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## Business-Government Relations and Economic Vulnerability

Rapid lending growth, an increase in corporate leveraging, declining returns on capital, and weaknesses in the financial sector contributed to the vulnerability of the most seriously affected countries well before the Asian financial crisis actually broke. Even if we acknowledge the central role of capital movements in triggering the crisis, any full account of its onset and depth must encompass these domestic conditions as well. To what extent can they be traced back to political factors and of what sort?

This chapter focuses on business-government relations and their effect on the policy environment in the period before the crisis. In the past, it was believed that the nature of business-government relations in Asia contributed to *good* policy, at least by developing-country standards; even the World Bank came around to this view in its *East Asian Miracle* report (World Bank 1993). But quite strict political requirements are required for such a “good equilibrium” to occur, including political counterweights to private economic power, meritocratic bureaucracies, independent regulatory agencies, and transparency in business-government relations.

These conditions were frequently missing, and as a result the patterns of business-government relations that had evolved in the region carried with them certain risks (see table 1.1). A first problematic fact is the highly concentrated nature of private economic power. A second cluster of potential risks has to do with the moral hazard that arises from various forms of government intervention (Krugman 1998d; Corsetti, Pesenti, and Roubini 1998), particularly government involvement in the financial sector and the conduct of industrial policy. Although the role of industrial policy in the crisis has almost certainly been exaggerated, political involvement

**Table 1.1 Risk in business-government relations**

<b>Policy and political conditions</b>	<b>Risks</b>
Industrial and financial concentration	Undue political influence; capacity for firms to blackmail government; moral hazard and “too big to fail” problem
Government intervention	
Financial sector	Management of past financial crises and government intervention in financial markets create moral hazard
Industrial policy	Government support for particular sectors or projects generates moral hazard
Liberalization, privatization, and deregulation	Capture of liberalization produces poorly designed reforms and weak regulation and provides opportunities for corruption and private fraud and malfeasance
Politics of business-government relations	Dependence of politicians on particular firms generates corruption, policy biases, and economic mismanagement

in the financial sector has unquestionably been a source of moral hazard, even in the absence of explicit guarantees.

However, a third source of policy and political risk arises as a result of liberalization, particularly of financial markets. In the absence of independent and capable regulatory institutions, financial market liberalization provides ample opportunities for private actors to engage not only in risky behavior, but also in fraud and outright expropriation. Political factors can have profound consequences for the opening of the capital account as well, leading to premature liberalization, inauspicious sequencing (such as opening short-term transactions before long-term ones), and weak regulation. Liberalization measures are as vulnerable to capture and distortion as other forms of government intervention.

These particular policy risks—whether from intervention or liberalization—result from certain political institutions and processes. I argue that overly close and nontransparent political relationships between politicians and particular firms contributed to the economic vulnerabilities outlined. Chapter 2 shows that these same conditions also affected how governments responded to early signs of difficulty and played an even more important role in how the crisis was initially managed.

## **The Microeconomics of the Crisis**

Microeconomic explanations for the crisis do not ignore larger risks associated with the conduct of macroeconomic and exchange rate policy, nor the vulnerabilities associated with increasing exposure to international capital flows (Caprio and Klingebiel 1997; Caprio 1998; Kahler 1998; Ito

**Table 1.2 Growth of investment and bank credit (percent)**

	1991	1992	1993	1994	1995	1996	1997
<b>Indonesia</b>							
GDP growth	8.9	7.2	7.2	7.5	8.2	8.0	2.2
Gross domestic investment as share of GDP	27.0	25.8	26.3	27.6	28.4	29.6	28.4
Bank credit to private sector as share of GDP	46.2	45.5	48.9	51.9	53.5	55.4	61.0
<b>South Korea</b>							
GDP growth	9.2	5.0	5.8	8.6	9.0	7.1	5.5
Gross domestic investment as share of GDP	38.4	36.6	36.0	35.7	36.6	36.9	35.0
Bank credit to private sector as share of GDP	56.8	56.8	57.9	60.4	60.7	65.7	73.4
<b>Malaysia</b>							
GDP growth	8.8	7.8	8.4	9.4	9.4	8.6	7.7
Gross domestic investment as share of GDP	35.7	36.0	38.3	40.1	43.0	42.2	42.4
Bank credit to private sector as share of GDP	75.3	74.6	74.8	74.9	85.1	93.1	103.9
<b>Thailand</b>							
GDP growth	8.0	8.1	8.3	8.8	9.3	6.4	-0.5
Gross domestic investment as share of GDP	41.6	39.3	39.5	40.0	41.1	41.1	35.6
Bank credit to private sector as share of GDP	67.7	72.2	79.8	90.9	97.5	100.0	118.7

Sources: Mody (1999); World Bank (1999d).

1999; Edwards 1999). However, features of the financial and corporate sectors—rapid lending growth, high corporate leveraging, excessive risk taking, and declining returns on capital—increased vulnerability to external shocks and magnified their effects (Kaminsky and Reinhart 1998; Krugman 1998d; Caprio 1998; Pomerleano 1998; Goldstein, Kaminsky, and Reinhart 2000; and on earlier crises, Caprio and Klingebiel 1997).

Prior to the crisis, lending growth in all four countries outpaced GDP growth by substantial margins (table 1.2). Rapid lending growth was accompanied by an increase in corporate leveraging. Korean companies have long sustained high debt-equity ratios, and saw them increase still further in the 1990s. Thailand also saw increases in leveraging, as did Malaysia, although from a lower base. Lending growth and high leveraging were matched at the national level by continuing high levels of aggregate investment. In Thailand, gross domestic investment averaged over 40 percent from 1991 to 1996. Malaysia saw a sharp increase in

**Table 1.3 Corporate leverage, short-term debt, and return on assets (percent)**

	1990	1991	1992	1993	1994	1995	1996
<b>Corporate leverage</b>							
Indonesia	n.a.	1.94	2.10	2.05	1.66	2.11	1.88
South Korea	3.11	3.22	3.37	3.63	3.53	3.77	3.55
Malaysia	1.01	0.61	0.62	0.70	0.99	1.10	1.18
Thailand	2.16	2.01	1.84	1.91	2.13	2.22	2.36
<b>Short-term debt/total debt</b>							
Indonesia	n.a.	47.6	59.2	60.4	58.4	58.2	56.7
South Korea	50.2	50.2	55.8	56.3	58.6	59.6	58.5
Malaysia	67.5	72.9	73.1	73.4	72.8	72.2	70.1
Thailand	61.2	65.7	74.8	73.6	72.4	67.1	67.2
<b>Return on assets</b>							
Indonesia	9.4	9.1	8.6	7.9	7.4	6.2	6.5
South Korea	4.1	4.0	3.9	3.6	3.4	3.6	3.1
Malaysia	5.4	6.2	6.0	6.5	6.3	6.1	5.6
Thailand	11.7	11.2	10.2	9.8	9.3	7.8	7.4

n.a. = not available

Source: Claessens, Djankov, and Lang (1998).

investment to over 40 percent as well. Investment in South Korea was somewhat lower but still extraordinarily high by world standards. Indonesia also registered a modest increase in aggregate investment albeit from a lower base than the other three crisis countries.

A striking feature of the financial profile of the Asian corporates was the bias in the maturity structure of their debt toward the short term.<sup>1</sup> Not only did short-term debt increase during the decade, but it also began from a very high level. The numbers in table 1.3 capture both domestic and foreign short-term obligations. The fact that foreign debt accounted for a growing share of total debt, and that it was increasingly short-term and often unhedged, made firms and the economy as a whole particularly vulnerable to adverse shocks (e.g., on Mexico, see Sachs, Tornell, and Velasco 1996; on Asia, see Radelet and Sachs 1998a, 1998b, and Ito 1999).

The dramatic increase in lending was accompanied by decreasing rates of return as a result of the declining availability of good projects, poor project evaluation, and a decline in the credit standards of banks. Thai and Indonesian companies had among the highest rates of return in the world during the early 1990s, but both saw declines over the course of

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1. When banks lend on a line-of-credit basis, these loans are recorded as short-term lending even if they are rolled over, including coverage of interest payments. This process is called "evergreening." Outstanding loans can thus grow without new cash flow to the borrower.

the decade of nearly 30 percent. South Korea saw a decline in returns on assets from performance that was already strikingly poor.

How developments in the corporate sector affected the banks *before* the onset of the crisis is not straightforward (World Bank 1998a, chapter 3). Except for South Korea, where bank profitability has historically been very low, the boom meant rising profits for banks. But accounting standards in the region do not differentiate between “income” derived from “ever-greening”—the practice of lending to cover interest payments—and actual interest payments. As a result, some (unknown) share of bank income and additions to net worth in each country was fictitious.

Moreover, each country saw important segments of the financial sector fare poorly during the 1990s, including the state-owned banks in Indonesia, finance companies in Thailand, and merchant banks in South Korea. Portfolio growth in these segments was typically tied to the property sector and equity markets.<sup>2</sup> Property prices were volatile in Malaysia, and vacancy rates in both Indonesia and Thailand by mid-decade were high, around 14 percent and increasing. As early as the end of 1996, property indexes on the Indonesian and Thai stock markets were off by one-third and three-fourths, respectively, from their 1993 peaks, suggesting that the asset bubble had begun to burst—and with it the value of collateral—well before the external crisis hit.

