

Financial Liberalization and Prudential Regulation in East Asia: Still Perverse

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1. INTRODUCTION

International standards and codes moved to the top of the reform agenda in East Asia after the crisis of 1997-8. Initially, two explanations of the 1997-8 Asian crisis dominated the literature: an international and a domestic-level explanation. The first located the origins of the crisis in unregulated and volatile international capital flows (Radelet and Sachs 1998; Wade and Veneroso 1998). The domestic explanation focused on the ways in which cronyism, corruption and poor domestic governance generally exacerbated problems of moral hazard (Krugman 1998; Corsetti et al 1998). The latter explanation predominated in official circles in the developed world and played an important role in the design of the structural reform packages attached as conditions of the IMF-led rescue packages (Blustein 2001).

Since then, there has been some convergence between these polarized positions (Eichengreen 2000; Hamilton-Hart 2000; Krugman 1999; Noble and Ravenhill 2000; Rosenbluth and Schaap 2002; Stiglitz 1998). This emerging consensus accepts elements of both of the early explanations. It accepts that domestic governance failures cannot explain why and when the crisis began, since such failures had persisted for some time before the crisis. However, domestic level factors rendered financial liberalization a much more dangerous proposition.² Thus, most commentators have largely accepted the core of the domestic explanation. In the context of financial liberalization and deregulation, weak prudential regulation and institutions created substantial vulnerabilities in various developing countries. As an IMF review in 2000 stated, 'financial sector vulnerability was at the root of the Asian crisis.' (Boorman et al. 2000: 5). The moral hazard problems associated with a politically and economically important banking sector may be increased by financial liberalization that erodes bank profitability. That is, greater competition may lead banks to take greater risks to sustain levels of profitability previously ensured by government restrictions on competition in the banking sector. Consistent with this argument, studies on banking and currency crises have found previous financial liberalization to be a significant predictor of future crises (Demirgüç-Kunt and Detragiache 1998; Glick and Hutchison 1999).

¹ London School of Economics. Draft 31 January 2002. I wish to thank Benu Schneider, Jonathan Di John, Ngairé Woods, and various seminar participants for helpful comments on an earlier draft. I also wish to thank the Institute of Defence and Strategic Studies, NTU, Singapore, for generously providing me with a visiting fellowship in 2001-2 when was on leave from the London School of Economics.

² One prominent line of argument in the debate over the Asian crisis was that the IMF was mistaken in requiring so-called 'structural' reforms to the Asian countries, and that its conditionality should have concentrated only on its core areas of expertise in monetary and fiscal policy (Feldstein 1998). However, this was less a disagreement concerning the importance of an adequate financial regulatory framework than about the legitimacy and appropriate scope of IMF conditionality.

The proposed solution, touted by the leading developed countries and the IFIs, is also essentially domestic in character: it demands the upgrading of the domestic economic governance framework in key emerging market countries via convergence on international ‘best practice’, as outlined in the various standards and codes. A key objective of government policy, and a core element of the IMF packages, has been to facilitate a move from a ‘relational-patrimonial’ system of financial regulation towards a (western-style) ‘rules-based’ system of prudential regulation and supervision. In the meantime, the process of financial liberalization begun in the 1980s in the crisis countries has been entrenched and accelerated by the IMF programmes of the late 1990s. The conspicuous exception, in the early post-crisis phase, was Malaysia, which reversed its pre-crisis levels of financial openness. More recently, however, even Malaysia appears to be converging upon this broad approach.

I argue that the main problem with this reform strategy is that it underestimates the likelihood of implementation failure in reforming countries. Formal convergence upon standards and codes is the easy part; real implementation failures mean that prudential regulation will dangerously lag the process of financial liberalization. Contrary to the intention of the standards and codes, regulatory forbearance remains chronic in a number of East Asian countries. The result is that policy sequencing remains perverse in most East Asian countries, essentially for political economy reasons. This creates ongoing financial vulnerabilities for these countries. I also argue that despite the desire of the IFIs to promote the implementation of financial governance reforms in East Asia, there are reasons to doubt that they have a strong interest in exposing the degree of implementation failure in the region. This in turn casts doubt upon their role as ‘enforcers’ of standards and codes.

The following section outlines how, until the Asian crisis, both the academic literature on sequencing and policy practice gave little attention to the prudential regulatory preconditions of financial liberalization. A third section discusses the important role of regulatory failures at the level of implementation, which can be a key source of perverse sequencing. It focuses on the specific area of regulatory forbearance relating to bank capital adequacy in Indonesia, Korea and Thailand. A fourth section attempts a rough estimation of real bank capital in Indonesia, Thailand and South Korea, noting how non-transparent is real bank capital even in the best case (Korea). A fifth section outlines how implementation failures occur when politicians may have strong incentives to supply the regulatory forbearance that weak banks and debtors demand. A conclusion discusses the implications for the standards and codes exercise.

2. FINANCIAL LIBERALIZATION: SEQUENCING ARGUMENTS AND THE WASHINGTON CONSENSUS

2.1 The sequencing literature

There is a substantial literature on the appropriate sequencing of capital account liberalization that goes back to McKinnon (1973) and Shaw (1973).³ The broad policy conclusion was that financial sector ‘repression’, common in developing countries, should only be removed gradually, and only in the wake of other policy

³ More recent work in this area includes Diaz-Alejandro (1988), McKinnon (1993) and McKinnon and Pill (1996).

reforms. In particular, fiscal consolidation/tax reform and price stabilization should precede and facilitate domestic financial liberalization (raising real interest rates to encourage savings to flow into the banking sector). Exchange rate reform should precede the liberalization of the current account (trade). External financial liberalization should come last. As McKinnon (1973: 4) warned, ‘the absorption of substantial amounts of foreign capital during the [trade] liberalization process may ... be a serious mistake.’ McKinnon was especially critical of the Latin American strategy of maintaining substantial trade restrictions whilst allowing in foreign direct investment, holding out the opposite Japanese strategy (which included controls on FDI as well as portfolio capital inflows) as a more appropriate model for developing countries.

There were important weaknesses in this literature. First, it said little about why in practice so many countries diverged from optimal sequencing. The assumption was that appropriate sequencing was essentially an intellectual problem to be solved by economists and then applied by governments. Second, the role of prudential regulation of the domestic banking sector was barely mentioned in this early literature. This was an important gap since, as various financial crises would later show, the upgrading of the financial regulatory framework was arguably another essential prerequisite of financial sector liberalization.⁴

Arguments about the optimal sequencing of reforms were partly swept aside by the triumph of the ideology of market liberalism from the late 1980s. Poland’s ‘big bang’ liberalization of 1990, to cite the most prominent example, effectively liberalized everything at once, well in advance of the construction of robust governance institutions appropriate to a market economy. McKinnon’s later (1993) book, firmly in the gradualist camp, argued that this kind of strategy was misguided, and that gradual sequencing, with foreign bank entry and capital account liberalization in particular coming last, was necessary (McKinnon 1993: 4-10). He made some passing remarks about institutional preconditions, such as the need to establish a framework of enforceable commercial law before the financial sector was liberalized (*ibid.*, p.7). In paper 7, he argued that an effective prudential regulation framework is especially crucial in countries experiencing macroeconomic instability.⁵ Although he accepted that effective prudential supervision was necessary even in macroeconomically stable countries, the emphasis on macroeconomic instability as a key source of financial sector misbehaviour was consistent with the dominant view of the time.

