be part of a captured syndicate because banks were assured by the Bank of Japan that the bonds would be repurchased at prices that guaranteed no capital loss after one year and the security companies were permitted to operate the 'unofficial' *gensaki* market.

After 1973, however, banks and securities companies were unwilling to absorb the large amount of bonds needed to finance the increased deficits under the captured syndicate framework. They were only willing to assist in financing the deficit if the Ministry of Finance provided enhanced portfolio diversification powers and permitted a secondary market in government bonds. Banks and securities companies became advocates of liberalization because, in the case of banks, liberalization was viewed as a method to restore lost market share and, in the case of the securities companies, liberalization was viewed as a means to enter profitable new markets.

The Ministry of Finance was thus under pressure to provide liberalization as the 'price' for financing the large central government deficits in the 1970s. Once liberalization began, such as permitting a secondary market for government bonds, the process became self-reinforcing.

Second, the end of the fixed exchange rate system in 1973 and the increasing role of Japan in world trade and finance brought considerable international pressure to establish money and capital markets to provide yen-denominated financial assets for investment and reserve purposes.

Third, by the early 1980s, international pressure, especially from the United States, was increasingly brought on Japan to liberalize and internationalize its domestic financial system. This pressure was only partly the outcome of the new policy of deregulation in the United States, but was viewed more by the United States as a way to reduce persistent trade deficits with Japan. In the early 1980s, the US Treasury argued the yen was undervalued because it lacked any desirable characteristics as an international investment or reserve asset and hence, provided Japan with an advantage in world trade. This, in turn, according to the Treasury's logic, was due to Japan's rigidly administrated, controlled, and internationally isolated financial system. The US Treasury argued that liberalization and internationalization of the financial markets in Japan would appreciate the yen and, hence, reduce Japan's trade surplus. Irrespective of the logic of the argument, US pressure on Japan was an important influence.

The emergence of a new market ideology was not a direct factor in Japan's decision to initiate financial liberalization although it had an indirect influence through pressure from the United States where there was a renewed faith in the market. External pressure increased after 1980, but by this point liberalization was already an established process in Japan. Thus in a broad sense the start of liberalization in Japan in the mid-1970s was not the outcome of a new market ideology or outside pressure. The catalysts for liberalization were internal and directly related to the slower growth environment after 1973 and the impact that the slower growth had on the traditional flow of fund patterns. Various groups in Japan supported liberalization for reasons of their own, and the Ministry of Finance was willing to supply specific types of liberalization in an effort to finance large deficits. There was never a broad consensus in Japan to adopt the market as the foundation for liberalization, and in this respect liberalization was more rhetoric than accomplishment. Once started, however, the process became self-reinforcing.

Accomplishments and conflicts

As shown in Appendix 6.1, financial liberalization from 1976 to 1989 was gradual, incremental, and administratively directed. By 1989, Japan achieved considerable progress when judged against the pre-liberalization structure and absence of the type of financial disruptions exhibited by other countries such as the collapse of the S&L industry in the United States. Loan rates and large deposit interest rates were liberalized, with complete liberalization achieved by 1994. Short- and long-term capital flows were relaxed and foreign financial institutions were permitted a small,

but significant, presence in the domestic system, especially in the securities market. Corporate flow of fund patterns reflected enhanced reliance on money and capital markets, both domestic and international, and reduced reliance on bank finance. Associated with this change in the corporate flow of funds was the beginning of the unraveling in the *keiretsu* relationship or main bank system.[6] Households had greater access to consumer and mortgage credit, and there was generally more competition between markets and securities companies.

These changes, however, paled in comparison with the reforms that would be required to render Japan's financial system compatible with the new economic, technological, and political environment that favored more open and competitive financial regimes. Six elements of the old regime continued to dominate Japanese finance through the 1980s and into the late 1990s (Cargill 2000):

- Regulation and supervision continued to emphasize nontransparency. For example, meaningful public information on the condition of individual banks and securities companies was unavailable.
- The system still continued to rely on mutual support or the convoy system to deal with troubled financial institutions.
- Government deposit guarantees were pervasive, with no concern expressed over the conflict between guarantees and the increase in portfolio diversification resulting from liberalization. While the Deposit Insurance Corporation insured deposits only up to 10 million yen, complete government deposit guarantees and a no-failure policy of financial institutions or markets were operational. The lack of concern about deposit guarantees is reflected by the small role played by the Deposit Insurance Corporation. Established in 1971 as a means to placate concern over a more liberal policy of permitting branching, the Corporation until 1995 played no meaningful role. It had a staff of fewer than fifteen individuals and reserves were so low that the failure of one medium-sized bank would render the Corporation insolvent.
- The banking and securities industry lacked efficiency in the delivery of financial services and lacked a corporate governance culture that emphasized shareholder interests. The lack of corporate governance was not confined to financial institutions, but to nonfinancial firms as well.
- The bonds between politicians, financial institutions, and regulatory authorities remained strong and generated serious 'agency problems' in financial regulation and supervision. Combined with nontransparency and pervasive deposit guarantees, these relationships ensured that any financial distress would first be met by denial, and once denials were no longer credible, by understatement of the problem. These relationships also ensured that forgiveness and forbearance would be the preferred policy response to any widespread financial distress.
- A complex system of government intermediation finance based on the Postal Savings System and the Fiscal Investment and Loan Program[7] not only remained an important part of the flow of funds but also increased its importance despite an official policy of liberalization. Postal deposits represented 30 per

> cent of total deposits in 1989, most of which were transferred to the Trust Fund Bureau of the Ministry of Finance and distributed to government banks and other entities as part of the Fiscal Investment and Loan Program. Such pervasive government influence in the financial system was inconsistent with any meaningful liberalization of the private sector.

The unwillingness to depart from the most important aspects of the pre-liberalization regime would create serious problems for Japan in the 1990s as economic and financial distress arose in response to the collapse of asset prices. The success of partial and incomplete liberalization in the 1980s gave Japan a sense of accomplishment that was unfounded and likewise, influenced the liberalization process in other Asian countries. Japan's apparent success from 1976 to 1989 in adopting a slow and gradual pace of liberalization while adhering to the basic elements of the pre-liberalization financial regime suggested to other Asian countries with similar economic institutions that economic growth did not require rapid liberalization. The obvious question is, 'Why did the Japanese economy and financial system perform so well during the 1976–89 period in the face of incomplete and unbalanced liberalization?'

Calm before the storm through the 1980s

Despite the conflicts, Japan's liberalization process through the 1980s appeared to progress smoothly. The Bank of Japan's success in maintaining price stability and the country's avoidance of inflation and disinflation that was experienced by other industrial countries in response to the second oil price shock in 1979 and 1980 had a profound and positive effect on real and financial activity in Japan. The Bank of Japan's price stabilization policies drew worldwide attention, especially since the Bank of Japan had achieve a degree of price stability while at the same time being one of the world's most formally dependent central banks.[8] Low and stable inflation in Japan not only provided a framework for sustained output growth, but also generated a narrow gap between regulated and unregulated interest rates. The narrow gap allowed a gradual and incremental approach to financial reform without generating incentives for market-regulatory conflicts that characterized financial reform in the United States in the late 1970s and early 1980s.

Other considerations, such as low levels of foreign borrowings and large holdings of international reserve assets, insulated Japan's financial system from external shocks. The contribution by the Bank of Japan, however, is considered to be the most important factor in understanding Japan's macroeconomic performance in 1975–89.

In the mid-1980s, Japan appeared to have achieved the contradictory objective of financial liberalization and the retention of key elements of the old financial regime. This was based, however, on the price stabilization policies of the Bank of Japan and corresponding sustained real economic growth and limited susceptibly to external shocks. Yet, the outcome was not sustainable and in the second half of the 1980s, the balancing act began to unravel.

The bubble economy period and subsequent collapse of asset prices

Japan appeared to achieve a smooth and gradual financial transition from 1976 to 1985. Interest rates were deregulated, money and capital markets began to develop, and Japan's financial system became increasingly integrated with the international financial system. Despite these achievements, however, the financial system continued to operate on the principles of the pre-liberalization regime: nontransparency, pervasive deposit guarantees, mutual support, and limiting bankruptcy. There was an inherent flaw: the newly emerging financial system provided enhanced opportunities to manage and assume risk, but the adherence to the old regime provided inadequate means to monitor risk and in fact, subsidized risk-taking. A stable macroeconomic environment through the first half of the 1980s achieved by a reduced deficit spending by the government, however, masked this inherent flaw.

Problems with the unbalanced liberalization process emerged in the second half of the 1980s when asset inflation (equity and land prices) became a prominent feature of the Japanese economy. Asset inflation was the combined outcome of easy Bank of Japan policy, enhanced diversification powers of financial institutions, and structural characteristics that provided a direct link between equity prices and bank capital. Bank capital varied directly with the equity market because BIS capital-asset requirements established in 1988 allowed 45 per cent of 'latent' or 'hidden' capital to be counted as tier II capital. Higher equity prices generated higher bank capital, which in turn generated higher bank lending. This process was reinforced by increased land values. Higher land prices generated higher collateral values, which in turn generated higher bank lending. High bank lending in turn supported higher equity and land prices. Easy monetary policy supported higher bank lending. The easy monetary policy can be attributed to the Bank of Japan's efforts to limit yen appreciation as an outcome of the Plaza Agreement and Louvre Accord. Because the official price indexes showed little or no inflation, the Bank of Japan concluded the increased liquidity would have no adverse effects on the economy. In hindsight, this was a policy error.

Japan lacked the means to monitor and evaluate the risk of rapidly increased bank lending, especially in the area of real estate. The financial system was nontransparent and lacked a financial disclosure framework. The main bank system had begun to unravel in response to financial liberalization and regulatory authority reliance on 'administrative guidance' was incapable of monitoring the rapidly changing characteristics of the financial system.

The collapse of asset prices and the start of economic and financial distress were initiated by the Bank of Japan's decision in May 1989 to raise the discount rate and shift to tight monetary policy for the next few years.

The 1990s: a decade of lost economic and financial development

The collapse in equity and land prices in 1991–92 brought an end to Japan's postwar economic and financial growth (see Appendix 6.1). The immediate effects of the collapse in asset prices were stagnant economic growth, deteriorating balance sheets of nonfinancial and financial firms, and decreasing bank capital. The financial distress was manifested by an increase in nonperforming loans and a regulatory response based on denial and nontransparency, and once denial and understatement were no longer credible, a regulatory response based on forgiveness and forbearance. The delayed response ultimately increased the economic and political cost of resolving the financial distress.

Government response: 1991–95

In 1991–95, the government was forced to depart from the long-standing policy of no failures of financial institutions or markets and officially close a small number of credit cooperatives and small banks. The government maintained, however, that the problems were confined only to small financial institutions and did not involve the large banks and securities companies that were at the center of the financial system. The convoy system was extensively used to assist the failed institutions, but even the small number of small failures combined with financial assistance from 'white knight' banks (and in one case, the Tokyo City government) by 1995 exhausted the resources of the Deposit Insurance Corporation. The policy of denial was not longer viable by 1995. The Deposit Insurance Corporation was insolvent as was the other much smaller deposit insurance agency. The Ministry of Finance was forced to admit that the *jusen*[9] industry (housing loan subsidiaries of banks) was insolvent and needed to be closed. The 'Japan premium' rose from essentially zero in 1994 to about 50 basis points in late 1995 (Figure 6.1). There is evidence that the Ministry knew of the *jusen* problems as early as 1993 but chose to adopt a policy of forgiveness and forbearance in the hope that recovery of land and equity prices would resolve the problem.

Recovery in 1996 and the Big Bang announcement

Three events in 1995–96 seemed to suggest a recovery and justification for the policy approach adopted in the first part of the 1990s. First, the economy began a recovery and by 1996, real GDP and equity prices were increasing, though land prices continued to decline. Second, the government initiated a number of institutional changes to deal with the nonperforming loan problem and increase prudential regulation. The Deposit Insurance Corporation was reorganized and the *jusen* industry was closed; however, the decision to require the banking system to absorb an unequal distribution of the *jusen* debt caused the Japan premium to sharply increase. In response, the Ministry of Finance announced a complete deposit guarantee effective through 31 March 2001. Institutions were established to

dispose of assets of failed cooperatives and the *jusen* industry. Third, while the Japan premium remained positive, it declined significantly in 1996, suggesting a reduction in the perceived risk of Japanese banks by the international community.

Despite these economic, institutional, and financial changes, Japan continued to rely on a policy of delay, forgiveness, and forbearance, and expected the recovery in real GDP and the stock market to resolve the problems. Despite the new institutions established to dispose of assets of failed institutions, little effort was made to dispose of the assets nor was any effort made toward preemptive closing of troubled institutions. The government's official estimates of nonperforming loan statistics were considered conservative by outside observers. As shown in Appendix 6.1, there was a general sense of optimism that explains the government's bold announcement in November 1996 of the Big Bang financial reforms.

The Big Bang announcement was a bold program to transform Japan's financial system to one that would be on a par with New York and London by 2001. The announcement did not contain a detailed set of proposals, but rather laid out the objective that financial reforms should be directed to making Japan's financial system open, competitive, and efficient. In the spring and summer of 1997, a flurry of administrative and legislative actions were taken to provide a foundation to achieve the Big Bang objectives. All remaining constraints on foreign exchange transactions were eliminated. The Bank of Japan Law was revised for the first time since 1942 to provide the Bank with legal independence from the Ministry of Finance. Many of the financial regulatory and supervisory functions of the Ministry of Finance were transferred to a new super-agency, the Financial Supervisory Agency, which would henceforth be responsible for financial regulation and supervision. These changes were significant, but unfortunately, they did not address the serious distress that permeated the financial system and were predicated on the view that the financial distress would be resolved by increased economic growth.

A turning point in Japan in late 1997

The Asian crisis occurred in 1997 and 1998, but Japan had already experienced several years of severe economic and financial distress. The Japanese economy reached a turning point in late 1997, after which economic and financial distress increased and brought the country close to economic and financial collapse. Three internal considerations help to understand this turning point. The concurrence of the Asian crisis had some adverse impact on Japan, but the two situations are largely independent. The Asian countries from 1990 to mid-1997 had not been significantly impacted by Japan's economic and financial distress, and Japan's turning point in late 1997 is traceable to internal factors.

First, the sharp downturn in real GDP was caused by a restrictive fiscal policy and a 'credit crunch' as banks attempted to reestablish BIS capital-asset ratios in the context of declining equity prices (Ito and Sasaki 1998). In April 1997, the government ended a temporary tax cut that had been previously enacted and increased the consumption tax from 3 to 5 per cent. This action was predicated on the view that the economy had recovered and the size of the central government deficit

would increase. In hindsight, the fiscal action was a clear error that generated a decline in real GDP and an increase in financial distress.

Second, while some progress was made in reducing nonperforming loans in 1995 and 1996, banks, cooperatives, and government banks still held large amounts of nonperforming loans, estimated at between 5 and 10 per cent of GDP. The two agencies designed to dispose of loans from failed institutions merely functioned as warehouses rather than loan-disposal agencies. A reasonable accounting of the condition of banks and securities companies would have revealed many institutions close to being or already insolvent. The weak condition of the financial system made it susceptible to any shock.

Third, the shock came in the form of the failures in November 1997 of Hokkaido Takushoku Bank and Yamaichi Securities Company. The failure of these two institutions shocked the regulatory authorities and contradicted the government's claim that the financial distress was confined to only smaller financial institutions. The failures ended the convoy system for all practical purposes since virtually every financial institution was troubled. The Ministry of Finance, for example, had made a concerted effort to merge Hokkaido Takushoku Bank with a stronger institution, but no 'white knights' could be found, even with government support. The market reacted by sharply increasing the Japan premium, and bank equity prices declined relative to the rest of the market.

The government responded in early 1998 by committing 30 trillion yen to support deposits and inject capital into the banking system, promising greater transparency in the reporting of nonperforming loans, and promising a more aggressive approach to dealing with troubled financial institutions. The first attempt to inject capital into the banking system on 1 March 1998 showed the old regime still influenced decision-making. There was no serious effort to evaluate risk or require due diligence from the receiving twenty-one banks. A series of scandals at the Ministry of Finance and the Bank of Japan in 1997 and 1998 further weakened confidence in the government's ability to manage the crisis.

In July 1998, the Hashimoto government and the Liberal Democratic Party suffered a serious defeat in the Upper House elections. While the Upper House or House of Councillors is not the major decision-making component of the Diet, the LDP's loss reflected a no-confidence vote by the public. Hashimoto resigned in July and the new Prime Minister Obuchi promised a more aggressive approach.

Government response in late 1998 and 1999

In October 1998, the commitment of public funds to protect depositors and inject capital into the banking system was increased to 60 trillion yen, and the Long Term Credit Bank and Nippon Credit Bank were nationalized (but sold to the private sector a short time later). The March 1999 capital injection was a significant improvement over the March 1998 injection. The amount was large and an attempt was made to obtain due diligence and to evaluate the risk of the receiving bank. These actions and evidence of a recovery in the economy in 1999 suggested a turning point manifested by the end of the Japan premium in April 1999.

In addition, liberalization policy continued; for example, fixed brokerage commissions on the securities markets were eliminated. However, the most dramatic liberalization policy was directed toward the large role of government financial intermediation. In 1998 the government set into motion reforms of the Postal Savings System and the Fiscal Investment and Loan Program scheduled to go into effect 1 April 2001. At that time, postal deposits would no longer be transferred to the Ministry of Finance for distribution to government banks and other government entities. Instead, postal deposits would be invested in safe assets such as government bonds. The government banks and other entities previously dependent on disbursements from the Ministry of Finance would be required to issue their own 'agency' bonds or participate in 'FILP bonds' issues by the Ministry and indistinguishable from general government debt. The reforms also require a more transparent accounting of government entity operations. The 1998 reforms included other changes designed to reduce and base on a more market-sensitive foundation government financial intermediation.

Signs of recovery, Bank of Japan policy, and economic and financial crisis

Real GDP declined 1.1 per cent in 1998, but in 1998 the economy grew at 0.8 per cent in 1999 and 1.1 per cent in 2000. The Nikkei index increased from a low of about 14,000 in late 1998 to about 18,000 at the end of 1999. Regulatory authorities believed the major banks were adequately capitalized and the banks were focusing serious attention on reducing nonperforming loans. Regulatory authorities turned their attention to resolving small insolvent cooperatives, and concern that large numbers of small institutions would be closed prompted them in late 1999 to push forward by one year the planned end of the complete deposit guarantee set into place in 1995. The new decision is to phase out the complete deposit guarantee in two steps. On 1 April 2002 the guarantee will be removed on time deposits and on 1 April 2003, on transaction deposits. Nonetheless Japan did not achieve the degree of recovery exhibited in other Asian countries. While the Asian countries exhibited a faster recovery, Japan continued to be vulnerable to renewed economic and financial distress (Table 6.1).

