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POSTCRISIS ASIA: BRIGHT FUTURE AHEAD

CRISIS POSTMORTEM AND YEAR 2000 PROSPECTS

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BY UWE PARPART

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INTRODUCTION

In a speech before the American Society of Newspaper editors in 1998, U.S. Federal Reserve Chairman Alan Greenspan proclaimed:

> The current turmoil in East Asia is easy to categorize as one of many such crises over the decades. Nonetheless, it appears to be an important milestone in what evidently has been a significant and seemingly inexorable trend toward market capitalism and political systems that stress the rule of law

Greenspan may have spoken out a bit early. At the time of his April 1998 speech, and after a false start for some regional stock markets in the first quarter, the worst of the Asian economic downturn still lay ahead. But now, a year later, it is becoming evident that — not for the first time — an early call by the Fed chairman will prove correct.

Unlike the Latin American debt crisis of 1982 and the 1994–95 Mexican currency debacle, which changed little in Latin America or in global finance, the Asian crisis of 1997–98 and the dramatic collapse of at least four former "miracle" national economies have, in less than two years' time, brought to the region political, economic and social changes one might otherwise not expect in a decade. And they are precisely of the nature Greenspan says: freer markets, strengthened rule of law, and the potential for a much-enhanced democratization of capital.

Crisis-driven reforms, moreover, have not remained confined to the countries most immediately affected. China is instituting far-reaching constitutional reform, including recognition of the right to private property and supremacy of the rule of law, and is speeding up reform of its chaotic financial and moribund state-enterprise systems. Even Japan has at long last realized the need for in-depth supply-side reforms, including significant tax relief for corporations and individuals, last year completely liberalized its foreign exchange market; and is proceeding apace with the Tokyo “Big Bang” program to create capital markets to compete with and have similar regulatory regimes to those of New York and London.

Worldwide, as the Asian crisis proved contagious beyond anyone’s early expectations or fears, we now see renewed emphasis on transparency, due diligence and risk management standards, adequate loan-loss provisions, and political accountability.

The Asian crisis has been analyzed and reanalyzed. No single explanation of how economic miracle could turn into unprecedented debacle in the course of a few short months has been generally accepted. In what must be a historical first, even the International Monetary Fund (IMF), in a voluminous January 1999 report, has owned up to mistaken judgments and policy prescriptions. This study, while adding a few points to and suggesting some changes of emphasis in the ongoing debate over reasons and causes, concentrates on the *future* of the Asian economies and capital markets.

ASIA 2000: A SNAPSHOT OF THE FUTURE

East Asians (India is a somewhat different matter) are pragmatic and pay little attention to theoretical or ideological fine points. Just as important, throughout their modern history — from the Japanese Meiji reformers to Deng Xiaoping and his post-1978 market policies to the risk-taking entrepreneurs who seized the opportunities for rapid growth offered by large capital inflows after the 1985 Plaza Accords — they have proved fast learners. Such pragmatism and the ability to respond quickly to past mistakes have transformed the Asian crisis economies to an extent often overlooked in the continuing abundance of bad news. No great help either is the current propensity of emerging-market analysts to make bearish forecasts worldwide: A bearish call proved wrong is soon forgotten; a bullish one gone awry makes you the fool to blame.

But, as I shall show in detail (and barring disasters in Japan and China I regard as improbable), by the year 2000 East Asia can become a more investor-friendly region than it was as little as two years ago.

On the macroeconomic side, we can expect the following picture:

- Resumption of moderate gross domestic product (GDP) growth in the 0 – 3 percent range, with Korea on the high side of that
- Gradual resumption of export growth, again with Korea in the lead
- Continuing high current account surpluses in the range of 5 percent to 8 percent of GDP

- Record levels of foreign direct investment, spurred by continuing opportunities for acquisition of distressed assets in the corporate (including banking) and property sectors
- Foreign reserves rebuilt to pre-crisis levels
- Stable currencies valued at 30 – 40 percent discounts to pre-crisis levels
- Low interest rates (by regional standards) not seen since the late 1980s
- Subdued inflation rates at or below 5 percent

Tables 1 and **2** present detailed forecasts by country.

If this sounds too good to be true, consider the large-scale debt write-offs, workouts, and corporate restructuring now under way and the equally significant legal and regulatory changes introduced since 1997 or now being promulgated. Consider as well the key political and constitutional changes from Korea to Thailand and (prospectively) Indonesia that have created or will create the preconditions for stable and popularly supported governments willing and capable to sustain implementation of in-depth reform. (Only Malaysia, which has temporarily shut itself off from the region-wide reform drive and jailed the deputy prime minister and finance minister who had called for it, Anwar Ibrahim, is a possible exception.)