This dominant view was embodied in the so-called Washington Consensus on appropriate development policy of the early 1990s. The emphasis was firmly upon the combination of macroeconomic stabilization, trade and financial liberalization, with less attention to appropriate sequencing (Naim 1999). However, there was little attention given to the institutional/governance requirements of financial openness, with the possible exception of the now standard recommendation of central bank independence in monetary policy. Before and after the Asian crisis, the US government was also pushing financial liberalization for its own purposes, though it

⁴ Diaz-Alejandro (1988, originally published 1985) argued that the Chilean crisis of the early 1980s was due to a combination of premature financial liberalization and lax prudential regulation.

⁵ This is because macro instability creates positive covariance of default rates amongst bank borrowers, providing banks that have deposit bases guaranteed by the government an incentive to bet on favourable macro outcomes through overlending (McKinnon 1993: 90).

continued to argue that financial liberalization had welfare benefits for the countries involved (US Treasury 2000). As Lawrence Summers, then America's deputy Treasury Secretary argued in 1997, 'financial liberalization, both domestically and internationally, is a critical part of the US agenda.' The IMF itself, with its limited institutional knowledge of banking sector regulation, was also guilty of myopia.⁶

After the Asian crisis, the emphasis upon institutional and governance reforms, including the upgrading of prudential regulatory frameworks, has of course been much greater. In October 1998, the G-7 countries commissioned Mr Tietmeyer, former President of the German Bundesbank, to recommend various reforms to promote international financial stability. The Tietmeyer report of February 1999 advocated little in the way of reform to the existing international architecture, besides more coordination amongst the key international and national authorities involved in financial sector stability. The main emphasis was upon formulating and disseminating a set of international 'best practice' standards and codes for financial sector governance. The Financial Stability Forum, established in April 1999 by the G-7, was placed in charge of this task. Its various working groups, which have included developing country representatives, in turn placed most emphasis not upon the regulation of international financial flows, but upon reforms to domestic regulatory governance.⁷

Consistent with this approach, the G-7 Finance Ministers, reporting to the heads of government meeting in Cologne in July 1999, strongly prioritized the importance of domestic institutional reform *in emerging market countries*. The promotion of global financial stability, they argued:

... does not require new international organisations. It requires that all countries assume their responsibility for global stability by pursuing sound macroeconomic and sustainable exchange rate policies and establishing strong and resilient financial systems. It requires the adoption and implementation of internationally-agreed standards and rules in these and other areas. It requires the existing institutions to adapt their roles to meet the demands of today's global financial system: in particular to put in place effective mechanisms for devising standards, monitoring their implementation and making public the results; to have the right tools to help countries to manage crises; and to take steps to enhance their effectiveness, accountability and legitimacy. It also requires the right structure of incentives for all participants in the international financial system: national authorities as well as the private sector (G-7 Finance Ministers 1999).

This paper must leave aside the interesting question as to why many of the major emerging market countries have apparently signed up to this agenda. For present purposes, it is important to note that the new emphasis on domestic financial governance reform has not entailed the rejection of the Washington Consensus. On the contrary, the consensus has merely been supplemented. Financial liberalization

⁶ This is the position of an IMF-commissioned independent review of IMF surveillance: see IMF 1999.

⁷ For example, the emphasis of the report of the working group on capital flows is upon on the costs imposed by 'distortions that may arise from national policy measures or international regulations that biasing capital flows towards forms that can generate greater volatility or risk.' (Financial Stability Forum 2000).

continues to be promoted as welfare enhancing, with the additional proviso that an effective prudential regulatory framework is in place. Larry Summers' well-known airline metaphor captures the dominant view nicely, which is that financial liberalization is worth having despite the risks, and that the solution is to build a (domestic) regulatory infrastructure that can support it.⁸

In keeping with this 'enhanced' Washington Consensus, recent literature has explicitly recognized effective prudential regulation as a necessary precursor to financial liberalization (Williamson and Mahar 1998). In this view, the appropriate sequence is now macroeconomic stabilization, enhanced prudential supervision, and only then capital account liberalization. Barry Eichengreen (2000: 184) makes a similar argument:

'problems in these areas [bank regulation, corporate governance, accounting, insolvency codes, etc] are too pressing to do nothing. If the Asian crisis has taught us one thing, it is that countries cannot restore exchange rate and balance of payments stability without rectifying deficiencies in their domestic financial systems...The particulars of these arrangements can differ – countries can reach these goals by different routes – but any country active in international financial markets must meet internationally accepted standards.'

If it is suggested that the costs of regulatory upgrading may be too great, the standard response is that the required reforms are 'necessary' anyway, and that the benefits of having them extend well beyond the financial sector. However, it is very difficult to find serious assessments of the costs of domestic governance reform. Perhaps even more remarkably, there is little evidence linking directly the level of compliance with the various international standards and codes on the one hand and financial efficiency and stability on the other (Jordan and Majnone 2002: 21).

It is worthwhile enumerating just how extensive the 'governance requirements' of the new consensus have become. Mishkin (2001) argues that in order for financial liberalization to work and to make financial crises less likely, various institutional/governance prerequisites are necessary, including: 1) adequate prudential supervision, 2) high accounting and disclosure standards, 3) effective legal and judicial systems, 4) the facilitation of market-based discipline through entry and exit policies, competition policy, etc, 5) reduction of the role of state-owned financial institutions, and 6) elimination of too-big-to-fail in the corporate sector. These are in addition to the standard macro- and micro-economic requirements of the early 1990s. This vast new agenda was clearly reflected in the various structural conditionalities attached to the IMF-led rescue packages for Thailand, Indonesia and Korea (Kapur 2001; Goldstein 2001).

The consensus is summarized in figure 1. In the standard scenario, countries that move from quadrant I to II create moral hazard problems and greater financial fragility in the process. A number of the so-called 'systemically important' emerging market countries went through this process in the 1980s and 1990s. In the past, extensive restrictions on the financial sector, including barriers to entry, legal limits

⁸ A related line of argument is that financial openness combined with trade closure renders economies especially vulnerable to financial crisis (such combinations are most marked in Latin America). Again, the recommended solution is greater trade openness rather than financial closure (IMF 2002: 108).

on the ability of financial firms to offer different financial services, the regulation of interest rates, branching limits, etc, may have served as a form of prudential supervision (quadrant I). By raising bank profits, they may reduce incentives for banks to engage in risky lending (Hellman, Murdoch and Stiglitz 2000). Banks in such regulatory environments typically constitute a kind of protected oligopoly; their centrality to the domestic financial and political system ensures they are too important to fail (Rosenbluth and Schaap 2002). Close relationships between banks and bank regulators are common, and regulation is more relationship-based than rules-based. The moral hazard implications of such protective prudential regimes may require substantial limits on the operating freedom of banks. Once these kinds of restrictions on the operating freedoms of banks are removed, competition intensifies and relationship-based regulation breaks down. Since risk-taking by banks may become excessive, optimal sequencing would require a preceding or simultaneous move towards enhanced regulation via a ‘rules-based’ regulatory framework (quadrant IV).

Figure 1: Combining Prudential Supervision and Financial Liberalization

		Prudential Supervision Standards	
		Low	High
Financial Liberalization	Low	I. ‘Profit-padding’ regulation	III. Excessive protection
	High	II. Moral hazard danger	IV. Competitive regulatory environment

[adapted from Rosenbluth and Schaap 2002: 8].