In the background was a growing debate over the role of monetary policy and the concern that the Bank of Japan would cut short the slowly evolving recovery. The Bank of Japan was increasingly criticized for not adopting a more aggressive monetary policy (e.g. Posen 1998). Despite the appearance of expansionary policy, critics contended that the Bank of Japan had permitted a gradual decline in the price level (Figure 6.2). Declining prices increase the real debt burden, making it more difficult to resolve the nonperforming loan problem, reinforce expectations of further price declines, thus reducing spending, and increase the real rate of interest despite historically low nominal interest rates. The Bank of Japan responded that it had done all it was capable of doing. In February 1999, the Bank adopted an unprecedented zero rate policy for the interbank rate. The Bank of Japan argued that conditions did not warrant extraordinary monetary policy beyond the zero

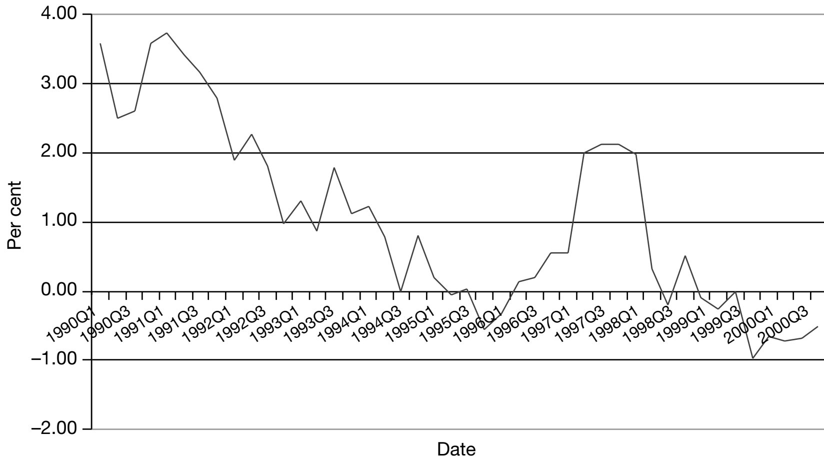

Figure 6.2 CPI inflation rate, 1990: 1 to 2000: 4.

Source: Federal Reserve Bank of San Francisco, OECD database.

rate policy such as extensive purchases of government bonds or other assets to inject funds into the economy. The Bank of Japan rejected calls for inflation targeting, arguing that part of the decline in prices was due to external forces (low priced imports from China). In the Bank's view more aggressive monetary policy would be fiscally irresponsible or involve the central bank in providing credit to specific sectors of the economy.

In fact, rather than adopt a more expansive policy, the Bank of Japan raised the targeted interbank rate on August 2000 on the view that the economy had reached an expansion phase. This proved to be a policy error. The economy slowed and went into recession in October 2000. The Bank of Japan reversed policy in January 2001, and by March 2001 it had essentially reverted back to a zero rate policy. Real GDP was expected to decline in 2001 and there is no clear expectation as to when the nonperforming loan problem will be resolved.

Despite unprecedented institutional and attitudinal changes in Japan in the 1990s, the nonperforming loan problem remains unresolved, many financial institutions are insolvent or close to insolvent based on market accounting of assets, and the economy shifted into recession (see Appendix 6.1). Japan's economy presents a remarkable postwar record. The end of economic growth started in 1990 after four decades of impressive economic growth with either moderate or low inflation. After six years of stagnant performance, the Japanese economy in 1997 and 1998 came close to a deflationary-downward spiral. The economy experienced a tentative recovery in 1999 and 2000 but slid back into recession in late 2000 in spite of some major structural changes. Japan's performance over the past twelve years is indeed a manifestation of 'the world's slowest crisis,' and the transition from the most impressive example of the 'Asian miracle' to an economic performance that rekindles memories of the 1930s is indeed remarkable.

Japan at the start of the new century

Japan achieved significant institutional and attitudinal change by the end of the 1990s and set in place an infrastructure to deal adequately with weak financial institutions and nonperforming loans and pursue the objectives of the 1996 Big Bang announcement, which remains the operating guideline for financial liberalization. Japan as of 2001, however, appears to be shifting back into a state of crisis and there is growing concern whether Japan can recover in the near future. Japan's future looks even more pessimistic in the current decade as Japan's population is projected to start declining after 2007 and the ratio of nonworking to working aged population is projected to increase significantly. This raises two questions: first, why has change been so difficult in Japan and by implication in other Asian countries; and second, what are the challenges facing Japan in the new century?

Why has liberalization been such a slow and incomplete process in Japan?

Liberalization has been slow, incomplete, and disruptive in Japan as well as in other Asian countries. In contrast, liberalization has been more successful in western economies such as the United States. Western economies experienced financial disruptions such as the collapse of the S&L industry and banking problems in the United States or banking problems in the Scandinavian economies, but these were successfully resolved.

There are several factors that explain the slow pace of reform in Japan, and their absence in or smaller significance for the United States, for example, explains the faster pace of liberalization in the latter. It is important to emphasize, however, that there exists in all countries resistance to financial reform from government regulatory authorities as well as vested interests in the old regime. The difference between Japan and Asian economies on one side and the United States on the other is one of degree.

More radical transition in Japan

In Japan the financial regime emphasizes mutual support, long-term relationships, nontransparency, and avoidance of uncertainty (limit bankruptcy), pervasive deposit guarantees, and loan guarantees. These are also characteristics found throughout Japanese economic institutions and relationships. These characteristics are not absent in the United States, but play a smaller role influencing economic decisions and economic institutions and, hence, present less of a constraint on liberalization. The US financial system prior to liberalization was already under the influence of market forces, whereas liberalized markets and institutions were not a part of pre-reform Japanese finance. Thus the transition in the United States was not as radical as it is for Japan and hence, easier to achieve.

Continuation of bank-finance model in Japan

The bank-finance model of Japan in which intermediation finance provides the major channel of transferring funds from surplus to deficit units restrains liberalization. The absence of nonbank financial channels limits competition and the regulatory structure built around bank-finance has an inherent tendency to resist development of money and capital markets. This is clearly changing in Japan, but compared with the United States, bank finance remains dominant and the regulatory and supervisory framework remains focused on bank finance. The continuation of the bank-finance model makes it difficult to depart from the long-term customer relationship lender–borrower framework since bank-finance is more compatible with nontransparency, which in turn makes it more difficult for money and capital markets to develop. In the United States, banks have been forced to compete with open money and capital markets and these markets played an important role in promoting competition in the financial system. The majority of depository institutions and government regulatory authorities resisted eliminating deposit rate ceilings in the 1970s, but the ability of depositors to withdraw funds and place them directly in the money market via money market mutual funds rendered deposit ceilings ineffective, disruptive, and eventually led to their end in 1980. In addition, there already existed a significant regulatory framework for money and capital markets ensuring that bank-regulatory institutions could not effectively resist liberalization because it reduced the role of banking.

The financial regime remains a part of industrial policy in Japan

The Japanese financial system continues to be regarded as a part of an overall industrial policy focused on economic growth. This commitment to growth has waned somewhat in the past decade, and private financial institutions in Japan have become more sensitive to the household sector. Nonetheless, economic growth and the industrial policy perspective of the financial system continue to influence the government's view of liberalization. There is an underlying concern that liberalization might contribute to consumer and mortgage credit expansion, viewed as less productive than credit allocated to the commercial sector. Liberalized consumer credit might also contribute to a reduced saving rate, viewed as an important foundation for economic growth. In contrast, the financial system in the United States is viewed as a service industry to any sector, and financial regulation and supervision are focused more on ensuring stability than on directly supporting economic growth.

The Japanese financial regime's record of success in the postwar period

It is difficult to argue with success. Despite the lost decade in Japan and the sharp but short contraction in other Asian countries during the crisis, the financial regimes of Asian countries supported an impressive record of economic growth during the second half of the twentieth century. Regulatory authorities have an incentive to

view recent events as short-term shocks or as macroeconomic policy failures rather than reflecting fundamental flaws in the financial regime. In this regard, the rapid recovery in Korea and other Asian countries reduces enthusiasm for making the difficult policy decisions required by liberalization and strengthens the view that the problem is not necessarily in the old financial regime.

The large role of government financial intermediation

Government financial intermediation has been a prominent feature of postwar Japanese finance, and while government financial intermediation also exists in the United States it is neither as large nor market-insensitive as in Japan. The Postal Savings System and the Fiscal Investment and Loan Program, seldom discussed outside of Japan, represent a large and growing component of Japanese finance that constrain liberalization in many ways. Despite an official policy of liberalization, government financial intermediation has actually increased its role since 1976. In 2000, the Fiscal Investment and Loan Program budget represented almost 11 per cent of GDP and postal deposits represented about 35 per cent of total deposits.

Attributes of Japanese society

Lincoln (2000) emphasizes specific attributes of Japanese society that limit enthusiasm for liberalization which, in turn, are embedded in economic institutions: reliance on personal relations, hierarchy, wide gap between facades and individual characteristics, and preference for indirectness and informal agreements. Although American society has these attributes as well it is not nearly as hierarchical, is more willing to reveal individual characteristics, and can be very direct and legalistic Also, personal relationships in America are not nearly as binding in economic matters as in Japan.

Lack of critical observers

Group orientation and the high cost of individual behavior that runs counter to the group make it difficult for institutions to evolve and criticize government policy in Japan. Academics and other policy watchers in Japan are likely to incur greater penalties for public criticism than in the United States.

Challenges facing Japan

There are two immediate challenges facing Japan: first, establish sustained positive economic growth and a low but positive inflation rate and, second, resolve the nonperforming loan problem. Traditional fiscal policy in the form of public works is not likely to be effective. Despite the large central government deficit a tax reduction designed to stimulate growth is worth considering. The main burden of stimulating the economy thus resides with Bank of Japan policy. The Bank of Japan, however, has resisted what it refers to as 'nonstandard' monetary policy, but the crisis situation in late 2001 may force the Bank to reconsider. There

have been increasing calls for the Bank of Japan to adopt an explicit inflation target and conduct policy to achieve that target. There have even been suggestions from the Diet that the Bank of Japan should directly conduct open market operations in corporate debt.

The nonperforming loan problem has actually increased in magnitude since the early 1990s despite a series of efforts to resolve the problem. The basic issue is an unwillingness to force bankruptcy on large numbers of borrowers and force banks to more aggressively write off loans. Forgiveness and forbearance have clearly failed to resolve the problem and have only increased the ultimate economic and political cost of resolving the nonperforming loan problem. As long as the economy operates below its potential and the nonperforming loan problem remains unresolved, Japan will not likely be able to successfully implement the reforms that have been initiated or the new reforms that will be enacted in the coming years. Setting aside these two immediate concerns, more aggressive action is needed to shift the financial system from a bank-financing model to a mixed bank and open market financing model, and government deposit guarantees need to be reduced while the safety net system incorporates a limit on guaranteed deposits. An explicit and limited deposit guarantee system is preferable to the implicit guarantee of all deposits characteristic of Japanese finance. This implicit guarantee was made explicit in 1995 and originally scheduled to end on 1 April 2001. The end of the complete guarantee was postponed and is now scheduled for removal in two stages: the first stage on 1 April 2002 for time deposits and the second stage on 1 April 2003 for transaction deposits. The slide into recession in 2001, however, has raised the question as to whether the new schedule will be followed.

Both of these longer-run reforms – encouraging direct financial markets and reducing government deposit guarantees – are constrained by the large role of government financial intermediation in the form of the Postal Savings System and the Fiscal Investment and Loan Program. Thus, the third reform needs to focus on reducing government financial intermediation and eliminating the Postal Savings System. In some degree, reform of government financial intermediation may be the most important structural change left.

The Postal Savings System and the Fiscal Investment and Loan Program have resisted reform during the past two decades of financial liberalization. In fact, postal deposits and the entire Fiscal Investment and Loan Program have increased their relative importance since 1976, and in 1997 the Postal Savings System was being offered as a model for other Asian countries (Kanabayashi 1997). The Postal Saving System complicates Japan's deposit guarantee system since postal deposits are direct government debt. (Bank deposits are insured by the Deposit Insurance Corporation, which was insolvent for a short time in the mid-1990s.) Postal deposits limit the development of open money and capital market since they represent such a large percentage of household wealth, part of which would support money and capital market development in the absence of the postal deposits.

In 1998, legislation initiated reform of government financial intermediation that became effective 1 April 2001. Prior to 1 April 2001, postal deposits and other sources of funds were transferred to the Trust Fund Bureau of the Ministry of

Finance, which in turn were distributed to government banks and other government entities. Starting 1 April 2001 these funds are no longer transferred to the Trust Fund Bureau but instead will be invested in safe assets such as government debt. The government banks and other entities will either obtain funds by selling their own debt (agency securities) or obtain funds from debt issues by the Ministry of Finance (Fiscal Investment and Loan Program bonds). The Postal Savings Systems has essentially become a 'narrow bank.'

There is considerable debate about whether these are meaningful reforms since they merely change the channels of finance for government institutions. The political economy of reform, however, significantly changed in April 2001 when Koizumi became Japan's new prime minister defeating the more traditional LDP candidate Hashimoto. Koizumi has advocated privatization of the Postal Savings System and greatly reducing the role of government financial intermediation. It is too early to determine how reform of government financial intermediation will proceed. If Koizumi were successful, it would rank as one of the most radical changes in Japan's financial system in the postwar period.

Lessons from Japan and the Asian crisis

The last part of the twentieth century witnessed major institutional and attitudinal changes in financial regimes throughout the world, including the Asian countries. The pace of reform in Asian countries, however, has been slow and in the 1990s, disruptive. In the case of Japan, financial distress continues into the new century while most of the other Asian countries recovered from the crisis of 1997 and 1998. What lessons have been revealed by the Japanese experience and the Asian crisis? While the two events are not causally related, they are the outcome of much the same problem – enhancement of market forces in the context of an incomplete and unbalanced liberalization process. The following is a selected list of important lessons revealed by both the decline of Japanese economy in the 1990s and the Asian crisis.

Special conditions no longer exist

Japanese and other Asian financial systems evolved under special conditions that were not sustainable. Much like Krugman's argument (1994) that the 'Asian miracle' was based on special and unsustainable conditions, Asian financial systems were also successful because of special conditions that were not sustainable. These systems were based on regulated financial regimes, internationally isolated financial regimes, limited channels of finance, and required high rates of economic growth to appease those restricted from using the financial system as a source of funds (households) and to mask inherent inefficiencies in the flow of funds from surplus to deficit units in a rigidly regulated and controlled financial regime. In addition, there existed a consensus in many Asian countries for economic growth and a willingness to use the financial system as an instrument of industrial policy to achieve narrow economic objectives. The emergence of market forces clashed with these financial regimes; increasing internationalization of economic and financial activity forced

these financial regimes to become more integrated with the world economy; advances in computer and telecommunications technology made it increasingly difficult to impose binding constraints on financial transactions; and high rates of economic growth could not be maintained. Irrespective of one's normative view of market forces, once Asian countries became more integrated with the world economy and permitted market forces a greater play, the old regimes became no longer sustainable.

Deposit guarantees, moral hazard, and the fundamental flaw in the liberalization process

Deposit guarantees are a feature of every financial regime. They can be institutionalized in the form of explicit deposit insurance such as in the United States or in the case of Asian countries in the form of an implicit and general commitment by government to protect deposits with whatever means are necessary. Deposit guarantees, however, possess moral hazard and failure to modify the deposit guarantee system in the face of financial liberalization creates a fundamental flaw that renders the financial system inefficient and unstable. Deposit guarantees eliminate depositor discipline and encourage risk-taking on the part of depository institutions while, at the same time, liberalization enhances the ability to manage and assume risk. The outcome can be imprudent loan and investment portfolio behavior on the part of depository institutions.

Deposit guarantees are part of the mutual support system in Japan and other Asian countries and have been difficult to reform since they are pervasive and regulatory authorities in both countries are reluctant to expose depositors to risk. While deposit guarantees are desirable at some level to protect small depositors and limit contagion, they possess moral hazard. Deposit guarantees need to be explicit, limited, and backed up by both policy attitudes and funds designed to deal with troubled financial institutions in a timely manner. In this way, deposit guarantees are less likely to lead to forgiveness and forbearance policies for dealing with troubled financial institutions.

Agency problems

Political relationships between regulatory authorities, financial institutions, and politicians provide incentives for regulatory authorities to adopt delay, forgiveness, and forbearance as the preferred policies in dealing with troubled financial institutions. This practice has been common in virtually every Asian country and is a particularly serious issue since a key element of Asian financial regimes has been a close relationship between regulatory authorities, financial institutions, politicians, and business firms. Agency problems enhance moral hazard, reduce pressure on troubled financial institutions to improve their performance, reduce the credibility of the regulatory authority, and ultimately increase the economic and political cost of resolving financial problems.

Nontransparency

Nontransparency has been a major feature of Asian financial regimes and has had two adverse effects. First, nontransparency makes it difficult to assess the condition of financial institutions and large nonfinancial corporations and, second, it enhances the potential for regulatory authorities, financial institutions, and businesses to engage in mutual support, restrain competition, perpetuate insularity, and conceal the real cost of government failure in the financial system. The culture of nontransparency also provides meager and sometimes misleading information to regulatory authorities themselves, understates the degree of balance sheet deterioration, enhances the moral hazard problem, and contributes to delayed response to dealing with troubled institutions.

Inadequate funding to support deposit guarantees

Deposit guarantees are increasingly being redesigned according to the US-type deposit insurance system. There is growing recognition even in the Asian countries that government deposit guarantees need to be limited and made more explicit. After over two decades of inactivity since being established in 1971, Japan's Deposit Insurance Corporation was reformed in 1995 to assume a more meaningful role in the financial system, and Korea is in the process of establishing a deposit insurance system. Both systems are not yet in place, as the Korean and Japanese government imposed a complete deposit guarantee through 2001 and 2003, respectively, to ensure stability of the financial system.

Deposit insurance is not the same as private insurance but represents a government guarantee; however, the insurance reserves need to be sufficiently large enough so the insurance agency is not constrained in dealing with insolvent institutions in a timely manner. This became readily apparent in the United States in the case of the collapse of the S&L industry. By 1985 the cost of closing insolvent thrifts was conservatively estimated to be at least three times the insurance reserves of the Federal Savings and Loan Insurance Corporation and thus forgiveness and forbearance become the only practical policies that could be implemented without admitting government failure. Eventually, public funding was required to bailout the S&L industry in 1989.

This issue is relevant to the nonperforming loan problem in Japan. Japan's nonperforming loan problem has been allowed to persist partly because of an unwillingness to commit public funding to resolve the problem. Only reluctantly did Japan resort to public funding in 1998 and 1999. Inadequate funding to support either explicit deposit guarantees like deposit insurance or the type of implicit guarantees common in Asian financial systems provides incentive to adopt forgiveness and forbearance as the preferred policy for dealing with nonperforming loans and troubled financial institutions. At some point, public funding becomes a necessary part of resolving financial distress, but public funding depends on the reputation of the regulatory authorities and the perceived benefits of the financial system to the public.