A final source of vulnerability is the weakness of regulation and poor disclosure and transparency (Corsetti, Pesenti, and Roubini 1998; Radelet and Sachs 1998a, 1998b; Ito 1999). A comparative overview by Caprio (1998) ranked 12 middle-income countries in East Asia and Latin America on a number of indicators of the regulatory environment. The four most seriously affected countries consistently ranked toward the bottom of this group.<sup>3</sup> Caprio constructed a measure of transparency that includes, among other things, whether banks require ratings and whether the top banks have international ratings; South Korea tied for 5<sup>th</sup> among the 12, Thailand came in 7<sup>th</sup>, and Indonesia and Malaysia tied for 8<sup>th</sup>. A ranking done in 1993 by Capital Information Services (CIS) included judgments

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2. Corsetti, Pesenti, and Roubini (1998) estimate bank exposure to real estate at the end of 1997 from 15-25 percent of loans in South Korea, to 25-30 percent in Indonesia, to 30-40 percent in Malaysia and Thailand.

3. On capital adequacy requirements, Malaysia tied with one other country for 5<sup>th</sup>, and Indonesia, South Korea, Thailand tied with one other country for 7<sup>th</sup> (last place). On loan classification requirements, Indonesia ranked 8<sup>th</sup>, Malaysia and South Korea tied for 9<sup>th</sup>, and Thailand ranked 11<sup>th</sup> (again, last place). On liquidity requirements, Malaysia and Thailand tied for 8<sup>th</sup>, South Korea 9<sup>th</sup>, and Indonesia 10<sup>th</sup> (last place). Finally, Caprio ranked the countries on foreign ownership of banking assets, on the assumption that foreign banks are likely to introduce best practice and higher levels of transparency. Malaysia ranked 8<sup>th</sup>, Indonesia 9<sup>th</sup>, South Korea 10<sup>th</sup>, and Thailand 12<sup>th</sup>. On the summary rankings of these four indicators, plus an additional one on the overall operating environment, Malaysia ranked 7<sup>th</sup>, South Korea 9<sup>th</sup>, Thailand 11<sup>th</sup>, and Indonesia 12<sup>th</sup>.

about the quality of information provided by banks on a range of indicators, from profits and losses to assets and liabilities, including substantial contingent ones (Delhaise 1998). All the Asian countries fared poorly.<sup>4</sup> Despite such a weak informational base, both international and domestic lenders continued to extend credit; we return to this issue below. The relevant point here is that when investors, creditors, and outside analysts do not have a clear picture of the health of financial institutions, adverse shocks are more likely to feed assumptions that things are even worse than they look.

## **Business-Government Relations: The Benefits**

Before turning to how business-government relations might have contributed to these problems, we first have to address how—and whether—countries in Asia had previously combined the advantages of close business-government relations while avoiding the risks. Chalmers Johnson's (1983) pioneering analysis of Japan outlined an answer to this question that influenced all subsequent writing on the subject. Johnson argued that a "developmental" state guaranteed a policy commitment to economic growth and cooperation with the private sector that "avoided an emphasis either on private profit or the state's socialization of wealth" (Chalmers Johnson 1999, 57-8). Others placed even greater emphasis on how "strong" governments (in some cases authoritarian ones) enjoyed political independence from private actors (Haggard 1990, 1994). This autonomy allowed governments to control the policy agenda and granted them the capacity to "discipline" firms (Amsden 1989): to condition various government supports on performance, and thus to assure that industrial policy did not result in the gross misallocation of resources so common elsewhere in the developing world.

Competent, meritocratic bureaucracies and the concentration of decision-making power in relatively insulated economic agencies played a crucial role in the model of the developmental state. By socializing government officials toward common goals, meritocratic bureaucracies limited the opportunities for rent-seeking (Evans 1995, 1997). Governments in a number of developing Asian countries also granted substantial independence to reformist technocrats and shielded them from political pressures. Such independence remains critical with respect to the conduct of monetary and fiscal policy and the regulation of financial markets.

Finally, governments of the region were able to limit rent-seeking by controlling the way business was politically organized and interacted

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4. Out of a maximum possible score of 1000, Thailand ranked the best in the Asia-Pacific region, but it received a score of only 442; Malaysia, Indonesia, and South Korea had scores of 423, 401, and 329, respectively.

with government. “Deliberation councils” made up of government, business, and other representatives signaled government commitment, increased the credibility of policy, and established trust while guaranteeing a certain degree of transparency that limited the opportunities for private dealing (Fukuyama 1995; World Bank 1993; Campos and Root 1996, chap. 5; and Chang 1994, but see MacIntyre 1994a). Policy networks linking business and government also increased the flow of information, thus improving the quality of policymaking on the one hand and communicating the government’s policy objectives to private actors on the other. As Maxfield and Schneider (1997, 13) summarize, “Trust between business and government elites can reduce transaction and monitoring costs, diminish uncertainty, lengthen time horizons and . . . increase investment.”

But where effective, these relations rested on the political preconditions noted above—relatively independent governments and bureaucracies that were not beholden to particular business interests. Moreover, where direct business-government consultation was successful, it occurred through mechanisms that were relatively open, if not to the public at large at least to diverse private-sector groups. These arrangements guaranteed that opportunities for private dealing and rent-seeking by individual firms could be checked.

## The Concentration of Private Economic Power

Against these potential benefits of close business-government relations must be set a number of important risks. The first lies in the increasingly concentrated industrial structure that accompanied developing Asia’s rapid growth, and the potential this brought for business influence on policy and even blackmail of government.

Bird (1999) has collated average four-firm concentration ratios; that is, the average share of total sales in each sector accounted for by the top four firms (see table 1.4). These ratios are surprisingly similar for Indonesia, Malaysia, and South Korea. Although high in comparison with the United States and United Kingdom, they are less than for several other developing countries (Pakistan, Turkey, and Sri Lanka).<sup>5</sup>

As Bird acknowledges, however, these numbers miss a crucial feature of industrial organization in Asia: the existence of highly diversified family-owned or -controlled conglomerates that operate in many markets at once. The best known example of this phenomenon are the Korean *chaebol*. In

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5. Bird also argues (against received wisdom) that concentration has been trending down in Indonesia as a result of greater openness to trade, although concentration is more constant over time in Malaysia and South Korea.

**Table 1.4 The concentration of private economic power (percent)**

	Indonesia	South Korea	Malaysia	Thailand
Average concentration ratios (4-firm level)	54.0 (1993)	57.0 (1987)	53.0 (1990)	n.a.
Ownership concentration in 10 largest firms (3 largest shareholders)	53.0	23.0	46.0	44.0
Share of total outstanding shares owned by 5 largest shareholders (unweighted)	67.5	38.1	58.8	56.6
Share of total market capitalization controlled by top 15 families	61.7	38.4	28.3	53.3
Market share of five largest banking institutions, end-1997 (share of bank loans)	41.0	75.0 <sup>a</sup>	41.0	70.0
Share of firms unable to cover interest expenses from operational cash flow (peak number and year)	63.8 (1 <sup>st</sup> half 1999)	33.8 (1998)	34.3 (1998)	32.6 (1997)

n.a. = not available

a. Market share for South Korea is for 8 dominant nationwide banks.

*Sources:* Concentration ratios, Bird (1999); ownership concentration in 10 largest firms, La Porta, Lopez-de-Silanes, and Schleifer (1999); family control, Claessens, Djankov, and Lang (1998); concentration of outstanding shares, Asian Development Bank (1998, all listed companies in Indonesia, Malaysia, and Thailand, sample of 81 listed firms for South Korea); market share of banks, Casserly and Gibb (1999); debt-servicing problems, Claessens, Djankov, and Klingebiel (1999).

1995, the top five *chaebol* accounted for 25.9 percent of all shipments in the manufacturing sector, and 27.2 percent of value added (Yoo 1999).

In Southeast Asia, diversified Chinese business groups have been among the largest firms in both Indonesia and Malaysia, but the last decade has also witnessed a particularly rapid expansion of new “local” (*pribumi* in Indonesia, *bumiputra* in Malaysia) business groups as well (Gomez and Jomo 1997, Searle 1999 on Malaysia; Pangestu and Harianto 1999 on Indonesia). In Indonesia in 1992, the top 10 groups accounted for half of the total turnover of the top 100 companies in the country, and 80 percent of the assets of the country’s top 300 groups were controlled

**Table 1.5 Ownership of South Korean business groups by insiders**  
(percentage of common shares held)

Business group	Founder	Relatives	Member companies	Total
Hyundai	3.7	12.1	44.6	60.4
Samsung	1.5	1.3	46.3	49.3
LG Group	0.1	5.6	33.0	39.7
Daewoo	3.9	2.8	34.6	41.4
Sunkyong	10.9	6.5	33.5	51.2
Sangyong	2.9	1.3	28.9	33.1
Hanjin	7.5	12.6	18.2	40.3
Kia	17.1	0.4	4.2	21.9

Source: World Bank (1998a), 60.

by Indonesian-Chinese conglomerates (Pangestu and Harianto 1999). By the early 1980s, 50 of Thailand's 100 largest manufacturing firms belonged to 1 of 16 conglomerates, which jointly accounted for fully 90 percent of the assets of all Thai enterprises (Rock 1995, 14).