2.2 Sequencing in practice

Rosenbluth and Schaap (2002: 8) argue that quadrant II is such a dangerous combination that it is rare and unlikely to persist for long. On the contrary, however, it is clear that many countries, developing and developed, have moved blithely from quadrant I to II in recent years, apparently in disregard of the high costs of financial crises (Barro 2001). Perverse sequencing, far from being rare, is arguably the norm and it can persist in particular cases for long periods. Indonesian financial liberalization, which began in the early 1980s, was followed by some (largely ineffective) efforts to raise prudential standards only in the early 1990s. Thailand and to a large extent Korea fit the same pattern. Dramatic improvements to prudential supervisory frameworks typically follow rather than precede crises. Prime examples are the new FDIC Act of 1991 in the US after the S&L crisis and the extensive reform

programme of many East Asian governments in the wake of the regional financial crisis of 1997-8.

Thus, we confront the standard political economy question as to why countries tend to delay upgrading prudential financial supervision and indulge in perverse sequencing. One reason, at least in the years prior to the new consensus, could be imperfect technical knowledge concerning optimal sequencing. However, even before the Asian crisis, there were clear indications that policymakers in various countries perceived the need to improve prudential supervision at the same time as proceeding with financial liberalization. There were attempts in Thailand and Indonesia, for example, to impose new limits on related party lending by banks in the early 1990s. Korea had recently formulated a financial governance reform plan when the crisis struck, and had introduced new financial regulations in the pre-crisis period. Many developing countries adopted the Basle capital adequacy ratios (CARs) in the early and mid-1990s, including all the major East Asian ones.

A second factor is that financial liberalization is simply much easier to implement than is enhanced prudential supervision. The former requires minimal institutional capacity, since it involves removing pre-existing controls. Thus, in countries with weak government, deregulation is the easier option, producing a potentially perverse outcome (quadrant 2, figure 1). The simple matrix of figure 1 does not allow us to make a cost-benefit calculation about the net benefits of shifting from quadrant I to quadrant IV, not least when economists dispute the growth benefits of financial liberalization.⁹ The institutional investment costs of moving to quadrant IV (or quadrant III) may be sufficient to discourage policymakers from attempting to raise prudential standards in the first place, or to undertake financial liberalization first in the hope that stronger prudential rules and enforcement may be achievable in the longer term (particularly if they estimate the risks of this strategy to be limited). There is evidence that this strategy was indeed pursued by technocrats in various countries.¹⁰ However, resource constraints are very unlikely to be the only explanation.

A third reason is that political institutions can allow vested interests to block reform. It is sometimes argued that democratization has hampered the institutional reform process in East Asian countries, notably in Thailand before the crisis, and in Thailand and Indonesia after the crisis. In Thailand and Indonesia, there has been a sharp increase in the number of veto players since 1997-8, who may block reform at key points in the political process (see table 1). The post-crisis constitutional reforms in Thailand have created a system of checks and balances that has substantially weakened the ability of the central government to achieve reform. The result has been a prolonged delay in key legislative reforms, including a proposed new companies act, Bank of Thailand independence, and outstanding weaknesses in the bankruptcy code. Thus, in the Thai case, veto players have so far prevented the wholesale reform of regulatory institutions and law. Consistent with this view, in Singapore and Malaysia, fewer veto players have made reforms politically easier.

A related possibility is that electoral laws may affect the incentives for elected politicians to undertake prudential reform. Rosenbluth and Schaap (2002) discuss how centrifugal and centripetal electoral systems create tendencies for politicians to cater

⁹ For recent discussions, see Klein and Olivei 1999, and Arteta, Eichengreen and Wyplosz 2001.

¹⁰ Confidential author interviews, Thailand, March 2002, and Indonesia, May 2002.

to the preferences of the median voter or to narrow electoral interests respectively. Politicians in centripetal electoral systems tend to resist raising prudential standards because it may undermine the position of banks, who are often substantial contributors to political financing and play important roles in local economies.¹¹ Proportional representation (PR) rules in particular tend to create weak parties, with politicians appealing to organized interests rather than the median voter. PR in Indonesia and Thailand has reduced party discipline and promoted rampant money politics. Consistent with Rosenbluth and Schaap, limited deposit insurance schemes have yet to be introduced in these countries. However, this could simply reflect the post-crisis difficulty of removing the blanket guarantee on banks without precipitating further bank runs.

¹¹ One example is Japan, where local banks they have been heavy lenders to *nokyo*, or private agricultural cooperatives, which are electorally influential (Amyx 2000: 139). The centrifugal-centripetal dimension of electoral laws is not the only possible relevant one. The way in which electoral boundaries are drawn may also affect policy choices, such as that which favours rural constituencies in Japan.

Table 1: Political-Institutional Characteristics, Selected East Asian Countries

	Constraints on Executive: XCONST (Polity IV, 2002, 0-7 range, global mean 3.6)	Electoral system (Beck et al 2001)	Dominant ownership structures (Claessens et al)	Regulator: Statutory Independence
Indonesia	XCONST=6	PR (closed list)	Families, state (banks)	Yes (BI); plans 'FSA'
Thailand	XCONST=7	PR	Families, state (banks)	Not yet (BOT)
Korea	XCONST=6	Mixed	Families, companies, state (banks)	Yes? (FSS/FSC)
Malaysia	XCONST=4	Plurality	Families, state (banks)	No (BNM)
Singapore	XCONST=3	Plurality	Families, state (banks)	No (MAS)

The problem with all the above explanations is that they are less helpful for understanding why formal regulatory upgrading and regulatory forbearance can occur together. In the Indonesian case, for example, formal regulatory upgrading since the crisis has been extensive. Indeed, this is true in all the major East Asian countries with the partial exception of Thailand, where key new legislation has been blocked. In Indonesia, despite the fact that a more powerful parliament since the crisis has also complicated the reform process, key pieces of legislation were forthcoming in 1998-2000. Anyone who reads the various documents relating to financial regulatory reform in Indonesia cannot fail to be impressed at the degree of formal change that has occurred. However, as I argue below, implementation failure is chronic here and elsewhere.

3. IMPLEMENTATION FAILURE: CAPITAL ADEQUACY RULES

Implementation failure rather than the blocking of key reform legislation is the key obstacle to the upgrading of financial sector governance in much of East Asia today. To make a counter-factual argument, even if Thailand had achieved the same degree of formal regulatory reform since 1997 as many of its Asian neighbours, implementation failures would still have minimized its practical effects. In Indonesia, formal reform success has simply meant that opponents have concentrated their efforts on undermining the implementation of the new prudential rules. This outcome might be described as *formal regulatory upgrading with continued regulatory forbearance*. Giving the impression of regulatory upgrading might be beneficial for various groups in emerging market economies, but keeping bad banks and related debtors alive via regulatory forbearance may be the preferred option.

To illustrate this point, I turn below to consider the specific case of the bank capital adequacy framework of 1988 that all major East Asian countries have adopted. Naturally, regulators in the crisis-hit countries strenuously deny that they are engaged in regulatory forbearance. They claim that they strictly implement new rules relating to loan classifications and provisioning for NPLs, and that regulator discretion is

effectively ruled out by new automatic prompt corrective action (PCA) rules.¹² However, the ambiguity of the rules, not least in calculations of bank capital, facilitates forbearance, as does the fact that regulatory interpretations of the rules are often hidden from public view. There is nothing specific in the Basle Core Principles of Effective Bank Supervision (1999), the most important set of standards for financial sector governance, regarding the problem of dealing with undercapitalized banks (Asian Policy Forum 2001: 12). This allows considerable discretion to supervisors in this area: supervisors and banks may reach agreement on appropriate actions and any penalties. This collusion can result in apparent rather than real convergence in capital adequacy ratios (CARs).