Exclusion of the household sector from the financial system

There is an interesting difference between the US and Japanese reaction to public funding to bail out troubled financial institutions that has implications for a broad range of policies for dealing with economic and financial distress. In the United States there was little public comment and criticism when taxpayer funds, estimated to range from $150 to $200 billion, were used to dispose of assets of failed S&Ls after 1989. In Japan, in contrast, the public has been unfavorable to using taxpayer funds to deal with insolvent institutions and nonperforming loans and has a general distrust of regulatory authorities. The difference is explained by the respective roles provided to the household sector in each financial regime.

The US system is open and designed to service all demands for funding and as a result, the household sector has had extensive access to the financial system. In particular, the S&L industry provided mortgage credit at favorable terms that imposed no interest rate risk on the borrower in that mortgages were made at fixed rates and borrowers always had the option to refinance if interest rates declined. The favorable mortgage market supported widespread home ownership, which in turn increased household wealth in the 1970s and 1980s as real estate prices rose faster than the general inflation rate. Thus, the household sector was a net beneficiary of financial regulation even in the context of the S&L bailout.

This situation contrasts sharply with that in Japan and other Asian countries. The financial regime was designed to limit household access to support high savings and provide funds to the business sector to support industrialization. In the past, high rates of economic growth compensated the household sector for limited access, but in recent times, lower and unstable economic growth provide little offset. In addition, there is widespread consensus among the public that the financial system has been designed and regulated to primarily serve the interests of the government, financial institutions, and the business sector. The public regards this system as corrupt and is thus opposed to the use of taxpayer funds to solve the financial problems, and the political leaders have been reluctant to make a case for more public funding, which might be required.

Orderly exit for weak financial institutions

Penalties for failure need to be clear to all participants. Departures from the penalty function have serious consequences for the liberalization process. Until only recently Japan imposed no serious penalties on large institutions while allowing small institutions to fail. Liberalization requires a new attitude that accepts failures of financial institutions, even large institutions, as a normal part of the economic process. While there may be reasons to treat large institutions differently in the sense that some institutions are 'too large to close,' there should be no institution 'too large to fail.'

Money and capital markets

The establishment of money and capital markets is critically important in Japan and other Asian countries. They encourage transparency, enhance the channels of finance, contribute to internationalization of finance, weaken the bank-finance model, provide a foundation for the efficient evaluation of risk, and provide a foundation for efficient monetary policy. The fact money and capital markets have been a relatively small part of Asian financial regimes accounts for the slow pace of development. Until Asian countries seriously expand money and capital markets financial liberalization will be a slow and incomplete process. The limited development of money and capital markets not only limits the benefits of the liberalization process, but it also limits the application of the Internet to financial transactions. The liberalization process in the United States, in contrast, has benefited from the existence of deep and broad money and capital markets in three ways. First, the existence of money and capital markets by their nature made liberalization a less radical policy; second, money and capital markets made it more difficult for regulatory authorities to hold on to elements of the old regime; and third, money and capital markets provided a foundation for applying the rapid advances in computer and telecommunications technology that will be a major force of economic growth in the new century.

Concluding comment

Liberalization has been an agenda item in Japan since the mid-1970s. Japan pursued an incomplete liberalization process by allowing an increased role for market forces while maintaining key elements of the pre-liberalization financial regime at the same time. The conflict led to excessive risk-taking without adequate means of monitoring and evaluating risk. This conflict manifested itself in the bubble economy of the second half of the 1980s with the assistance of an easy monetary policy by the Bank of Japan. The collapse in asset prices after 1990 and a government response wedded to the old financial regime delayed resolution of the nonperforming loans problem. A series of policy errors and failure to resolve the nonperforming loans problem led to the general collapse in late 1997 and 1998. While the Asian crisis contributed to Japan's problem, it cannot be regarded as a cause of Japan's problems any more than can Japan's economic and financial distress in 1990–97 be said to have caused the Asian crisis.

The Asian crisis and Japan's own problems reveal the fundamental conflict between liberalization and efforts to retain key elements of the old financial regime that served Asian countries so well during much of the postwar period. New attitudes and institutional changes are needed to reduce reliance on bank finance, increase transparency, limit government deposit guarantees, enhance and enforce prudential regulation, reduce reliance on forgiveness and forbearance as a policy approach to dealing with troubled institutions, and reduce the role of government financial intermediation. While most of the Asian countries have recovered from the crisis, it is difficult to be optimistic about Japan's prospects for recovery in the near future.

Appendix 6.1 Financial change in Japan: 1976–2001

Japan's pre-liberalization financial system was one of the most regulated and internationally isolated among the industrial countries. Economic, political, and technological forces emerged in the 1970s inducing a shift to a more open and competitive financial system. Official liberalization starts in 1976.

↓

Japan achieves partial liberalization with significant accomplishments by the early 1980s. Interest rates deregulated, increased integration with the international financial system, initial development of money and capital markets, and enhanced portfolio diversification powers provided to financial institutions.

↓

Elements of the old regime remain in place: nontransparency, mutual support to limit bankruptcy among large business firms and financial institutions, pervasive deposit guarantees, inefficient financial institutions, and government financial intermediation in the form of the Postal Savings System and the Fiscal Investment and Loan Program. The Postal Savings System and the Fiscal Investment Loan Program actually increased their respective roles in Japan's financial system despite an official policy of liberalization. The increasing role of government financial intermediation illustrates lack of a strong commitment to financial liberalization in Japan.

↓

During the first half of the 1980s, Japan appeared to have achieved a smooth and gradual liberalization process that fundamentally left unchanged the essential elements of the pre-liberalization financial regime. Bank of Japan policy from 1975 to 1985 provided a stable macroeconomic environment that permitted Japan to pursue an incomplete and unbalanced liberalization process.

↓

In the first half of the 1980s low and stable inflation and high rates of real economic growth provided a false sense of accomplishment.

↓

Banks and other financial institutions take advantage of new portfolio diversification powers without adequate government oversight. The old system of administrative guidance cannot monitor risk, the main bank system is declining, and the lack of corporate governance compounds the problem.

↓

Asset inflation (land and equity prices) starts in 1986 and by 1987 becomes a speculative bubble in which increasing land and equity prices cannot be supported by economic fundamentals. Asset inflation is the combined outcome of easy Bank of Japan monetary policy and a flawed financial structure in which liberalization has enhanced the ability to assume risk, but regulation subsidizes risk.

↓

Asset inflation sets up a feedback relationship between bank capital, bank lending, land prices, and equity prices. Increased equity prices increase bank capital because banks are permitted to count part of their capital gains on equities as capital. Increased bank capital provides the basis for increased lending. Increased land prices increase collateral and support increased lending. Increase bank lending provides support for increased equity and land prices and so on.

↓

Asset inflation in the second half on the 1980s combined with real GDP growth and virtual price stability rationalizes the phrase 'bubble economy.'

↓

Asset prices collapse as the Bank of Japan reverts to tight monetary policy in May 1989.

↓

In the first half of the 1990s nonperforming loans and insolvent small cooperatives and banks for the first time since 1950 become a feature of the Japanese financial system. Declining equity prices reduces bank capital and generates a credit crunch. Banks under pressure to satisfy BIS capital-asset requirements reduce asset growth because of inability to raise new capital and declining equity prices. Economic and financial distress increases.

↓

Regulatory authorities deny the problem and then understate the seriousness of the problem when the denials were no longer credible. Regulatory authorities emphasize the financial distress is concentrated in the smaller institutions. The large financial institutions that stand at the center of the financial system are financially secure according to the government. Regulatory authorities adopt a policy of delay, forgiveness, and forbearance based on the hope that economic growth and asset prices will recover and solve the problem.

↓

Lack of a critical outside group makes it easier for regulatory authorities to adopt a policy of delay, forgiveness, and forbearance. No public support for a bailout.

↓

In 1995 the financial distress reaches a level that can no longer be denied or easily understated. The Japan premium becomes a prominent feature of Japanese bank risk, the *jusen* industry is insolvent, and the Deposit Insurance Corporation is insolvent.

↓

As a result of these events, the Ministry of Finance in 1995 reorganizes the Deposit Insurance Corporation, adopts prompt corrective action as the preferred regulatory approach to dealing with troubled financial institutions, and closes the *jusen* industry.

↓

The Japan premium declines (Figure 6.1), equity prices begin to recover, and real GDP begins to increase signaling an end to the recession. There is a general sense of optimism that the worst is over and while some structural changes were necessary, the policy of forgiveness and forbearance appeared to be successful. The optimism is manifested by the November 1996 Big Bang announcement.

↓

ASIAN CRISIS IN 1997 AND 1998: In hindsight, the Asian Crisis was a currency crisis due to large amounts of external debt, inadequate international reserves, and increasing concern by international investors that specific Asian countries could not service the external debt and prevent currency depreciation.

↓

Despite Big Bang announcement and improved economy in 1996, Japan approaches an economic and financial abyss in late 1997 and early 1998. Negative economic

growth and the failure of Hokkaido Takushoku and Yamaichi Securities shows that financial distress has reached the center of Japan's financial system.
↓
Public funds are raised, but adherence to mutual support system in first distribution in March 1998 shows that Japan has yet to break from the past. The public rejects the government's approach to the economic and financial distress in July 1998. The defeat of the Liberal Democratic Party in the Upper House results in the resignation of Prime Minister Hashimoto.
↓
New Prime Minister Obuchi adopts more aggressive approach with larger commitment of public funds. The Nippon Credit Bank and the Long Term Credit Bank are declared insolvent and nationalized in late 1998. Public support for the government's efforts to resolving the financial problems, however, is tenuous due to past policy failures and scandals at the Ministry of Finance and the Bank of Japan.
↓
Liberalization policy continues in 1998 with the most significant action taken to reform the Postal Savings System and the Fiscal Investment and Loan Program.
↓
ASIAN COUNTRIES IN GENERAL RECOVER IN 1999 AND 2000 WHILE JAPAN CONTINUES TO BE VULNERABLE TO RENEWED ECONOMIC AND FINANCIAL DISTRESS
↓
By 2000 major attitude and institutional changes have occurred and a general sense of cautious optimism permeates government policy that the worst may be over. The economy appears to have entered into an expansion phase in June 1999.
↓
The macroeconomic background however, is weak and Bank of Japan policy comes under increasing criticism for allowing a slow and gradual decline in the price level that becomes more serious by 1999. The Bank of Japan adopts a zero rate target for the interbank rate in February 1999. Debates about the 'liquidity trap' rekindle memories of the Great Depression and Federal Reserve Policy in the United States. The Bank of Japan raises the targeted interbank rate in August 2000 and the economy enters a recession in October 2000. The Bank of Japan reverts back to a zero rate policy in early 2001.
↓
As of 2001, the nonperforming loan problem is unresolved, the economy again is in recession, and despite the initial optimism surrounding Prime Minister Koizumi's policies in the spring and summer of 2001, by the end of the year there is growing concern about Japan's prospects for recovery.
↓
The 1990s are Japan's lost decade in terms of economic and financial development. Despite new policies and institutions in 1998 and 1999, the first two years of the new century suggest Japan's problems are far from over. There is a growing unease that the first decade of the new century has the potential to become Japan's second lost decade.

Source: Sequence through May 1989 (Cargill, forthcoming)

Notes

1 There now exists an extensive literature on Japan. This chapter draws on Cargill (1998 and 2000), Cargill and Royama (1988) and Cargill *et al.* (1997 and 2000). The literature on Japan also includes works by Fieldman (1999 and 2001), Hoshi and Kashyap (1999 and 2001), Hoshi and Patrick (2000), and Mikitani and Posen (2000). Woo *et al.* (2000) and Krugman (2000) provide an overview of the Asian crisis less focused on Japan.
2 These include different arrangements of nonfinancial businesses, degrees of credit allocation, degrees of financial repression, and degrees of independence of central bank policy. See Cargill (1998) for a comparison between Japan and Korea, and Cargill and Parker (2001) for a comparison between Japan and China.
3 This and the following section draw from Cargill and Royama (1988) and Cargill *et al.* (1997 and 2000).
4 Detailed discussion of the evolution of Japanese financial and monetary institutions in postwar Japan can also be found in Aoki and Patrick (1994), Hoshi and Patrick (2000), Patrick (1994), Feldman (1986), and Suzuki (1980 and 1987).
5 Japan avoided the inflation and disinflation experienced by most industrial countries in response to the 1979 and 1980 oil price increases.
6 Aoki and Patrick (1994) provide an overview of the main bank system.
7 Cargill and Yoshino (1998, 2000 and forthcoming) and Kuwayama (2000) provide detailed discussion of these institutions.
8 Measures of central bank independence are presented in Cukierman *et al.* (1992).
9 Cargill *et al.* (1997) provide a detailed discussion of the *jusen* industry and its role in the bubble economy.

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7 The case of China

Nicholas R. Lardy

Introduction

By conventional measures, China escaped the most adverse consequences of the Asian financial crisis. More than two full years after the onset of the crisis, China's economic growth, while down somewhat compared with pre-crisis levels, remained the highest in the region. The value of the currency, the renminbi, remained fixed at 8.3 *vis-à-vis* the US dollar and official foreign exchange reserves expanded by a further US$49.7 billion in the three-year period ending December 1999. Inflows of foreign direct investment reached a plateau in 1998 and then shrank by 12 per cent in 1999. But even in 1999, inflows were US$40 billion, the largest of any emerging market economy (*The Economist* 2000). Export growth moderated somewhat in 1998 and 1999, but unlike other countries in the region, China was able to sustain strong import growth and maintain a significant positive trade surplus.

The central thesis of this chapter is that China avoided the Asian financial crisis primarily because its financial system was relatively closed. Domestic financial liberalization had not yet begun, limiting China's vulnerability to a currency crisis. Yet the country remains vulnerable to a domestic banking crisis. Sustaining strong economic growth and avoiding a banking crisis will depend very much on skillful implementation of further financial and other economic reforms. This is because China's pre-crisis financial fundamentals were in many ways considerably worse than those of other Asian countries that were drawn into the contagion – its fiscal position was fundamentally weaker; economic growth was decelerating; price deflation was deepening; the balance of payments, particularly the capital account, had deteriorated at a pace and for reasons that are not well understood; and political constraints had inhibited the rapid closure and exit of large numbers of money-losing state-owned companies, compounding weakness in the financial sector.

Sidestepping the Asian crisis

As already indicated, China weathered the first two years of the Asian crisis remarkably well. This is primarily attributable to four factors. First, and perhaps

most important, China's currency was not convertible on the capital account. Foreigners held almost no renminbi-denominated financial assets that they might have sold, perhaps setting in train a series of events leading to a significant depreciation of the renminbi. For example, in domestic equity markets, foreigners are allowed to purchase only special foreign currency-denominated shares that are not legally available to domestic investors. If the outlook for the price of these shares declines, foreign portfolio managers can only sell these shares to other foreigners, who must also pay in dollars. Thus even when foreign portfolio managers all run for the exit at the same time, there are no implications for the value of the domestic currency; this situation contrasts dramatically with that in Southeast Asia in the fall of 1997. Capital controls, of course, were far from perfect so there was significant capital flight, both before and after the Asian crisis.

Also, in contrast with the situation elsewhere in the region, domestic and foreign speculators had no way to act on the view that the Chinese currency was overvalued. Legal purchase of foreign exchange was limited to importers, to Chinese citizens holding documents authorizing them to travel abroad, to enterprises or financial institutions that needed foreign exchange to repay a previously approved foreign currency loan, or foreign investors (including those in joint ventures) who wished to repatriate some or all of the domestic currency dividends that have been declared by the firm's board of directors. The option of acquiring foreign exchange illegally on black markets was quite limited. Thus Chinese citizens who anticipated a declining value of the renminbi generally could not convert a significant portion of their domestic currency into foreign currency. Similarly, China's limited foreign exchange futures markets are legally open only to those firms that wish to hedge a documented need to complete a future trade-related transaction that is denominated in foreign currency. This effectively precluded speculators from taking short positions in the domestic currency.

A second factor insulating China from the crisis was its extraordinarily strong balance-of-payments position in the run-up to the crisis. As shown in Table 7.1, in 1996 and again in 1997, the current account was in surplus. Indeed the current account surplus recorded in 1997, US$29.7 billion, was a historic record by a very large margin. Thus, unlike other countries in the region, China did not need to increase its borrowings abroad in order to finance a current account deficit. Moreover, largely because of record level inflows of foreign direct investment, China concurrently was running a large capital account surplus. Indeed the US$40 billion capital inflow in 1996 was, by a very wide margin, an all-time record. Thus official foreign exchange reserves also grew by record amounts in 1996 and 1997 – US$31.4 billion and US$34.9 billion, respectively – despite a large adverse errors and omissions entry in the balance of payments in both years.

Third, and closely related, compared to several other countries in the region, China's official external debt was modest relative to its official holdings of foreign exchange. As shown in Table 7.2, in 1996, for example, official reserves of US$105 billion were the equivalent of 90 per cent of external debt, which stood at US$116.3 billion. Moreover, the structure of China's external debt was favorable. Loans from foreign governments and international financial institutions, which have highly

Table 7.1 China's balance of payments, 1996–98 (US$ billions)

	1996	*1997*	*1998*
Current account	7.2	29.7	29.3
Trade account	19.5	46.2	46.6
Capital account	40.0	23.0	–6.3
Errors and omissions	–15.6	–17.0	–16.6
Change in reserves[a]	–31.4	–34.9	–5.1

Sources: State Statistical Bureau (1997: 627–728, 1998: 92–3), State Administration of Foreign Exchange (1998).
Note: a. Reserve increases are indicated by a negative sign.

Table 7.2 China's reserves and external debt, 1995–98 (US$ billion)

		1995	*1996*	*1997*	*1998*
Official foreign exchange reserves		73.6	105.0	139.9	145.0
Official external debt		106.6	116.3	130.9	146.0
Of which: commercial loans		52.6	56.9	64.8	68.2
Of which: short-term		11.9	14.1	18.1	17.3
Independent estimates of:					
Total external debt	: World Bank	118.1	128.8	146.7	156.1
	: Institute for Int'l Finance	126.4			162.8
	: Deutsche Bank				180.0
	: JP Morgan		150.3	166.5	158.4
	: Moody's	128.5	141.8	159.1	171.3
Commercial loans	: BIS	67.1	79.8	90.1	82.7

Sources: Armstrong and Spencer (1999: 53), Bank for International Settlements (1997, Statistical Annex 2; 1999: 20), JP Morgan (1998: 78, 1999a: 68, 1999b: 56), Moody's Investors Service Global Credit Research (1999: 1); State Statistical Bureau (1998: 292, 670; 1999, 285, 626); World Bank (1997: 132, 1999a: 152, 1999c).

concessionary interest and repayment terms, accounted for fully one-third of external debt in 1996. Moreover, short-term debt accounted for only 13 per cent of external debt. As a result, China's reported debt service ratio in the 1990s remained consistently well below 10 per cent (State Statistical Bureau 1998: 292).