As a result, East Asia is emerging from two years of crisis and massive destruction of capital with recapitalized financial institutions that conform to international reporting and capital adequacy standards; improved corporate governance and shareholder rights; more equitable property rights and conditions of doing business for foreigners; and more open, more versatile, and better regulated capital markets.

Table 1. Economic Country Forecasts

Country	GDP Growth (%)		Export Growth (%)		Current Account (%)		Foreign Direct Investment ($ Billions)		Inflation (%)	
	1998	1999	1998	1999[3]	1998	1999	1998	1999	1998	1999
Japan[1]	-2.8	1.0	..	..	3.4	3.30	..	..	0.5	-0.4
China	7.8	6.6	1.8	..	2.4	1.80	46.0	50.0	-0.8	2
Taiwan	5.0	3.9	-8.8	..	2.0	2.20	..	..	1.7	1.6
Hong Kong	-5.0	-1.0	..	0.2	..	1.20	..	..	2.9	-0.5
Indonesia	-15.3	-3.4	-5.0	5.8	3.0	2.00	..	..	61.1	21.8
Malaysia	-7.5	-2.0	-5.8	1.0	11.0	9.20	..	..	5.2	5.8
Philippines	0.2	2.5	17.9	14.0	1.2	0.60	..	..	9.8	8.8
Thailand	-8.0	1.0	-6.6	2.0	11.4	8.40	7.6	10.0	8.1	2.5
Korea[2]	-7.0	-1.0	-1.7	8.32	13.2	8.70	8.9	12.0	7.4	2.9
Singapore[3]	0.7	-0.8	..	1.1	19.2	18.40	..	..	0.0	2.9

Notes.
[1] EIU forecast
[2] Government of Korea, Q1 1999
[3] Courtesy of Merrill Lynch
[4] F = Forecast. For GDP, 1990 figures are year-on-year percentages.

Sources: IMF, World Economic Outlook, Dec. 1998; Merrill Lynch, Asia Stats, 31 Aug 1998; Economist Intelligence Unit Country Reports: Hong Kong, 4th Quarter 1998; IMF, IFS February 1999; ING Barings; Warburg Dillon Read

Table 2 Financial Forecasts by Country

Country	Foreign Reserves (US$Millions)			Exchange Rate			Interest Rate *(Lending Rate)*		Interest Rate Forecast (3-mo. implied forward rate)
	1997	**1998**	**1999**	**1997**	**1998**	**1999**	**1997**	**1998**	**1999**
Japan	219,648	21,5741	..	130	117	126.5	2.45	2.28	..
China	142,762	148,637[1]	..	8.3	8.28	8.70	13.20	16.39	..
Taiwan	83,502	92,616[2]	..	32.5	32.25	32.10	..	7.704[7]	..
Hong Kong	92,800	88,650[3]	..	7.8	7.74	7.77	9.50	9.00	5.53
Indonesia	16,587	22,713	17,700	5,00	7,600	8,00	21.82	35.68	34.38
Malaysia	20,788	22,979[4]	21,900	3.9	3.80	3.80	9.53	8.04	5.20
Philippines	7,266	9,004'[5]	11,500	40.0	39.1	42.2	16.28	14.60	14.00
Thailand	26,179	28,825	28,000	46.5	36.0	38.3	14.42	11.50	4.80
Korea	20,368	51,974.5	60,000	1630	1204	1290	11.90	14.20	..
Singapore	71,289	75,910[6]	81,000	1.7	1.65	1.63	6.32	6.33	1.20

Notes

[1]November 1998
[2]February 1999, Central Bank of China
[3]October 1998
[4]November 1998
[5]September 1998
[6]October 1998
[7]Prime rate, Central Bank of China

Sources: IMF, World Economic Outlook, Dec. 1998; Merrill Lynch, Asia Stats, 31 Aug 1998; Economist Intelligence Unit Country Reports: Hong Kong, 4th Quarter 1998; IMF, IFS February 1999; ING Barings; Central Bank of China

This decidedly more investor-friendly Asia of the year 2000 will sustain its recovery and reconstruction in subsequent years less subject to the hazards and sudden reversals of the 1986–96 boom decade. That the crisis has also gone far toward potentially breaking the oligarchic stranglehold of a few dozen families over a pre-crisis one-third (Korea, Hong Kong) to one-half (Indonesia, Philippines, Thailand) of the corporate sector, with a much wider dispersion of ownership (including foreign) as the outcome, further improves political and economic development prospects.