3.1 Loan Accounting Rules:

Countries account for NPLs very differently, though there has been some convergence in loan accounting standards in recent years towards the US system.¹³ Loans are typically defined as under-performing when an outright default occurs, and when repayments are classified as ‘overdue’. However, the time period by which such loans are judged overdue can make much difference. In Korea and Japan before the crisis, loans were judged non-performing if repayments were overdue for more than 6 months, compared to the US standard of 90 days. Most countries in the region have, since the crisis, converged upon the 90-day standard.¹⁴

Ambiguity arises in the application of this rule, however. Loans with concessional terms (those that have been restructured via extended maturities or reduced interest rates) may or may not be included in the definition. This can have a big impact in crisis countries. The definition of concessional terms may also be more or less strict. In Indonesia today, both the banks and the regulator (Bank Indonesia, BI) classifies as ‘pass’ many loans that have been restructured. The IMF has forced BI to include a separate line for restructured but passed loans in its monthly reporting requirements for banks, so that in principle one can add these back in to official NPLs. However, the relatively small numbers of restructured loans reported by Indonesian banks (see table 3 below) raises questions as to whether this requirement encourages banks not to report some problem loans as restructured.

In Thailand after the crisis, debt classified as doubtful or loss was reclassified as substandard when a debt restructuring agreement was signed. Debt classified as substandard or special mention remained in that category until 3 months of repayments or 3 installments were fulfilled, after which they are upgraded to the pass (accrual) category. This less conservative standard (compared to the US, which requires 6 months of repayments) was further relaxed on 10 April 2000, allowing the immediate reclassification of restructured loans to accrual status that satisfy certain

¹² Author interviews, various East Asian financial regulators, 2000-2002. Typically, such rules have been closely adapted from the US FDIC model, which were rewritten in 1991 in the wake of the S&L crisis.

¹³ This system classifies loans as pass, special mention (sometimes ‘precautionary’), substandard, doubtful and loss (see Comptroller of the Currency 2001: 36-7).

¹⁴ Only in March 1998 did Japanese authorities adopt rules defining banks’ NPLs similar to those adopted by the US SEC (i.e. defaulted loans, and loans in arrears for more than 90 days, or loans with concessional terms). Indeed, before March 1996, the definition of NPLs in Japan was simply ‘defaulted loans and loans with arrears.’ From 1996-98, the definition was modified to specify NPLs as loans in arrears for more than 180 days, and loans with concessional interest rates below the official deposit rate. See Fukao 2002.

criteria. However, Thai banks, unlike their Indonesian counterparts, are not required to report the total amount of such restructured debt in accrual status. We can see, however, from the high levels of ‘re-entry NPLs’, reported to and by the Bank of Thailand (BoT), that many restructured loans continue to turn bad again (see table 2 below).

Table 2: Thailand: Increase in NPLs by financial institution, 2002 (Baht millions)

(Classified by Financial Institution Group)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
New NPLs									
Private banks	4,082	4,717	6,504	6,076	6,895	7,490	6,213	4,709	5,432
State-owned banks	2,011	3,926	2,606	3,156	1,553	5,037	1,872	1,152	1,486
Foreign banks (full branch)	603	167	765	156	146	5,309	399	190	921
Finance companies	134	115	131	168	430	525	352	344	249
Total	6,830	8,925	10,006	9,556	9,024	18,361	8,836	6,395	8,088
Re-Entry NPLs									
Private banks	13,843	8,138	17,774	14,748	16,686	9,972	14,558	10,361	13,986
State-owned banks	10,168	1,073	4,723	5,976	8,740	5,180	1,608	2,116	8,102
Foreign banks (full branch)	18	7	455	78	229	424	13	49	59
Finance companies	271	204	374	530	888	408	348	492	92
Total	24,300	9,422	23,326	21,332	26,543	15,984	16,527	13,018	22,239
Total increase in NPLs	31,130	18,347	33,332	30,888	35,567	34,345	25,363	19,413	30,327

Source: Bank of Thailand,

http://www.bot.or.th/BOThomepage/databank/Financial_Institutions, accessed 11 December 2002.

In Korea, the adoption of US-style ‘forward-looking criteria’ (FLC) for loan classification since 1999 has possibly provided it with a more strict classification system than those in Southeast Asia. FLC systems rely heavily upon credit rating skills within banks and on the part of ratings agencies. In less developed countries like Thailand and Indonesia, such skills are often lacking, and few firms have credit ratings. Even in Korea, only the largest firms are rated, so that banks must also rely on backward-looking criteria (credit history) in loan classification. Thus, the difference between Korea’s system and those of Indonesia and Thailand may be less in practice than at first appears. Furthermore, in contrast to loan classification systems that rely only upon a borrower’s repayment history, FLC introduces an element of judgement and hence room for regulatory discretion.

3.2 Provisioning Rules:

Banks are typically required to set aside ‘loan loss provisions’ against outstanding loans. The US system requires different percentages of total loans to be set aside as provisions, depending upon the classification of each loan according to the accounting rules. Similarly, the new Thai system requires the following percentages of loan loss provisions for each category of loan: Normal, 1%; Special Mention, 2%; Substandard, 20%; Doubtful, 50%; Loss, 100%. Thus, lax accounting rules will overstate real capital by the total amount that would, under stricter rules, be set aside as additional loan loss provisions.

Furthermore, regulators in Thailand and Indonesia allow banks to deduct from required loan loss provisions the value of collateral (up to 75% of such value in Indonesia, up to 90% in Thailand) attached to each non-performing loan. In doing so, they do not necessarily diverge substantially from international best practice; indeed, there is little evidence of convergent practice regarding the treatment of collateral in the G-10 countries, and most allow collateral to play some role in loan classification or provisioning requirements (Song 2002: 18). Where this is done, it assumes that in the event of default, the bank could collect the assumed value of the collateral. Of course, this may not be the case, depending upon the nature of the collateral, the country's bankruptcy code and judicial system, and how the collateral is valued. In cases like Thailand and Indonesia, where most collateral is in the form of illiquid real estate, and when the foreclosure regime is dysfunctional, a best practice (conservative) approach would be not to allow such netting practices regarding required provisions.¹⁵

In the case of Thailand, the BoT defines the market value of collateral as 'the probable price on the date of the collateral asset valuation or appraisal under normal market conditions with no transaction costs (nor taxes).'¹⁶ The 'normal market conditions' clause, and the poor quality of valuation firms in Thailand, suggests that collateral is often overvalued, and banks therefore comparatively under-provisioned. Indonesia has a slightly more conservative policy relating to collateral. However, there, as in Thailand, the ability of banks to collect attached collateral through the court system in a timely manner is poor, casting doubt upon the value of such collateral to banks. In Korea, as in the US, collateral is taken into account when classifying loans as substandard or below, though it is not explicitly deducted from the provisioning requirement (Comptroller of the Currency 2001: 37; KorAm Bank, *Annual Report 2001*: 41-2; Song 2002). However, the outsider is largely in the dark concerning the manner in which this classification is done.