These figures on the current account and external debt compare quite favorably with several of the countries engulfed in the Asian financial crisis. In Korea, for example, the current account deficit was 4.4 per cent of gross domestic product (GDP) when the crisis struck. The current account deficit in Thailand in 1996 was even higher – 7.9 per cent of GDP. The comparison on the short-term debt side is also quite favorable to China.

On the eve of the Asian financial crisis in June 1997, the ratio of short-term external debt to international reserves had risen to well above 100 per cent in South Korea, Indonesia, and Thailand (Council on Foreign Relations 1999: 45). In China, in complete contrast, official reserves were more than eight times the level of reported short-term external obligations. Even if a significant portion of the

difference between officially acknowledged and independent estimates of China's external obligations (as shown in Table 7.2) are short-term, the coverage ratio is likely to be around three.

A fourth and final factor insulating China from the financial crisis was the continued confidence of households in the financial system, and in particular, the four largest state-owned banks. Several of China's banks were almost certainly insolvent, but none was illiquid. Household savings continued to pour into banks during the Asian financial crisis, obscuring their insolvency. This huge flow of savings, which added hundreds of billions of renminbi to saving deposits annually, is a function of three factors. First, the national saving rate has increased over the course of the reform era and since 1993 has exceeded 40 per cent of gross domestic product, putting China at or near the top of the world's saving league (World Bank 1999a: 72). Second, the share of national savings that is generated by the household sector has risen dramatically. Third, the absence of alternative financial assets means that as long as households have confidence in the banking system, they place a disproportionately large share of their financial assets in bank saving deposits. At the end of 1996, for example, households held more than three-quarters of their financial assets in the form of bank saving deposits (Lardy 1998b: 32). Thus banks did not face a liquidity problem. However, if any of these factors were to change, banks could face liquidity problems.

Changes in the financial system

Economic reforms beginning in the late 1970s brought about substantial changes in China's financial system. Among the most important was an overhaul of the mechanism of financing state-owned enterprises. In the plan era, these firms remitted their profits in their entirety to the Ministry of Finance and received budgetary grants that financed both fixed asset investments and a large portion of working capital needs. This system was not consistent with the more decentralized economic decision-making introduced beginning in the early 1980s. To provide appropriate incentives, firms were allowed to retain a growing share of their profits to finance their own investment. Furthermore, beginning in 1983, state budget financing of working capital was drastically curtailed and starting in 1985, the budget also no longer provided fixed asset investment funds for most state-owned enterprises. Thus by the mid-1980s, firms began to borrow significant amounts of funds from banks for the first time.

A second important reform was a significant restructuring of financial institutions. China, on the eve of the reform, operated a mono-banking system in which one institution, the People's Bank of China, acted simultaneously as China's central bank and the sole deposit taking and lending institution. While there appeared to be other financial institutions, their roles were limited. The Bank of China, for example, was subordinate to the People's Bank, and its role was limited primarily to handling foreign exchange and international payments. The Construction Bank was a bank in name only; it did not take deposits or make loans but was responsible for disbursing fixed investment funds for projects included in the state plan and

financed through the state budget. Moreover, the Construction Bank was administratively subordinate to the Ministry of Finance.

This simple institutional structure began to change once reform was launched in the late 1970s. The Agricultural Bank was established as an independent bank in February 1979 and in March of that year, the Bank of China was legally separated from the People's Bank. In October 1979, the Construction Bank was separated from the Ministry of Finance and a few months later, it was allowed to begin taking deposits and making loans, rather than simply serving as a conduit for budgetary funds earmarked for fixed asset investment projects.

The single most important step came in 1983, when the State Council designated the People's Bank as the central bank and created the Industrial and Commercial Bank to take over the deposit-taking and lending functions of the People's Bank. The Industrial and Commercial Bank, which formally began operations in 1984, immediately became China's single largest financial institution. Beginning in the mid-1980s, the authorities established a small number of new national-level comprehensive banks and a somewhat larger number of new regional commercial banks. Examples of the former include the Bank of Communications, headquartered in Shanghai, and the CITIC Industrial Bank, the banking arm of the state-owned CITIC Group. Examples of the latter include Merchants Bank, headquartered in Guangdong Province, as well as development banks in Guangdong, Pudong, and Shenzhen. China also developed an array of nonbank financial institutions such as trust and investment companies, urban credit cooperatives, and finance companies. The system of rural credit cooperatives, which was established in the 1950s, was also expanded. Virtually all of these institutions, however, were owned and controlled by the central government in Beijing or by local governments.

The Shanghai and Shenzhen Stock Exchanges opened in 1990 and 1991, respectively, adding an alternative source of finance for Chinese domestic firms.

The array of changes summarized above is probably best interpreted as financial reform rather than financial liberalization. The underlying structure of the financial system changed less than the institutional changes suggest. In certain important respects, China's financial system remained what might be called semi-repressed. The interest rate structure was distorted, banks were subject to excess taxation, and credit was allocated bureaucratically to preferred end-users, notably state-owned companies. The preconditions necessary for successful financial liberalization were still lacking. The fiscal system was weak and little progress had been registered in the privatization of state-owned companies. The interpretation that China's financial reforms fell short of liberalization is supported by an analysis of the key features of the Chinese financial system on the eve of the Asian financial crisis.

Interest rate controls

Perhaps the best indicator of the lack of financial liberalization in China in the first two decades of economic reform was the inability of the central bank to liberalize interest rates. During the Asian financial crisis, the central bank exercised almost complete control of the full range of interest rates on both deposits and loans. For

example, on the deposit side, the central bank specified the interest rates that financial institutions could pay for demand deposits and for three-month, six-month, one-year, two-year, three-year, and five-year time deposits. Banks had absolutely no flexibility to compete for deposits on the basis of the interest rate paid since the rates were all fixed and uniform across all institutions.[1] On the lending side, the central bank set separate interest rates that financial institutions could charge for working capital loans of six months or less, working capital loans of from six months to a year, as well as for fixed asset loans of less than a year, one to three years, three to five years, and more than five years.

The financial system may be regarded as semi-repressed because of distortions in the interest rate structure. Interest rates, particularly on the lending side, were frequently negative in real terms. During periods of very high inflation in 1988–91 and again in 1993–96, the central bank allowed banks to introduce value guarantee deposits in which the interest rate paid on deposits of three years or more was tied to the rate of the increase in prices over the period of the deposit. In principle, the central bank guaranteed that the real rate of return on these long-term deposits would not be negative, insulating savers from the effects of inflation and helping to maintain the flow of funds into the banking system. Savers, however, were not insulated from losses on their demand deposits and short-term fixed deposits. The interest rates on these deposits were not indexed and were adjusted upward by much less than price increases during inflationary periods. For example, in 1995, when consumer prices rose 17.1 per cent, the interest rate on demand deposits was only 3.15 per cent, in effect imposing a substantial inflation tax.

Distortions on the lending side were even greater. In periods of rising inflation, the central bank's upward adjustments of the interest rates financial institutions could charge on loans typically lagged far behind inflation, meaning that the real cost of funds to borrowers fell dramatically. As shown in Figure 7.1, in some periods of extreme inflation the real interest rate charged to borrowers actually became highly negative. This was most obvious in 1993–95 when the real rate of interest – defined as the difference between the one-year working capital loan rate and the rate of inflation of industrial goods prices – fell as low as −15 per cent. The real lending rate remained negative for three years, and the real interest rate financial institutions charged borrowers was also negative in 1988–90.

One corollary of financial repression on the lending side, of course, was excess demand for funds. Excess demand for funds was managed through a system of lending quotas established by the central bank for each of the major financial institutions. The quotas established for each bank a ceiling that limited the magnitude of the increase in the loans outstanding for each bank.

Another corollary of financial repression was a systematic suppression of bank profitability, which is discussed further. Particularly during periods of high inflation, the cost of funds to banks increased significantly while their lending rates fell to negative levels, placing a huge squeeze on their operating margins.

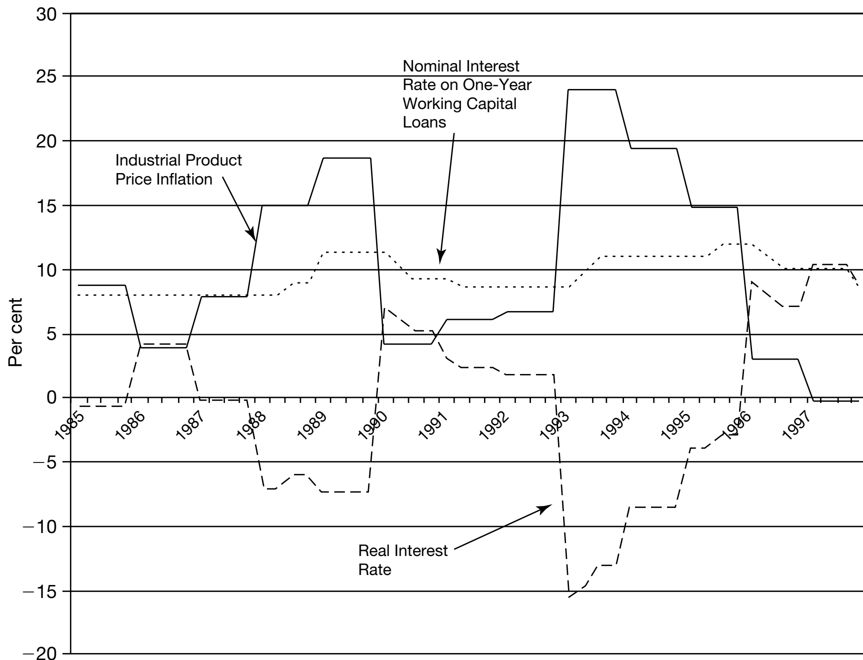

Figure 7.1 Chinese interest rates, 1985–97.

Source: Lardy (1998b: 108); National Bureau of Statistics (1999: 305).

Bank-dominated financial system

A second important characteristic of China's financial system is its heavy dominance by state-owned banks, even by Asian standards. As shown in Figure 7.2, from 1987 through 1997, banks on average accounted for almost 90 per cent of all domestic financial intermediation. Moreover, there is no evidence that the banks' share of financial intermediation shrank over this period. The role of nonbank financial institutions – such as trust and investment companies, leasing companies, and finance companies – was never large and declined consistently over the decade. Despite the opening of two formal stock exchanges in the early 1990s, the role of capital markets remained unusually small. Equities and corporate debt combined accounted for only 0.7 per cent of financial intermediation in 1994–96. This share rose to about 5 per cent in 1997, when the value of initial public equity offerings grew dramatically. But as the value of initial public equity offerings and the net value of corporate bond sales fell in 1998 compared to 1997, the growth in the role of capital markets in domestic financial intermediation was not sustained (China Securities Regulatory Commission 1998: 27, 1999: 17).[2]

Moreover, the banking system is characterized by a high degree of concentration. In the mid-1980s, the four largest state-owned banks – the Industrial and Commercial Bank, the Bank of China, the China Construction Bank, and the

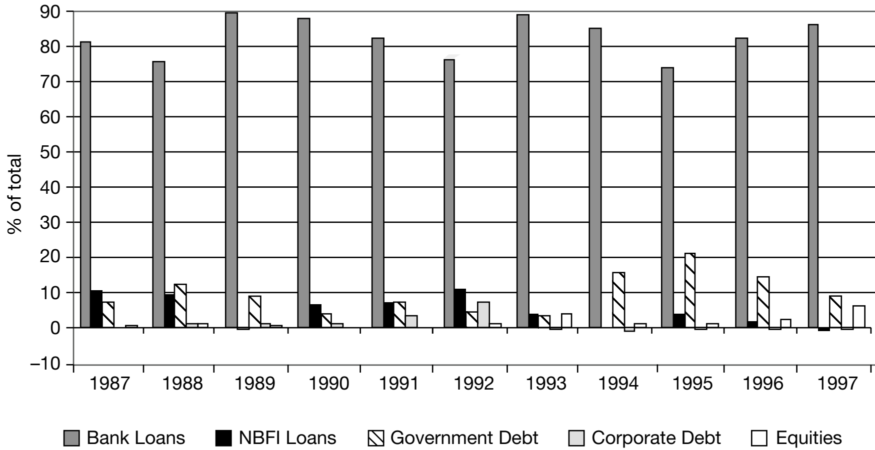

Figure 7.2 Domestic financial intermediation in China by type.
Source: Lardy (1998a).

Agricultural Bank of China – accounted for all of the assets in the national banking system. Although banks that were established in the mid-1980s have developed their branch networks and expanded their lending quite rapidly, they still account for a very small share of the activities of the banking system. By year-end 1995, these new institutions accounted for less than 8 per cent of bank assets (Lardy 1998b: 224). Two years later, their assets were just over 9 per cent of bank assets (Armstrong and Spencer 1999: 59).

The dominance of state-owned banks and the high degree of bank concentration had several unfavorable implications. First, there was insufficient competition in the financial system. Neither capital markets nor the large number of second-tier banks created since 1985 were sufficiently strong competitors to stimulate the dominant institutions to become more efficient intermediaries of funds. This lack of competition contributed to a long-term decline in the rate of return on assets of the banking system, as is discussed further. Second, since most bank lending is short-term, some borrowers have sold long-term bonds offshore to finance infrastructure projects, such as toll roads, which have a long payback period. Since these projects typically generate no foreign exchange income to service the external debt, this offshore borrowing involves significant foreign currency risk. Third, the dominance of state-owned banks has meant that the flow of resources has gone overwhelmingly to state-owned companies, leaving much of the rest of the economy starved for funds.

Excessive credit growth

The third feature of China's pre-crisis financial system, shared with several other countries in the region, was excessive credit expansion. Credit grew far more rapidly

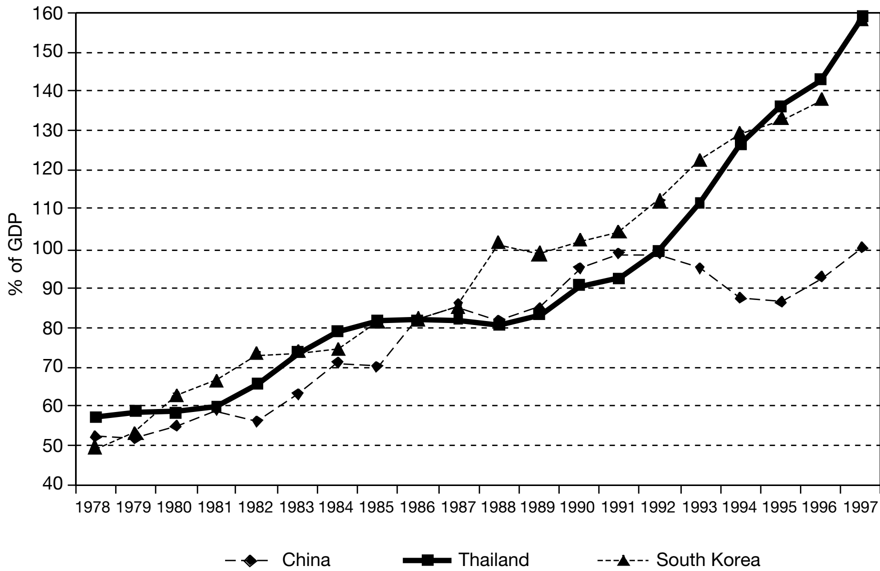

Figure 7.3 Domestic credit, 1978–97.

Source: Lardy (1998b: 78); International Monetary Fund (1999: 568–71, 878–80).

than output. As a result, total loans outstanding from all financial institutions grew to 100 per cent of GDP by year-end 1997 from 50 per cent in 1978. As shown in Figure 7.3, this is a trajectory that shares similarities with the expanding ratio of lending to GDP in Thailand and South Korea. As will be discussed later in this paper, the underlying cause of this rising ratio is similar across these countries – excessive lending for commercial and residential property development and excessive investment in manufacturing, which is reflected in rates of return falling below the cost of funds, and the build-up of high levels of excess capacity over a broad range of sectors.

Weak financial performance

A fourth feature of China's pre-crisis financial system was the weak financial condition of China's financial institutions, particularly the four largest state-owned banks. The reported pre-tax profits of the four banks as a group grew at an extremely low rate; indeed in 1997, they were only RMB20.5 billion, exactly the same as in 1988 (Lardy 1998b: 101).[3] But since the assets of these banks grew enormously over the same period, the rate of return on assets fell by more than four-fifths, from 1.1 per cent in 1988 to 0.2 per cent in 1997, far below the returns achieved by well-managed banks in other countries. Profits of the four biggest banks fell further in 1998. Profits at the Construction Bank and the Industrial and Commercial Bank of China combined rose by almost RMB 1 billion. But profits at the Bank of China,

which in 1997 accounted for almost one-third of the pre-tax profits for the four banks as a group, plunged by RMB 2.4 billion (Bank of China 1999: 39).[4]

Moreover, since Chinese banks are required to report interest that has not been paid as income, the underlying financial reality is far worse than the banks' reported results.[5] For example, the Construction Bank in the four-year period 1993–96 reported after-tax profits of RMB11.6 billion. However, taking into account phantom interest income, the bank actually incurred a cumulative loss of RMB22.4 billion. Thus the real rate of return on assets was negative (Li 1998: 33).

In addition, the rules of the Ministry of Finance limit the amount of earnings that can be added to reserves for nonperforming loans. In 1998, for example, provisions for bad loans were limited to 1 per cent of outstanding loans at the end of the year, regardless of the actual quality of a bank's loan portfolio. This limitation also results in a significant overstatement of bank profitability.

The large and growing share of loans that are recognized to be nonperforming also reflects the poor performance of banks and other financial institutions. According to People's Bank of China Governor Dai Xianglong and other high-ranking economic and banking officials, the share of nonperforming loans of the four largest state-owned banks rose from 20 per cent at year-end 1994 to 22 per cent at year-end 1995 and then 25 per cent at year-end 1997. Moreover, the share of nonperforming loans falling into the most impaired categories expanded significantly (Lardy 1998b: 119, 122, 206, 280). China's fifth-largest bank, the Agricultural Development Bank, has also had rapid growth in nonperforming loans. Although the bank was not created until 1994, 26 per cent of its loans were acknowledged to be nonperforming by year-end 1996. In 1997, it reported massive operating losses exceeding RMB15 billion, more than 13 times its capital at year-end 1996 (Chinese Finance and Banking Society 1998: 571).[6]

Nonbank financial institutions have loan portfolios that on average are even more impaired than those of banks. At year-end 1996, nonperforming assets of nonbank financial institutions were acknowledged to be 50 per cent of their total assets. For example, nonperforming loans of China's rural credit cooperatives were acknowledged to be 38 per cent of their total lending at year-end 1996. Over half of these cooperatives were running in the red, with cumulative losses of more than RMB14 billion in 1996 (*Zhongguo xiangzhen qiye* 1998: 38).

