



**A Tale of Two Crises:  
The Political Economy of East Asian Finance  
in the 1990s and 2000s**

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**October 2010**



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## **A Tale of Two Crises: The Political Economy of East Asian Finance in the 1990s and 2000s\***

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The crises of 1997-98 and 2008-09 are watersheds that had a profound impact on East Asian economies and polities, but they did so in different ways that are important to understand. In the 1990s, the financial systems of the region itself played a major role in detonating and propagating the crisis. In the 2000s, by contrast, the principal problems in East Asia came from the outside, mainly via the disruption of world export markets. How do we account for the minor role that East Asian financial institutions played in the current crisis, especially since banks and related institutions were at the center of the economic distress in other parts of the world? This is the main puzzle addressed in this paper.

In offering an explanation for the different characteristics of the two crises in East Asia, the first hypothesis is that financial systems across the region were strengthened considerably in the intervening decade. This process typically involved the capitalization and privatization of banks, the elimination of non-performing loans, the growth of capital markets, and the creation or improvement of regulatory agencies. Regulators, in turn, insisted that banks act cautiously with respect to participation in international markets for new and complex financial instruments — unlike the situation in the industrial countries. Of course an element of luck may have been involved. If the recent crisis had occurred a few years later, more Asian financial institutions might have moved into new instruments. Beyond these similarities, a second hypothesis is that countries differed in terms of the actors and processes that were involved in the policy changes, based on variations in their historical and structural characteristics.

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The paper examines changes in East Asian financial systems since 1990 through a two-part analysis. The first part provides an overview of the region as a whole. It presents macroeconomic and financial indicators over the two decades to analyze changes in the performance of the financial systems in the leading countries of the region. The main focus is on the banking sector, but emerging bond and equity markets are also taken into account. Indicators of interest include: GDP growth rates, inflation rates, current account balances, international reserves, bank capitalization, non-performing loans, credit ratios, and the size of the capital markets. This section tests the first hypothesis mentioned above: that East Asian financial systems are now stronger and more diversified and thus better able to withstand global financial pressures. As a follow-up, we ask whether the current crisis — even if it originated outside the financial sector — may nonetheless have a negative impact on banks and other financial institutions at a later point in time.

The second part of the paper focuses on two countries in the region — Korea and China — to ask how the changes in their financial systems came about. While these two economies are arguably the most successful in the region, they differ in several ways that are important to the paper. Most notably, Korea was a major crisis country in the 1990s, while China was much less affected. Examination of a crisis and a non-crisis country from the earlier period can provide a useful perspective on the causal dynamics of the two crises and policies relating to the financial sector in the intervening period. In terms of mechanisms, the hypothesis is that in the crisis case of Korea, external actors were especially influential in bringing about change, while in a non-crisis case like China, the changes resulted mainly from domestic decisions.<sup>1</sup>

The rest of the paper is organized as follows. Section 2 discusses the literature on financial crises and our hypotheses. Section 3 provides a brief look at the 1997-98 crisis. Section 4 presents the regional analysis of changes between 1998 and 2008. Section 5 consists of the two case studies. Section 6 concludes.

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<sup>1</sup> This paper is a complement to another one that compares East Asia and Latin America (Stallings 2009). Surprising similarities are found across the two regions. As in East Asia, the financial sector in Latin America was cleaned up after serious crises in the 1990s. Likewise, crisis countries (Mexico in the other paper) and non-crisis countries (Brazil) behaved in ways that were surprisingly similar to what happened in Korea and China, respectively.



## Financial Crises in the Literature

The 1997-98 crisis served as a catalyst for the development of an extensive new theoretical literature on financial crises.<sup>2</sup> The analysis of new causes began with the argument that the Asian crisis was not an example of the old macroeconomic syndrome seen throughout the postwar period, whereby a large fiscal deficit and loose monetary policy led to a devaluation that had negative impacts on the economy and thus on banks' loan portfolios. Nor was it the result of microeconomic problems in particular banks, leading to panics that spread to the banking system as a whole and sometimes undermined the currency as a result of rescue policies. Rather, new interpretations had to be sought. Two sets of explanations were initially proposed — one focused on internal imbalances, the other on external relationships. Eventually some degree of convergence emerged around the idea that both domestic and international factors were involved, perhaps in a necessary and sufficient relationship.

The domestically oriented (“fundamentalist”) approach argued that structural and policy distortions in the countries concerned were the main causes of the crisis. An early version of this approach, put forth by the International Monetary Fund (IMF), focused on four alleged problems.<sup>3</sup> First was over-investment relative to domestic savings, which — given the lack of fiscal deficits — was the counterpart of large current account deficits and increasing (short-term) foreign capital inflows. Second were deficiencies in macroeconomic management, mainly pegging exchange rates to the dollar but also ignoring underlying demand pressures. Third were financial sector weaknesses, including inadequate regulation and supervision, poor corporate governance, lack of transparency, and imprudent lending. Fourth was the international environment, but the focus was on declining competitiveness rather than financial flows and contagion. Others added a stress on “moral hazard,” or the expectation that governments would come to the rescue if problems arose (e.g., Corsetti, Pesenti, and Roubini 1998a, 1998b).

The other approach to explaining the crisis agreed that these domestic weaknesses were present, but pointed out that they had existed for a long time while the crisis countries had been highly successful. Understanding the reasons for the crisis was argued to require a focus on new relationships with the international financial markets. In particular, the liberalization of the capital account of the balance of payments in

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<sup>2</sup> With respect to the developing world, it had actually begun with the Mexican crisis of 1994-95 or even the Chilean crisis of 1981-82.

<sup>3</sup> IMF (1997b). Successive issues of the World Economic Outlook, after this first reaction in the early months of the crisis, reflected the increasing convergence of opinions across the initial domestic-international divide.



developing countries had enabled banks and corporations to borrow large amounts of capital from abroad, but these same flows could easily be reversed if a political, economic, or even psychological shock occurred. These outflows, or “sudden stops,” were the main source of the crisis.<sup>4</sup>

One of the problems with both approaches — in addition to the tendency to focus on one explanation or the other, rather than the relationship between them — was the blurring of banking and currency crises. The literature on so-called twin crises addressed this distinction. Kaminsky and Reinhart (1999), together with others who built on their path-breaking work, stressed the need to separate the two types of crisis since they are related, but different. In historical terms, Kaminsky and Reinhart found many currency crises but few banking crises before financial liberalization ended the tightly controlled financial systems in developing countries. In the 1980s and 1990s, by contrast, both were frequent. The general pattern was for banking crises to precede currency crises, being set off by financial liberalization, credit booms, and excess liquidity. Banking crises undermined the currency, leading to devaluations that, in turn, exacerbated the banking problems. As will be seen, twin crises are central to our analysis of Asian crises.