3.3 Deferred Taxes:

Companies, including banks, are often allowed to carry forward losses as assets that can be offset against taxes in future years. These deferred tax assets often have value for a limited period (say 3 or 5 years), but their value depends on the assumption that the bank will enjoy future taxable profits sufficient to utilize the value of the asset. If not, assets will be overstated and their value may subsequently need to be written down, reducing capital. In Japan, for example, where losses can be carried forward for 5 years, Fukao (2002: 5) argues that the likely unprofitability of Japanese banks going forward makes deferred tax assets another source of overstatement of Japanese bank CARs. In the USA, by contrast, banks can only claim deferred tax assets of the lesser of the amount that is expected to be claimed within one year or 10% of Tier I capital.¹⁷ The much laxer rule in Japan is another source of inflated bank capital as compared to the US.

¹⁵ For precisely these reasons, the Czech National Bank in July 1998 disallowed the previous practice of allowing banks to subtract the value of collateral from the provisioning requirement on loans overdue by more than 360 days (Song 2002: 21).

¹⁶ BoT, 'Regulations for Collateral Valuation and Appraisal,' <http://www.bot.or.th/bothomepage/notification/fsupv/2541/thtm/RCVA.DOC>, accessed April 1, 2002. Italics added.

¹⁷ Comptroller of the Currency 2001: 69. In October 2002, the newly appointed head of the FSA suggested that the US system should be adopted by Japan from 31 March 2004 (IDEAglobal,

3.4 Sources of Capital:

A bank's liabilities such as shareholder equity and subordinated debt make up core capital. However, cross-shareholdings, which are common in a number of Asian (and European) countries, may reduce the real level of capital. If a bank is part of a corporate group, related companies may provide a significant proportion of its equity capital. Supervisors are increasingly attempting to ensure that they supervise financial institutions on a consolidated basis, so as to ensure that capital is not double-counted in this way. However, not all regulators (including those in Thailand and Indonesia) have such authority yet, though they claim to ensure such cross-shareholdings are taken into account in calculating CARs.

Other problems arise over the inclusion of non-equity instruments in bank capital. In Indonesia, IBRA-issued recapitalization bonds form the bulk of Indonesian banks' reported CARs. If such bonds are held on a banks' investment book, as most are, they are valued at par (on the argument they are risk-free). If they are held on the trading book they must be marked-to-market, but this can be difficult because of the illiquidity of secondary bond markets. In Thailand, regulators allowed banks to issue expensive hybrid debt instruments (so-called CAPs and SLIPS) and to include these in Tier I capital, as long as maturities were at least 10 and 5 years respectively.¹⁸ The Bank of Thailand claims these are Basle-compatible, but officials at the BIS are doubtful.¹⁹ This makes the official Tier I CAR in Thailand incomparable to those of other countries. In Japan, Fukao (2002: 5-6) argues that real bank capital is systematically overstated because related life insurance companies hold substantial proportions of banks' subordinated debt (and in turn, the life companies' debt of which is often held by the banks). The Japanese MOF and subsequently FSA have also exercised forbearance regarding required capital for these insurance companies, which are often chronically weak.

3.5 Unrealized Capital Gains and Losses:

Basle rules permit regulators to allow banks to allow up to 45% of unrealized capital gains as Tier II capital; in fact, many developing countries allow up to 100%. This, and how much of unrealized losses banks are required to deduct from capital, can vary. In the case of Thailand, 70% of land and 50% of building revaluation values can be incorporated in Tier II capital. In Indonesia and Korea there is no such provision. Although Japanese authorities tightened loan loss provisioning rules in 1998, they simultaneously loosened the rules relating to unrealized capital gains and losses, and allowed banks to include unrealized gains from real estate assets.

3.6 Weak Auditors:

Regulators are often dependent upon external auditors discovering problems relating to bank loan accounting and provisioning practices. Even when regulators

'Takenaka battles old-guard, surprise from the BOJ?', accessed from www.ideaglobal.com, 30 October 2002).

¹⁸ Such capital must also be fully amortized in the last five years of maturity. Early redemptions are not permitted without BoT permission, which is a problem as the cost of such capital is currently very high, with coupon rates between 15-23%. This makes it likely that BoT permission for redemption will be granted after 5 years, in 2004.

¹⁹ Author interviews, Hong Kong, April 2002, and Thailand, March 2002. In the US, approved subordinated debt instruments are only allowable as Tier II capital: Comptroller of the Currency 2001: 40.

have a permanent on-site supervisory presence in large banks, which is increasingly common, they may not have the capacity to monitor all accounting decisions. Auditors, who can provide another form of supervision, have often been found to be incompetent, or willing to collude with banks, and not just in East Asia. In a number of East Asian developing countries, international accounting firms tended to franchise their name to local auditors without being concerned about staff quality. And of course, even the international accounting firms have sometimes failed to live up to their reputation. Thai and Indonesian officials now complain that auditors have become excessively conservative since the crisis.

4. ESTIMATING REAL BANK CAPITAL IN INDONESIA, KOREA AND THAILAND

For all of the above reasons, bank capital ratios should generally not be compared either across time or across countries. A further consideration reinforces this conclusion. In much of East Asia, where lending is often to related parties, the quality of assets may be low as compared to those of banks in other countries (Asian Policy Forum 2001: 12; Shirai 2001a: 59-60; Rojas-Suarez 2001). In such circumstances, required CARs should arguably be higher than for banks in advanced countries. Indeed, some East Asian countries, including Hong Kong and Singapore, require CARs to be considerably higher than the 8% Basle minimum. However, the Basle Committee has given no guidance as to how much higher these requirements need to be in the case of emerging market countries, presumably in part because of the political sensitivity of the issue.

Some suggest abandoning CARs and other traditional ratios altogether for emerging market countries and recommend greater reliance on alternative market-based indicators. These include banks' interest rate spreads, deposit rates, interbank rates and loan growth (Rojas-Suarez 2001; Shirai 2001a: 60). Others try to recalculate CARs using more conservative accounting. For example, Fukao (2002: 6) estimates that if the Japanese regulatory authorities adopted conservative definitions in the above areas, the real level of capital of Japanese banks would have been less than 1% in September 2001, compared to the official level of 10.7%.²⁰ Many market analysts think even this estimate is optimistic.

At the end of the first quarter of 2002, the average risk-based Basle CAR of the top 25 US banks was 12.41%.²¹ On the face of it, Asian banks have converged towards this level: Thai banks' average CAR was 13.1%, while that for Korean and Indonesian banks was 10.8% and 19.3% respectively. For some Indonesian banks, official CARs are in excess of 30%. There is little doubt, given the above considerations, that this (over-) convergence is more apparent than real. As a first cut towards comparing East Asian developing country CARs with those in the US, I simply focus on pure equity capital, given the evident problems with the definition of capital in the Basle regime. The (unweighted) average for the top 25 US banks' equity capital to total asset ratio was 7.97%. On this measure, officially Asian banks score worse than US banks, but not disastrously so (table 3). Indeed, Indonesian and Thai

²⁰ Source: Japanese Bankers Association, <http://www.zenginkyo.or.jp/en/stat/index.html>, accessed June 12, 2002.

²¹ Data from FDIC, 'The 25 Largest Banking Companies', FDIC Research Staff publication, 1st quarter 2002, available at: <http://www.fdic.gov/bank/analytical/largest/2002may/top251st2002.pdf>.

banks appear better capitalized than Korean banks, which is not in accordance with market opinion.

