INTRODUCTION

The Asian economic crisis of 1997–98 was an unfortunate outcome of confluence of “weak” domestic financial systems in Asia and volatile international capital movements brought about by the globalization of financial markets (Dean 1998, Goldstein 1998, Montes 1998, Radelet and Sachs 1998). Given the technological advances in information and communications of the late 20th century, globalization of financial markets was perhaps inevitable although its rapid progress since the 1980s was abetted by a widely accepted notion that free capital movements were better than less-than-free capital movements (Caprio 1998, Eichengreen 1998). As it turns out, this notion—which is based on a simple extension to financial markets of the dictum that free trade in goods increases economic efficiency and thus improves economic welfare—requires many qualifiers to be valid. The Asian economies that suffered dearly from the crisis of 1997–98 were victims of this naive notion about free capital movement. We now know better: If a country is to benefit from free international capital movement it must have, inter alia, a sound and strong financial system that can deter panic capital movement and withstand systemic shocks from such a movement, if it is to occur.

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

Inadequate regulation, banking supervision, accounting standards, financial transparency, legal protection and accountability in corporate governance, combined with pervasive market imperfections, government interventions in business, and the common (and locally rational) practice of relying on political or personal relationships to advance and protect one’s business ventures (“crony capitalism”) all led to a high proportion of “bad loans” and “bad investments.”

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

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

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

There are others such as Hellman, Murdock, and Stiglitz (1997) who do not go as far as Wade and Veneroso or Kumar and Debroy in categorizing Asia’s financial systems as unique, differing from the Anglo-American system. But they nevertheless argue that the standard financial liberalization policy is based on a naive acceptance of neoclassical \textit{laissez-faire} ideas and is, therefore, inappropriate for many developing countries. For them, the right financial regime for the developing countries is “financial restraint”—a system in which the government imposes some restrictions on financial transactions but the rents therefrom are captured by the financial and
Another view of financial liberalization and its possible linkage to the crisis in Asia is that while it was basically a correct policy, it was incorrectly implemented. For instance, according to Camdessus (1998), Managing Director of the International Monetary Fund, what weakened the Asian financial systems was an inappropriate or “disorderly” manner of financial liberalization that did not pay enough attention to the proper phasing and sequencing of capital account liberalization. Masuyama (1999) also argues that financial liberalization in Asia was carried out without due consideration for readiness and sequencing, adding that the policy was often undertaken under foreign pressure, influenced by liberalization ideology and the self-serving motives of foreign financial institutions. Likewise, Radelett and Sachs (1998) argue that financial liberalization in the crisis countries was carried out in a “haphazard and partial” manner, making those economies vulnerable to a rapid reversal of international capital flows.

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

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

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

The second possible reason for the failure of the reforms is that even if the blueprint for reform was a correct one, its implementation might have strayed from its true course because of the pressures of various interest groups. For instance, according to Park (1998), the Western governments pressured the developing countries to open their capital markets for foreign investment although they were aware that the accounting practices and disclosure requirements in the developing countries did not conform to the accepted standards and that the supervisory authorities in those countries did not enforce rules and regulations as tightly as they should.

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

FINANCIAL LIBERALIZATION: FROM DEREGULATION TO INSTITUTIONAL REFORM

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

**Round 1: Deregulation**

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

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

**Round 2: Macroeconomic Stability and Imperfect Financial Markets**

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

McKinnon (1988: 387–88) was one of the first to point out the importance of macroeconomic stability as a condition for successful outcome of financial liberalization. Fry (1988) also focused on the necessity of stable macroeconomic policy but added a sound regulatory framework as a precondition for successful financial liberalization. He was, however, cognizant of the difficulty of creating such a regulatory framework in the developing countries where human capital and knowledgeable auditors or supervisors were in short supply.

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

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

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

Paralleling this progress in the literature on financial liberalization was a new development in the
theoretical literature on financial markets due primarily to the contributions made by Joseph Stiglitz and his co-authors. Starting with the basic premise that financial transactions are more severely constrained by asymmetric and imperfect information and costly contract enforcement than commodity transactions, Stiglitz (1989) argued that financial markets do not operate according to the textbook model of supply and demand. Instead, because of the problems of adverse selection, moral hazard, and contract enforcement—characteristics inherent to transactions in financial markets—credit- and equity-rationing may occur even in competitive financial markets that are free of government intervention. In other words, market failure is an inherent characteristic of financial markets.