If we focus on the four internal factors discussed above, substantial overlap exists with analyses of the current crisis in the United States. Large current account deficits were typical of the U.S. economy — though due to over-consumption rather than over-investment. Macroeconomic management was deficient in many ways, and lack of competitiveness was becoming more evident. Financial factors also showed great similarity and are generally agreed to have played a central role in fomenting the crisis: 1) low interest rates, easy credit, imprudent lending, and excessive leverage; 2) lack of transparency, complex instruments, and opaque, off-balance sheet activities; and 3) the wave of deregulation that occurred over several decades.<sup>5</sup>

There is also an international component to the explanations for the U.S. crisis, which is most commonly associated with the ideas of Federal Reserve Chairman Ben Bernanke (2005). Ironically, it derives from the aftermath of the Asian crisis itself. As Asian governments and consumers became more cautious after 1997, according to Bernanke, they accumulated large reserve balances and began to export capital to the rest of the world, especially to the United States. This excess liquidity, in the absence of

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<sup>4</sup> See Calvo (1998) for an elaboration of the term sudden stops. Radelet and Sachs (1998) provide another version of this argument, centering their analysis on “the intrinsic instability of international lending,” or what they call self-fulfilling crises.

<sup>5</sup> Although they differ in discourse and emphasis, these factors are common to both orthodox and heterodox explanations for the crisis. See, for example, Bernanke (2009) and Stiglitz (2010), respectively



adequate regulation, fuelled lending and raised the tolerance for risk. Eventually it resulted in asset bubbles, which burst and set off the current crisis.

The crucial point for our argument is that this set of domestic and international factors — which did characterize East Asia in the 1990s — was not typical of the region in the 2000s. Looking in particular at financial policies, East Asian countries had made substantial progress. Lending, especially in the housing market, was quite cautious. Transparency had been improved, and banks had not entered the market for exotic products. Regulation had been strengthened, not loosened. On the external front as seen in the Bernanke analysis, the Asian countries had become lenders rather than borrowers in international markets. It was their “savings glut” that was exported to the industrial world. Thus, given the absence of the causal factors, it should be no surprise that East Asia did not suffer a financial crisis in 2008-09. This is not to say that the region did not have an economic crisis, but it was caused more by trade than financial mechanisms in the first instance.

What, then, led to the important change in policy stance between 1997-98 and 2007-08, which in turn differentiated East Asia from the industrial countries where financial crises did occur? In particular, who were the actors and what were the processes involved? These questions were generally ignored in the economics literature on the two crises, but political economists made important contributions. While several books dealt with the role of actors in the 1997-98 crisis itself (e.g., Pempel 1999; Haggard 2000), we will concentrate on the post-crisis period. External and internal approaches again tended to divide analysts on these questions.

On the one hand, several studies portrayed the IMF — frequently operating in conjunction with the U.S. government — as the main actor in shaping the response to the crisis. This was especially true in the immediate aftermath, as symbolized by the memorable photo of IMF Managing Director Michel Camdessus, standing over Indonesian President Suharto as he signed an agreement with the Fund. Although the IMF was heavily criticized for the macroeconomic conditionality on its rescue packages, probably more important were the structural reforms that the Fund was argued to have imposed. These included capital account opening, greater receptivity to foreign investment, and stricter adherence to “international standards” in the financial sector. Overall the result was said to be loss of economic sovereignty.<sup>6</sup>

On the other hand, domestic actors dominated other studies as exemplified by one on the adoption of financial reforms in Korea and Taiwan after the 1997-98 crisis (Lim

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<sup>6</sup> See, for example, Stiglitz (2002, especially chp. 4). A critical, but more measured, approach to the role of international financial institutions can be found in Dooley and Frankel (2002, chps. 10 and 11).



2009). The author acknowledged that the IMF package was the starting point for reform in the Korean case; this was not true in Taiwan since it did not suffer a crisis like many of its neighbors. Nonetheless, the actual analysis is almost completely focused on the role of the domestic political system — democratization — and the implications for interactions between governments and local business groups. The argument is that democratization differentially empowered bureaucrats and business in the two cases, thus leading to different degrees of reform in the two countries.

A third example provides the balance that seems most sensible in fusing domestic and international approaches. It is an analysis of bank privatization in the post-crisis period in two East Asian and two Latin American countries (Martinez-Diaz 2009). The IMF, the OECD, and the U.S. government are key participants in all four cases, but the relative power and ideology of local governments and businesses are equally important. In three of the four cases, the author argues that external actors reinforced the liberalizing inclinations of local actors, but in Korea he says that the IMF imposed its view.

From these literatures, we arrive at the two hypotheses that were mentioned earlier. First, on the economic side, East Asia did not suffer a financial crisis in 2008-09 because countries of the region had eliminated the causes of crisis as they existed in East Asia itself in the late 1990s and in the United States in the 2000s. These included both internal and external elements. Second, on the political economy side, both foreign and domestic factors were also relevant. Our synthesis suggests that the presence or absence of a crisis determined the relative influence with external actors more important in crisis countries and domestic actors dominant in non-crisis cases.

## **Financial Crisis in the 1990s**

East Asian financial systems were in a state of transition in the 1990s. The region's banks had traditionally had very little autonomy to make loan decisions; rather, governmental authorities provided funds and directed their use to promote particular industries and firms. This meant that regulation and supervision were weak if they existed, central banks were under the control of finance ministries, and banks lacked skills at credit evaluation. By the mid- to late 1980s, however, banking systems in East Asia had already begun to change. This was partly due to structural shifts in their own economies, but it also reflected the fact that a number of East Asian countries had become major players in world markets and the industrial countries complained that their banks provided unfair



advantages. With the partial exception of China, East Asian economies — including their financial systems — became much more open.

Of the liberalizing countries, four became engulfed in dramatic financial crises a decade later. To the external world, the events appeared to erupt suddenly in July 1997, when Thailand was forced to devalue the baht. In reality, the problems began much earlier. As stressed in the preceding section, these included both domestic and international imbalances, where the latter were made possible by financial liberalization. One country's problems turned into a region-wide crisis when contagion spread from Thailand to three of its neighbors during the second half of 1997, but internal weaknesses had already built up in other Asian economies. In addition to Thailand, the crisis countries included Indonesia, Korea, and Malaysia.<sup>7</sup>

The country whose crisis constituted the biggest surprise to outsiders and insiders alike was Korea, which had become a major economic powerhouse especially in terms of its export capacity. Partly as a result of its economic position, Korea was under pressure to liberalize its financial system, and it began to do so in the 1980s. The plan was to carry out the liberalization gradually to avoid the kinds of vulnerabilities that others had encountered. In the early 1990s, however, Korea began negotiations to join the OECD, which led to an acceleration of both internal and external reforms. As is generally acknowledged, the sequencing of the liberalization process was poorly planned, and a significant short-term debt was built up through borrowing by both financial and nonfinancial firms. These processes provided the conditions for contagion to spread from Southeast Asia to what appeared to be one of the strongest economies in the world.<sup>8</sup>

While the four countries in East Asia that are mentioned above suffered twin crises, several in the region either did not have crises or they were of different types. For the purposes in this paper, the most important non-crisis country was China.<sup>9</sup> China's banking sector was dominated by state banks in the 1990s. In addition, the currency was only partially convertible, interest rates were set by the central bank, and state directives affected the operation of all aspects of the financial system. These characteristics meant that China was relatively insulated from the financial crisis that engulfed its neighbors. Nonetheless, growth slowed sharply in 1998-99 and unemployment increased. The government did not reduce the value of the currency to match devaluations in other Asian countries, thus keeping regional conditions from deteriorating further. Rather it

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<sup>7</sup> For overviews of the Asian crisis, see Agénor et al (1999); Masuyama, Vanderbrink, and Chia (1999); Dooley and Frenkel (2002); Lee (2003). Park and Wyplosz (2007) provide a look back a decade after the crisis.