A starker indication of the concentration of private economic power can be seen in the data on the extent of ownership concentration in table 1.4. Indonesia appears particularly concentrated on these measures, whereas South Korea, and by at least one measure Malaysia, would appear to be somewhat less so.<sup>6</sup> But in Korea, lax rules on corporate governance have allowed families to control firms and whole groups through mechanisms such as cross-ownership within the group and deviation from one-share-one-vote rules (Yoo 1999). For example, the founder of Hyundai and his relatives own a little over 15 percent of the group, but through intra-group cross-holdings effectively control 60 percent (see table 1.5). Similar mechanisms have been documented for Malaysia as well (see Gomez and Jomo 1997).

The role of finance in the concentration of private economic power varies in important ways across the countries. In South Korea, the financial system is relatively concentrated, but the government has limited the ability of business groups to control financial institutions (Woo 1991; Choi 1993). In Thailand, by contrast, the banking sector is highly concentrated and has long been privately owned. Family-owned private banks such as Bangkok Bank and the Farmer's Bank have been at the center of diversified business groups. In Indonesia before the crisis, the majority of the 144 private commercial banks were also controlled by four or five family groups (Kahn 1999).

The relationship between the concentration of private economic power and political influence is not necessarily straightforward. In Indonesia,

6. Malaysia's difference in this regard reflects the government's self-conscious efforts to offset the dominance of Chinese business by promoting *bumiputra* firms.

the fact that ethnic Chinese account for a small share of the population and a large share of wealth makes them more, not less, politically vulnerable.

In general, however, economic concentration implies that private actors can bring relatively large resources to bear on the political process. When banks and firms are very large relative to the economy as a whole, their distress necessarily has systemic implications. Some sense of the magnitude of this problem can be gained from the last row in table 1.4, which shows the number of firms facing liquidity problems at the height of the crisis. Large banks and firms facing distress used their size in a “too big to fail” blackmail game: support us or else!

## **The Politics of Moral Hazard I: The Government and the Financial Sector**

A second source of economic vulnerability is the pursuit of policies that generated moral hazard. With the exception of insurance for small depositors—and even that policy is controversial in some circles—no government has an incentive to extend guarantees in an explicit way; such a policy would be akin to the childhood prank of pinning a sign on someone’s back that says “kick me.” Nonetheless, firms might form expectations about the government’s future behavior from its handling of past financial crises. Could banks and borrowers count on the government to come to their rescue, or had the government limited the risks of moral hazard by forcing shareholders, creditors, and borrowers to absorb losses and aggressively prosecuting fraud and malfeasance?

In Malaysia and Thailand, banking authorities responded to financial crises in the 1980s in ways that strengthened the legal framework and sought to limit moral hazard. Yet despite these efforts, the continued involvement of the government in the financial sector in Indonesia, Malaysia, and South Korea created the ongoing risk of politicization of both lending decisions and any subsequent losses that arose, even in equity markets.

Thailand had a financial crisis in 1983-84 that resulted in the collapse of Asia Trust Bank (the 12<sup>th</sup> largest bank in terms of assets) and a number of finance companies.<sup>7</sup> In return for orchestrating liquidity support, the government pushed mergers, took over partial ownership of some institutions, placed public officials into executive positions, and expanded the Bank of Thailand’s regulatory powers. By the time the crisis eased, 13 finance companies had had their licenses revoked.

In a pattern that was again visible in the 1997-99 crisis, however, the treatment of the banking sector was more lenient. One bank was effectively

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7. My thanks to Kit Panupong for his assistance on this section.

nationalized, but a number of other major banks received extensive liquidity support through a newly created Financial Institutions Development Fund (FIDF). The FIDF, which was under the control of the central bank, had a wide range of powers at its disposal to assist and rehabilitate financial institutions, including the power to write down capital and replace management. However, the fund also enjoyed substantial discretion and could support institutions through low-interest loans, deposits, or purchase of convertible debentures and shares.

The crisis of the mid-1980s occurred under a liberalizing but semi-authoritarian regime and involved an expansion of the government's regulatory authority, the closing of a number of institutions, and the imposition of conditions on others; even under those political conditions, forbearance was shown toward the largest banking institutions. The crisis of the 1990s by contrast occurred under a democratic opening that provided multiple new channels for business lobbying of government.

The problems facing the country's financial institutions became apparent as early as 1991 when the Bank of Thailand detected irregularities in a struggling mid-sized bank, the Bangkok Bank of Commerce (BBC). A bank examination in 1991 revealed that 27 percent of BBC's total assets were nonperforming (Nukul Commission Report 1998, para. 283). Subsequent examinations in 1993 and 1994 showed that the problem had only worsened. The government agreed to purchase a substantial stake in the bank through the FIDF, but without any writedown of shareholder capital or replacement of management. The central bank governor defended this action on the grounds that similar forbearance had been shown toward banks in the past (Nukul Commission Report 1998, para. 300 and 306)!

As the extent of mismanagement at BBC became public in mid-1996 following disclosure by the opposition, there was a run on the bank. After having indulged BBC for an extraordinary period, the central bank finally took formal control of BBC. Ultimately, a total of \$7 billion was spent to keep BBC afloat. Although the FIDF recovered some of that money, the bailout set a dangerous regulatory precedent and severely damaged the reputation of the Bank of Thailand. The Nukul Commission, established in 1998 to investigate the causes of the crisis, sidestepped the issue of outright corruption, stating somewhat obliquely that "in a [sic] recent past, top BOT officials were inclined toward political interests" (para. 317). But several politicians within Prime Minister Banharn's Chart Thai party were known beneficiaries of large loans from BBC (*The Nation*, 13 March, 18 April 1997; Pasuk and Baker 1998, 105-10, 259).

Indonesia is frequently invoked as the quintessential case of crony capitalism. As longtime observers of the Indonesian financial sector Cole and Slade (1998, 65) put it, "in the 1990s the 'Suharto connection' became the 'guarantee' or collateral underlying the viability of many enterprises and financial institutions, most obviously in banking and securities mar-

kets. Any financial regulator who attempted to apply prudential rules to such connected financial institutions or transactions . . . was removed from his position. Politics and connections dominated.”

The power and value of a genuine Suharto connection were widely understood. This was starkly illustrated in 1990 when Bank Duta, a private bank housing the substantial deposits of several political foundations controlled by Suharto, lost nearly half a billion US dollars in foreign exchange speculation. Bank Duta was promptly rescued by two other large corporate groups with very close financial ties to Suharto, which in turn were quickly rewarded with other forms of state largesse (Schwarz 1994, 112).

The failure of Bank Summa, only 2 years after the Bank Duta case, demonstrates that what Suharto gave he could easily take away. Bank Summa was owned by the Astra group, the second largest industrial conglomerate in Indonesia. Despite its early association with Suharto, the group had consciously distanced itself from the Suharto circle and refused to participate in the Bank Duta restructuring. The regulators were subsequently turned loose on Bank Summa, and the bank was forced into liquidation at enormous cost to the parent company. Moreover, other cronies were allowed to buy up a number of Astra assets (Cole 1999).

The problems in the Indonesian banking sector were not limited to crony banks; the direct involvement of the government in the banking sector created additional moral hazard problems. Of the top 15 banks in Indonesia before the crisis, 6 had the government as the largest shareholder (Nasution 1999, 83).<sup>8</sup> Nonperforming loans at state-owned banks in 1996 totaled 16.6 percent of their total credits, in comparison with 13.8 percent for private nonforeign exchange banks and 3.7 percent for private foreign exchange banks—although, as we will see in chapter 4, these numbers must be treated with appropriate suspicion.

Following a recapitalization of a number of state-owned banks in 1992, Bank Indonesia announced plans to prosecute bad debtors in 1994, and the next year publicized a list and prevented them from leaving the country. Nonperforming loans temporarily fell. But the high-profile case of Eddie Tansil suggests the government’s unwillingness to monitor private borrowers (Backman 1999, 32; Delhaise 1998, 132). Following parliamentary queries and revelations, Tansil was convicted of bribing officials at the state-owned development bank Bapindo to obtain \$430 million of unsecured loans, on which he later defaulted. Tansil was jailed, but he is thought to have subsequently bribed his way out; his whereabouts remain unknown.

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8. These 6 banks controlled fully 30 percent of assets in the banking system, and that underestimates the government’s role because of a number of banks controlled indirectly by the central bank, line ministries, and the military.