There are, however, some cautions:

Financial markets and banking system reform and bank recapitalization notwithstanding, question marks remain regarding Japanese recovery; financial-system reform in China is just now starting in earnest and a financial blowout there cannot be ruled out and would produce a serious regional setback. As trade and investment relations between those two economies and the rest of East Asia have since the early 1990s dominated such relations with the rest of the world, developments in the region's two largest economies must be factored in. Further, not a few analysts have cautioned about an economic slowdown in the United States, the region's single most important trading partner and absorber of exports. I am optimistic with regard to all three areas of concern.

The Japanese economy, which has stumbled along from fiscal stimulus to fiscal stimulus without lasting positive impact, will produce no spectacular early comeback; but economic measures now instituted — most notably further monetary easing (including the prospect of partial debt monetization) endorsed by a

February 20 meeting of G-7 finance ministers and central bank governors — will allow for modest recovery. In China, constitutional reform will give Premier Zhu Rongji a freer hand to proceed with his reform agenda. There is no upside for China in currency devaluation. Lastly, latest economic results in the United States point, if anything, toward accelerated economic expansion. The U.S. economy, powered by continuing rapid technological innovation, is on so sustained an economic growth path that even some expected financial market corrections will not seriously threaten.

The Chinese Year of the Rabbit, 1999, will be seen by future historians as Year One of renewed East Asian economic expansion and, by investors who failed to get back into Asia, as the year they missed an opportunity that will not soon recur.

A WORD ON A TERM

The term “Asian crisis” is widely used and apparently readily understood. It is nonetheless, at least in part, a misnomer and potentially misleading.

For the first time in recent memory, developing Asia — at 2.6 percent — grew only marginally faster (by 0.4 percent) in 1998 than the world economy as a whole (2.2 percent) or the G-7 major industrialized nations (2.2 percent). In 1997, the growth differentials had still been 2.4 percent and 3.6 percent, respectively; in 1996, 3.9 percent and 5.2 percent. By historical Asian standards, that’s a crisis.

Those figures, of course, include the economies of mainland China, Taiwan, and India whose 1998 growth rates were curtailed by just 1 percent each compared to 1997 (and about 2 percent each compared to 1996) and compensated for the massive 1998 contractions in Korea and Southeast Asia.

But therein lies the point to be made: The term “Asian crisis” averages over an array of economies of vastly different sizes, fortunes, structures, modes of organization, and levels of development. Both in real terms and for purposes of this study, segmenting the continent’s major economies into four different groups makes the most sense. These are:

(1) Japan

(2) China and Taiwan

(3) ASEAN-4 (Indonesia, Malaysia, Philippines, Thailand) and Korea

(4) India

This leaves out the Hong Kong Special Administrative Region (SAR) and Singapore, city economies best viewed and analyzed as service center adjuncts to regions (2) and (3). Korea is grouped with the ASEAN-4 for exhibiting similar structural problems as evidenced in the 1998 collapse.

With the term “Asian crisis” thus qualified, in assessing the impact of the crisis on capital markets and their prospects this study will focus principally on the economies of group (3). (See **Table 3**.)

CREATIVE DESTRUCTION

Since July 1997 — by any standards one cares to apply — an enormous destruction of capital (real and implied) has been visited upon East Asia. By conservative estimates (figures do not include Japan):, some $500 billion of equity market capitalization has been lost in the past 27 months; there was an additional nearly $500 billion of lost expected gross domestic product growth; and an as yet largely unrestructured and unallocated $400 billion in bad debt continues to weigh down banks' and corporations' balance sheets. Judging by the results of distressed-asset auctions in Thailand and Korea and bad debt purchases by foreign institutions, only between 10 percent and (at the very most and in rare cases) 35 percent of that will be recovered. To put that total $1.3 trillion wipeout in perspective, it equals around 15 percent of the U.S. GDP. That's the bad news.

On the positive side, by some point in 2000 — differing from country to country and industry to industry — there will be cleaner slates, leaner enterprises, and healthier corporate and bank balance sheets than the region has seen in two decades and comparing favorably to most any other region of the world economy.