<sup>8</sup> On the Korean financial system, see Hahm (1999, 2007); Cho (2002); Coe and Kim (2002); Ahn and Cha (2004); Kim (2006); Lee and Lee (2009); Park (2009); OECD (2010, chp. 3).

<sup>9</sup> Others included Taiwan and the Philippines.



adopted an expansionary fiscal and monetary policy; the latter operated through the state-owned banks. Reserve requirements and interest rates were lowered, and consumer credit for housing and autos was allowed for the first time. The crisis did, however, convince the government that weaknesses in its financial system were in urgent need of being addressed.<sup>10</sup>

## Changes Following the 1990s Crisis

The period following the 1997-98 crisis brought significant changes in the financial systems of most East Asian countries. These changes were of two main types: strengthening the banking systems and expanding capital markets to provide complementary resources for both the public and private sectors. Countries that had suffered severe financial crises obviously had the most work to do, but those that had “escaped” also saw the need for reform. An important difference between the two groups, as will be discussed in more detail in later parts of the paper, was the driver of reform — external actors (especially the International Monetary Fund) or internal actors (mainly the governments themselves). The drivers, in turn, affected the degree to which reforms were carried out, but all countries moved in the same direction.

### Policy Change: The Banking Sector

Policy changes in the banking sector can be divided into three main categories: cleaning up bank balance sheets, privatizing banks, and improving regulation.<sup>11</sup> With respect to cleaning up balance sheets, two main goals were typically pursued: removal of non-performing loans and recapitalization.

A number of mechanisms were used to deal with non-performing loans (NPLs). One of the most common was the creation of asset management companies (sometimes known as “bad banks”) that would assume control of the NPLs, leaving the banks with clean balance sheets to continue lending (the “good bank” part of the institutions). The asset management companies would then try to dispose of the NPLs, hoping to recoup

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<sup>10</sup> On the Chinese financial system, see Huang, Saich, and Steinfeld (2005); Naughton (2007); Riedel, Jin, and Gao (2007); Yu (2007); Barth, Tatom, and Yago (2009); García-Herrero and Santabárbara (2009); Zhu, Cai, and Avery (2009).

<sup>11</sup> While the following discussion draws on the experiences of developing countries in the 1990s, many of the same policies have been followed or are under discussion in the United States and the EU today.



some of the underlying value as borrowers regained the ability to service their obligations when the crises abated. Asset management companies could be financed by governments or by the private banks themselves. In some cases, banks were required to buy back their bad loans over a given period of time. An incentive to do so was prohibiting them from paying dividends until the loans were repurchased.

A complementary procedure to shore up banks in difficulty was to provide funds to restore their capital-asset ratios to nationally or internationally mandated levels. Internationally, the Basle I agreement required banks to maintain at least an 8 percent risk-weighted capital asset ratio, but many governments — especially in developing countries — thought that a higher level was necessary since their banks were more vulnerable than those in developed countries. Again there were various mechanisms for recapitalization. The most common were to require banks to raise capital on the private markets or for the government itself to provide funds — with or without taking control of the banks in the process.

Related to these mechanisms for cleaning up bank balance sheets was privatization of state-owned banks. In many instances, privatization was an *ex ante* process that actually contributed to banking crises, especially when privatization took place in a highly politicized way. Under those circumstances, new owners often did not know much about running banks and/or were mainly interested in acquiring banks to make quick profits. In some of the crisis cases, governments took full ownership or control of selected banks as part of the clean-up process, and then re-privatized them afterwards. In other cases, privatization took place only *ex post*, after crises, as part of a long-term reform effort under the belief that the private sector — domestic or foreign — was better able to manage banks in ways that enhanced the public good. While this remains a controversial proposition, it gained widespread support during the early 2000s.<sup>12</sup>

Beyond the immediate aim of cleaning up balance sheets and changing bank ownership, most countries affected by banking crises also wanted to make policy changes to prevent crises from recurring in the future or at least to make them less likely and more manageable. Improved regulation and supervision are central to forward-looking reforms. In East Asia, with its tradition of state influence — or direct control — over the financial sector, privatization had to be complemented by institutions that employed prudential regulation. Where such institutions already existed, modifications took place to strengthen their capacity. In general, post-crisis regulation in Asia was quite cautious, and regulators either discouraged or prohibited banks from participating in derivatives

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<sup>12</sup> See, for example, World Bank (2001); La Porta, Lopez-de-Silanes and Shleifer (2002); Galindo and Micco (2003); Barth, Caprio, and Levine (2005).



and complex instruments as offered by the industrial countries (Boorman 2009; Goldstein and Xie 2009).

### **Policy Change: Capital Markets**

Emerging market economies — including East Asia — traditionally had bank-based financial systems, with small, poorly developed capital markets. Bond markets tended to be shallow, heavily dominated by government debt, and with low turnover. Stock markets likewise featured few issues, and their volatility reduced their value for long-term investment purposes. Thus banking systems provided the main source of finance for both public and private borrowers. Recent financial reforms changed the way that banking systems operate, but they also provided stimulus for capital market development.

Stock markets have generally existed for a long time in the larger economies, despite their often weak performance, so the primary concern has been the promotion of bond markets. Several reasons are cited for doing so. First, a bond market is the only way to establish market-based interest rates. Second, in the absence of a bond market, savers will have fewer investment opportunities and thus may save less. Third, firms will face a higher cost of funds without a bond market and may turn toward short-term activities. Fourth, to compensate for the lack of bond markets, firms and governments may borrow abroad and thus take excessive foreign exchange risks. Fifth, the banking sector becomes more significant than it would be otherwise, which makes the economy more vulnerable to crises (Herring and Chatusripitak 2000; BIS 2002; Litan, Pomerleano, and Sundararajan 2003, chp. 2).

In the aftermath of the Asian financial crisis, governments of the region became very interested in establishing or strengthening capital markets (Kim 2001; Yoshitomi and Shirai 2001). The argument was that their absence was one of the causes of the crisis. To diversify the financial sector, a set of policy changes was required. Some of the policies with respect to banking that have already been discussed, and implemented in the countries themselves, had a positive impact on capital markets. Financial liberalization both served as a signal to potential market participants that a government was committed to private sector participation in the economy and opened space for market mechanisms to function. Opening the capital account made foreign participation in the market possible; privatization provided new firms that were eager to obtain funds; and pension and insurance reforms brought new actors on the demand side. In addition, the reforms led to increased macroeconomic stability, which was positive for the development of



capital markets, while the size of government budget deficits was crucial in determining who would have access to the new markets.<sup>13</sup>

Reforms of the economy as a whole were complemented by changes that were specifically oriented to improving capital market functioning. A study by the World Bank identified five such areas: creation of supervisory agencies, establishment of insider trading laws, and improvement of custody arrangements, trading systems, and clearing and settlements processes. More generally, corporate governance was strengthened to protect the rights of investors, including minority shareholders (World Bank 2004).