Malaysia had a financial crisis in 1985-87 involving three banks, a number of deposit-taking cooperatives (DTCs), and illegal deposit-taking institutions (Sheng 1992; Thillainathan 1998). The government forced the banks to recognize all losses, despite substantial management and shareholder resistance, changed management, and required existing shareholders to inject as much capital as possible through a new share issue; the central bank recapitalization was conditional. When the economy began to rebound, however, the central bank changed its approach by establishing a fund to support select *bumiputra* enterprises; this more interventionist approach was again visible during the current crisis.

The political economy of the DTCs was contentious. After the government suspended 24 of them, depositors argued that their deposits should be guaranteed in full. However, the government committee charged with overseeing the rescue rejected this argument and imposed partial losses on depositors. Those responsible for mismanagement were charged in court; some were sentenced to jail. Few of the DTCs survived the crisis.

But if Malaysia did somewhat better than Thailand in managing its financial crisis in the 1980s, it shared with Indonesia the problems associated with growing government involvement in the financial sector.

As in Indonesia, the problems were not simply ones of how the financial crisis was managed, but of the deepening general involvement of the government in the banking sector. Between 1970 and 1990, 8 of the top 10 banking institutions that had been controlled by Chinese and foreign interests were brought under the control of either *bumiputra* or government companies (Gomez and Jomo 1997, 60-66; Searle 1999, 75).<sup>9</sup> The second largest bank, Bank Bumiputra, was established by the government in 1965 to help ethnic Malays; problems of moral hazard were particularly acute there. In 1984, Bank Bumiputra reported massive losses stemming from loans to Hong Kong-based speculators in Malaysia's largest banking scandal and was taken over by the state-owned oil company Petronas. Petronas came to the rescue a second time in 1989, and the bank was bailed out again in 1998 (see chapter 4). The sixth largest bank, United Asian Bank, was controlled by a company that was itself controlled by the ruling UMNO party.

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9. The first, third, and fifth largest banks in the country before the crisis began their lives as Chinese-owned institutions but came under government control (Maybank and United Malayan Banking Corporation, or UMBC) or had substantial government ownership (D and C Bank). In some cases, government control of banks, particularly smaller ones, came following runs or other problems of mismanagement that forced government intervention. In other cases, however, such as the government's acquisition of shares in UMBC, the motives were explicitly political and involved efforts to counter concerns about Chinese ownership of banks. UMBC was later acquired by a prominent UMNO party leader and then sold back to the state when the government required ministers to divest their holdings of listed companies (Lee 1987, 328; Searle 1999, 142)!

Thus the appearance of a private banking sector in Malaysia is somewhat misleading. Government involvement in the banking sector has in fact been pervasive and motivated by a particular political strategy of developing *bumiputra* interests, with the strong implicit commitments such a program implies.

The government's involvement in the financial sector in Malaysia extends to the stock market (Gomez and Jomo 1997, 34-39; Perkins and Woo forthcoming). One component of the New Economic Policy was the requirement that firms over a certain size—with some exceptions such as export-oriented enterprises—sell 30 percent of their shares to *bumiputras*. One way of doing this was simply to allow certain individuals to acquire shares at a discount, making share allocation a vehicle for patronage. But this was unwieldy and did not achieve the social objective of increasing the wealth in *bumiputra* hands because the shares could simply be sold. Beginning in the 1980s, discounted shares were acquired by unit trusts set up by the government-owned Permodalan Nasional Berhad (National Equity Corporation, or PNB). The shares were acquired by government grants and interest-free loans and the trusts offered guaranteed rates of return. As a result, the government came to have a particularly strong interest in the performance of the stock market, opening another window for moral hazard.

South Korea's financial history, finally, has been anything but smooth (Cole and Park 1983; Woo 1991; Choi 1993). The events of 1997-98 were the third in a cycle of lending and investment booms dating to the 1960s, each of which was followed by financial crisis. The most recent of these occurred in the wake of the heavy and chemical industry drive of the 1970s, when a rapid expansion of credit from state-owned banks resulted in significant surplus capacity in a number of sectors. Under authoritarian auspices, the government undertook a forced restructuring of a number of major heavy industries in 1981-82 and a second round of corporate restructuring and debt rescheduling for 78 troubled enterprises in 1986-88. The government steered a middle course between bailouts and allowing firms to fail by forcing takeovers and mergers. But this required giving generous financial incentives to the acquiring firms, including long grace periods on interest payments, tax breaks, and outright grants (Moon 1994, 149).

Following the transition to democracy in 1987-88, the political opposition protested the substantial costs of the 1980s bailouts and the close nature of business-government relations more generally. The governments of both Roh Tae Woo and Kim Young Sam reverted to a variety of direct means to limit *chaebol* borrowing.<sup>10</sup> However, as the data in

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10. These included limitations on borrowing for "noncore" business, requirements to sell idle buildings and land, and limits on intra-group investments.

table 1.2 show clearly, these efforts had very little influence on the extent of corporate leveraging in the 1990s. Moreover, the combination of high spreads between lending and deposit rates and the notoriously low profitability of Korean banks was a clear sign of extensive nonperforming loans (Dalhaise 1998, chap. 5). Rather than being called, bad loans were compensated by overdraft privileges at the central bank (Park 1999).

Although the government's ownership of banks was not as extensive as in Indonesia, neither was it trivial (Haggard and Mo 2000). During the 1994-96 period, the Korean Development Bank increased credit for facility investment at a rapid pace. This lending signaled government commitment to larger projects, again raising moral hazard questions. The Roh and Kim governments also prolonged the government's involvement in the banking sector in other ways. The government did not even abandon its practice of reviewing the appointment of top bank managers until 1993, and even after that point, policy continued to play a role in bank lending decisions (Park 1999). For example, the Kim Young Sam government made concerted efforts to press banks to channel credit to small and medium-sized enterprises.

But in some cases, government involvement was altogether lacking in a policy rationale, as the Hanbo scandal of 1997 showed.<sup>11</sup> With a total of 24 subsidiaries, the Hanbo group was the country's 14th largest *chaebol* (by assets) in 1995. With government blessing, the group had developed a proposal for a massive steel complex. During the final stages of construction in 1996, the firm ran into serious delays and construction costs more than doubled. After a number of secondary financial institutions cut the supply of new credit to the firm in late 1996, Hanbo's main banks stepped in temporarily to prop up the group, but by January it was clear that Hanbo was insolvent and creditors took control.

Once under bank control, the full extent of Hanbo's difficulties became apparent. The firm was able to borrow more than \$3.5 billion for the steel project because top bank managers circumvented normal loan review processes. The subsequent legislative investigation revealed that the chairman of Hanbo directed bribes toward the presidents of his main creditor banks, but also to members of the National Assembly Finance Committee (including members of the opposition) and to one of Kim Young Sam's aides, who directed the president's economic advisors to pressure Hanbo's banks to continue to lend.<sup>12</sup>

The Hanbo case was unique in the extent of malfeasance but probably not altogether exceptional. The scandal severely weakened the govern-

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11. The following two paragraphs draw on Schopf (2000).

12. Additional money was also spent to secure the license for the plant in the first place, to secure support from local politicians around the site who faced opposition on environmental grounds, and to subsequently quiet legislators who might blow the whistle.

ment's ability to manage emerging problems in the banking and corporate sector before the crisis broke (see chapter 2). As in the other crisis countries, continued government involvement in the banking sector weakened bank incentives to aggressively monitor their corporate clients.

## **The Politics of Moral Hazard II: Industrial Policy**

A second, related explanation for the crisis in Asia is that moral hazard arose from the conduct of industrial policy (Wolf 1998; *The Economist*, 15 November 1997). Was industrial policy—in the specific sense of government targeting of particular industries—present in the crisis countries, and if so, was it pervasive enough to contribute significantly to the financial weaknesses noted above?

In Thailand and South Korea, the answer is almost certainly “no.” In Thailand, the government was involved in extending protection to capital goods industries in the 1970s and early 1980s (Rock 1995). However, a brief infatuation with mimicking Northeast Asian industrial policy by creating a “Thailand Inc.” passed with the export-led growth of the mid-1980s. Large-scale, state-led efforts such as the Eastern Seaboard project were scaled back and transferred to private hands (Pasuk and Baker 1998, 81-89). The government has played no role in the allocation of credit to industry (although it has required banks to extend credit to agriculture) or the granting of subsidies for particular activities, and the Board of Investments has taken a permissive approach to the designation of “priority” sectors for investment incentive purposes.

South Korea, of course, does have a very long history of industrial policy. But the heavy industry drive of the 1970s—the heyday of industrial targeting—was held responsible for a variety of economic ills. After seizing power in a coup in 1980, Chun Doo Hwan began to gradually dismantle the industrial policy regime (Haggard et al. 1994; Chang, Park, and Yoo 1998). These efforts accelerated with the inauguration of the Kim Young Sam administration in 1993. By the time of the crisis, Korea's industrial policy was limited to a handful of R&D supports in some high-technology industries. The long legacy of industrial policy may have contributed indirectly to the bank-*chaebol* relations described in the foregoing section, but there is little ground for arguing that the investment boom of the 1990s resulted from government targeting of particular industries.