The Debt and Asset Bubbles

The debt and asset-price bubbles in Thailand, Indonesia, Malaysia, and Korea had built up from the mid-80s through 1997. Why they collapsed at the precise time they did and at the rate, to the extent, and with the unanticipated contagion effects seen in 1997 and 1998 will continue to be debated. How and why the buildup happened and that it was unsustainable is rather less of an issue and readily

Table 3. Real GDP: Comparative Sizes and Growth Rates

Country	1997 US$ Millions	1998 GDP Growth (%)
Japan	4,003.5	-2.8
China	464.3	7.8
Taiwan	242.5	5.0
Hong Kong	107.5	-5.0
Indonesia	115.6	-15.3
Malaysia	73.0	-7.5
Philippines	45.3	0.2
Thailand	110.3	-8.0
Korea	305.8	-7.0
Singapore	79.8	0.7

Sources: IFS; Economist Intelligence Unit, 4th Quarter 1998 documented. Indeed, since a similar scenario was played out in Japan between 1985 and 1991, caution flags should have gone up a lot earlier than they did (see **Figures 1A–1C**).

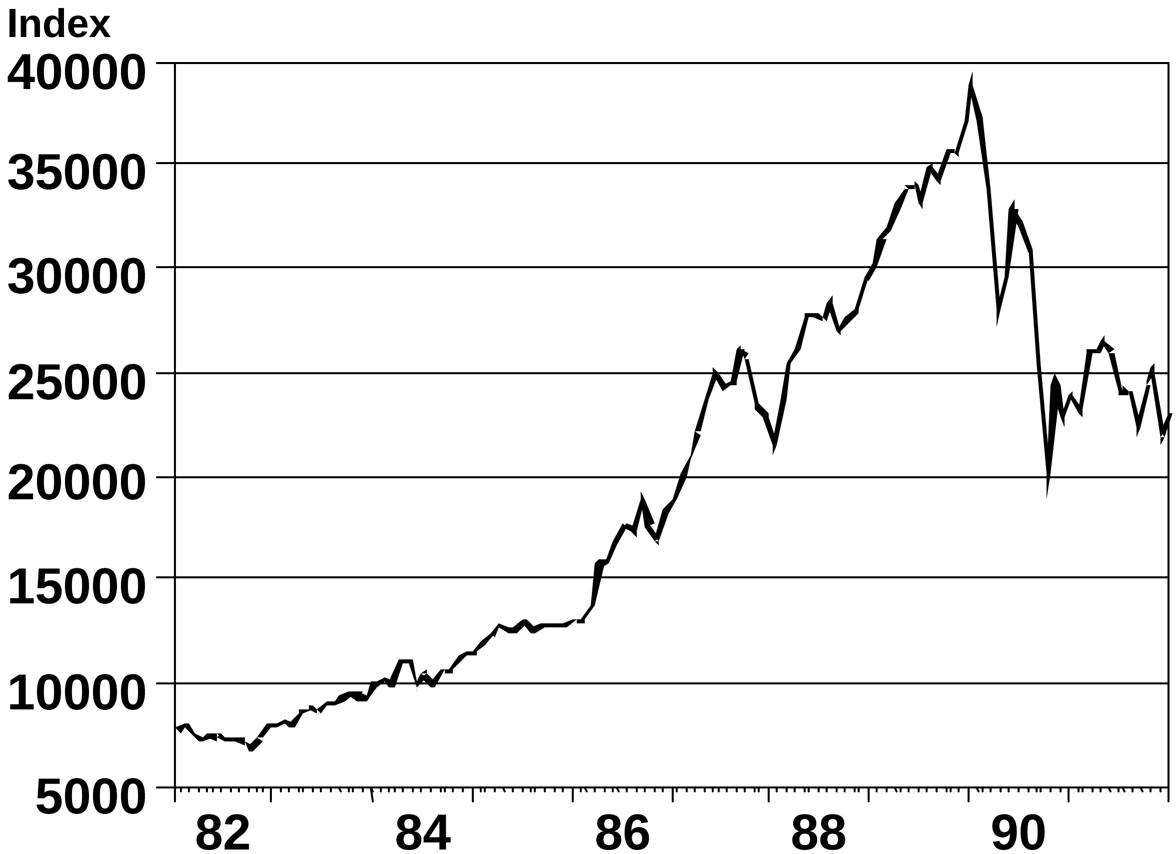
Instead, in 1993, we had the World Bank's glowing policy research report, "The East Asian Miracle: Economic Growth and Public Policy," touting the experience of the eight high-performing East Asian economies (HPAEs) — Hong Kong, Indonesia, Japan, Malaysia, the Republic of Korea, Singapore, Taiwan (China), and Thailand — and concluding that it "can be recommended with few reservations."