But there are good reasons to believe that even this picture is misleading, particularly for Indonesian and Thai banks. As noted above, their ability to deduct the value of allowable collateral from provisioning requirements may artificially inflate equity capital. If such collateral is overvalued and/or uncollectable within a reasonable time frame, this will require additional provisions in the future, reducing equity capital. As a worst-case calculation, I assume the value of such collateral is zero. Second, there is a widespread concern that Indonesian and Thai banks have engaged in superficial restructuring of problem loans. If so, restructured loans classified as 'passed' or merely precautionary/special mention should attract a higher provision than the small amounts usually required. Here, I assume these restructured loans should attract a 'substandard' provisioning requirement of 20% (which is not especially conservative), and subtract from equity capital the increased provision that would result from such a reclassification.

A further possibility would be to assign an extra provisioning requirement to all related party loans, but this is difficult to do since data on how much of such loans are already provisioned for is generally unavailable. Indeed, data availability is a real problem generally, calling into question the claims made by regulatory authorities in these countries that their financial sector accounting is now fully transparent. Thai banks are required to provide figures on the value of collateral that may be deducted from provisioning requirements, but they do so infrequently, often only in annual reports. Furthermore, they do not provide data on the (re-)classifications of restructured loans. The opposite situation prevails in Indonesia. As for Korea, the regulatory authority requires banks to apply an apparently more sophisticated procedure for loan classification based on FLC, but in practice the manner of loan classification (and the role that collateral may play in mitigating credit risks) is very non-transparent. We must simply take the word of the authorities that such standards are applied as rigorously in Korea as in the US. A number of bank analysts in Asia dispute this.

Lacking key data for each country makes comparison very difficult. Furthermore, the figures for adjusted equity by individual bank in table 3 may be misleading in particular cases, since much depends upon the conservatism of managements. However, the overall weighted averages should be indicative of the overall levels of capital in each country's banking system. Generally, there is little doubt that real (unweighted) equity to asset ratios amongst banks in these countries are much lower than US banks, and in some cases may be negative. On US criteria it is likely that a number of Thai and Indonesian banks remain at least 'significantly undercapitalized' and in some cases 'critically undercapitalized' (Comptroller of the Currency 2001: 43ff). In the US since 1991, this would trigger a mandatory requirement for a capital restoration plan, which, in the Thai and Indonesian context, would require either bank closure or further injections of state funds into banks.

Table 3: Adjusted Equity to Asset Ratios for Indonesian, Korean and Thai Banks

Country	Bank	Equity: Asset ratio (2002, Q1)	Official CAR	Official NPLs/Loans	Extra provisions required assuming collateral value=0 (at 12/2001)	Restructured: Pass	Restructured: Precautionary/Mention	Restructured: Special provision @20%	Adjusted Equity: Asset ratio
Thailand	BBL	3.6%	11.2%	16.2%	162,439,754,530	unavailable	unavailable	NA	-9.3%
Thailand	BOAyudhya	3.5%		15.4%	unavailable	unavailable	unavailable	NA	
Thailand	TFB	3.7%	12.9%	12.1%	47,393,673,000	unavailable	unavailable	NA	-2.3%
Thailand	DBS-TDB	4.4%	12.4%	5.8%	2,758,009,560	unavailable	unavailable	NA	1.6%
Thailand	TMB	3.7%	12.2%	11.4%	unavailable	unavailable	unavailable	NA	
Thailand	SCommB	8.8%	16.6%	19.0%	66,210,493,000	unavailable	unavailable	NA	-0.3%
Thailand	TB	19.9%		3.4%	unavailable	unavailable	unavailable	NA	
Thailand	KTB	6.4%	15.7%	7.7%	58,179,757,000	unavailable	unavailable	NA	0.9%
Thailand	BT	4.5%		3.1%	unavailable	unavailable	unavailable	NA	
Thailand	SCityB	3.4%		2.6%	unavailable	unavailable	unavailable	NA	
Thailand	W. AVERAGE	5.0%		11.6%					-2.3%
Korea	Cho-Hung Bank	4.5%	10.4%	6.9%	unavailable	unavailable	unavailable	NA	NA
Korea	Woori Bank	3.9%	11.3%	7.6%	unavailable	unavailable	unavailable	NA	NA
Korea	Seoul Bank	2.9%	9.2%	9.6%	unavailable	unavailable	unavailable	NA	NA
Korea	KEB	3.3%	11.0%	7.2%	unavailable	unavailable	unavailable	NA	NA
Korea	Kookmin Bank	5.7%	10.2%	4.2%	unavailable	unavailable	unavailable	NA	NA
Korea	Shinhan Bank	6.4%	12.0%	2.0%	unavailable	unavailable	unavailable	NA	NA
Korea	KorAm Bank	4.0%	11.2%	6.3%	unavailable	unavailable	unavailable	NA	NA
Korea	Hana Bank	4.6%	10.3%	3.4%	unavailable	unavailable	unavailable	NA	NA
Korea	W. AVERAGE	4.8%		5.6%					NA
Indonesia	BCA	10.0%	40.1%	11.3%	unavailable	1640	0	311.6	10.0%
Indonesia	Lippo	12.1%	25.4%	8.6%	unavailable	333926	532156	143269.3	11.5%
Indonesia	Mandiri	4.0%	26.4%	15.4%	unavailable	0	0	0	4.0%
Indonesia	BNI	7.8%	15.6%	28.7%	unavailable	416595	9899115	1564020	6.6%

IndonesiaBRI	4.2%	13.7%	13.7% unavailable	648310	2983585	570716.7	3.5%
IndonesiaBTN	3.2%	13.8%	12.4% unavailable	13275	2427	2886.3	3.2%
IndonesiaDanamon	8.7%	38.8%	3.8% unavailable	47626	271767	49813.99	8.6%
IndonesiaBII	1.7%	14.6%	20.2% unavailable	100360	885730	151927.9	1.3%
IndonesiaNiaga	3.7%	17.5%	15.1% unavailable	0	0	0	3.7%
IndonesiaUniversal	1.6%	2.2%	11.9% unavailable	844439	69102	170808.7	0.3%
IndonesiaPan Indonesia	18.6%	36.9%	10.6% unavailable	918570	447	174595.4	17.6%
IndonesiaBuana Indonesia	9.1%	23.2%	1.3% unavailable	1194	1170	402.36	9.1%
IndonesiaMega	3.9%	11.4%	0.3% unavailable	43	188	36.37	3.9%
IndonesiaW. AVERAGE	6.2%		14.3%				5.9%

For the Thai banks that have provided recent information on their deductible collateral, subtracting it from equity capital reduces the weighted average equity to asset ratio of Thai banks by over 7%. The Bank of Thailand and the Thai banks would no doubt claim this is wholly unreasonable, but in a system where collection of collateral may take years, where valuations are questionable, and when the BoT itself remains under the ultimate control of the Ministry of Finance, outsiders may reasonably suspect that current rules inflate the real equity base of the banking system. Furthermore, if superficial NPL restructuring is still going on in Thailand, accounting for it would further reduce the real equity bases of Thai banks.