Assessing the significance of industrial policy in Malaysia presents some complications because of the centrality of ethnic considerations in economic policymaking (Bowie 1988; Jesudason 1989; Gomez and Jomo 1997; Mahathir 1999; Jomo 1986, 1994, 1995; Gomez 1990, 1991, 1994, 1999; and Searle 1999). Following ethnic riots in May 1969, the government adopted a New Economic Policy (NEP), which explicitly sought to redis-

tribute wealth from non-Malays, particularly foreigners and Chinese, to Malays.<sup>13</sup> Dissatisfied with the meager results of these policies, then-Minister of Trade and Industry Mohamed Mahathir shifted course in 1980 by initiating a “Look East” policy, modeled explicitly on Japan and South Korea. The state-owned Heavy Industries Corporation of Malaysia (HICOM) was the central agent of this big push, and undertook joint ventures with foreign companies in a variety of sectors, including steel, cement, natural gas, and most controversially, a national car project, the Proton.

Virtually all the HICOM ventures ended up losing money. When the country experienced a recession in the mid-1980s, Mahathir moved to professionalize the management of state-owned enterprises (SOEs), corporatize and privatize selectively, revamp incentives for foreign investors, and pay greater attention to exports. Nonetheless, protection for some state-supported projects continued, and the government remained committed to certain other projects, such as the national car effort, despite the fact that it was nominally privatized.

Indonesia, finally, is the case in which government involvement in the economy was most extensive, indeed even bewildering. In contrast to South Korea, where industrial policy was conducted primarily by channeling financial subsidies to private firms, SOEs played a more central role in Indonesia, particularly during the oil boom of the 1970s. By the mid-1980s, there were more than 200 public enterprises, sales of which accounted for approximately a quarter of GDP.

With the decline in oil prices in the early 1980s, technocratic reformers gained greater control over the policy agenda and gradually shifted the emphasis toward a private-sector led import-substitution approach, supplemented after 1985-86 with greater emphasis on export promotion. Among the instruments for achieving the development of domestic industries were “officially sanctioned cartels (cement, glass, plywood and paper), price controls (cement, sugar, automobiles); entry and exit controls (plywood and automobiles); [and] exclusive licensing (clove marketing, wheat flour milling),” not to mention the continued role of public-sector monopolies in a range of sectors, including energy and mining, public utilities, fertilizer, plantations, and some “strategic”—although not rapidly growing—sectors such as steel (Jomo et al. 1997, 144). The Investment Coordinating Board maintained complicated lists of activities eligible for various incentives, but “the list served more as an instrument of discretionary control over both foreign and domestic private investors than as a tool for guiding investment incentives into potential high-growth areas” (Felker and Jomo 1999, 47; see also MacIntyre 1993).

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13. To implement these objectives, the government established a number of public corporations as well as a licensing system to ensure that new investments complied with the NEP’s objectives.

After 1988, the government embarked on a modest reform program for SOEs, including some selective privatization after 1994, but more important a further liberalization of both trade and foreign direct investment (Bresnan 1993, chap. 10; Winters 1996, chap. 4; Felker and Jomo 1999). At the same time, the government grouped 10 “strategic industries” under the Coordinating Agency for Strategic Industries controlled by the state minister for research and technology, B.J. Habibie. Although deemed “strategic,” these industries were in fact dominated by SOEs in sectors such as aircraft, shipbuilding, and steel, all of which benefited from direct and indirect state subsidies, government procurement, and other restrictive arrangements. Although the operations and finances of the firms are far from transparent, the assessments that exist find substantial losses and failure to meet policy objectives (McKendrick 1992). In 1991, the World Bank found that Habibie’s projects accounted for fully half of all losses by SOEs (cited in Schwarz 1999, 87).

In sum, industrial policy played some role in generating moral hazard in Indonesia and Malaysia, but it seems difficult to argue that it was a central factor in the financial weaknesses outlined in the previous section. Except for the Habibie projects, the general trend in the four countries was in the direction of less rather than more industrial targeting. Indeed, it was the process of liberalization, rather than industrial policy, that was subject to some of the most damaging forms of political manipulation.

## The “Capture” of Liberalization

If government interventions of various sorts can generate moral hazard, a different but no less significant set of risks is posed by weakly regulated liberalization, particularly of the financial sector. These problems may reflect either “sins of omission” or “sins of commission.” In the first case, well-intentioned reforms, typically championed by technocrats and supported by international financial institutions, are undertaken without adequate legal, administrative, or informational capacity to check private ineptitude, malfeasance, or fraud. In the second case, political interference in either the design or implementation of the reform undermines its stated objectives. It is important to distinguish between the two problems. The first can be solved by increasing bureaucratic capacity, but the latter requires more fundamental institutional and even political reform, such as increasing the independence of central banks and regulators.

The problems of financial liberalization were clearly most acute in Indonesia, and centered not on the capital account, which had been relatively open since the late 1970s, but on domestic liberalization. Ironically, the financial reforms of the 1980s and 1990s were seen by technocrats as a way of minimizing abuses in the banking system (Cole and Slade 1996, chapter 10; Hamilton-Hart 1999). These efforts began with the removal

of credit controls and interest rate ceilings in June 1983 and accelerated through a wide-ranging set of reforms in 1988 that included reduced restrictions on establishment and branching of banks and finance companies and issuing of equities and the adoption of extraordinarily low (2 percent) reserve requirements. The number of private banks mushroomed from 74 before the reform to 239 in 1996. Nonbank financial institutions proliferated even more rapidly, and the capitalization of the stock market increased dramatically (Cole and Slade 1996, chapter 6; Hamilton-Hart 1999).

The private sector supported decontrol and promotion of the private financial markets. Chinese businessmen and bankers were particularly well-positioned to take advantage of the new regime, including the opportunities to finance their banking and corporate expansion through share issues with minimal disclosure (Cole and Slade 1996, 334). However, the “opportunities” created by the reforms included the ability to form “swindle” banks:

The typical swindle bank makes loans to non-bank companies owned by its principal owner(s) to finance questionable investment projects, usually at inflated prices. Liabilities of such banks are mainly deposits owned by the general public, liquidity credit from Bank Indonesia, unsecured commercial paper sold to the general public (including foreigners), and equity shares owned by Bank Indonesia and other state-related institutions. . . . Such banks typically really have negative net worth. (Nasution 1999, 85-86)

The technocrats were not unaware of these problems and after a series of delays, Bank Indonesia tightened the framework for banking regulation in 1991 and strengthened the regulation of the stock exchange over the first half of the 1990s. But the complicated nature of banking regulations, competition between the Ministry of Finance and central bank, and the lack of information and personnel all limited the capacity of the government to implement the new regulatory regime (Cole and Slade 1996; Hamilton-Hart 1999; Hill 1999, 61-67).

However, there can be little doubt that politics also limited the ability of the regulators to confront bankers and problem debtors. The president showed a continuing propensity to intervene in the loan decisions of both state-owned and private banks. Any financial regulator who attempted to enforce prudential rules on connected financial institutions was removed from his position, including the managing director of the central bank in 1992 and the minister of finance in 1996 (Cole and Slade 1998, 65).<sup>14</sup>

Political considerations also influenced the liberalization process in Thailand. Following the cleanup of the crisis of 1983-84, technocrats turned their attention to initiatives designed to mobilize financial savings and

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14. Prudential regulation of the stock market was similarly complicated by a variety of interest group pressures (Cole and Slade 1998, 229-34).

force greater competition on a protected and oligopolistic financial sector dominated by a handful of powerful, family-controlled banks (Pakorn 1994, Alba, Hernandez, and Klingebiel 1999; Yos and Pakorn 1999; LoGerfo and Montinola 1999).<sup>15</sup>

Early efforts in 1989-90 to remove or increase ceilings on both deposit and loan rates met resistance from the larger commercial banks, which feared competition from smaller banks, foreign entrants, and finance companies (Doner and Unger 1993, 119-120). However, the major banks quickly realized that they could benefit quite substantially from deregulation. The first liberalization program (1990-92) relaxed controls on banks' portfolios and branching and allowed commercial banks to underwrite debt instruments and sell mutual funds. Expanded opportunities for non-bank financial institutions did not necessarily hurt the banks; of the 93 finance and securities companies in the country, no fewer than 26 were affiliated with private Thai commercial banks. A number of these companies, which played a central role in making the multibillion-dollar commercial paper market, began to experience distress as early as mid-1996 (Overholt 1999).

The further opening of the capital account began with the acceptance of the obligations of the IMF's Article VIII in May 1990 and culminated with the launching of the Bangkok International Banking Facility (BIBF) in 1993. The 49 Thai and foreign banks with BIBF licenses were allowed to borrow offshore and relend to domestic borrowers at substantial spreads, with the additional benefit of a fixed exchange rate and a number of tax advantages.

The external imbalances and macro and microeconomic problems created by financial liberalization have been a leitmotif of virtually all writing on Thailand's crisis, as has been the inadequacy of prudential regulation, particularly with respect to the finance companies (Pakorn 1994; Nukul Commission Report 1998, para. 434; Alba, Hernandez, and Klingebiel 1999; Yos and Pakorn 1999; LoGerfo and Montinola 1999; Overholt 1999). To what extent did politics affect the design and implementation of liberalizing initiatives?