Despite a substantial increase in the write-off of bad debt on the balance sheets of the four largest state-owned banks, it appears that the share of nonperforming loans rose further by year-end 1998. For example, the Bank of China increased its write-offs of nonperforming loans by RMB1 billion (or about 25 per cent) to reach RMB5.3 billion. But its nonperforming loans expanded by RMB19.2 billion. The total quantity of nonperforming loans reached RMB135 billion or 10.29 per cent of the bank's total loan portfolio, up from 9.98 per cent in 1997 (Bank of China 1999: 46–7). The share of nonperforming loans in the portfolios of two smaller banks – the Everbright Bank and the Shenzhen Development Bank – also increased sharply in 1998 (Moody's Investors Service 1999: 18).

As in the case of the bank profitability figures, these numbers would be substantially worse if international accounting standards were applied. Chinese data on

nonperforming loans historically have been based on the payment status of loans, not an assessment of the ability of the borrower to service the debt. Payment status is a lagging indicator of loan quality and is manipulated by evergreening, through loan rollovers and capitalization of interest.[7]

A third indicator of the weakness of the financial system is sharply declining capital adequacy. The reported net worth of the four largest state-owned banks at year-end 1997 was RMB273.91 billion, only 2.16 per cent of assets on an unweighted basis. This represents an enormous deterioration from 1985 when net worth stood at RMB84.8 billion or 13.2 per cent of assets. Moreover, Chinese banks carry nonperforming loans that are classified as bad – i.e. loans on which the borrower has already gone through bankruptcy and liquidation but on which the lender has not recovered – on their balance sheets. At year-end 1997, bad loans represented 2 per cent of all loans, meaning that the four largest state-owned banks as a group almost certainly were insolvent.[8] Only if they could recover almost 100 per cent of their nonperforming loans that are not classified as bad would they have had a positive net worth.[9]

Other major portions of the financial system were also insolvent. For example, nonperforming loans of the Agricultural Development Bank at year-end 1996 were 12.3 times the bank's capital and those of the system of rural credit cooperatives were 4.37 times its capital. On any reasonable estimate of the likely rate of recovery of nonperforming loans, these institutions had a highly negative net worth. Although system-wide data are not available, the liquidation of the China Agricultural Development Trust and Investment Company in 1998 and the bankruptcy and likely liquidation of the Guangdong International Trust and Investment Company (GITIC), the Guangzhou International Trust and Investment Company (GZITIC), Guangdong Enterprise, and other trust and investment companies suggests that solvency was a major problem in the trust and investment sector of the financial system as well.

To a substantial degree, the weak financial condition of banks and other institutions reflects the policy of financial repression pursued by the central government throughout the reform period. The most obvious mechanism of repression was the requirement that banks lend almost exclusively to state-owned enterprises at interest rates far below those that would have prevailed in a more liberal financial environment. But the state instituted a number of other policies to ensure that banks also became a major direct source of government tax revenue. First, as has already been noted, the Ministry of Finance precluded banks from realistic levels of write-offs of nonperforming loans. Such write-offs would have reduced bank income and thus taxes paid to the Ministry of Finance. Second, the Ministry of Finance required banks to pay taxes on accrued interest, i.e. interest that should have been paid by borrowers but was not. Moreover, even when such interest payments were never forthcoming, banks were not allowed to go back and restate their earnings and recover taxes that had been paid on phantom income. Finally and much less well-known is that banks were required to pay taxes on their gross income from interest and fees, as well as pay income taxes on their operating earnings. This combination meant that banks were subject to effective tax rates of about 80 per cent (Lardy

1998b: 171). As a consequence of these policies, on the eve of the Asian financial crisis, taxes paid by the four largest state-owned banks accounted for about one-sixth of central government revenues.

Weak supervision and regulation

A final feature of China's financial system that is worth noting is the weak supervision and regulation. Although the People's Bank was transformed to operate solely as a central bank, it assumed the supervisory and regulatory roles of a central bank only gradually. Although the bank was established on 1 January 1984, it was not until 1986 that the State Council promulgated the formal regulation outlining the bank's responsibility for supervision of the growing number of banks and other newly emerging financial institutions, such as trust and investment companies and urban credit cooperatives. Additionally, the full legal basis for this role was not established until the National People's Congress passed the Central Bank Law in 1995.

Despite these developments, the ability of the bank to supervise financial institutions was impaired by political authorities at the local level. Well into the 1990s, provincial-level officials had a major role in the appointment of the heads of thirty provincial-level branch offices of the People's Bank, as well as more than 2,200 city- and county-level offices. These central bank officials were thus vulnerable to importuning by local party officials to extend credit to local branches of state banks that, in turn, would be funneled to support projects sponsored by these officials. At least through mid-1993, about 30 per cent of the credit extended by the central bank to the commercial banking system, which was an important source of funds for policy lending, was controlled at the branch level of the People's Bank. Not until mid-1993 was the authority to extend central bank credit to commercial banks centralized at the head office of the People's Bank.

The weak regulatory powers of the central bank are reflected in its inability to enforce the prudential standards promulgated in the Commercial Bank Law, passed by the National People's Congress in 1995. This law requires that the capital adequacy of banks be no lower than 8 per cent; the ratio of loans to deposits be under 75 per cent; the ratio of liquid assets to liquid liabilities be no lower than 25 per cent; and the loans to a bank's largest borrower not exceed 10 per cent of the bank's total capital (People's Bank of China Legal Department 1995, article 39).

When the law was passed, none of the major commercial banks were in compliance with the capital adequacy standard, the loan-to-deposit prudential ratio, or the liquidity ratio. Because none of the banks published data on loan concentration, it is not possible to evaluate their compliance with the restriction on the amount that could be lent to the single largest borrower. Although the Commercial Bank Law took effect in July 1995, most Chinese banks were unable to come into compliance with its provisions. For example, the loan-to-deposit ratio at the Industrial and Commercial Bank has remained consistently well above 80 per cent since 1995. More revealingly, in recent years, none of the annual reports of the major banks even mentions the prudential standards or their progress in coming into compliance.[10]

At one level, the financial reforms outlined above had little effect on finance of the corporate sector. Most critically, the banking and financial system operated to ensure that most investment funds flowed to state-owned companies. At year-end 1997, two-thirds of all short-term loans extended by the financial system went to the state sector.[11] Only 15 per cent of short-term loans went to agriculture and township and village enterprises. Foreign-funded firms received 3.4 per cent of the loans outstanding and loans to the private sector accounted for only 0.7 per cent of the total (People's Bank of China 1998: 92). The share of loans flowing to foreign-funded and private firms is particularly small in view of the fact that these categories of firms accounted for 13 per cent and 18 per cent, respectively, of manufacturing output (State Statistical Bureau 1998: 435, 437). In this critical respect, there was little change from the system of budgetary finance of the pre-reform era. It too channeled a disproportionately large share of resources to the state sector.

But because the financial condition of the state sector was poor, the shift from budget to bank finance of state-owned companies had important implications for the stability and viability of the financial system itself. A growing share of state-owned firms is unprofitable. In the manufacturing sector, for example, the share of state-owned companies losing money rose from under 10 per cent in 1985 to one-half by 1998. Reported financial losses grew more than 30-fold, from RMB3.2 billion in 1985 to RMB102.3 billion in 1998 (Lardy 1998b: 35, State Statistical Bureau 1999: 3).[12] Moreover, on average, these firms were increasingly highly leveraged. The debt to equity ratio for state-owned manufacturing and commercial companies rose from 122 per cent in 1989, a level not dissimilar to that observed for corporations in the United States, to 570 per cent in 1995, a level substantially exceeding the leverage of the average Korean *chaebol*, widely regarded as the most highly geared corporate sector in the world (Lardy 1998b: 41).[13] Daewoo, when it was teetering on the edge of bankruptcy in the summer of 1999, reported a debt-to-equity ratio of 354 per cent at year-end 1998. Its proposed restructuring, which ultimately failed, involved the sale of the group's shipbuilding, consumer electronics, personal computer, commercial vehicle, construction, and securities businesses. Had these transactions succeeded they were expected to yield sufficient cash to reduce the group's debt-to-equity ratio to 196 per cent (Burton 1999: 1).

The explosion of corporate debt relative to equity simply reflects the fact that many Chinese state-owned companies cannot cover their costs of production from income derived from the sale of their output. Liabilities rise relative to equity because firms are not using most of the borrowed funds to finance fixed asset investments; rather, firms are using the funds to pay wages and taxes and to finance growing inventories of unsold, and frequently unsaleable, goods.

Nonetheless state-owned firms have invested excessively in fixed assets as well. This is reflected in the low rates of capacity utilization in many product lines. As shown in Figure 7.4, by 1995 (the last year in which there was a comprehensive industrial census) low rates of capacity utilization were not limited to a few types of goods, but extended across a broad range of consumer products, including durables such as household air conditioners and televisions, as well as producer goods, for example, internal combustion engines.

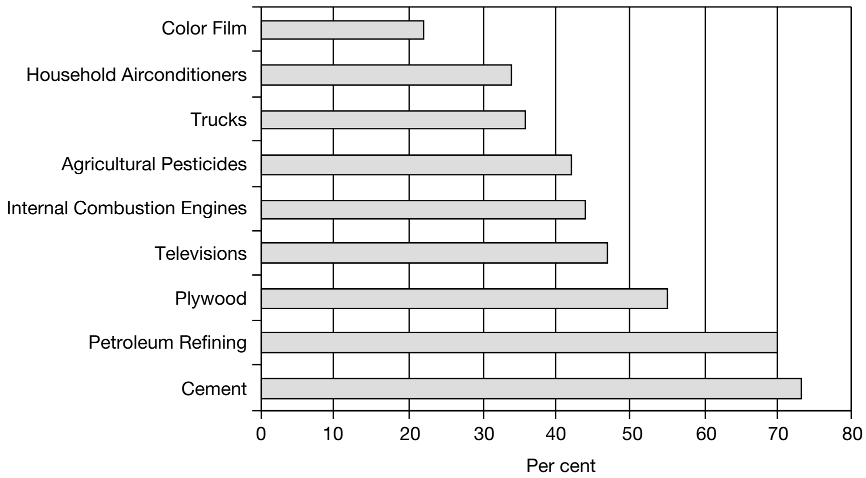

Figure 7.4 Capacity utilization in selected industries in China, 1995.
Source: State Statistical Bureau (1997: 454–5).

Response to the Asian crisis

The Asian financial crisis stimulated China's leadership into taking more vigorous action to avoid being drawn into the contagion. Some of these steps tightened existing capital controls by more careful monitoring and stricter control of China's foreign currency exposure. The ability of nonfinancial firms and subsidiaries and affiliates of financial institutions to borrow offshore was curtailed drastically (Lardy 1998b: 208–9). The government also sought to strengthen central bank supervision and regulation, a precondition for the successful operation of a more liberalized and decentralized financial system. The central bank, for example, in 1998 abolished its provincial level branches and replaced them with nine regional, supra-provincial branches. Since the bureaucratic rank of these central bank regional offices is above that of provincial governors and first party secretaries, the hope is that the central bank will be able to insulate local commercial banks from political interference in their lending decisions. According to Premier Zhu Rongji, 'the power of provincial governors and mayors to command local bank presidents is abolished as of 1998' (Mingpao 1998).

In 1998, the People's Bank began to introduce risk-based criteria for classifying loans. The new categories – pass, special mention, substandard, doubtful, and loss – are closer to international standards than the previous system and should provide the central bank with a more accurate basis for judging the quality of the loan portfolios of commercial banks.

The central bank also began the process of restoring the capital adequacy of the largest state-owned banks. In late summer of 1998, the People's Bank of China injected RMB270 billion into the largest state-owned banks to improve their capital position. In 1999, the Chinese government created four asset management

companies to take over a large portion of the bad debt of each of the major four state-owned banks. The first company, Cinda Asset Management Company, was formally created in April 1999 to take over about RMB250 billion in nonperforming loans from the China Construction Bank. In the summer of 1999, Huarong, Dongfeng, and Changcheng Asset Management Companies were created to take over nonperforming loans of the Bank of China, the Industrial and Commercial Bank of China and the Agricultural Bank of China, respectively. These asset management companies are issuing bonds to the banks in exchange for nonperforming loans. Since the bonds are implicit obligations of the Ministry of Finance, this process effectively converts what are in effect contingent liabilities of the government into implicit government debt. The exchanges result in an immediate improvement in the balance sheet of each of the banks and, because interest is paid on the bonds, a substantial improvement in each bank's profit and loss statement. The asset management companies are charged with recovering as much as possible from the original borrowers either through liquidation of the borrower's assets, debt-equity swaps, or debt restructuring.

The fiscal implications of China's program to restore its banks to health are substantial. The financing of the four asset management companies is expected to amount to RMB1.2 trillion to RMB1.3 trillion, or 15–16 per cent of gross domestic product. In addition, there is a substantial accumulation of nonperforming loans in banks other than the big four and in an array of nonbank financial institutions such as trust and investment companies and the system of rural credit cooperatives. The ultimate cost of restoring the health of the financial system may easily amount to 25 per cent or more of GDP.

Some have dismissed China's financial problems, arguing that nonperforming loans of state-owned banks and other financial institutions are properly regarded as a contingent liability of the government, and that since government debt relative to GDP is low, it can easily be financed once it is converted into an explicit obligation (Fernald and Babson 1999: 20–1, Roach 1998: 12). This judgment seems flawed in at least two respects. First, the sanguine view does not take into account the weaknesses in the present fiscal system. Consolidated government revenues in 1998 were only 12.4 per cent of gross domestic product, about half the average share for emerging market economies. Not only are government revenues low, but government debt has increased dramatically in recent years. At year-end 1998, the combined value of treasury debt, the debt of other 100-per cent government-owned entities such as the State Development Bank, and the RMB270 billion issued by the central government to partially recapitalize the four large banks in 1998 was 20.5 per cent of GDP, almost five times the level of 1993. Interest payments on the treasury portion of this debt in 1998 were RMB72.3 billion, almost fifteen times those of 1993 (Lardy 1999).

Second, it is not clear that the flow of new bad loans can be ended. It is uncertain whether the government will be able to successfully resolve the bad loans that have already accumulated in the banking system, but it is certain that it will not be able to do so unless the flow of new bad lending is ended quickly. This will not be possible unless the authorities are willing to cut off the flow of new lending to unprofitable

enterprises and unless banks face real incentives to adopt a commercial credit culture. To date, the regime has simply assumed that a change in regulations and incentives can induce commercial behavior on the part of state-owned banks. This assumption has been challenged by one of China's most distinguished reform economists, Wu Jinglian. Wu and his colleagues at the State Council Development Research Center have proposed that the state publicly list the largest state-owned banks, a step that is a precondition for privatization of banks (Reuters 1999).

Development of a commercial credit culture would be highly favorable for sustaining a high rate of economic growth. Most importantly it would lead to a significant increase in lending to the private sector, which as noted above has been crowded out of access to funds because of the voracious appetite for credit of state-owned companies. Private firms have become the major source of employment growth in the second half of the 1990s. It is likely that their contribution would increase further once a credit culture develops in the banks.

Conclusion

Although many economic indicators remain positive, it is clear that China has not fully escaped the risks exposed by the Asian financial crisis. Avoiding a domestic banking crisis will depend most critically on additional reforms in the real sector, an overhaul of the fiscal system that produces badly needed additional government revenues, and the rapid development of a commercial credit culture, without which efforts to restore the banks to financial health may be doomed. Even if new bad lending can be curtailed and commercial lending practices developed, China is at the beginning of what will be a long process of bank restructuring and financial liberalization.

It is important to note that the current environment is unfavorable to bank restructuring and recapitalization. Heavily leveraged corporations are struggling under mountains of debt. If economic growth falls further, a growing share of these firms will be unable to service their debt, adding to an already substantial accumulation of nonperforming loans in the banking system.

The external environment is also becoming increasingly unfavorable to bank restructuring and recapitalization. That has led to a rapid deterioration in China's balance of payments. While it has not been widely noticed, China experienced a dramatic deterioration in its capital account in 1997 and 1998. As reflected in Table 7.1, a capital account surplus of US$40 billion in 1996 fell to a capital account deficit of US$6.3 billion in 1998. The decline occurred despite a continued strong inflow of foreign direct investment – US$42.4 billion, US$45.4 billion, and US$45.5 billion in 1996, 1997, and 1998, respectively. The deterioration had several causes. First, between 1997 and 1998, portfolio investment swung from a US$6.8 billion inflow to a US$3.7 billion outflow. That was the largest single adverse change in the capital account. The decline in 1998 occurred because China issued a relatively small amount of foreign bonds compared to the amount of bonds that were maturing, the number of new foreign currency-denominated issues dropped to a trickle in 1998, and there was a significant increase in Chinese purchases of foreign

equity and debt securities. Second, there was an increase of more than US$12 billion in trade credit extended by China to foreign buyers of its goods, which is entered in the balance of payments as a capital outflow.[14] Finally, foreign banks withdrew their loans to China, a reversal of earlier years in which commercial lending increased rapidly. In 1998, according to official data, China's net repaid foreign loans amounted to US$3.3 billion.

Because of a strong current account position in 1998, China was still able to add US$5.1 billion to its official holdings of foreign exchange, despite an adverse errors and omissions entry in its accounts of almost US$17 billion. But in 1999, China's positive current account position eroded rapidly. The trade surplus amounted to only US$29.1 billion, compared to US$43.6 billion in the prior year.[15] The current account surplus in 1999 will be around US$12 billion, well under half the level of 1998. It is difficult to explain what happened to the capital account in 1999, since, with one exception, information on the capital account is released only once a year and with a lag of six to seven months. The exception is gross foreign direct investment inflows, which were US$40 billion, off 12 per cent compared to 1998. In the wake of the decision in January 1999 to liquidate the Guangdong International Trust and Investment Corporation (GITIC), the likely liquidation of Guangdong Enterprises, and the unfavorable terms that have been offered to creditors of the Guangzhou International Trust and Investment Corporation (GZITIC), it is likely that international commercial bank lending to China has continued to shrink. As shown in Table 7.2, BIS-reporting banks reduced their exposure to China by US$7.4 billion in 1998. Given the Standard Charter and Hongkong Shanghai Bank's substantial increases in the first half of 1999 in provisions for lending to China, it seems quite likely that new international bank lending has been curtailed and total exposure reduced as maturing loans in some cases are paid off. In short, the capital account deficit of 1998 may have expanded somewhat in 1999. Nonetheless the expansion of the capital account deficit was not sufficiently large to prevent an increase of US$9.7 billion in official holdings of foreign exchange. China's foreign exchange reserves are sufficiently large to finance any likely overall balance-of-payments deficit for many months. Nonetheless, unless the trends analyzed above are reversed, devaluation is increasingly likely. Although devaluation may stimulate export growth and demand for import-competing industries – especially the hard hit steel, chemical, and shipbuilding sectors – it inevitably would exacerbate the external debt repayment burden of the corporate sector, again adding to the growing problem of nonperforming loans. It also would directly and adversely affect banks and other financial institutions since they also have borrowed large amounts of funds offshore.