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

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

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

**Round 3: Institutional Preconditions**

New insights in the operation of financial markets led to a new round of debate on financial liberalization in the early 1990s with the focus now shifting from government to market failure. The general conclusion from this new round of debate was that the developing countries do not have the institutions necessary for free-market policy and, furthermore, those institutions do not get established quickly and spontaneously. Its implication is clear: the institutions necessary for a
market economy must be purposefully created prior to financial liberalization (Akyüz 1993, Villanueva and Mirakhor 1990, Caprio et al. 1994, Gertler and Rose 1996, Demirguc-Kunt and Detragiache 1998, Drees and Pazarbasioglu 1998, and Sikorski 1996). Such institution building requires government activism. Thus Villanueva and Mirakhor (1990) point to the importance of institutional reform prior to financial liberalization by calling for the development of financial “infrastructure” such as adequate legal and accounting systems, credit appraisal and rating, and adequate channels for the flow of information. Likewise, Gertler and Rose (1996) propose that the government should pay attention to creating an efficient system of contract enforcement and creating a viable borrowing class. Thus they argue that financial liberalization should be coordinated with policies promoting growth and stability of the real sector, which would increase the creditworthiness of borrowers.

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

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

Second, the success of financial reform depends on the initial stock of human capital as bankers
need to have skills in risk assessment and the ability to gather information about new potential
credit, if they are to make correct loan decisions. Third, the success of financial reform depends
on the initial stock of information capital, which in turn depends on the existence of audited
financial statements, developed equity markets, and the level of acquisition of public and client-
specific information. The fourth requirement for successful financial reform is the existence of a
system of rules and procedures for the implementation of decisions within banks. As pointed out
by Caprio (1994: 61), these requirements cannot be implemented overnight as their development requires time and diligence.

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

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

SUMMARY OF THE COUNTRY STUDIES

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

Thailand

Financial liberalization in Thailand began in the early 1990s with the abolishment of interest rate
ceilings and the gradual development of capital and bond markets. Also, as part of their financial
liberalization efforts, Thailand accepted Article VIII of the IMF Agreements in May 1990, thus
relaxing exchange controls and reducing restrictions on capital account transactions.
A consequence of these deregulatory measures was a rapid increase in capital inflows to Thailand. Between 1987–90, a few years preceding the capital account opening, and 1995-96 Thai banks’ share of the country’s net private foreign capital inflows increased from 14.7 to 49 per cent, more than a threefold increase in less than a decade. Foreign borrowing of the nonbank sector also increased from less than two per cent to 22 per cent over the same period. Interestingly enough, the share of foreign direct investment in Thailand decreased from 25 per cent to 8.5 per cent during the same period.

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

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

Bhanupong argues that the opening of the capital account before the establishment of prudential
regulations and the establishment of the BIBFs were a major policy blunder for Thailand.

According to the author, local financial institutions in Thailand had limited capabilities for handling huge capital inflows, and the development of sound financial institutions, markets and policy instruments should have therefore preceded the opening of the capital account.

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

**Indonesia**

Until Indonesia was engulfed in a crisis in 1997, various outward signs indicated a healthy economy with moderate inflation and interest rates and a relatively stable rupiah exchange rate, which are often cited as indicators of sound economic fundamentals. In reality, however, these were largely artificial phenomena created by implicit and explicit government subsidies and massive capital inflows that camouflaged an economy suffering from weak economic fundamentals, large external debts, and a fragile banking system.
The high rate of economic growth in the early 1990s was mostly associated with unproductive investments in “strategic industries” and the nontraded goods sector. Those investments were largely financed by massive capital inflows that occurred in the wake of the banking sector reform in October 1988. The nation’s total external debt as of March 1997 was US$135 billion, which was nearly triple the debt in 1989 and equivalent to 160 per cent of the annual GDP. The private sector owed over 60 per cent of the nation’s debt, 90 per cent of it in short-term debt. Thus by 1997 Indonesia became highly vulnerable to currency crisis and, of course, that is exactly what happened when foreign lenders refused to roll over the country’s huge short-term debt.

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

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

Indonesia is a country with an adequate provision of prudential rules and regulations on the books, as it has adopted since 1991 many rules and regulations recommended by the Committee on Banking Regulation and Supervisory Practices under the auspices of the Bank for International Settlements (BIS). What the country failed to do in a commensurate manner, however, was to strengthen its legal and accounting systems so that prudential regulations and supervision could be effectively enforced. Poor governance rooted in an unaccountable judiciary and a corrupt government bureaucracy also contributed to the ineffective implementation of whatever prudential rules and regulations the country had adopted since 1991.