The creation of the BIBF had a complex of competing motives, including geostrategic and regional ones (Thorn 1994; LoGerfo and Montinola 1999). Economic reform and opening in Indochina appeared to offer tremendous opportunities for Bangkok to serve as a financial center for the region while expanding trade through the poorer East and Northeast of the country, from which—not coincidentally—a number of politicians drew support. Thai commercial banks saw opportunities in entering the Indo-

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15. Technocrats also sought to promote the capital market as an alternative to dependence on bank financing, while asserting greater control over a stock exchange (the Stock Exchange of Thailand, or SET), which had become the locus of a variety of fraudulent practices (Handley 1997, 100).

china market, and the initial expectation was that the BIBF would focus primarily on offshore or so-called “out-out” transactions. However, it became clear that the scope for “out-in” transactions exploiting large interest rate differentials and tax breaks dwarfed the offshore potential of the BIBF, and those transactions quickly came to dominate.

The consequences of both international and domestic liberalization hinged crucially on the regulatory capacity of the Bank of Thailand, and that in turn rested on the larger political milieu (LoGerfo and Montinola 1999). In 1988, the semi-democratic regime of Prem was replaced by a democratically elected coalition government under Chatichai. Although the transition to democratic rule was interrupted by a year and a half of military rule (February 1991 to September 1992), the introduction of democratic politics meant fundamental changes in the relationship among business, politicians, and regulators. Chatichai naturally expanded the role of the party politicians in the cabinet, including at the Ministry of Finance, while technocrats who had exercised influence over the budget process through the National Economic and Social Development Board (NESDB) saw their influence radically devalued.

The Bank of Thailand retained greater independence than the NESDB, but the governor holds his position at the pleasure of the minister of finance. In the early 1980s, the power of dismissal was used twice, resulting in what Amar Siamwalla has called “implicit intervention:” “Instead of submitting to explicit orders from the Minister [of Finance], the Governor would anticipate the Minister’s desires and follow the current political line” (Ammar 1997, 71). The Nukul Commission, established to look into the causes of the crisis, found increasing politicization of the bank and a declining willingness as well as capability<sup>16</sup> to make supervisory decisions (1998, para. 429, 434). The Securities and Exchange Commission, only formed in 1992, was also subject to intense lobbying throughout the 1990s to limit its oversight of insider dealing and other fraudulent practices on the stock exchange (Handley 1997, 108). Thailand’s problems were clearly not limited to lack of bureaucratic capacity.

As in Thailand, the banking crisis of the mid-1980s led to a strengthening of the legal framework of financial regulation in Malaysia; unlike Thailand, the process of financial market liberalization was more incremental and modest (Lin and Chung 1995; Thillainathan 1998, 14). Lending rates were freed up in 1991, and the government’s requirements that banks channel some share of total credit to “priority” sectors eased. The government also established an offshore financial center on the island of Labuan, but this center remained small and some administrative measures were used after 1994 to limit short-term capital movements (see appendix 2-1).

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16. One serious problem the Bank of Thailand faced was the departure of a number of skilled personnel to the rapidly expanding private financial sector; see *Manager* (Bangkok), February 1995, 27-31.

Given that the capital account was already relatively open, Labuan cannot be held responsible for the growth of Malaysia's foreign debt. Foreign banks did have a strong presence in the country—accounting for roughly 30 percent of loans and deposits when the crisis hit—but the government restricted both foreign and domestic entrants.

Nonetheless, there were a number of ways in which the government's interest in both ethnic redistribution and supporting favored enterprises complicated other liberalizing reforms and created incentives for lax financial regulation. The privatization program was envisioned as a new tool for achieving the objective of ethnic redistribution, but the line between this objective, political goals, and outright corruption sometimes blurred (Jomo 1995). The privatization of both infrastructure and state-owned companies typically occurred through negotiated tenders and involved a small number of firms.<sup>17</sup> Favored individuals benefited handsomely from the transfer of large blocks of shares in government companies without open tender (Gomez and Jomo 1997, chaps. 4, 5). But privatization did not serve to eliminate the problem of moral hazard because of the government's political as well as economic interest in seeing the projects successfully completed; in effect, the government took on large contingent liabilities as a result of a privatization process that should have shifted risk onto the private sector.

The government's political objectives also had a number of consequences for the regulation of the financial system. The government had a strong interest in lending to *bumiputra* entrepreneurs (to support the privatization program), in supporting the buoyancy of the stock market (due to the growing number of *bumiputra* investing in discounted shares and government-run unit trusts), and in supporting non-*bumiputra* Chinese firms that were linked to the government. As a result, limits on lending to speculative activities such as property development and share purchases were weak and weakly enforced. In 1997, the proportion of total loans to these activities reached 43 percent. In March 1997, just before the crisis, the central bank did finally move to curb these speculative excesses (Bank Negara Malaysia, *Annual Report 1997*, 78). But by that time, property and shares had already been used as collateral to secure additional bank credit, creating a financial system that was highly vulnerable to shocks (Perkins and Woo forthcoming).

South Korea's crisis was also preceded by a complex set of liberalization measures with respect to both the real and financial sectors; as in Malaysia, the two must be understood in tandem. In 1993, the Kim Young Sam government sought to curb increasing concentration by requiring *chaebols* to designate core industries and phase out their noncore businesses. In

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17. Of 13 large national projects that the government awarded between 1992 and the onset of the crisis, 8 were awarded to Renong Bhd, which had previously been the investment arm of the ruling party (UMNO) (Perkins and Woo forthcoming).

return, the government offered exemptions from a complex system of credit controls and regulations on entry, investments, acquisition of assets, and real estate holdings (Yoo 1999). Because the government had limited entry into a number of sectors in the past, and because of the opportunities posed by the strong yen, deregulation was followed by a rush of facility investments in a number of key industries, including steel, petrochemicals, semiconductors, and most controversially autos.<sup>18</sup>

As in the past, the rapid growth of facility investment during the boom of 1994-96 relied heavily on borrowing; domestic and international liberalization further encouraged this tendency (Chang 1998). In 1991, the government initiated major institutional changes in the financial markets. The most important of these was the licensing of merchant banks and the lifting of administrative controls on the yields and supply of commercial paper (CP), in which the merchant banks were the major market makers.

The creation of new merchant banks and the liberalization of the CP market was a major factor in the expansion of short-term financing (Cho 1998); it is also a case study in how financial reforms can be captured not only in their implementation but in their basic design.<sup>19</sup> In the early 1980s, the government expanded the number of investment and finance companies (IFCs) in an effort to bring informal financial market players under government regulation. In the 1990s, the IFCs expressed a strong interest in transforming themselves into merchant banks because of a number of privileges those institutions enjoyed. The government licensed 24 IFCs as merchant banks in two separate rounds, 9 in 1994, and 15 in 1996, supposedly to contribute to a more market-based financial system.

In fact, the licensing process was the result of intense lobbying efforts which, like the Hanbo scandal, involved kickbacks from the new merchant banks to bureaucrats and politicians (*Korea Herald*, 11 April 1998). According to an investigation by the Board of Audit and Inspection (BAI), three of the IFCs licensed in 1996 were insolvent *at the time they were licensed* (*Chosun Ilbo*, 18 March 1998)! Of the 16 merchant banks whose licenses were revoked by the government in 1998, 15 were new entrants in 1994-96.

These domestic developments took place against the backdrop of a gradual opening of the capital account (Park 1998; Cho 1998). The United States exerted pressure for greater financial openness beginning in the late 1980s. These pressures then accelerated in anticipation of OECD membership in 1996. The Korean government's strategy for liberalization of

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18. After a long controversy, the president granted Samsung a permit to build a passenger car factory in December 1994 over strong opposition by incumbent firms and bureaucrats at the Ministry of Trade and Industry. What appeared to break the stalemate in favor of Samsung was the decision to locate the plant in Pusan, the economically struggling hometown of President Kim Young Sam.

19. I am indebted to Jungkun Seo for this analysis of the merchant banks.

the capital account was a gradual one. Fearful of destabilizing portfolio movements and facing resistance from domestic underwriters, the government liberalized transaction-based flows such as short-term trade credits first while only gradually opening portfolio investments and restricting investments in domestic fixed-income assets. The government also sought to control direct borrowing by the *chaebol*. However, the government was unduly lax with respect to bank borrowing, particularly with the merchant banks.<sup>20</sup> Behind a number of the merchant banks were the *chaebol*; denied ownership of banks, they had acquired stakes in nonbank financial institutions as a conduit for financing their own operations.

As in the other cases, regulators lacked both the independence and capacity to monitor the international operations of banks adequately. The Kim Young Sam government recognized this problem and in early 1997 created a financial reform committee to devise a more independent regulatory structure. Instituting these changes not only came too late but, as will be shown in the next chapter, the government faced substantial political and bureaucratic resistance to its efforts. Reform had to await the coming of the Kim Dae Jung government.