China's experience in the Asian financial crisis certainly supports the view that premature capital account liberalization increases a country's vulnerability to a currency crisis. Had the capital account been open, it seems quite likely that China would have been drawn into the contagion that swept over much of Asia in the second half of 1997. The Chinese authorities understand this lesson. They remain committed to moving toward capital account convertibility, but the timing will be determined by their ability to both rehabilitate domestic financial institutions and strengthen the regulatory and supervisory powers of the central bank.

China's experience also demonstrates the advantage of relying primarily on foreign direct investment as opposed to potentially more volatile sources of foreign funds such as loans, bank deposits, stocks, and bonds. The latter are often short-term in nature and easily reversed.

It would be hard to argue, however, that the case of China supports the desirability of postponing financial liberalization. In certain respects, financial liberalization has not yet begun in China. A high degree of financial repression remains, with the central bank continuing to exercise pervasive controls over interest rates on both the deposit-taking and lending sides of banking business. Similarly, banks remain subject to confiscatory levels of taxation. The costs of this approach are high. Most obviously, intermediation remains quite inefficient, resulting in the continued waste of a large share of national savings. Above all, the current system is not sustainable. It is, in effect, a pyramid scheme that is viable only as long as there is a continued large flow of household savings into the banking system. The sooner more fundamental reforms are undertaken, the lower the ultimate costs to depositors will be.

Notes

1 Prior to October 1997, the central bank had allowed financial institutions some discretion in adjusting their interest rates on loans around the officially posted rates. From 1993 through the middle of 1996, the flexibility was 20 per cent on the upside, 10 per cent on the downside. However, rural and urban credit cooperatives had additional flexibility to raise rates as much as 60 per cent and 30 per cent above the posted rates, respectively. They were each limited to 10 per cent flexibility on the downside. Beginning 1 May 1996, general upside flexibility, including that for urban credit cooperatives, was reduced to 10 per cent. Rural credit cooperatives could adjust their rates only 40 per cent on the upside, 10 per cent on the downside. Beginning 23 October 1997, all flexibility was eliminated.

2 The IPO value of domestic currency equities, including the proceeds of rights offers, fell from RMB85 billion in 1997 to RMB78 billion in 1998. The net issuance of corporate bonds in 1998 was only RMB6.5 billion, down from RMB8.5 billion in 1997.

3 In the interim years, pre-tax profits rose to peak at RMB32.3 billion in 1992.

4 This figure is on an unconsolidated basis, i.e. it includes only the Bank of China. On a consolidated basis, the profits of the Bank of China and its wholly-owned subsidiaries declined by RMB5.2 billion in 1998.

5 The period of time over which banks must record interest as having been paid even when that interest payment has not been received was reduced in recent years, presumably reducing the degree to which bank earnings have been overstated.

6 After an extraordinary 'non-operating subsidy income' item, the bank's profit and loss statement showed pre-tax losses of only RMB 2.53 billion.

7 Historically loans have been classified as overdue (not repaid when the term specified in the loan contract expires), doubtful (overdue for more than two years (this was changed to one year in August 1998) or to a borrower who has ceased operations, regardless of the payment status of the loan), and bad (loans to bankrupt or dead borrowers where the collateral has not been sufficient to cover the principal). Beginning in 1998, the central bank began to introduce a risk-based loan classification system.

8 Of the four largest banks, the Bank of China is by far the strongest. Its capital relative to assets and loan-loss reserves as compared to its loan portfolio are both higher than that of other state banks and its ratio of nonperforming loans is significantly lower. In part this is because of the Bank of China's strong international orientation. More than

one-third of the bank's assets are outside of China, primarily in Hong Kong. Profits generated from its overseas businesses account for 90 per cent of the bank's reported profits in 1998. In contrast, the other three major state-owned banks have almost no foreign presence.

9 Loans comprise an unusually high share of bank assets in China. Thus if bad loans equal to 2 per cent of all loans were written off, it would absorb a large share of bank capital, which for the four largest banks were equal to 2.16 per cent of assets. For example, at year-end 1997, loans comprised two-thirds of all of the assets of the China Construction Bank (Chinese Finance and Banking Society 1998: 560).

10 The sole exception is the Bank of China, which does report on its capital adequacy.

11 Short-term or working capital loans accounted for three-quarters of all loans outstanding from the financial system at year-end 1997. No data are available on the distribution of loans for fixed asset investment by ownership of the borrower, but these are likely to be even more heavily concentrated in state-owned companies than are working capital loans.

12 These data are for state-owned manufacturing enterprises with independent financial accounting.

13 These data almost certainly understate the debt-equity ratios in Chinese state-owned companies as these firms' liabilities are understated. For example, the data include only liabilities to banks and other financial institutions and do not include huge net payables that are due to the non-state sector. Assets are almost certainly overstated because of the application of unrealistically low rates of depreciation on fixed assets and the valuation of huge inventories at list price rather than market value. In many cases, the latter may approach zero.

14 Inconsistencies in the presentation of the trade credit figures in the balance of payments in 1998 lead one to question the accuracy of these numbers.

15 The numbers cited are from the Ministry of Foreign Trade and Economic Relations. They differ slightly from the data on the trade account shown in Table 7.1, which originate from the State Administration of Foreign Exchange.

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8 Financial liberalization in India

Issues and prospects

Rajendra R. Vaidya

Introduction

The Asian economies that succumbed to the currency and banking crises of 1997–98 were those that had maintained generally stable macroeconomic conditions, recorded spectacular growth for over a decade, and received large inflows of foreign capital after having undertaken substantial financial and capital account liberalization (Radelett and Sachs 1998). India, which had by far a more modest growth performance and a less stable macroeconomic situation but also had a relatively less open capital account and had made limited progress on financial liberalization, was not severely affected by the crisis. In fact, what really helped India was that its banks and firms had very limited access to capital markets abroad.

The closest occasion that the Indian economy came to a full-blown currency crisis was in the summer of 1991 when the country was in the midst of a balance-of-payments crisis, with foreign exchange reserves enough to cover less than two weeks of imports. The immediate cause of the crisis was a sharp rise in oil prices and a sudden drop in remittances of migrant workers in the Gulf following the annexation of Kuwait by Iraq. The situation was further complicated by the increasing difficulty in obtaining commercial loans and the outflow of foreign currency deposits held by nonresident Indians, which created a general expectation that the Indian government would default on its external commitments. The situation was alleviated with help from the International Monetary Fund and the initiation of industrial and financial sector reforms. The shock of 1991 had little to do with financial liberalization and more with unfortunate external circumstances and poor fiscal management by the government. In fact, it was due to this shock that financial liberalization was initiated in India.

Since 1991, India has made various attempts to liberalize its financial system and open its capital account. Although progress thus far has been slow, India will certainly make further progress in opening the capital account. The Asian crisis of 1997–98, however, raises questions about the wisdom of capital account liberalization, as there are as yet no set answers on how to deal with various problems arising from capital inflows. As acknowledged by Furman and Stiglitz (1998: 102): ‘in the debate over how to cope with capital inflows and with rapid capital outflows, the disagreements among economists counsel a degree of humility. We do not have

all the answers.' The choice of the exchange rate regime for a country that has chosen to open its capital account is another (though related) unsettled question where consensus on policy advice does not exist.

A lesson one might draw from the contrasting experiences of India and the crisis-afflicted countries of Asia is that financial and capital account liberalization can render an economy vulnerable to crisis. Nobody, however, seriously argues that liberalization on both these fronts is not advantageous in the long run, or that a world of financial repression and permanent control over all capital movements is preferable. The question is how and at what pace a relatively closed economy, whose financial system has been severely repressed, should move towards a more open and less repressed financial system.

At the microeconomic level, capital account and financial liberalization can lead to serious mismatches in the balance sheet of players in the financial system and large corporations. The two important mismatches that could arise are a mismatch of maturities and a mismatch of currency denominations. These mismatches can lead to an increase in the vulnerability of the economy to tumble into a full-blown financial crisis in the face of a seemingly harmless negative shock (either external or internal) to economic activity. In what follows, I attempt to gauge how vulnerable the Indian economy has become to such a financial crisis following the reforms of 1991.

The chapter begins with a macroeconomic overview of the economy between 1984/85 and 1997/98, followed by a description of the various policy regimes since 1951. It then discusses the problems created by capital inflows and the choice of exchange rate regime, the effects of India's financial sector reforms on commercial banks, development banks and private corporate firms, and the political economy aspects of financial liberalization. The chapter ends with some concluding remarks.

Macroeconomic overview

Table 8.1 presents the growth rates of various macro aggregates from 1984/85 to 1997/98.[1] In the years between 1984/85 and 1987/88, the growth rate of real gross domestic product (GDP) hovered around 4 per cent, and in 1988/89, India recorded a spectacular growth rate. In the three years that followed, the economy slowed and growth fell to nearly zero for 1991/92 as a result of contractionary policies that had been adopted in response to the 1991 crisis. After 1992, India experienced robust real GDP growth. The subsequent slowdown in 1997/98 has been attributed to the East Asian crisis.

The rate of inflation, measured by the rate of growth of the wholesale price index, was high prior to 1990/91 but remained under 10 per cent.[2] In subsequent years it rose above 10 per cent until 1994/95 when it began to fall. Since then it has been well under control. Prior to 1990/91, money supply growth was in the range of 18–20 per cent and correspondingly, Reserve Bank of India (RBI) credit to the government and reserve money also grew rapidly. But after 1990/91 there has been a slowdown in money supply growth (this slowdown is more pronounced in the growth rates of RBI credit to the government and reserve money).

Table 8.1 Growth rate of basic macroeconomic indicators (percentage)

	1984/85	*1989/90*	*1990/91*	*1991/92*	*1992/93*	*1993/94*	*1994/95*	*1995/96*	*1996/97*	*1997/98*
Gross domestic product	3.8	6.9	5.4	0.8	5.3	6.2	7.8	7.6	7.8	5.0
Wholesale price index	6.5	7.4	10.3	13.7	10.1	8.4	10.9	7.7	6.4	4.8
M_3	18.7	19.9	15.4	19.4	14.2	19.8	22.3	13.7	16.2	17.6
Reserve money	9.2	17.3	20.0	13.4	11.5	25.0	22.1	14.7	3.0	13.1
RBI credit to gov't	11.8	21.7	21.6	5.8	4.7	0.9	2.2	19.6	2.3	8.8
Total foreign reserves	21.3	–11.2	82.6	108.9	28.9	96.5	32.0	–6.8	27.6	22.1
Exports	4.5	18.9	9.2	–1.5	3.8	20.0	18.4	20.8	5.3	1.5
Imports	–5.9	8.8	13.5	–19.4	12.7	6.5	22.9	28.0	6.7	4.2

Source: Government of India (various years).

Table 8.2 presents various macro aggregates as ratios of GDP. Imports as a ratio to GDP rose from about 8 per cent in 1984/85 to over 10 per cent in 1997/98. Exports as a ratio to GDP rose from under 6 per cent to 9 per cent between 1984/85 and 1997/98. The ratios of the current account deficit and the trade deficit to GDP were well in excess of 2 per cent from 1985/86 to 1990/91. After 1990/91, these ratios were well below 2 per cent although in 1997/98 they inched back near the 2 per cent level. The saving rate rose from 20 per cent of GDP in 1984/85 to 27 percent in 1990/91. The investment rate in the corresponding period rose much faster leaving a gap of about 3.8 per cent of GDP. The policy measures that were undertaken in response to the crisis of 1990/91 brought down this gap to under 1 per cent in 1991/92. It has been under 2 percent since then (except in 1992/93).

We turn next to the fiscal position of the government. The gross fiscal deficit as a ratio to GDP was extremely high (in excess of 8 per cent) over the period of 1984/85 through 1990/91, after which it fell to below 7 per cent (with the exception of 1993/94).

The ratio of external debt to GDP peaked at about 46 per cent in 1990/91 as an outcome of the IMF borrowing (in response to the 1990/91 crisis), but declined thereafter to about 26 per cent in 1996/97. The ratio of short-term debt to total external debt was the highest in 1989/90 and remained relatively high in 1990/91 and 1991/92, after which it fell dramatically to about 5.5 per cent in 1996/97. The debt service-to-exports ratio and the ratio of short-term debt to foreign exchange reserves exhibited a similar trend and in 1996/97, these ratios stood at about 8.2 and 0.2 per cent, respectively. The foreign exchange reserves stood at a comfortable sum of US$30.1 billion in December 1998, of which US$27.0 billion were in foreign currency reserves.

We have noted that the current account deficit rose dramatically in the late 1980s even though the growth rate of exports was very high. The rise in the current account deficit thus cannot be attributed to a falling export growth rate. Joshi and

Table 8.2 Selected macro aggregates of India (percentage)

	1984/85	*1989/90*	*1990/91*	*1991/92*	*1992/93*	*1993/94*	*1994/95*	*1995/96*	*1996/97*	*1997/98*
Imports/GDP	8.2	8.6	9.0	8.7	10.0	9.1	9.5	11.1	10.8	10.6
Exports/GDP	5.6	6.8	6.8	8.0	8.5	8.7	8.8	9.6	9.2	8.9
Trade balance/GDP	–2.6	–1.9	–2.2	–0.7	–1.5	–0.4	–0.8	–1.5	–1.6	–1.8
Current account/GDP	–1.4	–2.8	–3.6	–0.4	–2.0	–0.5	–1.1	–1.8	–1.2	–1.7
Real investment/GDP	21.8	28.1	31.0	26.2	26.8	24.6	27.9	28.5	28.1	27.2
Domestic savings/GDP	20.2	25.1	27.2	25.6	24.6	24.0	26.7	26.6	26.8	25.3
Gross fiscal deficit/GDP	8.4	8.7	9.3	6.6	6.4	7.5	6.1	5.5	5.2	6.1
External debt/GDP	31.9	34.1	45.8	44.5	36.3	33.0	29.1	26.1	26.0	na
Short-term debt/external debt	9.9	10.3	8.2	7.1	3.9	4.3	5.2	7.2	5.5	na
Short-term debt/foreign exchange reserves	2.2	3.8	1.4	1.0	0.2	0.2	0.3	0.3	0.2	na
Debt service/exports	18.4	15.2	14.4	13.8	11.7	10.2	7.3	6.6	8.2	na

Sources: Government of India (various years), Reserve Bank of India (various years).
Note: na = not available.

Little (1994) argue that the increase in the current account deficit to GDP ratio in the 1980s could be linked to an increase in the investment-savings gap. Underlying this was the widening fiscal deficits of the central government and an increasing burden of foreign debt. It is in this macroeconomic situation that the rise in oil prices triggered by the Middle East crisis of August 1990 caused a balance-of-payments crisis in early 1991. With the recent deterioration in the fiscal situation, there are clear signs of increased vulnerability of the economy to another such crisis.

Policy regimes

The Indian policy regime can be categorized into three distinct phases. The first phase was the era of planning in 1951–84 when the state had strict control over resource allocation. The second phase, 1985–91, was a period of partial deregulation when the state retained a major role in resource allocation even as private agents were given greater freedom in investment decisions. In the third phase, the post-1991 period, resource allocation was primarily market-driven.[3]

1951–84: an era of planning

In this period, national self-reliance was introduced as an explicit policy objective. Exports were not looked upon as an engine of growth and planners regarded import substitution as the prime means of achieving national self-reliance. This is evidenced by the nature of the policies that were followed during this period, a time when India had a highly restrictive and inward-looking trade and industrial policy regime. The various five-year plans set out industry-specific capacity targets accompanied by a financial plan designed to ensure that the targets were met. The principal instrument of industrial policy was an elaborate industrial licensing framework under the Industries Development and Regulation Act of 1951, which required a government license for either establishing a new unit (above a certain size) or making a substantial expansion to an existing unit.

Two laws have had the effect of creating formidable barriers to entry in India. One is the Monopolies and Restrictive Trade Practices Act (MRTP), which became effective in 1970 and was intended to prevent the concentration of economic power and check restrictive trade practices. The Act stipulated that all private sector firms with a capital base of over Rs.20 million (or Rs.200 *lakh*) were to be classified as MRTP firms and would be allowed to enter only selected industries; moreover, this was done on a case-by-case basis. The other law is the Foreign Exchange Regulation Act (FERA) of 1974, which regulated foreign investment in India by specifying a list of industries in which foreign firms were allowed to enter.

This period was one of increasing financial repression, especially from the early 1970s. In 1969, fourteen of the largest commercial banks were nationalized, and this was followed by the nationalization of an additional six banks in 1980. Moreover, commercial banks were increasingly pressured to lend to 'priority sectors' which were comprised of agriculture, small-scale industry, retail trade, transport operators, professionals, and craftsmen. By March 1979, the priority sector lending requirements stipulated that 33 per cent of each bank's total credit should be advanced to these priority sectors; this limit was later raised to 40 per cent. Moreover, bank-lending rates were regulated through an elaborate arrangement, which related interest rates charged to the amount of the loan. Deposit rates were also tightly regulated.

The banking sector was used as a captive source of funds for the government that controlled the statutory liquidity ratio (SLR) – the proportion of net demand and time deposits that banks must maintain within India in the form of cash, gold, and unencumbered approved securities. These securities are mostly central and state government liabilities and bonds issued by development banks and term-lending institutions.

1985–90: a period of partial deregulation

With the advent of the Rajiv Gandhi government in 1985, piecemeal reforms were initiated in industry policy, trade and finance.

Industry policy

Several initiatives were taken to limit the role of licensing and thus expanding the scope for contribution to growth by large business houses, encouraging modernization and allowing existing firms in certain industries to achieve a minimum economic level of operations. Perhaps the most significant step taken during this period was the enactment of the Sick Industrial Companies (Special Provisions) Act in 1985. Under this Act, a firm is declared to be 'sick' if (a) it has been registered under the Factories Act for five years and (b) it has accumulated losses that are in excess of its net worth. The Act provided for the establishment of the Board for Industrial and Financial Reconstruction (BIFR), which recommends measures to be taken with regard to the sick firm. The BIFR drafts a revival package that is agreeable to all involved parties (management, trade unions, creditors, and shareholders), and this package necessarily entails more loans being made to the sick firm. Very rarely does the BIFR recommend liquidation. There is unanimity among economists regarding the adverse effects of this act on the process of exit of firms from an industry (Saha 1995, Anant *et al.* 1992). In 1991, public sector enterprises were brought under the purview of this Act.