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

Korea

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

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

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

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

Yoon Je Cho argues that such structural problems should have been tackled before Korea began its financial liberalization. He rightly points out, however, that before the crisis many influential observers in Korea believed that financial liberalization would automatically solve many of the structural problems and would thus suffice in bringing about an efficient financial system.
Korea’s financial crisis of 1997–98 was, in Cho’s own words, a “natural consequence of the financial liberalization that had been carried out in an economy with a highly leveraged corporate sector, poorly developed financial market infrastructure, inadequate corporate governance, and a poor credit culture.” He argues that since reforming the real sector is a difficult, time-consuming process Korea should have undertaken financial liberalization in a gradual manner in pace with reforms in the corporate sector and the regulatory regime. An alternative strategy would have been to accelerate the pace of reform in the real sector to keep up with the reforms undertaken in the financial sector. It is, however, doubtful that this strategy would have been any easier to implement.

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

**Malaysia**

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

Share trading in Malaysia goes as far back as the 1870s, but it was only in 1960, the year of the
Malaysian Stock Exchange establishment, when serious public trading in stocks and shares
began. Since then the stock market has become an important source of corporate finance and has
superseded commercial banks as a source of corporate finance since the early 1990s. Much of the
fund raised in the equity market did not, however, go to new productive investments in the private
sector as more than 50 per cent of it went into the acquisition of existing public sector assets that
were being privatized.

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

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

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

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

The Philippines

The Philippine financial system managed to survive the Asian financial crisis relatively unscathed due to a couple of factors. First, in the preceding three years the central bank of the Philippines implemented various measures to strengthen its prudential framework and regulatory oversight over banks and to align domestic banking standards with international “best practices.” It also made the banks to achieve a high degree of capitalization. Second, compared with its neighbors, the surge in capital inflows to the Philippines came late and in relatively small amounts: in 1996 net foreign investment was only US$3.5 billion and in 1997 it actually fell to US$762 million.

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

In the Philippines, interest rate deregulation began in 1980 when interest rate ceilings on various
categories of savings and time deposits were lifted. Also beginning in 1990, the central bank began to dismantle various measures of control that had been introduced during the economic crisis of 1984–85 as well as other measures that had been put in place over the preceding four decades. But, as noted earlier, these measures of financial liberalization had very little to do with the relative immunity of the Philippine economy from the crisis of 1997–98. Furthermore, as emphasized by Maria Gochoco-Bautista, financial liberalization in the Philippines has failed to bring about a higher rate of economy growth because the limited nature of the reform left intact fundamental structural distortions in the economy.

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

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

A result of the absence of genuine reforms in the economy was periodic balance-of-payments crises, which made the Philippine government and the ruling elite depend on external financing and aid, particularly from the IMF and the World Bank. Although democracy has returned to the Philippines with the demise of the Marcos regime, many of the structural weaknesses of the past still remain because of the government’s inability to carry out reforms in the face of political opposition. The experience of the Philippines shows that simply deregulating interest rates or liberalizing the foreign exchange market and opening the capital account do not necessarily improve market competition nor turn the industries that have long benefited from protected domestic markets into export industries.

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

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

Japan

In November 1997, the Hokkaido Takushoku Bank and Yamaichi Securities Company went
bankrupt, followed by the failure of 30 financial institutions in 1998. Thomas Cargill attributes
the failure of the first two financial institutions to accumulating stresses in the Japanese financial
system resulting from the failure of its regulatory authorities to resolve the problem of
nonperforming loans and a series of policy errors. In other words, Japan’s economic and financial
performance in late 1997 and through 1998 was an event unrelated to the Asian crisis of 1997–98.

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

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

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

What Japan needs to do to pull itself out of economic malaise is, according to the author, to complete its financial liberalization by doing away with the key elements of the pre-liberalization regime that it has retained. Japan has made significant progress in that direction but its future still remains uncertain.
China avoided the Asian financial crisis primarily because its financial system was relatively closed and semi-repressed with its currency inconvertible on the capital account. In addition, China had had an extraordinarily strong balance-of-payments position for years prior to the crisis, its external debt was modest relative to its official holdings of foreign exchange, and its short-term debt accounted for only 13 per cent of the total external debt. Yet China remains, according to Nicholas Lardy, vulnerable to a domestic banking crisis.