## The Politics of Business-Government Relations

The foregoing review suggests strongly that the sources of economic vulnerability were not limited to particular policies but were rooted in basic features of the business-government relationship. In Western accounts, these political and institutional weaknesses are typically reduced to the problem of cronyism and corruption. As we have seen, problems of corruption and cronyism were certainly in evidence. But the political problem extended beyond the illicit to the influence that business interests exercised over legislation, regulation, and the legal process more generally.

Of course, the quality of the quantitative data on corruption is of somewhat questionable quality, usually taking the form of subjective valuations of businesspeople (Elliott 1997b).<sup>21</sup> But even if we take the data with a grain of salt and focus primarily on orders of magnitude and the general

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20. Over objections by the Ministry of Finance and Economy, merchant banks lobbied successfully to engage in international business, resulting in extraordinary risk-taking, such as investments in Thailand and in Russian bonds (*Business Korea*, September 1997, 24).

21. The problem with subjective assessments of experts or market participants is that corruption is likely to be confounded with a number of other things in respondents' evaluations, from policy to economic performance; e.g., all the crisis countries show an increase in corruption, according to Transparency International, between 1996 and 1997 when the crisis hits. Even the teams that generate the data issue cautions (see table 1-6). These caveats aside, some research has found statistically significant effects of corruption on growth and foreign investment (Mauro 1995; Wei 1997; Elliott 1997a).

direction of change, it is not particularly supportive of a simple corruption story (see table 1.6).

The two data sets examined here do confirm some suspicions. Hong Kong, the Philippines, Singapore, and Taiwan are, on average, less corrupt than the four most seriously affected countries discussed here. Among those, Indonesia is the most corrupt, and South Korea or Malaysia least, with Thailand in between. All are more corrupt than the OECD countries and three central European countries (Czech Republic, Hungary, and Poland).

But the data also present a number of anomalies. The “Asian eight” have, as a group, become less, rather than more corrupt since the first half of the 1980s. Moreover, corruption in these countries is less virulent than in Latin America, Africa, or the Soviet successor states. By the Transparency International data, the reduction in corruption in the region is greater than in other developing regions. If we turn from these averages to the performance of individual crisis countries, South Korea and Indonesia show improvements over time, including before the crisis, and Thailand improves by one measure while worsening by the other. There is little difference in scores between Indonesia—the hardest hit of the crisis countries—and the Philippines, which was affected but did not experience the profound shocks of the four countries analyzed here (see appendix 3-1).

What such indices do not capture is the broader political relationships between politicians and the private sector. These include the extent to which politicians rely on particular firms and groups for political support, the transparency of business-government relations, and whether institutions encourage healthy or perverse private-sector influence on policy.

The changing nature of business-government relations is most apparent if we focus first on the democracies. As in the other Southeast Asian countries, Sino-Thai business developed clientelistic ties with military leaders and bureaucrats not simply to pursue rents but for political protection (Doner and Ramsay 1998). Over time—and in contrast to Malaysia and Indonesia—the Chinese community became assimilated. Business associations formed in key sectors, including rice and banking, and established more institutionalized consultative processes with the government. In the early 1980s General Prem’s liberalizing military regime developed a Joint Public-Private Consultative Committee that provided a forum for the discussion of major policy issues (Anek 1992). However, this occurred during a period when the military-led government still dominated politics and granted the technocrats substantial control over key areas of policy, particularly macroeconomic policy. Such delegation limited to some extent the adverse consequences of continuing clientelism.

**Table 1.6 Indicators of corruption**

	ICRG Data				TI Data					
	1982-85	1992-95	Change <sup>a</sup>	1982-95	1980-85	1988-92	1996	Change <sup>b</sup>	1997	1998
<b>Most affected countries in Asia</b>										
South Korea	4.58	8.33	3.75	5.30	3.93	3.50	5.02	1.09	4.29	4.2
Thailand	5.63	5.00	-0.63	5.18	2.42	1.85	3.33	0.91	3.06	3.0
Malaysia	8.96	6.67	-2.29	7.38	6.29	5.10	5.32	-0.97	5.01	5.3
Indonesia	1.67	4.79	3.12	2.15	0.20	0.57	2.65	2.45	2.72	2.0
<b>Other Asia</b>										
Hong Kong	8.96	8.33	-0.63	8.52	7.35	6.87	7.01	-0.34	7.28	7.8
Taiwan	7.29	6.67	-0.63	6.85	5.95	5.14	4.98	-0.97	5.02	5.3
Singapore	10.00	6.67	-3.33	8.22	8.41	9.16	8.80	0.39	8.66	9.1
The Philippines	0.42	4.79	4.37	2.92	1.04	1.96	2.69	1.65	3.05	3.3
Average Asian	5.94	6.41	0.47	5.82	4.45	4.27	4.98	0.53	4.89	5.0
China	6.25	7.29	1.04	6.53	5.13	4.73	2.43	-2.7	2.88	3.5
A.I.S. <sup>c</sup>	9.01	8.88	-0.13	8.90	7.60	7.65	7.68	-0.08	7.82	7.77
Latin America <sup>d</sup>	4.79	5.03	0.23	5.01	3.71	3.37	3.54	0.17	3.16 <sup>e</sup>	3.34
Africa <sup>f</sup>	4.10	5.49	1.39	4.78	3.00	2.95	2.77	0.23	3.36 <sup>g</sup>	2.75
Eastern Europe <sup>h</sup>	6.39	8.06	1.67	7.36	3.47	5.21	5.27	-1.80	5.15	4.8
Soviet Union/Russia	6.67	5.21	-1.46	6.18	5.13	3.27	2.58	-2.55	2.27	2.4

A.I.S. = Advanced Industrial States

Note: The Center for Institutional Reform and the Informal Sector (IRIS) at the University of Maryland compiles a data set from data originally collected by Political Risk Services and published in the International Country Risk Guide (ICRG). This data set includes a number of political risk variables, including an assessment of the degree to which payments are required at high political levels for large transactions and at the lower levels for routine government functions such as customs clearance. The scale ranges from 0, indicating payments are “generally accepted” to 6, indicating little corruption. Data in table 1.6 are converted to a 10-point scale. Transparency International (TI), a Berlin-based NGO established in 1993, began its ranking of perceived corruption in 1995. The ranking, which starts at zero for the most corrupt and goes to 10 for the least, is based on a number of surveys. In 1996, for example, these included the ICRG/IRIS index, World Competitiveness Report of Institute for Management and Development, Hong Kong-based Political and Economic Research Consulting (PERC), DRI/McGraw-Hill Global Risk Service, Economist Intelligence Unit, and a survey of embassies and chambers of commerce from Göttingen University. Researchers from Göttingen University in collaboration with Transparency International subsequently created historical data, also based on other surveys (usually one or two for 1980-85 and three or four for 1988-92, depending on the country). For more details on the sources of these data by country, see the Web site maintained by Johann Graf Lambsdorff of Göttingen University, <http://www.gwdg.de/~uwwvicr.htm>. See also Elliott (1997 a), appendix B, for caveats about the use of these and other data.

- a. Period of change measured: 1982-85 to 1992-95.
- b. Period of change measured: 1980-85 to 1996.
- c. Based on data for Australia, Canada, Europe, Japan, New Zealand, and United States.
- d. Based on data for Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, and Venezuela.
- e. 1997 score for Ecuador not available.
- f. Based on data for Cameroon, Egypt, Kenya, Nigeria, South Africa, and Uganda.
- g. 1997 score for Cameroon, Egypt, Kenya, and Uganda not available.
- h. Based on data for Czech Republic, Hungary, and Poland.

The direct involvement of business in politics not only showed a secular increase (Anek 1992, 33), but also leapt upward whenever politics were liberalized or became more democratic (1973-76; gradual liberalization in the 1980s; 1988-91; 1992-present). Thailand's constitutions have produced a fragmented and weak party system, and the electoral system encourages personal rather than partisan campaign strategies (Hicken 1998, 1999). Campaigns are expensive and politicians of all major parties have turned to both Bangkok financial and industrial interests, and increasingly to the emergent provincial business elite, for support.<sup>22</sup> A number of business-people entered politics directly (Ockey 1992; Pasuk and Sungsidh 1996; Handley 1997).

To accommodate these political investments, coalition governments would form by allocating cabinet and subministerial positions to their members and channeling fiscal resources through the ministries to relevant supporters (Pasuk and Sungsidh 1996). These institutional arrangements naturally meant a diminished role for the technocrats, particularly after the transition to fully elected democratic governments in 1988-91 under Chatichai, and after 1992.

In sum, the new Thai democracy faced a number of problems in maintaining the political and institutional conditions required to hold private influences over public policy in check. Some parties, particularly the Democrats, expressed concern about these issues and sought to project an image of clean government. But as we will see in chapter 3, they also had to secure electoral support and ruled in coalition with other parties.

In South Korea, political liberalization and democratization have made business-government relations increasingly contentious (Haggard and Moon 1990; Moon 1994; Kim 1997). In the early 1960s, the military government of Park Chung Hee initially acted quite decisively to break up rent-seeking relationships between the government and the private sector. However, the new government quickly made peace with the private sector and established a variety of consultative mechanisms, including meetings between the president and chairmen or representatives of the major *chaebol*.