Trade policy

The shift from quantitative import controls to a system based on tariffs, which was initiated in the mid-1970s, was considerably quickened from 1985 onwards. Beginning in the mid-1980s, there was a renewed emphasis by the new administration on export promotion.

Financial sector reforms

One of the most significant reform measures initiated during this period was the reform of the call money market and the government securities market. Tight control of interest rates on money market instruments was eliminated, as was the severe restriction on eligible players in this market. By the late 1980s, there was significant deregulation and development of the short-term segment of the financial markets in India, but little progress was made in the deregulation of credit and capital markets.

There were two important initial conditions that deeply influenced the nature and success of the next reform phase. One was the presence of a diversified financial sector (though repressed) that had a long history in the intermediation of funds. Banks, development banks, and the stock market were the key players in this sector. The other was that although half-hearted, real sector reforms had begun and the inefficiencies generated by the 'command and control' regime in the industrial sector were widely being recognized.

1991 onwards: a move toward liberalization

Reforms in the industrial sector and opening of the economy to foreign trade and capital

As noted earlier, the year 1991 marks a watershed in Indian economic policy. As part of the structural adjustment program, there was a significant reduction in tariff rates, with the peak tariff rate falling from 300 per cent to 150 per cent and the peak duty on capital goods cut to 80 per cent. There was, however, little change in trade policy with respect to consumer goods, which were prohibited from being imported. Industrial licensing was abolished altogether except for a select list of environmentally sensitive industries. The MRTP Act was substantially revised, eliminating regulations restricting the growth and merger of large business houses. In 1993, the FERA was substantially revised so that what was a policy of restricting foreign investment had become a policy of actively promoting it. Between 1991 and 1993, India moved gradually to full current account convertibility. In the foreign exchange market, dealers are now allowed to buy and sell foreign exchange for current as well as capital account transactions. Firms earning foreign exchange through exports are allowed to retain a certain proportion of the foreign exchange proceeds to avoid costs of conversion and re-conversion. This limit is, however, changed from time to time and is the first thing to change when the rupee comes under pressure. In a foreign exchange market of this nature, there exists very limited scope for speculative activity.

Under the new policy guidelines on foreign investment, automatic permission is granted for foreign equity participation up to 51 per cent in a specified list of industries. Foreign investments in sectors not on this list must receive clearance by the Foreign Investment Promotion Board (FIPB). Since 1992, foreign institutional investors such as pension funds, mutual funds, investment trusts, and asset management companies have been allowed unrestricted entry, in terms of volume, in both the primary and secondary markets for corporate securities. Investment norms for nonresident Indians have also been substantially liberalized.

Large Indian corporations with sound financial positions were also allowed to issue foreign currency convertible bonds (FCCB) or equity global depository receipts on foreign stock markets. As a result, foreign investment (direct and portfolio) inflows into India have risen from a mere US$133 million in 1991/92 to about US$5 billion in 1997/98. Foreign capital can now flow into India with greater ease, but full capital account convertibility is yet to come.

Financial sector reform

In the financial sector, two important reforms were made that have affected the financing decision of firms: deregulation of interest rates (both for commercial banks and development banks) and freeing of pricing restrictions on the new issue of shares on the stock market.

There has been little change in restrictions on banks' use of credit, and most of the reforms in the credit market have occurred with respect to regulations on the

pricing of credit. There has been a gradual rationalization of bank lending rates: the number of different lending rates was reduced from six rates in October 1991 to four in April 1992 and finally to three in April 1993. In October 1994, the minimum lending rate on bank advances over Rs.200 thousand was discontinued and banks were allowed total freedom to set their own lending rates. On the setting of deposit rates, a gradual process of liberalization was also begun in 1992/93.

In order to improve the health of the banking system (and of the nationalized banks in particular), the Reserve Bank of India introduced a capital risk–asset ratio system for banks as a measure of capital adequacy. All banks were instructed to achieve a capital adequacy ratio of 8 per cent by March 1994. To help nationalized banks achieve this target ratio, the government provided Rs.57 billion (or Rs.5,700 *crores*) in the annual budget of 1993/94 for re-capitalization of nationalized banks. This clearly indicates the extent to which the earlier regime had weakened nationalized banks. Moreover, this helped a majority of banks to achieve the capital adequacy norms although a few have not yet achieved it. In 1994, nationalized banks were allowed to raise capital through the stock market by issuing new shares, and quite a few have availed themselves of this opportunity.

On the supervision and regulatory front, the RBI established the Board for Financial Supervision (BFS) in 1994. This board is authorized to supervise and inspect banks, financial institutions (including development banks) and other nonbank financial companies. New and more liberal guidelines were set up for the entry of new private sector banks (both domestic and foreign), and as a result, in 1994/95 and 1995/96, ten new private sector banks began operations.

In August 1991, the government permitted all development banks to charge interest rates in accordance with the perceived risks inherent in the projects subject to a minimum lending rate of 15 per cent. This was clearly a significant policy initiative that basically freed the interest rate on term loans. In the post-1991 period, the two development banks – Industrial Development Bank of India (IDBI) and Industrial Credit and Investment Corporation of India (ICICI) – have been deprived of cheap credit from the government and have been forced to raise resources from the public at market rates of interest. They have also begun to tap the new issues market and borrow in foreign capital markets.

In 1992, the Securities and Exchange Board of India (SEBI) Act was passed and the Capital Issues (Controls) Act was repealed, which led to the abolishment of the Office of the Controller of Capital Issues (CCI). SEBI was established and made the regulatory authority for new issues of companies, and was given the necessary legal powers to regulate and reform the capital markets. The most important fallout of this was the freeing of pricing and the establishment of new guidelines concerning new issues. Companies are now free to approach the capital market after clearance is obtained from SEBI. According to the SEBI guidelines regarding pricing of new issues, most categories of new issues (except those of new companies) are allowed complete freedom in pricing.

It is now well recognized that financial liberalization without a strong regulatory framework is most certainly a recipe for disaster. On this issue, policymakers face a difficult choice. On the one hand, if extremely stringent regulations such as

prescribing a high capital adequacy ratio for banks and other financial institutions or a detailed set of rules regarding the types of firms that are eligible for issuing new shares are adopted, then the freedom that financial liberalization intends to provide would be jeopardized. On the other hand, very weak or minimal regulations may lead to a financial system that is susceptible to fraud and panic. Although the theoretical literature is unanimous in calling for an 'appropriate regulatory framework,' it has very little to say about the actual design of such regulations, especially in a developing country context.

In India where the government owns the most important financial intermediaries, there was a long-held belief that government ownership is itself a substitute for a regulatory framework. However, the large bad debts of commercial and development banks have debunked this belief. Currently, three institutions perform the regulatory and supervisory function for the financial sector: the SEBI for the stock and bond markets, the Board for Financial Supervision (BFS) for commercial and development banks, and the Reserve Bank of India for all other institutions such as nonbank financial intermediaries. Since the BIS and RBI regulate government-owned financial institutions, it is not difficult to see that there is the problem of incentive compatibility in the government regulating itself.

There is no doubt that the extent of repression of the financial sector has dramatically been reduced since 1991. Nevertheless, the potential for the government to use the financial sector (especially the banking sector) for its own purpose remains large as all the major commercial banks continue to be owned by the government. Although financial sector reforms cannot run far ahead of reforms in the real sector there are two important areas of reform that have not received adequate attention. These are the privatization of commercial and development banks and public sector enterprises and the reform of bankruptcy procedures.

Privatization faces a great deal of opposition not only from trade unions but also from major political parties. What has been initiated is the piecemeal disinvestment of a small portion of shareholdings of the government, which does not alter the basic character of public sector firms.[4] The sole objective of this exercise has been to generate revenue for a cash-starved government. Bankruptcy procedures remain as costly and protracted (in the case where liquidation is allowed at all) as in the era of planning. This clearly has serious implications for all debt providers and corporate governance, as managers of firms are almost never penalized in bankruptcy states.

Capital inflows and the choice of the exchange rate regime

It is recognized that large capital inflows, especially of the short-term variety, pose a problem for economies with high rates of saving and investment.[5] As Furman and Stiglitz (1998) point out, in a country with high rates of saving and investment, the benefits of an even higher investment rate financed by short-term capital inflows (especially of the unhedged short-term debt variety) can be very small or even negative. This can happen because of diminishing returns to capital and the 'costs and imperfections involved in selecting, installing and monitoring new investment'

(Furman and Stiglitz 1998: 54). Large capital inflows in the face of unsustainable current account deficits, appreciating real exchange rates, and investments concentrated in the nontradeable sectors can be a recipe for disaster. Concerned with such dangers, Indian policymakers have allowed a very limited liberalization of the capital account.

If a developing country that is in the process of reforming its financial markets adopts a flexible exchange rate, then it must deal with the possibility of capital inflows increasing the demand for local currency and creating pressures for currency appreciation. If it has a fixed exchange rate regime, the government may be forced to sterilize monetary expansion created by capital inflows, thus putting upward pressure on the interest rate while avoiding an increase in domestic money supply. This, in turn, would further induce capital inflows. Thus the choice of an appropriate exchange rate regime is an extremely controversial issue.

In India, the exchange rate is 'market-determined' (i.e. it is a managed float), but strict control over the capital account has muted the influence of capital movements on the exchange rate and interest rates. In fact, when faced with large capital inflows in recent years, the government has chosen to sterilize reserves. In spite of such actions, the government could not prevent the rupee from coming under intense pressure, especially with the onset of the East Asian crisis. There exists considerable doubt whether the government has the ability to keep the rupee stable and maintain the current exchange rate regime. This problem is likely to grow with the increased opening-up of the capital account in the future. Currently, there seems to be no easy answer to this difficult problem.

Effects of financial sector reforms on commercial banks, development banks, and private corporate firms

All of the financial reform measures mentioned earlier are likely to have a profound impact on the balance sheets of commercial banks, development banks (particularly IDBI and ICICI), and private corporate firms in the manufacturing sector. Financial liberalization basically changes and expands the sources from which agents (firms, financial intermediaries, and households) can raise money and increases the avenues in which these monies can be invested. Moving towards capital account convertibility further expands these sources and uses for domestic agents. If these new sources of financing and avenues for investments are exploited indiscriminately, the structure of liabilities and assets of those agents could be negatively affected.

There could arise tendencies or circumstances that force banks and financial institutions in a liberalized environment to borrow 'short' and lend 'long' to such an extent that the entire system would be placed under stress. For example, if infrastructure projects with long gestation periods were financed with extremely short-term debt (overnight money in the extreme case), the agents undertaking such projects would run into a high liquidity risk. This liquidity risk could result in the inability of some agents to roll over their debt, thus leading to a crisis. In other words, there is the possibility of a systematic mismatching of maturities in the

balance sheets of financial institutions and firms, which would increase their liquidity risk and make them vulnerable to shocks.

Another mismatch that could arise from financial liberalization and endanger the financial system is the mismatching of currency denominations. If large amounts are borrowed in foreign currency for investments with payoffs in the local currency, then balance sheets will be exposed to risk in currency movements. In India, these mismatches have been kept low because of direct government intervention in the financial markets. However, as India continues with financial liberalization, it will have to find a way to keep the mismatches low and prevent a financial crisis.

The financial health of commercial banks is critical because of their predominant position in the intermediation process. Development banks are important as well because they are increasingly being allowed to arbitrate between international and domestic debt markets. We take a look at a sample of large manufacturing firms in the private sector to trace the structure of their liabilities in the post-1991 period in order to assess their financial fragility, since any deterioration in the financial health of firms would almost certainly feed back on the financial health of both commercial and development banks.

Commercial banks

Since the nationalization of banks in 1969, there has been a spectacular increase in the indicators of banking development. Perhaps the most important of these indicators is the increase in deposits as a ratio of national income, from 15.2 in 1969 to 70.0 in 1998 (Table 8.3). One result of the nationalization is the growth and spread of banks to all corners of the country. In spite of the new liberalized entry norms of 1997, nationalized banks (including the State Bank of India, the largest commercial bank in India) still account for over 80 per cent of total deposits and a little over 79 per cent of advances. Thus, banking in India remains a predominantly public sector activity and, as mentioned earlier, there are as yet no concrete proposals to privatize it.

Table 8.4 provides the ratio of total deposits to the total number of offices for various types of banks. The ratio for foreign banks is extremely high compared to other banks, but this is accounted for by the fact that foreign banks do not operate any rural branches, which generally have very small deposits per office.

The most awkward problem that nationalized banks face is their nonperforming assets. Since 1992/93, there has been a phased introduction of a system of income recognition,[6] asset classification, and provisioning for public sector banks. Recent data indicate that in 1996, about 18.7 per cent of the assets of nationalized banks were in either the substandard, doubtful, or loss category. While this figure declined to 16 per cent in March 1998, it is still an exceedingly high ratio for nonperforming assets by any standards. The absolute value of gross nonperforming assets continued to rise, arguably an effect of the extremely strict 'social control' (i.e. the priority sector lending requirements and the statutory liquidity ratio requirements) that the nationalized banks were subject to in the years before 1991.

In India, liberalization of the banking sector began, in part, as a result of an increasing awareness in the government that the twenty years of 'social control' over banks had led to a decline in efficiency and quality of assets. It is too early to

Table 8.3 Indicators of commercial banks: progress since 1969

	June 1969	*June 1984*	*March 1991*	*March 1994*	*March 1998*
Total number of offices in India[a]	8,262	45,332	60,220	61,803	66,137
Rural	1,833 (22.2)	25,372 (56.0)	35,206 (58.5)	35,329 (57.2)	32,918 (49.8)
Semi-urban	3,342 (40.5)	9,262 (20.4)	11,344 (32.2)	11,890 (19.2)	14,178 (21.4)
Urban	1,584 (19.2)	5,769 (12.8)	8,046 (13.4)	8,745 (14.1)	10,436 (15.8)
Metropolitan	1,503 (18.2)	4,929 (10.9)	5,624 (9.3)	5,839 (9.4)	8,605 (13.0)
Population per office (in thousands)	65	15	14	15	14.6
Deposits as a % of national income	15.2	37.9	50.0	51.8	70.0
Deposits per office (in lakhs)	56	143	334	524	1509
Credit per office (in lakhs)	44	95	202	270	590
Credit-deposit ratio (%)	77.5	67.4	60.6	51.6	53.5
Investment-deposit ratio (%)	29.3	36.3	37.7	41.2	36.1

Sources: Reserve Bank of India (various years, 1985, 1997, 1998), Central Statistical Organisation (1995).
Note: a. Figures in parenthesis indicate percentage of total offices.

Table 8.4 Deposits per office (Rs. million)

	June 1969	*June 1981*	*March 1990*	*March 1993*	*March 1997*
State Bank of India	4.9	13.6	37.8	58.5	94.9
Nationalized banks	6.4	12.9	35.7	51.5	85.1
Foreign banks	na	na	585.8	1,374.2	1,935.9
Regional rural banks	–	0.7	2.8	4.7	12.1
Other scheduled commercial banks	5.1	8.2	18.0	33.6	98.8

Sources: Reserve Bank of India (various years).
Notes: na = Not available.
– = Not applicable.

say whether efficiency has improved but, with respect to asset quality, there is still a long way to go. Although the banks remain a weak link in the financial sector, their public ownership has created a mirage of invulnerability to shocks. But as the financial health of the government itself deteriorates (and there are clear indications of this), its ability to continuously bail out banks has come into question.

In a sense, banks in India have remained invulnerable to external shocks because they have not been allowed to intermediate between foreign and domestic capital markets. They have very low foreign exposure, as their operation in foreign countries and the size of dollar-denominated nonresident Indian deposits are restricted. Moreover, since banks are not allowed to invest in high-risk instruments and sectors such as stocks, real estate, and foreign exchange, they are less exposed to what is called 'market risk.' Sen and Vaidya (1997) have also pointed out that bank balance sheets are fortunately not facing a systematic mismatching of maturities due to the fact that the commercial banks largely make only short-term loans. A major worry that remains, however, is the quality of bank assets.

Development banks

We focus our discussion on two development banks – namely, Industrial Development Bank of India (IDBI) and Industrial Credit and Investment Corporation of India (ICICI). It is important to note that although these institutions are called banks, they differ from commercial banks in two important respects. First, they do not seek deposits from the public and, second, they specialize in the provision of long-term loans.

Both institutions provide funds to private firms either by providing loans or subscribing to shares and debentures issued by them. They also underwrite new issues and provide guarantees for term loans and deferred payments to enable firms to tap other sources of credit. Here we concentrate on the structure of liabilities of these two institutions and gauge the extent to which they are vulnerable to financial shocks.

Industrial Development Bank of India (IDBI)

IDBI was created as a wholly owned subsidiary of RBI in July 1964 but was separated from it (i.e., its ownership was transferred from the RBI to the Government of India) in February 1975. Since then it has been coordinating the workings of all financial institutions engaged in financing the industrial sector in accordance with national priorities. In that capacity, IDBI has also financed other institutions by refinancing loans granted by commercial banks and subscribing to the share capital and bond issues of other smaller development banks. Before 1990/91, the government fixed the interest rates for IDBI loans (and other development banks), whether they are loans directly made to firms for their projects or are used to refinance loans from other financial institutions. Term loans were rationed among various firms and sectors depending on the priorities set by the Government of India. Since 1991, the interest rates charged by these institutions have been completely free of all controls.

In Table 8.5, we present the structure of liabilities of IDBI. The dependence on borrowings has gone down quite sharply although there has been a steady increase in foreign borrowings since 1995, which constituted about 12 per cent of total liabilities in 1998. This is not a very high figure, but to the extent that IDBI borrows in foreign currencies and lends to domestic firms with only rupee payoffs, there is a real danger that currency depreciation would adversely affect their balance sheet.

Table 8.5 Structure of liabilities of the Industrial Development Bank of India (as of March 31; percentage)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Total liabilities (Rs.billion)	227.68	280.41	310.83	345.88	381.62	446.03	503.29	599.57
Capital	3.09	2.69	2.42	2.18	1.97	1.84	1.31	1.10
Equity capital	3.09	2.69	2.42	1.45	1.31	1.45	1.31	1.10
Preference capital	0.00	0.00	0.00	0.73	0.66	0.38	0.00	0.00
Reserve funds & surplus	6.06	6.25	6.82	7.52	8.50	12.75	13.02	12.81
Deposits	7.53	7.11	7.85	9.09	9.58	8.97	7.34	8.83
Borrowings	76.22	76.84	75.97	71.33	71.18	67.14	67.89	67.09
Government	3.72	3.32	3.49	3.82	3.75	3.30	2.99	2.41
Foreign institutions	0.00	0.00	0.00	0.00	9.61	9.99	11.25	11.97
Debentures & bonds	49.70	50.82	49.86	45.31	48.20	46.45	47.29	48.22
Others	22.79	22.69	22.63	22.21	9.79	7.40	6.35	4.49
Other liabilities & provisions	7.10	7.11	6.94	9.87	8.77	9.31	10.44	10.17

Source: Center for Monitoring the Indian Economy (CMIE), PROWESS database.