### Outcomes of Policy Change

To test the first hypotheses of this paper — that the policy changes just outlined led to improvements in the operation and stability of the financial systems — we look at two types of indicators for the period between the crises period of 1997-98 and the onset of the current crisis in 2008. The first is change in the volume of credit provided by banks and capital markets, and the second is strength of the banking sector.

**Table 1. East Asia: Composition of Domestic Financial Sector, 1990-2007 (% GDP)<sup>a</sup>**

Asset type	1990	1995	2003	2007
Bank claims <sup>b</sup>	67	87	103	93
Bonds outstanding <sup>c</sup>	30	31	60	61
Stock market <sup>d</sup>	49	95	90	123
Total	146	213	253	277

Sources: *World Development Indicators online* (for bank loans and stock market); *BIS website* (for bonds).

<sup>a</sup> Unweighted average of China, Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand.

<sup>b</sup> Total claims by deposit money banks.

<sup>c</sup> Total bonds outstanding.

<sup>d</sup> Stock market capitalization.

Table 1 shows the change in bank claims, bonds outstanding, and stock market capitalization as a percentage of GDP in the major countries of East Asia from 1990 to 2007 (the year before the crisis began). There was a substantial increase with respect to each type of asset. Between 1990 and 2007, the East Asian financial sector nearly doubled

<sup>13</sup> For an overview of capital markets in developing countries, see Litan, Pomerleano, and Sundararajan (2003).



in size in comparison with the size of their respective economies. The highest growth was in stock market capitalization, while the smallest was in bank loans. For East Asia economies, unlike those in some other emerging market countries, the vast majority of financial assets went to the private sector, rather than financing government deficits.<sup>14</sup>

**Table 2. East Asia: Indicators of Banking Strength, 1997-2009 (percent)<sup>a</sup>**

Year	NPLs <sup>b</sup>	Provisions <sup>c</sup>	Capital <sup>d</sup>
1997	4.9		12.0
1998	24.6		8.9
1999	21.1		12.7
2000	16.8	31.5	15.0
2001	15.8	37.2	14.3
2002	15.9	38.7	14.3
2003	11.4	65.5	12.9
2004	8.9	70.8	12.6
2005	7.1	76.2	13.6
2006	5.9	88.7	14.2
2007	4.7	103.7	13.9
2008	3.3	115.5	13.9
2009 <sup>e</sup>	3.3	112.9	15.0

Source: IMF, *Global Financial Stability Report*, various issues.

<sup>a</sup> Unweighted average of China, Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand.

<sup>b</sup> Non-performing loans as a share of total loans.

<sup>c</sup> Provisions as a share of non-performing loans.

<sup>d</sup> Regulatory capital as a share of risk-weighted assets.

<sup>e</sup> Latest month available.

While the capital markets grew and provided more finance that could promote economic growth, the banking sector also became stronger in the post-crisis period. Table 2 presents three traditional indicators of banking strength: non-performing loans as a share of total loans outstanding, provisions as a share of NPLs, and the risk-weighted capital asset ratio. As can be seen, NPLs gradually fell and the capital asset ratio gradually increased. These changes, however, were not monotonic. NPLs in East Asia surged from 5 percent in 1997 to 25 percent in 1998 as a consequence of the crisis. Thereafter they

<sup>14</sup> Excluding China (whose data seem to be based on sui generis definitions), 79 percent of East Asian bank loans went to the private sector in 2007, compared to 66 percent for Latin America (World Bank, World Development Indicators online).



descended gradually to reach 3 percent by 2008, when the current crisis started. Provisions rose from a low of only 32 percent of NPLs in 2000 to 116 percent in 2008. Capital ratios fell suddenly during the crisis in 1998, from 12 percent in 1997 to 9 percent the following year, but they quickly recovered and remained in the 13-15 percent range throughout the rest of the period under study.

For comparative purposes, NPLs in the industrial countries have typically ranged from 1 to 3 percent — lower than the East Asian figures — but capital ratios and provisions in the industrial world have also been lower. Within East Asia, it should be noted that there are countries that match or exceed the performance of the industrial countries. In particular, Singapore has had especially strong financial indicators in recent years, as has Korea in the post-crisis period (IMF, Global Financial Stability Report, various issues).

### **Situation in 2008 and Impact of Current Crisis**

As of 2008, the financial systems in East Asia were as stronger than they had ever been. Non-performing loans were at low levels, provisions were high, and capital ratios were well above international standards. GDP growth had been strong, and inflation had come down. Indeed, there was a good deal of talk of the emerging market countries “decoupling” from the industrial economy problems. As we now know, that did not happen and East Asian countries saw sharp economic declines, but they recovered more rapidly than expected at the depth of the crisis — and more rapidly than the industrial countries.

Asian Development Bank (ADB) data show a V-shaped recovery for developing Asia, its broadest grouping that includes 44 countries. After a growth rate of 9.3 percent in 2006-07, regional growth fell to 5.9 percent in 2008-09 but is expected to return to 7.9 percent in 2010. For East Asia — which includes China, Hong Kong, Korea, Mongolia, and Taiwan — the numbers for the respective periods are 9.9, 6.6, and 8.4 percent. Both groups are clearly led by China where growth was 8.7 percent in 2009 and predicted to be 9.6 percent in 2010; the Korean growth rate was substantially lower in 2009, at only 0.2 percent, and a projected 5.2 percent in 2010 (ADB 2010).

Despite this strong performance, we also want to know whether the crisis itself has had a negative impact on the financial sector. That is, even if the crisis in East Asia did not begin as a financial crisis, did the economic crisis — and the policies to deal with it — spill over onto the banks and/or the capital markets? It is obviously too early to answer this question in detail, but three points can be made at this time. First, there have been no



major bank failures — a situation that is very different than in the crises of the 1990s. Second, while non-performing loans and capital ratios have generally deteriorated somewhat, they remain strong in comparison with previous years. Third, many countries put stimulus programs into effect, and in a number of cases the main public-sector banks were important instruments for disbursing money. This means that there could be a significant increase in NPLs in the next few years.

## The Process of Financial Reform

We now move from the regional level to look at two country case studies to investigate the process involved in responding to the 1997-98 crisis. The first country is Korea, which was one of the most badly damaged by the crisis. The other is China, which was only marginally affected. In both cases, we want to know what financial reforms were introduced in the aftermath of the crisis, how they came about, and who the main actors were.

### Korea: A 1990s Financial Crisis Country

South Korea's financial crisis in late 1997 was a great surprise to all. A new OECD member, the country was regarded as one of the most powerful emerging economies. It had had a state-dominated economy in the early postwar years with the banking sector subservient to government economic authorities, but by the 1980s this pattern had begun to change. Although the intention was to liberalize slowly, the pace picked up after the first democratically-elected government in Korea was inaugurated in 1993. As part of the liberalization, controls on short-term capital flows were loosened although longer-term flows were still restricted. Korean conglomerates (chaebol) were the main borrowers together with the banks themselves. Although risks were growing, on the surface the problems were not evident. After the Thai crisis hit the region in mid-1997, however, the holders of Korea's large short-term debt refused to roll it over, and foreign exchange reserves were exhausted in trying to help the banks and support the exchange rate. Floating the won resulted in a large devaluation that brought about a dramatic twin crisis (Cho 2002; Coe and Kim 2002; Ahn and Cha 2004).