As the *chaebol* grew in size and the government undertook its heavy industry drive in the 1970s, the nature of business-government relations again became increasingly controversial. When Chun Doo Hwan seized power in 1980, the government instituted tighter controls on credit, passed an anti-monopoly law, and forced the major restructuring of business outlined above (Haggard and Moon 1990; Moon 1994).

However, at the same time, both Chun and particularly his protégé Roh Tae Woo required resources to compete as the political system was

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22. The provincial *nouveaux riche* not only provided funding but also organized the regional and local machines that were critical for Bangkok-based parties to mobilize (and buy) votes in the provinces and rural areas.

slowly liberalized. Roh Tae Woo won the first democratic election for president by a plurality when Kim Dae Jung and Kim Young Sam split the opposition vote in 1987. But in 1995, under the Kim Young Sam administration (1993-98), an opposition lawmaker accused Roh of having amassed an enormous political slush fund (West 1997). Prosecutors were able to trace the funds because the new government had implemented a “real name” account system precisely to end the practice of hiding funds for tax and political purposes. The size of the fund Chun bequeathed to Roh—\$285 million—and the comparable amounts Roh added to it were stunning. The revelations immediately raised questions about the favors that firms had received in return, from licensing and finance to lax tax and regulatory treatment.

Beginning in the 1980s, and accelerating with democratization, the relationship between government and business became more contentious, and the consultative mechanisms that had existed in the past atrophied. The private sector became more assertive in lobbying against unwanted controls and openly supporting sympathetic candidates. As the Hanbo incident showed, democratization provided new channels for business influence through the legislature (Schopf 2000). But at the same time, Roh Tae Woo, Kim Young Sam, and Kim Dae Jung were all under continual political pressure—from labor, students, nongovernmental organizations, and the broader public—to “do something” about the increasing concentration of business and ongoing allegations of corruption and corporate malfeasance. These larger political battles over the nature of business-government relations were very much part of Korea’s adjustment efforts under both Kim Young Sam and Kim Dae Jung.

In Malaysia and Indonesia, the issue of business-government relations has much wider political implications because of the question of how to manage inter-ethnic inequalities. In Malaysia, where the Chinese community is much larger (approximately 27 percent vs. 3-4 percent, depending on definitions), those efforts have always been more institutionalized. In the West, Mahathir is associated with public sector initiatives, such as the Proton car project. But the core of his approach was to create a more competitive Malay private sector through privatization (Jomo 1995).

This shift in policy mirrored a fundamental transformation in the political base of the UMNO. At the time of its foundation, the UMNO was dominated at the grass roots by rural teachers; in 1981, a full decade after the NEP, school teachers still accounted for 41 percent of delegates to the UMNO’s General Assembly. However, this dropped to 19 percent in 1987, while businessmen constituted 25 percent in that year. By one estimate, almost 20 percent of the UMNO’s 165 division chairmen in 1995 were millionaire businessmen (Gomez and Jomo 1997, 26). Drawing on East Asian examples, the Mahathir administration devised a set of business consultative mechanisms to engage this important new constituency (Biddle and Melor 1999).

Yet at the same time, the dominant position of the UMNO and the increasing discretion in the hands of the prime minister (Milne and Mauzy 1999, chap. 2) sometimes resulted in a blurring of the boundary between government, party, and private interests. The UMNO deepened its involvement in business during the 1970s, in part to reduce its dependence on Chinese financing through its coalition partner, the Malaysian Chinese Association. In the 1980s, several party-controlled companies became among the largest conglomerates in the country. When the UMNO was forced to divest its holdings as a result of a challenge from a rival faction within the party, it did so to sympathetic business supporters. Ironically, this business base of support increasingly came to encompass Chinese as well as Malay entrepreneurs (Gomez 1999).

The discretion in the hands of the prime minister with respect to key policies such as privatization and the intertwining of party and business interests made conflicts of interest—at least as they would be understood in the United States—unavoidable. Moreover, they ran the risk of generating expectations that public and party enterprises or private firms with close political ties to the government would get bailed out (even if they in fact were not). It is again not surprising that, as in South Korea, the opposition focused substantial attention on cronyism and how to restructure business-government relations (see chapter 3).

Indonesia is the country to which the trio of sins—“corruption, collusion (or cronyism), and nepotism” (KKN in Indonesian)—was most frequently applied during the crisis, and with good reason (see Robison 1986; MacIntyre 1991, 1994b). The scale of corruption was clearly related to the highly concentrated nature of authoritarian rule in Indonesia. President Suharto could and did use presidential decree powers and other forms of discretion to benefit cronies and family (Indonesia Corruption Watch 1998) and gained from the general lack of transparency in government. The number of cronies—those with a continuing, close personal relationship with the president—appeared fairly small, and the number of extended family members involved in business numbered fewer than 20 (Schwarz 1999, chap. 6; Backman 1999, 263). But the diversified nature of their businesses cut across a large swath of the Indonesian economy (*Time*, 24 May 1999; Backman 1999, chapters 13, 14; Schwarz 1999, chapters 5, 6). Crony and family business empires of this scope would almost certainly have been impossible under more democratic, open, transparent political circumstances.

Business-government relations in Indonesia are further complicated by the fact that Chinese-Indonesians dominated the emerging private sector and were big beneficiaries of the liberalization of the 1980s and 1990s. Given Indonesia’s volatile political history and periodic violence against the Indonesian-Chinese, they naturally had incentives to form political alliances that could offer protection, including with the military. At the

same time, their minority status and wealth made them highly reluctant to engage in any overt political activity (MacIntyre 1991, 1994b). Rather, political relationships were more likely to be personal, clientelistic, and nontransparent, exactly the circumstances under which corruption and private dealing flourish.

Suharto (and lower-level political and military leaders) had to balance lucrative relationships with private Chinese-Indonesian businesses against demands for greater inter-ethnic redistribution. Suharto resisted a Malaysian-style program, but he periodically had reasons to respond to the *pribumi* private sector. The availability of oil money first provided the opportunity for a variety of programs that advanced *pribumi* businesses, from preferential awarding of contracts to bank lending (Winters 1996, chap. 3). Habibie's strategic industry initiative was partly a way to counter the weight of Chinese business and appeal to *pribumi* nationalism. Particularly after Suharto's reelection in 1993, the relative influence of Habibie supporters, cronies, and family rose at the expense of the technocrats.

## Conclusion

A number of features of the business-government relationship in the crisis countries increased their vulnerability to external shocks. These risk factors include the concentration of the private sector, government involvement in banking, industrial policy, and weakly regulated and "captured" liberalization. Of these risks, industrial policy appears to weigh least heavily, although its role cannot be dismissed altogether in Indonesia and Malaysia.

Yet a skeptic might still point out that these are all problems of long standing and that developing Asia managed to grow rapidly with them in the past. Again, why should these factors become a source of vulnerability now?

A first point this review should make clear is that the crisis of 1997-98 was not developing Asia's first. Thailand, South Korea, and Malaysia have had financial crises in recent memory, and although they were not on the scale of the crisis of 1997-98, neither were they costless. Some of the sources of financial vulnerability highlighted here are of long standing, but so is the propensity to financial crisis.

Second, it is misleading to say that the nature of the risks has been constant. Critics of liberalization like to underscore that it is the new element in the policy mix, and thus the factor likely to be of most obvious causal weight (Wade and Veneroso 1998; Chang 1998, 1999). But the risk of government intervention and poorly regulated liberalization are not mutually exclusive, and a demonstration of the significance of the latter does not constitute proof for the unimportance of the former. Unfortu-

nately, it is quite possible to have the worst of both worlds: government intervention that generates moral hazard and political uncertainty and precipitous liberalization that creates risks of a different sort.

Moreover, other things *were* changing. The trend toward increasing concentration of private economic power has been a secular one, and some patterns of government intervention (such as the new strategies for advancing favored entrepreneurs in Malaysia or the increasing presence of the Suharto family in Indonesian business) are of relatively recent vintage. More important, we have seen that the politics of business-government relations has not been constant either, with the government becoming more porous to private influence in Indonesia, Malaysia, and Thailand, and in some ways in South Korea well.

Perhaps more important, the overall context of policy had changed. In the early phases of growth, both the social and private returns on capital are very high. Close business-government relations served the function of assuring investors, often in highly uncertain political environments, and thus inducing the high levels of capital accumulation that was central to the Asian model. But as the returns to capital fall over time, the political order becomes more stable, and efficiency in the allocation of resources becomes more important for sustained growth, the logic of costly assurances to private actors becomes less clear. The inability of investors to monitor both business-government relations and the firm also becomes more costly. In short, relationships that might have had some use at one point in time may prove dysfunctional at a later stage of growth.

A final response accepts that the catalog of vulnerabilities outlined here does not, in itself, constitute a theory of financial crises but only a set of factors that can increase the propensity to crisis and compound their costs when they strike. However, the problems in business-government relations we have noted also affect how governments manage problems in the financial sector and foreign exchange markets and how they are perceived by those markets; chapter 2 takes up these questions.