Indeed, it may be much worse than the calculations in my table suggest. An example of the vast gap that remains in loan classification standards between Thailand and more developed countries is given by DBS (Singapore) Group's consolidated accounts for 2001. This group has a Thai subsidiary, DBS-Thai Danu Bank. DBS Group is required by the Monetary Authority of Singapore to note in these accounts that Thailand's loan classification standards are much laxer than those in Singapore, and that if Singapore loan classification standards were used instead of Thailand's, Thai Danu Bank's NPLs would be much higher than as reported in Thailand.²² According to Singapore loan classification standards, Thai Danu Bank's NPLs at the end of 2001 were 27.7% of total loans, whereas by Thai classification standards they were merely 5.8%. The resulting translation loss accrued by the parent group more than offsets Thai Danu Bank's 2001 profits. If we were to multiply the official NPLs of other Thai banks by 4.8 times (the amount of 'understatement' of Thai Danu Bank's NPLs), the picture is rather gloomy. The weighted average of official NPLs as a percentage of total loans of Thai banks in early 2002 stood at 11.6%. By this rough estimate, real Thai NPLs (based on Singapore classification standards) could be over 55%. This in turn suggests that the Thai banking system remains massively under-provisioned.²³

Indonesian banks are required to submit monthly information to BI, which then publishes some of the data on the BI website. This does not include information on the value of collateral attached to loans, but it does include data on the reclassification of restructured loans. Perhaps the surprising thing about the latter is that the numbers are so small, though many commentators claim that the practice predominates in Indonesia (it is well to remember that the majority of Indonesian corporations remain effectively bankrupt).²⁴ As noted earlier, Indonesian transparency in this regard may give banks incentives to understate restructured loans. If so, the published figures may underestimate the impact of any loan misclassification on banks' equity to asset ratios. Furthermore, given the extent of the problem of realizing collateral in a dysfunctional legal system, if this were fully accounted for, it is likely that real bank equity to asset ratios would be much lower than those published. Finally, the apparently healthy published bank equity to asset ratios in Indonesia reflect as much the collapse of bank intermediation in the Indonesian economy since the crisis as anything else.

²² DBS Group, *Annual Report 2001*, notes to the consolidated financial statements, p.126.

²³ Another Singapore-owned Thai bank, UOB-Radhanasin Bank, also estimates on its group accounts that Radhanasin Bank's NPLs are 1,996 million baht. This compares with the 407 million baht of NPLs Radhanasin reported to the BOT. The factor of difference is very close to the TDB case at 4.9 times. (UOB Group, *Annual Report 2001*, and UOB-Radhanasin Bank monthly reports to BOT, available at http://www.bot.or.th/bothomepage/databank/financial_institutions/npl_fi/254412/ecb.htm).

²⁴ Various interviews, Jakarta, May 2002.

All this is not to argue that all is well with Korean banks. Some argue that the government has continued to put pressure on banks to lend to important companies in difficulty, such as Hynix semiconductor, and that the regulatory authorities have exercised forbearance on these loans. Hynix loans were often classified until late 2001 as ‘precautionary’, requiring a relatively low 2% provisioning requirement (subsequently, Korean bank creditors were required to write down substantial values of these loans). This and other cases raise concerns as to whether the full extent of problem loans in the Korean banking system has been recognized. In general, the difficulty of assessing whether real bank capital in Korea is as high as the official figures suggest casts doubt on the extent to which the practice of ‘transparency’ significantly reduces uncertainty in financial markets.

5. EXPLAINING IMPLEMENTATION FAILURES

Why do serious implementation failures may occur even when formal reforms are achieved? One explanation focuses on legal frameworks. Most notably, the common law legal frameworks inherited from Britain by Malaysia and Singapore appear to have left these countries with much more effective corporate law (in general, see La Porta et al 1998a, 1998b). Bankruptcy systems in particular are much more effective in the ex-British colonies than in other Asian countries.²⁵ This may counterbalance two other institutional factors which Singapore and Malaysia share with most East Asian countries and which otherwise tend to bode poorly for effective prudential supervision: ownership structures dominated by families and the state, and politically subordinate supervisory institutions (except, in theory, Bank Indonesia since 1998) (see table 1).

A basic problem with the legal origin hypothesis is that it does not specify why countries so ‘burdened’ with civil law frameworks do not simply change them to rebalance the law in favour of creditors. Explaining this may require attention to electoral rules, veto players, vested interests and so on. Taking the case of bankruptcy laws, for example, it was evident in many Asian countries before the crisis that these were dysfunctional, typically being chronically biased in favour of debtors. Although, as in Thailand, reform of the bankruptcy and foreclosure system had been considered in the early 1990s, there was little political support for this. Creditors were not overly concerned because rapid growth and connected lending meant that even poorly managed firms rarely went bankrupt; and long delays in foreclosing on assets could even work to the benefit of creditors in an economy with asset price inflation. Furthermore, debtors had a strong incentive to organize to oppose such reforms, and they sometimes occupied positions of influence or veto power in the Thai (or Indonesian and Korean) political system. Thus, for fundamentally political rather than legal reasons, the legal regime often exhibited a strong degree of inertia.

Another theory that addresses both legislative failure and implementation failure focuses explicitly on distributional factors and sectoral interests. Hamilton-Hart (2000: 110) argues that financial liberalization typically precedes the enhancement of prudential supervision for a simple reason: the benefits of financial liberalization are concentrated (amongst borrowers and some financial sector firms),

²⁵ In Thailand, the backlog in the commercial court runs up to 10 years. In Indonesia, despite the new bankruptcy framework, IBRA (the state-owned bank asset management agency) has yet to win a case in the commercial court. Most commentators agree such outcomes are due to a combination of incompetence and high levels of corruption.

while the costs are diffuse and often delayed. Conversely, the benefits of prudential supervision (preventing crises) are diffuse, while the costs are concentrated. This means that financial sector lobbies have strong incentives to push for financial sector liberalization, but they have little interest in pushing for enhanced prudential supervision, the costs of which may fall mainly upon them. Large borrowers may also oppose stricter prudential regulation if this raises the costs of finance. In countries such as Indonesia, Thailand and Korea, where company groups often used related banks and NBFIs as a source of intra-group financing, the costs of imposing and enforcing new rules limiting related lending and single/group lending limits were particularly costly for powerful lobbies.

This helps explain why prudential regulation was limited, or weakly enforced, in these countries before the crisis and why sequencing was perverse. It also helps to explain why enhancements to prudential supervisory frameworks tend to follow crises, since if the median voter bears much of the cost of perverse sequencing when crises hit, governments may come under general electoral pressure to raise prudential standards. However, what the theory does not tell us is why in some countries financial sector interests are less successful than in others in blocking the implementation of enhanced prudential standards.

One factor could be external pressure. The IMF required Indonesia, Thailand and Korea to make regulatory upgrading a key priority. Furthermore, the IMF's requirements became, in part, a stamp of approval for private capital markets as well. However, in spite of such clear (and similar) external pressure, implementation failures continue in these countries, though probably much less in Korea.