With its foreign exchange reserves virtually gone, the government saw no choice but to approach the IMF for assistance. On December 4 the Fund approved a \$21 billion loan,



which was part of an overall package of \$55 billion to be jointly provided with the World Bank, the Asian Development Bank, and G-7 governments. In absolute terms, this was the largest rescue package ever provided, but as a share of the economy it was much smaller than the \$50 billion Mexican package authorized three years earlier. Moreover, the disbursement was to be spread out over more than two years in line with progress on structural reforms and tightening of fiscal and monetary policy (IMF 1997a). Foreign creditors viewed these steps as inadequate, and the crisis worsened. On December 19, the Korean government turned to the United States for help. The U.S. government persuaded the IMF to further frontload its resources and used its influence with international banks to get them to roll over their short-term loans. These moves restored a semblance of investor confidence with respect to Korea, and attention could turn to longer-term measures.

The institutional reforms undertaken by the Korean government were typical of crisis countries across the globe.<sup>15</sup> First, the banking sector itself was rehabilitated. Government funds, amounting to 30 percent of the 2002 GDP, were injected into the banks to deal with NPLs. Five commercial banks were closed, seven were required to submit restructuring plans, and the vast majority of the merchant banks were disbanded. Second, the legal and regulatory apparatus was strengthened. A consolidated Financial Supervisory Commission (FSC) was established and put in charge of several existing supervisory organs.<sup>16</sup> The Korean Asset Management Corporation (KAMCO) was restructured under FSC guidance, and a fund within KAMCO was created to purchase non-performing loans.<sup>17</sup> Third, the FSC strengthened prudential regulatory policy through a forward-looking approach to asset classification, limits on short-term foreign borrowing by banks and on bank lending to large borrowers, and increased disclosure requirements.

Fourth, to reduce moral hazard, a new deposit insurance scheme was introduced, which explicitly limited insurance to 50 million won (around \$40,000 at the current exchange rate) per person per institution. Fifth, the capital account was further liberalized. Restrictions on mergers and acquisitions by foreigners were abolished; foreign investment in the Korean Stock Exchange was fully liberalized; and foreign investment in non-listed firms was permitted. Other measures included liberalization of foreign investment in Korean bonds, money market instruments, and real estate. Sixth, changes were made in corporate governance of the financial sector. Most importantly, foreigners

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<sup>15</sup> These reforms are described in many publications. See, for example, Lim and Hahm (2004); Lee et al (2005); Kim (2006); Lim (2009); Martinez-Diaz (2009).

<sup>16</sup> The FSC is now called the Financial Services Commission.

<sup>17</sup> KAMCO bought over \$63 billion of loans (face value) for a cost of around \$24 billion between the end of 1997 and the end of 2001.



were allowed to own commercial banks and become bank executives. At the same time, rights of minority stockholders were strengthened.

Capital markets in Korea — and especially bond markets — got a boost after the crisis, but they were lower priority than banks. Three main steps were taken to promote capital markets. First, reform measures were implemented to strengthen corporate governance, accounting procedures, and disclosure. Second, new instruments were introduced, such as mutual funds, real estate investment trusts (REITs), asset-backed securities, and derivatives. Third, all restrictions were eliminated on foreign participation. As a consequence, the foreign share of assets on the Korean Stock Exchange more than doubled from 14.6 percent in 1997 to 37.3 percent in 2006 (Hahm 2007). It was not until mid-2007, however, that the legislature approved the main changes for the capital markets through the Capital Markets Consolidation Act. Sometimes billed as a “Big Bang,” like that in London two decades earlier, the Act aimed to integrate the various parts of the capital markets to increase competition and thus efficiency. It also sought to consolidate smaller firms to create globally-competitive investment banks and promote new products. Finally it set out to increase transparency and provide a legal framework for prudential regulation. The new measures were scheduled to go into effect in February 2009, but since that date coincided with the current global crisis, less has been accomplished than was anticipated (Kim 2008; Cho and Jung 2010).

Table 3 shows how the reforms strengthened banking performance indicators. Non-performing loans peaked at 11 percent of total loans in 1999,<sup>18</sup> but declined rapidly in the next five years to around 1 percent. At the same time, the capital-asset ratio increased. Even in the crisis period it still met the BIS requirement of 8 percent, but increased to over 12 percent by the mid-2000s. Provisions for NPLs rose from 84 percent in 2003 (earliest available data) to over 200 percent in 2007.

Another type of performance indicator is the contribution to economic growth. Korean banks provide a large volume of credit to the economy in general and the private sector in particular. Loans outstanding were equal to more than 100 percent of GDP by 2007, up somewhat from before the crisis. Over 98 percent of this credit was going to private borrowers, unlike the situation in many emerging markets where large amounts of credit go to the public sector. Capital markets also grew substantially in the period after the crisis. Stock market capitalization as a share of GDP rose from an average of 35 percent in 1992-96 to 78 percent in 2003-07 (and 107 percent in 2007). Domestic bonds

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<sup>18</sup> Unofficial estimates were much higher. World Bank economists estimated that NPLs, at their peak, represented 30-40 percent of total loans; see Caprio and Klingebiel (2002).



issued by the non-financial corporate sector amounted to 22 percent of GDP in 2007, about the same as before the crisis.<sup>19</sup>

**Table 3. Korea: Indicators of Banking Strength, 1997-2009 (percent)**

Year	NPLs <sup>a</sup>	Provisions <sup>b</sup>	Capital <sup>c</sup>
1997	5.8		
1998	7.6		8.2
1999	11.3		10.8
2000	8.9		10.5
2001	3.3		10.8
2002	2.4		10.5
2003	2.6	84.0	11.1
2004	1.9	104.5	12.1
2005	1.2	131.4	13.0
2006	0.8	175.2	12.8
2007	0.7	205.2	12.3
2008	1.1	146.3	12.3
2009 <sup>d</sup>	1.5	125.2	14.2

Source: IMF, *Global Financial Stability Report*, various issues.

<sup>a</sup> Non-performing loans as share of total loans.

<sup>b</sup> Provisions as a share of non-performing loans.

<sup>c</sup> Bank regulatory capital as a share to risk-weighted assets.

<sup>d</sup> September.

Korea has been moderately affected by the current crisis. As a very open economy that lost capital at a rate surpassing that in 1997, growth contracted sharply (5 percent) in the last quarter of 2008. But the government's rapid and comprehensive response resulted in a small positive growth rate of 0.2 in 2009, projected to rise to 5 percent in 2010 (ADB 2010). At the same time, the IMF (2009) expects the recovery to be protracted because of Korea's dependence on exports and the high leveraging of households and SMEs. Nonetheless Korea's top trade partner is China, which has recovered much more rapidly than expected as we will discuss in the next section. The availability of domestic credit will be an important advantage going forward.