IDBI's loan portfolio is not well diversified, largely a legacy of the pre-1991 regime. For example, IDBI has a very large exposure in the iron and steel sector (about 12.6 per cent of total outstanding loans as of March 1998), which in part is due to the government policy of supporting this sector. Recently, as a result of reduced import tariffs on steel and the collapse of the steel price in the world market, the steel industry in India has come under tremendous pressure. The ability of firms in this sector to repay IDBI loans is now doubtful.

According to the new guidelines set out by RBI for classification of assets, as of the end of March 1993, IDBI classified 92.5 per cent of its loan and assistance portfolio as standard (i.e. bearing normal risk), 3.1 per cent as substandard, and 4.4 per cent as doubtful debts and loss assets. The comparable figures for March 1998 were 89.9 per cent, 7.0 per cent and 3.1 per cent, respectively. As of March 1998, IDBI had a capital adequacy ratio of 13.7 per cent, but further deterioration is expected.

Industrial Credit and Investment Corporation of India (ICICI)

ICICI was set up as a private sector development bank in 1955. Its share capital was subscribed to by foreign institutions (including the World Bank), commercial banks, and insurance companies. Presently, government-owned institutions such as banks and insurance companies hold a large part of its share capital.

Table 8.6 presents the liability structure of ICICI, which is similar to that of IDBI except that foreign borrowings have been much larger. They have dropped, however, from about 40 per cent of total liabilities in 1992 to a little over 22 per cent in 1998. The loan portfolio of ICICI is much more balanced than that of IDBI. In March 1993, nonperforming assets (i.e. substandard and doubtful) were 8.8 per cent of total assets, but in March 1997 they were reduced to 7.8 per cent – a substantially better performance as compared to IDBI. As of March 1997, the capital adequacy ratio was 13.2 per cent, which was above the norm of 8 per cent set for all India development banks. As in the case of IDBI, ICICI has borrowed in foreign currencies and lent to firms whose payoffs are in rupees. It is thus vulnerable to a shock arising from currency depreciation.

Large private manufacturing firms

The financial health of firms is crucial to the overall well-being of the economy and particularly for commercial banks and other financial institutions that have lent money to them. As noted earlier, since 1991 there has been a substantial deregulation of interest rates, the new issues market, and private foreign capital inflows (both direct investment and portfolio investment). Moreover, since 1992 some Indian firms with a sound financial position are allowed to issue convertible debentures – foreign currency convertible bonds (FCCB) – or equity global depository receipts (GDRs) on foreign stock markets.

To gauge the effect these measures might have had on the financing pattern of Indian firms, we have constructed a sample of firms on the basis of the following two

Table 8.6 Structure of liabilities of the Industrial Credit and Investment Corporation of India (as of March 31; percentage)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Total liabilities (Rs. billion)	77.40	108.44	131.36	160.27	196.05	233.24	363.47	460.39
Capital	1.48	1.57	1.84	1.54	1.54	1.61	1.30	1.65
Equity capital	1.48	1.57	1.84	1.54	1.54	1.29	1.09	1.03
Preference capital	0.00	0.00	0.00	0.00	0.00	0.32	0.21	0.62
Bonus equity capital	0.09	0.06	0.05	0.04	0.03	0.03	0.02	0.01
Reserve funds & surplus	6.54	6.69	7.35	7.70	9.22	8.83	10.73	9.11
Deposits	0.70	3.44	8.07	9.24	8.66	9.68	6.02	6.70
Borrowings	86.17	83.95	76.93	75.71	74.12	73.46	75.07	74.90
RBI	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Banks	0.23	0.21	0.18	0.00	15.82	9.72	7.18	4.38
Financial institutions	8.43	4.38	3.62	14.97	0.51	0.15	0.00	0.00
Government	2.36	2.89	3.68	4.21	4.45	3.81	2.91	2.26
Foreign institutions	33.16	39.82	34.79	28.39	24.69	26.13	25.10	22.14
Debentures & bonds	33.19	27.24	24.50	26.72	28.64	33.66	39.88	46.12
Other	8.79	9.41	10.17	1.40	0.00	0.00	0.00	0.00
Other liabilities & provisions	5.12	4.35	5.82	5.82	6.46	6.42	6.88	7.64

Source: Center for Monitoring the Indian Economy (CMIE), PROWESS database.

criteria. First, the firm must have sales larger than Rs.500 million in 1988/89 and, second, the ratio of manufactured goods sales to total sales is greater than 80 per cent. Firms that meet these criteria are large firms, which we believe are the ones that are affected most by the liberalization measures, especially those relating to FCCBs and GDRs.

Our focus here is on the manufacturing sector, and we do not consider firms engaged predominantly in trading and real estate. Using the PROWESS database provided by the Centre for Monitoring the Indian Economy (CMIE), we have identified 286 firms satisfying the two criteria in 1989.

Table 8.7 presents the consolidated sources of funds statement for these firms. The number of firms has changed over time since 1988/89 because of some exits, mergers, and non-reporting. The percentage of funds raised externally rose dramatically until 1994/95 – from 61 per cent in 1988/89 to 72 per cent in 1994/95 – but fell thereafter. The percentage of funds from capital markets (new equity, debentures and bonds, and fixed deposits) followed a similar pattern, peaking at 46 per cent in 1993/94. A very significant part of the drop in the importance of external sources is due to a decrease in the funds intermediated through capital markets. This was largely because of the nearly stagnant stock prices between 1995/96 and 1997/98, which possibly contributed to the rise in the cost of funds raised though the stock market. Borrowings, which had fallen to just about 4 per cent, rose to become much more important as a source of funds in 1996/97 and 1997/98. This clearly highlights the ability of Indian firms to substitute one source of funds for another depending on their relative cost. This is likely to be one of the most important positive influences of the financial sector reforms.

Table 8.8 presents the consolidated liabilities of these firms. The most notable feature is an increase in the share of total foreign currency loans in total liabilities, rising from a little over 2 per cent in 1989 to over 8 per cent in 1998. There is a gradual upward movement in this share, not a dramatic increase as in some other countries that have undertaken financial liberalization. Although this is not a large share, there is still a danger of a sudden currency depreciation affecting these firms adversely if their revenue is primarily in the local currency.

The ratio of foreign borrowings to total borrowings presented in Table 8.9 is another ratio that is of particular interest in the present context. The percentage of firms with no foreign borrowings has fallen slightly over the years – from about 96 per cent in 1990/91 to about 88 per cent in 1997/98. The largest increase – from 1.42 per cent to 7.09 per cent – occurred in the range between 0.1 to 0.5 per cent for the ratio of foreign borrowings to total borrowings. What these numbers indicate is that even though the post-1991 changes in India's financial policies have had some positive effect on domestic financial intermediation, their effect on foreign borrowings by private manufacturing firms has been very negligible.

The political economy of financial liberalization

The phenomenon of eroding fiscal conservatism and the introduction of real and financial sector reforms (their occurrence, continuance, and success or failure) invite

Table 8.7 Sources of funds of private corporate firms in the manufacturing sector (as of March 31; percentage)

	1988/89	*1989/90*	*1990/91*	*1991/92*	*1992/93*	*1993/94*	*1994/95*	*1995/96*	*1996/97*	*1997/98*
Total sources/ uses of funds (Rs. *crore*)	3,152.38	10,254.47	11,294.75	17,845.28	17,426.06	20,991.48	34,709.96	32,183.38	31,844.11	28,831.73
Internal sources	38.71	34.81	39.39	31.72	29.85	29.96	27.62	39.91	37.59	43.18
Retained profits	17.82	15.81	18.41	15.45	10.82	17.97	17.51	26.79	16.84	18.31
Depreciation	20.90	18.99	20.98	16.26	19.03	11.99	10.11	13.12	20.75	24.86
External sources	61.29	65.19	60.61	68.28	70.15	70.04	72.38	60.09	62.41	56.82
Capital markets	17.26	22.05	12.61	13.59	30.49	45.68	33.38	12.18	16.56	18.71
Fresh capital (excl. bonus issue)	2.06	1.85	2.01	2.06	4.24	4.20	3.77	3.94	0.44	1.79
Share premium	3.11	6.47	3.60	1.98	17.14	27.25	27.40	9.21	7.27	2.45
Debentures/bonds	5.94	12.63	6.88	9.77	8.57	13.06	2.11	–0.97	7.93	12.53
Fixed deposits	6.15	1.10	0.13	–0.22	0.54	1.17	0.11	–0.01	0.92	1.95
Borrowings	19.50	22.00	25.19	32.95	29.17	4.16	17.76	29.03	36.57	28.56
Bank borrowings	13.18	9.68	11.17	9.56	10.42	–5.05	13.56	18.69	7.09	4.90
Financial institutions	4.07	8.12	10.17	16.03	13.71	2.44	2.90	3.72	10.08	3.86
Loans from corp. bodies	–0.23	–0.26	0.18	0.61	0.25	1.65	0.83	–0.10	1.74	–0.57
Group/associate cos.	0.00	0.04	0.06	0.02	–0.04	0.23	–0.07	0.06	0.61	0.41
Other borrowings	2.48	4.46	3.67	6.75	4.78	5.11	0.47	6.71	17.66	20.36
Current liabilities & provisions	24.52	21.15	22.80	21.75	10.49	20.21	21.24	18.89	9.29	9.55
No. of companies	286	275	281	275	273	275	277	277	275	267

Source: Center for Monitoring the Indian Economy (CMIE), PROWESS database.

Table 8.8 Structure of liabilities of private corporate firms in the manufacturing sector (as of 31 March; percentage)

	1989	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Total liabilities (Rs. *crore*)	43,047.63	50,314.96	60,945.68	74,982.55	90,285.20	110,058.05	142,241.79	170,078.75	193,643.66	216,146.59
Net worth	32.35	32.15	32.83	30.94	33.40	38.15	41.52	42.26	41.28	41.26
Reserves & surplus	24.52	24.97	26.06	25.05	27.28	32.25	35.77	36.74	36.17	36.21
Direct addition to reserves	0.42	0.44	–0.04	1.05	0.11	0.18	–0.15	0.31	–0.17	0.45
Total borrowings	39.18	39.88	39.44	41.73	42.01	37.79	34.40	33.91	36.92	38.09
Bank borrowings	12.45	12.14	12.38	12.15	12.11	8.91	10.29	12.07	11.66	10.96
Financial institutions	9.31	9.36	9.77	11.71	12.34	10.58	8.95	8.19	8.68	7.97
Gov't sales tax deferrals	0.74	0.67	0.65	0.70	0.69	0.71	0.63	0.62	0.53	0.56
Debentures/ bonds	9.14	10.32	9.83	10.21	10.15	10.72	8.91	7.23	7.59	8.37
Fixed deposits	3.99	3.60	3.02	2.36	2.07	1.88	1.52	1.26	1.26	1.35
Foreign borrowings	1.09	1.20	1.27	1.76	2.00	1.97	1.98	2.84	4.60	6.36
Loans from corp. bodies	0.46	0.35	0.32	0.39	0.37	0.60	0.69	0.55	0.74	0.56
Group/assoc. companies	0.03	0.03	0.04	0.04	0.02	0.06	0.03	0.04	0.13	0.17
Other companies	0.42	0.31	0.28	0.35	0.34	0.54	0.66	0.52	0.61	0.39
Commercial paper	0.00	0.06	0.11	0.33	0.33	0.92	0.27	0.02	0.15	0.46
Other borrowings	2.01	2.04	2.10	2.12	1.97	1.48	1.17	1.13	1.69	1.51
Current portion of long-term debt	0.52	0.85	1.12	1.95	2.12	1.98	1.69	2.59	2.34	1.98
Secured loans	7.37	8.28	10.07	32.82	35.13	31.26	26.87	27.34	28.34	27.25
Unsecured loans	2.13	1.97	2.58	7.51	7.35	7.92	7.81	6.85	8.96	10.94
Total foreign currency loans	2.12	2.83	3.25	4.81	4.75	4.57	4.25	5.15	7.15	8.06
Current liabilities & provisions	28.47	27.97	27.73	27.33	24.59	24.06	24.08	23.83	21.80	20.64
No. of companies	286	275	281	275	273	275	277	277	275	267

Source: Center for Monitoring the Indian Economy (CMIE), PROWESS database.

Table 8.9 Foreign borrowings/total borrowings of private corporate firms in the manufacturing sector

	1990/91	*1992/93*	*1994/95*	*1996/97*	*1997/98*
Number of firms	281	273	277	274	267
Percentage distribution					
0	95.73	94.14	93.50	90.55	87.69
Between 0 and 0.1	1.78	2.20	2.53	1.45	3.36
Between 0.1 and 0.5	1.42	2.56	2.89	6.91	7.09
Greater than 0.5	1.07	1.10	1.08	1.09	1.87
Median	0.00	0.00	0.00	0.00	0.00
Average	0.01	0.01	0.02	0.03	0.03
Standard deviation	0.08	0.09	0.09	0.10	0.13

Source: Center for Monitoring the Indian Economy (CMIE), PROWESS database.

political economy explanations. The costs that a transition from financial repression to financial liberalization imposes on certain segments of society may be large and immediate. In a democracy, it is only natural that sections of society that are hurt by the reforms would lobby hard to retard their progress. The benefits of reform are rather defused (it is difficult to pin down which interest group or political grouping exactly benefits from a better allocation of resources and a more efficient intermediation of funds). Moreover, these benefits are likely to materialize only in the future and are contingent upon a host of other policies being in place.

When state planning and the implied controls on resource allocation were in place during the 1951–84 period, there was an implicit assumption on the part of both the political proponents of planning and the people at large that policymakers (and governments in general) were acting to maximize the collective welfare of society. Over the years, and certainly after 1984, there was an increased realization on the part of the people that this assumption was highly questionable. The low rates of growth, fiscal irresponsibility and high inflation rates prompted an increasing number of people to realize that political parties in power manipulate policies in order to maximize the likelihood of their being reelected. The high turnover of parties in power both at the state and central government levels, especially after 1991, suggests that people are now both aware of and disillusioned with the motives of political parties.

Political parties have responded by partially abandoning the ideology of state planning and are increasingly publicly singing praises of the market mechanism. The two principal parties – the Indian National Congress and the Bharatiya Janata Party – are certainly doing this. The main opposition to this ideological transformation of the Indian polity comes from the Communist parties, which remain quite powerful in certain small states, although their numbers in the national parliament have declined since 1991.

The erosion of fiscal conservatism began in the mid-1980s and this trend has not been effectively reversed until now. Successive governments have found it extremely difficult to cut various subsidies and chalk out an effective program of privatization.

Thus the government has continued to finance an inefficient and largely bankrupt public sector (including public sector banks) and has kept doling out subsidies without increasing the tax base or initiating radical tax reforms. For instance, the entire agricultural sector is out of the direct tax net and no political party seems to be willing to pay the price of taking unpopular decisions. What underlies the inability of recent governments to curtail deficits may have more to do with the fact that in a democracy (that is faced with regular elections), the incentives that politicians respond to may often make low deficits politically impossible.[7]

As long as fiscal deficits are high, the government is forced to make the financial system subservient to its needs. In such a situation, the government would be reluctant to give up or even water down its power that enables it to force players in the financial system, especially the banks, to hold government debt at low rates of interest. In other words, high fiscal deficits, which have their root cause in domestic politics, are not conducive to rapid financial reform.

In India, all government-owned institutions (including commercial banks and other public sector firms) are highly overstaffed and have extremely powerful labor unions. These have successfully thwarted all moves towards privatization as they expected it to lead to downsizing and layoffs. The power of these unions can be gauged from the fact that they have been able to considerably slow down the complete computerization of public sector commercial banks, arguing that this would make some bank employees redundant. Government ministers (and politicians) who exercise the power to grant favors are also opposed to deregulation, as it would lead to the closing down of offices and thus loss of patronage power. It is thus India's political system that has put the brake on the reform process in general and financial liberalization in particular.

Conclusion

India was saved from the contagion effect of the Asian financial crisis of 1997–8 in part because of its limited reliance on private foreign capital. However, the changes in financial policy that have been undertaken since 1991 have exposed the economy to a new set of shocks which hitherto were not allowed to affect the economy. This, of course, is a direct consequence of financial liberalization. The pressures that capital account convertibility will bring on both the foreign exchange and capital markets will clearly be much larger. There is no doubt that the workings of both the foreign exchange and capital markets will have to be strengthened (in both the operational and regulatory sense) to make them capable of dealing with these changes if the benefits of capital account convertibility are to be reaped.

In India, the banks remain the weakest link in the financial sector. The large number of their nonperforming assets is capable of putting the entire economy under enormous strain when faced with a crisis. This strain would arise because the government would have to provide financial support to weak banks even if the overall expenditures are curtailed, and this would invariably involve a cut in spending on social sectors like health and education. Such a reallocation of resources would be very painful in a poverty-stricken economy like India.[8]

The development banks do not seem to be capable of withstanding a large negative shock either. IDBI has a fairly large number of nonperforming assets while ICICI has a large amount of debts denominated in foreign currencies. Lastly, private sector firms have displayed some flexibility in their financing pattern since 1991. All this notwithstanding, the precarious fiscal balance still leaves the economy in an extremely weak position in the face of an external shock such as a sustained high price of oil. The second round of reforms that is on the cards will need to be decisive with respect to India's ability to respond to future shocks. At present, privatization and reduction of the size of government are being discussed, but whether they will actually be implemented remains to be seen.

Notes

1 The year 1997/98 refers to the financial year cycle of 1 April 1997 through 31 March 1998. All flow variables refer to financial years whereas stock variables are as of 31 March of the relevant year.
2 In a largely non-indexed economy like India, inflation rates close to 10 per cent or more increase poverty and thus are regarded as a social evil.
3 It should be noted that this kind of periodization is widely accepted in the literature. For example, see Joshi and Little (1994).
4 For details regarding the disinvestment program, see Vaidya (1994).
5 One striking similarity between India and the East Asian economies is the rather high savings rate.
6 Prior to 1992/93, the accounting system used by banks allowed them to book interest payments in their accounts irrespective of whether the interest payment was actually paid by the debtor firm or not. The new system of income recognition introduced in 1992/93 does not allow this practice to continue.
7 For more on this point, see Sen and Vaidya (1996).
8 If the poverty line is set to be associated with a daily consumption expenditure of roughly a dollar a day, one out of every three persons in India will be officially poor. For a good survey of recent poverty estimates and trends, see Dev and Ranade (1999).

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