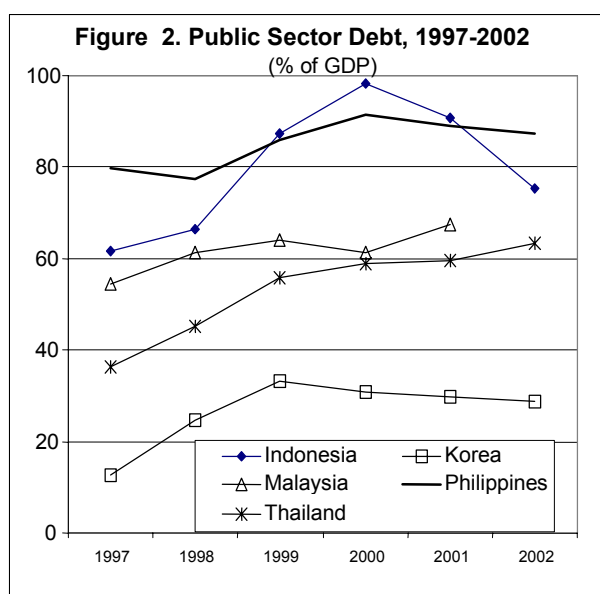
Another factor is corruption. The weaker elements of the financial sector and major debtors have a powerful incentive to demand regulatory forbearance. Although most commentators would mention Thailand and Indonesia in this context, Korea's new Financial Supervisory Service has also had at least one case of bribery.

Severe fiscal constraint may mean that even uncorrupt politicians and officials have an incentive to supply the private sector with the regulatory forbearance they demand (see figure 2 below). When the banking sector is burdened with high NPLs, raising prudential standards (such as CARs) may also raise the short term fiscal (and hence electoral) costs of crisis resolution if this in turn requires the government to recapitalize banks. Thus, after severe financial crises, the costs of raising prudential standards may be high for the financial sector itself, for heavily indebted firms and sectors, as well as for the median voter. This in turn may unleash a political struggle over the distribution of resolution costs. In turn, this political struggle tends to lead governments to delay the realization of such costs, even if this raises the ultimate cost of resolving the financial sector problems. Delay can be achieved by regulatory forbearance, increased debt issuance rather than current taxation, and so on. Since the ability of governments in developing countries to issue debt is usually constrained, this is rarely the whole solution. Were Indonesia and Thailand fully to converge to US regulatory standards, the required recapitalization of the banking system this would require would have major fiscal consequences.

Politicians in Asian countries since 1997 have come under considerable pressure from voters and the IFIs to be seen to raise prudential standards. Furthermore, large debtors and banks have found it much more difficult to oppose such reforms compared with the pre-1997 period. However, there is no easy way out for governments when the banking sector is burdened with high NPLs. Politicians

may try to square the circle by raising formal prudential standards while encouraging the financial supervisory authorities to forbear in terms of their implementation, even if this raises the ultimate fiscal cost of resolving the financial sector problems.

Whether banks themselves favour full recognition of NPLs and government recapitalization, or continued regulatory forbearance, depends on the relative costs of these strategies. When the supply of funds for bank recapitalization is limited, bank owners tend to favour forbearance in the hope that either future government support may be forthcoming or that the cost of new equity will eventually fall so as not to dilute their control.²⁶ This may be part of the problem in Japan. Korea, by contrast, with its more developed capital markets and taxation system, was able to sustain the fiscal cost of bank recapitalizations much more successfully. Furthermore, its more robust economic recovery has enabled it to implement reforms more vigorously than in Thailand and Indonesia. Consistent with this interpretation, the stalling of Korean economic recovery in 2000 did temporarily delay the second stage of reform, in part because of concern that stricter prudential regulation had exacerbated the credit crunch.²⁷



Source: World Bank (2002): 12. Note: Indonesian and Korean figures are for central government; estimates for 2002.

6. CONCLUSION: IMPLICATIONS FOR THE STANDARDS AND CODES EXERCISE

As we have seen, the problem in post-crisis East Asia is that a number of countries, having accepted the task of convergence upon the major standards and codes, have then found it difficult to implement them in practice. It is unlikely that

²⁶ The severity of the conditions attached to bank recapitalizations will also affect bank incentives.

²⁷ Confidential author interview, senior Financial Supervisory Commission official, Seoul, Korea, September 2000.

East Asian countries are alone in this. Thus, the standards and codes exercise risks creating a large ‘forbearance gap’ between formal rules and regulatory practice.

Implementation failures can mean, as suggested by the case of bank CARs, that countries never make it to quadrant IV and may remain stuck in quadrant II (figure 1). Many economists, and the IFIs, might be accused of blithely recommending deep political and bureaucratic reform without adequately understanding the difficulties of achieving successful reforms of this kind. The demand for regulatory convergence places an enormous burden upon the governance capabilities of the state. It requires dramatically enhanced monitoring capabilities (such as in bank supervision) and enforcement capabilities (given that the number of explicit rules has been greatly increased). At the same time, the need for government recapitalizations of banks has led to a great accumulation of financial and non-financial assets in the hands of government agencies. Although this was intended to be temporary, in most cases the sale of state assets has been delayed (due to slower than expected growth, ongoing difficulties in resolving NPLs and corporate restructuring, and weak bankruptcy regimes). The result is that this has created additional opportunities for rent-seeking and political patronage.²⁸

To the extent that continued governance failures are recognized by the IMF, FSF and other agencies, this tends to lead to the conclusion that greater ‘market discipline’ is a necessary supplement to strengthened prudential regulatory standards. In practice, this has bolstered the case for further financial deregulation and (in principle) a government withdrawal from active intervention in the financial markets. Remaining controls on interest rates have typically been removed, and capital controls have been discouraged.²⁹ However, if the argument presented here is correct, the result may simply be a growing gap between financial liberalization and weak prudential regulation. This may matter less in an environment in which banks have been very unwilling to make new loans to corporations, as in Indonesia and Thailand, but this is hardly an adequate basis for long term financial stability.

Therefore, not only does the standards and codes exercise *not* ensure global financial stability, it may even make it worse. It could be argued that ‘transition problems’ are inevitable and that the standards and codes exercise will eventually produce beneficial outcomes. Who, after all, can argue with the desirability of implementing regulatory ‘best practice’? This paper suggests that this view is complacent and does not take account of the political economy factors that are likely to produce a continued forbearance gap in many developing (and developed) countries.

There are a few further implications. If implementation failures are likely to continue to be chronic, the best solution for particular countries may be to remain in quadrant I. That China and Taiwan, which both suffered far less than other Asian

²⁸ For a general discussion of this ‘grabbing hand’ view of prudential regulation, see Barth, Caprio and Levine 2001. They contrast this political economy view of regulation with the standard ‘helping hand’ view of government assumed by most economists.

²⁹ Hellman, Murdoch and Stiglitz (2000) argue that simply introducing new capital requirements (which many emerging market countries made the centerpiece of their regulatory policies in the 1990s in the wake of the Basle I accord) may have the perverse effect of eroding the franchise value of banks, providing them with further incentives to gamble. They argue for the retention of deposit interest rate ceilings in the interim before enhanced prudential regulation is achieved.

countries during the crisis, also maintained capital controls of various kinds, suggests that financial openness for some of the others was premature and counterproductive.

It is also important to note that the IFIs, who have the responsibility to monitor and enforce the implementation of the standards and codes, may have mixed incentives to do so in practice. Is it in the interest of the IMF and World Bank, or their respective executive boards, to argue that Indonesian and Thai banks might still need massive recapitalizations? This could trigger bank runs and require fiscal infusions that the governments are not in a position to make. Notably, the IMF, in the case of Indonesia, continues to gloss over implementation failures in continuing to extend its lending programme to Jakarta. And none of the East Asian countries, with the exception of Hong Kong, have published ROSCs relating to financial sector governance. Finally, nor have private capital markets been any more successful in enforcing convergence. A strong implication of this paper is that domestic political and institutional factors are more important than are external factors in explaining the degree of real convergence in regulatory governance.

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