At the structural level, the Korean financial system has become the most "westernized" of the East Asian countries, a surprise since it had been the archetypical

<sup>19</sup> Data on bank loans and stock market capitalization are from the World Bank, World Development Indicators (online); bond data are from the BIS online data base.



government-directed economy in the 1960s and 1970s.<sup>20</sup> As of December 2003, 44 percent of bank assets were held by foreigners, including a mix of foreign commercial banks, investment banks, equity funds, and insurance companies, but no large international banks fully owned any major Korean banks as they did in other emerging market economies (unpublished data provided by the Bank of Korea). Over the next several years, that pattern began to change. Citibank and Standard Chartered each purchased a medium-sized Korean bank, and HSBC considered doing so but the current crisis interfered.<sup>21</sup> Beyond ownership changes, the Korean regulatory system and corporate governance also began to meet international standards.

Who were the main actors behind these changes in Korea's financial system? The Korean crisis was such a shock that it transformed the entire context of decision making. As one former high official put it, "We had been very arrogant and refused to listen to outsiders' advice before the crisis. All of that changed in 1997" (interview). In addition to a new perception of vulnerability, the Korean government also needed money, and it came with conditions.

Analysts differ on the importance of foreign actors in general, on which foreigners were in the lead, and on how much foreign demands diverged from the views of Korean officials. One group argued that the IMF and the U.S. government essentially coerced the Koreans into accepting a package of reforms that were very much against Korean preferences. For example, Martinez-Diaz (2009, 156-57) says, "In the absence of ideological support for banking-sector opening, external pressure became the single most important force pushing the reform through the Korean political system. This pressure was exercised in an environment in which Korea's dependence on external resources was at its peak." Blustein (2001, chps. 5 and 7) and Stiglitz (2002, chp. 4) make similar arguments. There is agreement that the U.S. government was crucial in convincing its own and other G-7 banks to roll over short-term credits to Korea, as well as providing part of the reserve tranche of the rescue package. A question is whether the U.S. government was behind the demand to open Korean financial markets to foreign participation and, if so, whether it was acting on behalf of the private sector; Blustein (2001, chps. 5 and 7) provides some evidence that both were true. The external actors are said to have increased their influence by combining the IMF conditions with Korea's promises to the OECD and the WTO, since the latter had especially robust enforcement powers.

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<sup>20</sup> For a discussion of the surprising convergence of the Korean and Chilean financial markets, see Stallings (2006).

<sup>21</sup> Currently plans are underway to privatize the remainder of the government-owned banks, including Woori, Korea Development Bank, and the Industrial Bank of Korea. It is unclear whether foreign institutions will play a major role.



A more nuanced approach was taken by some Korean analysts. Lim and Hahm (2004) stressed the importance of timing with respect to the election of President Kim Dae-Jung in December 1997 and his willingness to back the IMF reform package. Since Kim was an outsider with strong links to the labor movement, he was able to obtain their support. The chaebol were unable to object, even to the corporate restructuring, because of the dire nature of the crisis and the fact that their public image had been badly damaged by their role in bringing on the crisis. These authors agreed that international actors were an important complement to domestic political factors, providing a list of the main ways in which different international actors had influence (pp. 27-28). International organizations acted mainly through forcing the recognition of bank losses and stimulating institutional reform; foreign creditor banks also fought for recognition of losses (although they tried to avoid paying for their share); and direct investors were most important in reform of business practices. Lee et al (2005) also stressed the importance of Kim Dae-Jung's role. As they put it, "[Kim Dae-Jung] saw American pressures for reform as legitimate advice of a concerned ally and asked labor to sacrifice in the interest of all Koreans. He was better [positioned] than other political leaders to push through IMF conditionalities without precipitating nationalist and progressive political backlashes" (p. 18).

Lim (2009) paid less attention to foreign influence. She emphasized the importance of democratization in Korea and its impact on the relative power of domestic actors. Specifically, democratization limited the power of bureaucrats in the economics ministries, increased the fragmentation in the legislature, created conflict between president and legislature, and increased the power of big business. All of these trends weakened the government in comparison with the situation under military rule, which she says helped to explain the crisis itself. After the crisis, she argues, the Kim Dae-Jung government "[used] pressure from the United States and the IMF's conditionality...to legitimate demands for sacrifice in all sectors of Korea" (p. 94).

In all of these versions, then, external actors are seen to play a significant role in post-crisis reform in Korea, although the particular level of protagonism varies. These range from foreign actors as the dominant force to a subtle interaction with domestic groups to the external actors as scapegoats. However portrayed, the foreign influence resulted from the nature of the crisis and the resultant weakening of ideas and actors in Korea itself.

### **China: A Country that Escaped the 1990s Crisis**

China's experience with reform is the most dramatic among emerging market countries. While many have made a transition from state-dominated economies, where the financial



sector was subservient to government officials, to ones that operate according to market rules and international norms, the change was greatest in China. When China started its market reforms in 1979, its financial system consisted of a single bank — the People’s Bank of China (PBC). The PBC served as deposit bank, lending bank, payment system, and cash agent for the government. There were no capital markets and no insurance companies.

Financial diversification began in the 1980s. The PBC assumed some functions of a typical central bank, while four state-owned commercial banks — the Bank of China, the Agricultural Bank, the Construction Bank, and the Industrial and Commercial Bank — were set up to take over some of its previous activities. These banks were initially used as quasi-fiscal agents to facilitate reform and development of the economy according to central plan priorities. In the mid-1990s, three new “policy banks” — the State Development Bank, the Export-Import Bank of China, and the Agricultural Development Bank — began to provide subsidized credit to the government’s priority projects. As a consequence, the four state-owned commercial banks evolved further in the direction of their western counterparts and are the dominant institutions of the financial sector today. In addition, publicly-listed commercial banks were established, and many non-bank financial institutions appeared, notably the thousands of rural and urban cooperatives (Lardy 1998; Chen, Dietrich, and Fang 2000; Barth, Tatom, and Yago 2009; Zhu, Cai, and Avery 2009).

In China, as in most of Asia, the Asian financial crisis of 1997-98 was a major turning point. China itself did not have a serious crisis. While GDP growth slowed by about three percentage points between 1995-96 and 1998-99, output still expanded by nearly 8 percent in 1998, a year in which most economies in the region contracted. Moreover, China’s external accounts continued to be strong, and the government helped to prop up the economies of its neighbors by avoiding a competitive devaluation of its currency. No banks collapsed or had to be intervened, as happened elsewhere in the region. Nonetheless, the problems of the highly successful Asian economies — and especially those of Korea — were a wake-up call to China. According to a former World Bank resident representative in Beijing, “When the Asian financial crisis hit South Korea in late November 1997, just after that country had become a member of the OECD, China’s leaders were shocked. Suddenly a keen and broadly shared awareness developed of the risks to which China’s own financial system could be exposed” (Bottelier 2009, 55-56).

The pace of financial reform, then, accelerated in the late 1990s and was pushed even further by China’s accession to the WTO at the end of 2001, when the government committed itself to a significant opening of the financial sector (Lardy 2002). With respect to the banking sector, it is possible to identify a number of important steps that have been taken. They are similar in quality, if not in quantity, to those undertaken in Korea.