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

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

The fiscal burden for restoring the health of the banking system is enormous. Lardy estimates it to amount to 25 per cent of the nation’s GDP. This will be a significant burden on China’s fiscal capability, given that consolidated government revenues in 1998 were only 12.4 per cent of GDP. Worse, the government debt has increased dramatically in recent years with the total sum of its debts reaching 20.5 per cent of GDP. Furthermore, it may not be possible to end the flow of new bad loans unless no new lending is made to unprofitable state-owned enterprises and unless the banks adopt a commercial credit culture.

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

**India**

India is a country that has made numerous attempts to reform the financial system and open the capital account since 1991. It has made, however, little progress on that front, and it is ironically the lack of progress in capital account opening that helped India escape from the Asian crisis with relatively little damage to its economy.
India’s economic policy regime has gone through three distinct phases. The first phase, 1951–84, was the era of planning when the state had strict control over resource allocation. The second phase, 1985–91, was a period of partial deregulation when the state retained a major role in resource allocation even though the private sector was given greater freedom in investment decisions. The third phase is the post-1991 period when resource allocation is primarily market-driven. Since 1991 there were two important reforms in India’s financial sector—deregulation of interest rates and freeing of pricing restrictions on the new issues on the stock market. There has been, however, little change in the restrictions on banks’ use of credit, and all of the major commercial banks are still owned by the government.

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

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

Since the mid-1980s, the Indian government has tried to eliminate various subsidies and expand the tax base or implement tax reforms. But not having had much success in that endeavor the government has resorted to requiring the banks to hold its debts at low interest rates in order to finance fiscal deficits. Such an arrangement would not have been possible if the banks had not been state-owned and had been free to make their own portfolio decisions. Thus recurring fiscal deficits have made the government reluctant to carry out financial liberalization.

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

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

CONCLUDING REMARKS

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

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

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

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

What this observation by Lin and Nugent suggests is that the imported institutions will have to be modified to fit in with indigenous informal institutions while, however difficult it might be, the indigenous institutions will also have to change to some extent to accommodate the transplanted institutions.
If it is the country’s informal institutions that must change to make the transplanted formal institutions work effectively the reform may take years, if not a generation. In fact, this is a conclusion reached by some observers of the Eastern and Central European reform experiences, which were based on the standard reform package prescribed by Western economists (Murrell 1995). For instance, according to Brzeski (1994: 6):

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

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

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

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

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

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

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

Strengthening the domestic financial system by building necessary national institutions is
obviously a lesson that we all have learned from the Asian crisis if a developing country is to benefit from participating in global capital markets. But, what has also been made clear is that strengthening the domestic financial system will not be enough to reduce the likelihood of a future crisis because the price of participating in global capital markets is a greater exposure to financial instability originating abroad. As long as capital can move freely between countries, financial markets know no borders and often make no distinction between a particular country that is suffering severe financial instability and the “similar” countries that are not (Wyplosz 1999). As we now know, international financial markets reacted violently and indiscriminately to the financial crisis in Thailand, turning that into a region-wide crisis in Asia. That was clearly a case of one country’s financial instability having a spillover effect on other countries’ financial health and demonstrates the need for international coordination in maintaining financial stability. In other words, in this world of imperfect information financial stability is an international public good, which by its nature will be under-provided in the absence of international coordination.

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

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

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

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

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

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

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

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

6 This obviously makes it difficult to know whether any particular reform is inappropriate or not until the country is actually afflicted by a crisis. In fact, in our review of the relevant literature published prior to the Asian crisis, we failed to find any mention of inappropriate or disorderly financial reform. Rather, most of the pre-crisis studies give the impression that financial reform in Asia was cautiously and gradually undertaken, and in the right sequence. See, for example, Nam (1997), Chang and Pangestu (1997), and Yusof et al. (1997).
Although there is no clear consensus on the definition of institutions there appear to be, according to Nabli and Nugent (1989: 9), three basic characteristics that are common to most definitions of a social institution. These characteristics are: (1) the rules and constraints nature of institutions, (2) the ability of their rules and constraints to govern the relations among individuals and groups, and (3) their predictability in the sense that the rules and constraints are understood as being applicable in repeated and future situations.

The standard reform package consists of macroeconomic stabilization, the liberalization of domestic trade and prices, current account convertibility, privatization, the creation of a social safety net, and the creation of the legal framework for a market economy.

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

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

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

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