First, there was an internal restructuring of almost all major state banks; this involved massive layoffs of redundant personnel together with the development and computerization of management information and accounting. It also included a scheme to deal with non-performing loans, which had not been considered a significant problem earlier. In 1999, four asset management corporations (AMCs) were created to absorb some of the NPLs from state banks. The volume of the NPLs was subject to great controversy. A BIS study published in 2002 estimated the total to be 42 percent of total loans, including both those turned over to the AMCs and those still held by the banks themselves (Ma and Fung 2002). Other estimates placed the amount as high as 65 percent (Lardy 2001); the peak official figure was 30 percent in 2001.<sup>22</sup> Thanks to three waves of government money that was poured into the banks to deal with the NPLs, the total fell significantly to 13 percent by 2004 and 2.4 percent in 2008. Second, in addition to relieving the NPL problem, the most important state banks were recapitalized, often beyond the international norm of 8 percent of risk-weighted assets. This was partly the result of capital injections by the government from the budget and the foreign exchange reserves and by increased provisions from the banks themselves from higher operating profits. But it was also the result of the entry of foreign capital into the banking sector, which merits a discussion of its own.

The third change, then, was new regulations on the entry of foreign capital, which came into the banking sector in three main ways. One was the sale of small shares in state banks — not just in the four main state banks, but also in some of the publicly-listed (but still state controlled) institutions. For example, Citibank bought 5 percent of Shanghai Pudong Development Bank; HSBC acquired 8 percent of Bank of Shanghai; and Newbridge Capital purchased a 20 percent share in Shenzhen Development Bank. A second channel involved initial public offerings (IPOs) in Hong Kong for several of the state banks. A third channel was that, in preparation for the IPOs, China sought foreign strategic investors for the banks that were to be listed. The 2004 purchase by HSBC of a 20 percent stake in Bank of Communications, China's fifth largest bank, was the icebreaker. Between mid-2005 and mid-2010, three more obtained strategic investors: Bank of America in China Construction Bank, a consortium led by Royal Bank of Scotland in the Bank of China, and a Goldman Sachs-led group in the Industrial and Commercial Bank of China (Leigh and Popiera, 2006). The Agricultural Bank lagged

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<sup>22</sup> According to Ma and Fung (2002, 2), the AMCs purchased \$169 billion of NPLs (1.4 trillion yuan) in 1999-2000. Apparently, unlike Korea and other countries, the loans were purchased at face value rather than at a significant discount.



behind the others, since its problems were the most serious, but it was listed in summer 2010 in the largest IPO in history.

Fourth, improvements were made in the bank regulatory system. The China Banking Regulatory Commission (CBRC) was established in March 2003. This move separated bank supervisory and regulatory functions from the central bank and allowed the latter to concentrate on developing a new approach to monetary policy. The CBRC has grown into a respected and effective institution. It works with the two other financial sector regulatory agencies — the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Commission (CIRC) — although some coordination problems exist. Regulation has benefitted from cooperation with international financial agencies, including the BIS, of which China became a member in 1996. The Chinese government has been particularly eager to take advantage of training opportunities offered by the BIS as well as those provided by the IMF, World Bank, and Asian Development Bank.

Beyond banking, China has two stock markets, in Shanghai and Shenzhen, where the number of listed companies rose from zero in 1990 to around 1200 in 2002 and 1600 in 2008. Market capitalization at some \$2.8 trillion exceeds that of all Asian exchanges except Japan. A much smaller bond market, predominantly featuring issues of government paper, completes the current design of the main financial institutions (Shirai 2002a and b; Bottelier 2007a and b). Several developments have contributed to the enlargement and strengthening of the stock and bond markets. First, corporate governance and transparency have improved, although there is still much more to do on these fronts. Second, the range of tradable instruments has expanded significantly to include central banks bills of various maturities, short-term corporate bonds, mortgage-backed securities, and RMB-denominated bonds issued by multilateral banks.

Third, progress has been made in creating a market-based solution for non-tradable public shares in companies listed on the stock markets. It involved negotiated compensation for the owners of tradable shares in return for consent to make non-tradable shares tradable. When this arrangement was extended in 2006 to all listed companies that were majority state-owned (well over 90 percent of all listed companies), it led to a bull market over the next two years till the current crisis hit in 2008. Fourth, the responsibility for the issue of corporate bonds was shifted from the National Development and Reform Commission, successor of the National Planning Commission, to the CSRC. This change had the effect of lifting restrictions on who could issue corporate bonds and, coupled with the initiation of short-term corporate bonds, opened the possibility of strengthening this segment of the capital markets.



Table 4 provides data to illustrate the increasing strength of the financial sector. By 2008, NPLs had fallen to 2.4 percent with provisions at 134 percent of NPLs, and the risk-weighted capital asset ratio rose to 12 percent. The size of the financial sector is huge. Bank credit as a share of GDP has typically been well over 100 percent, and stock market capitalization rose rapidly after the reforms in 2006, as discussed above. In 2007 market capitalization was 184 percent of GDP, a bubble that burst the next year as happened in other countries as well. Bond markets are much smaller at 48 percent of GDP in 2007-08. Over half of Chinese bonds are issued by the government; only about 10 percent are issued by corporations.<sup>23</sup>

**Table 4. China: Indicators of Banking Strength, 2000-09 (percent)**

Year	NPLs <sup>a</sup>	Provisions <sup>b</sup>	Capital <sup>c</sup>
2000	22.4	4.7	13.5
2001	29.8	5.2	12.3
2002	25.5	5.3	11.2
2003	20.4	19.7	-5.9
2004	13.2	14.2	-4.7
2005	8.6	24.8	2.5
2006	7.1	34.3	4.9
2007	6.2	39.2	8.4
2008	2.4	116.4	12.0
2009 <sup>d</sup>	1.6	155.0	10.0

Source: IMF, *Global Financial Stability Report, various issues*.

<sup>a</sup> Non-performing loans as share of total loans.

<sup>b</sup> Provisions as a share of non-performing loans.

<sup>c</sup> Bank regulatory capital as a share to risk-weighted assets.

<sup>d</sup> December.

While China did not escape the current crisis, it recovered much more rapidly than other major economies and, indeed, is helping other economies to recover too. Growth fell from 13 percent in 2007 to an average of 9.2 percent in 2008-09 and a projected 9.6 percent in 2010 (ADB 2010). This strong performance was due in large part to China's enormous stimulus package of \$586 billion or 15 percent of GDP spread over two years (Xu 2010). A worry for some experts — and the PBC — is that the large majority of this

<sup>23</sup> Data on bank loans and stock market capitalization are from the World Bank, World Development Indicators (online); bond data are from the BIS online data base.



stimulus was disbursed via bank loans, which increased by more in the first seven months of 2009 than in the two previous years combined. The basis of the concern is that the rapid increase in lending may well result in a renewed NPL burden and weaken the banking sector going forward.

Again we want to ask about the actors and processes behind the financial reforms. While the changes in China were similar to those in Korea, the processes were not. On the one hand, since there was no crisis in China in 1997-98, the IMF and U.S. government were not involved in a rescue and no external conditionality was imposed. On the other hand, the democratization process, which was alleged to be important in Korea, was not directly relevant for China either. The only obvious area of overlap between the two cases involved the role of political leadership.

As we saw, a number of Korean scholars pointed to the central importance of President Kim Dae-Jung in enabling the financial reforms to be implemented in that country after the 1997-98 crisis. Similarly, in the Chinese case, there is substantial agreement about the leading role of Premier Zhu Rongji. Each reached the peak of his power in 1998, just after the crisis, and served for a half decade till 2003. But Zhu was not an outsider like Kim; nor did he have any kind of popular mandate to fall back on. He reached the premiership thanks to the support of Chinese Communist Party (CCP) elder, Deng Xiaoping. On his well-known Southern Tour in 1992, Deng declared Zhu “the only [Chinese politician] who understands economics” (Brahm 2002, xxix) and backed him for high posts in both the party and the state.

In his earlier positions as deputy premier and governor of the PBC, Zhu had already begun to promote macroeconomic reforms. After the crisis, they went forward but financial reforms took center stage. The question of interest here is how Zhu garnered the support to make major reforms both before and after the Asian crisis — especially after Deng passed from the scene in the mid-1990s. The answer depends on how we understand the operation of politics in an authoritarian system and Chinese politics in particular.

As we found with respect to Korea, there is also debate in China on the relative importance of domestic versus international actors in economic policy making. The dominant position views the Chinese state as making its own decisions — for its own reasons. Zweig and Chen (2007, 1) put it this way: “Most academic explanations of China’s reforms, and even its foreign policy, have been based on domestic politics. Elite preferences or intra-elite conflicts, regional interests, or domestic political coalitions have been highlighted by scholars as the driving forces behind policy shifts within the domestic polity and economy.” Within this approach, however, there is still a substantial amount of variation.



Two examples illustrate the differences with respect to financial reforms. Brahm (2002) focuses on political leadership and, in particular, the role of Zhu Rongji to explain the reforms. He portrays Zhu as making decisions based on a fairly well thought out agenda with the goal of strengthening the Chinese nation, using a combination of shifting alliances and sheer force of personality to get his proposals approved by the state and party apparatus. In the process Zhu was said to be creating a new kind of development model that combines state and market. Shih (2008), following a rational choice approach, agrees that Zhu was central but sees him making decisions on the basis of political ambition and political survival rather than promoting any consistent agenda. Indeed there is the implication that Zhu betrayed Deng's vision by shifting to a more conservative policy path to attain the premiership. In general, Shih argues that Chinese economic policy is based on political factions and shifting relationships between generalist and technocratic leaders who draw their followers from provincial and central government cadres, respectively.

An alternative view about Chinese policymaking stresses the role of external actors. Two Chinese scholars make the general argument. Chen (2007) argues that international structures — political-military, economic, and normative — place serious constraints on China's foreign policy choices. This means that an aggressive policy is not possible. Moreover, both he and Su (2007) believe that China's leaders have internalized international norms on the benefits of a market economy.

A specific example of the role of external actors can be seen in the negotiations leading to China's 2001 accession to the WTO, which was relevant for the financial reforms because they "locked in" China's commitment to an open financial system. While Fan (2007) argues that China controlled the process throughout, others say that external forces were dominant. Stiglitz (2002, 62-64), for example, says that the U.S. government used the trade negotiations in much the same way that he claims the IMF/U.S. partnership imposed conditionality on Korea and other countries. In the case of China, he says that a key demand was one by the U.S. Treasury for faster liberalization of China's financial markets.

In summary, the dominant line of analysis sees domestic politics as the most important explanation of the financial and other economic reforms in China. A good deal of variation fits within this approach, ranging from leaders trying to implement an agenda to factions fighting for political survival to institutions creating constraints and producing path dependence in policy making. A small, but growing literature also sees institutions as very important, but they are international institutions rather than domestic ones.



## Conclusions

This paper has analyzed the changes in financial sector behavior in East Asia with a particular focus on Korea and China. The purpose was to explain why the current crisis in the region was not initiated by financial crises as occurred there in the 1990s and happened in the United States and Europe since 2008.

Two hypotheses were presented: (1) the governments in the region responded to previous crises (in their own countries or elsewhere) by substantially strengthening their banks, diversifying their financial sectors in terms of expanded capital markets, and using a cautious regulatory approach; (2) while the policies followed were similar, the processes were different. In one group of countries — represented by Korea, which had suffered a twin crisis in the 1990s — external actors were very important. In another group — represented by China, which did not have a financial crisis but learned from its neighbors — domestic actors were dominant.

The data presented in the first half of the paper amply support the first hypothesis. In terms of the three typical indicators of bank strength — non-performing loans, provisions to cover expected loan losses, and capital to cover more general risks — the region improved to the point where the banks were stronger than they had ever been and compared favorably to those in the industrial countries. Overall, they operated in a cautious way and did not engage in “exotic” investments as did their counterparts in the developed countries. The same was true for the two countries examined in more detail. Capital markets also grew across the region, so that financial sectors were more diversified and risks could be spread more broadly. Beyond stability, the financial sector was making an important contribution to investment and growth in their respective economies, which in turn strengthened the banks.

The two case studies also support the second hypothesis about different processes involved in countries that had twin crises in the 1990s and those that did not. Because of the need for external resources to staunch the hemorrhaging of capital in the face of a foreign exchange crisis, the usual path to obtain those resources involves a loan from the IMF, perhaps supplemented by funds from other multilateral or bilateral sources.<sup>24</sup> The IMF was, indeed, the lead actor in Korea, and the U.S. government was also heavily involved. Both multilateral and bilateral resources were conditioned on changes in macroeconomic variables and in the financial sector. China’s main involvement with the international financial institutions was through their providing training for technicians in its financial sector. The difference in foreign participation was important because it

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<sup>24</sup> Some countries refuse to deal with the IMF as occurred with Malaysia in 1997-98, but such cases are rare.



affected the degree to which new financial policies were adopted. Clearly Korea moved much further toward “international standards” than did China. Examples include a much higher share of foreign ownership in Korea, a freely convertible currency, and less intervention in financial decision-making more generally.

Despite the fact that the paper provides significant support for both hypotheses, it also offers some hints that the processes we have analyzed may be more complex than has been argued so far. With respect to the quantitative analysis of regional financial indicators, two points can be raised. First, in the process of improving these indicators, other problems may have been created that are not obvious from the indicators themselves. For instance, the AMCs — used in both Korea and China to clean up bank balance sheets — may be creating contingent liabilities for their respective governments that will eventually have to be dealt with through fiscal policy. Second, and related to the first point, the stimulus measures used to offset the economic crisis that struck both countries may ultimately have quite negative effects on the banks and capital markets by producing a large volume of new non-performing assets.

With respect to the qualitative analysis of the actors and processes in a crisis and non-crisis country, the argument that external actors dominate the former and domestic actors the latter is certainly oversimplified. While there does seem to be an emphasis in this direction, there are also serious arguments that domestic politics played an important role in Korea and that international actors, norms, and structures were relevant for explaining China’s financial reforms. In reality, it is the interaction between external and internal forces that offers the most powerful and interesting agenda for studying the future of the financial sector in East Asia. ■



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