Actually, no reservations were revealed. Rather, the reader of the report was told that, "In large measure the HPAEs achieved high growth by getting the basics right." Moreover,

> the fundamental policies do not tell the entire story. In most of [the HPAEs] the government intervened — systematically and through multiple channels — to foster development, and in some cases the development of specific industries. Policy interventions took many forms. Policies to bolster savings, build strong financial markets, and promote investment [included] keeping deposit rates low and maintaining ceilings on borrowing rates to increase profits and retained earnings, establishing and financially supporting government banks, and sharing information widely between public and private sectors. Policies to bolster industry included targeting and subsidizing credit to selected industries, protecting domestic import substitutes, supporting declining industries, and establishing firm — and industry-specific export targets.

Figure 1A. Japan - Equity Index

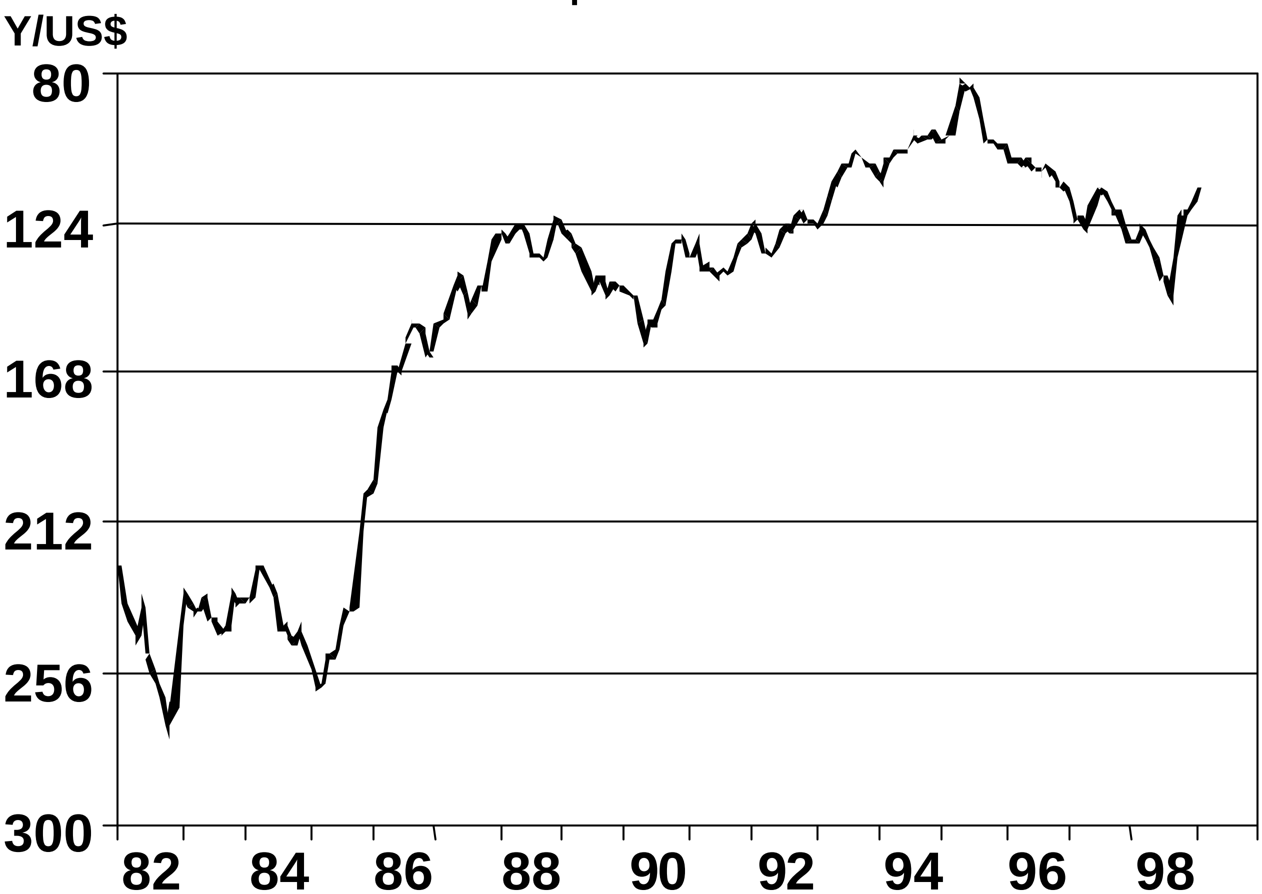
Nikkei 225



Source: Datastream

Figure 1B. Japan - Exchange Rate

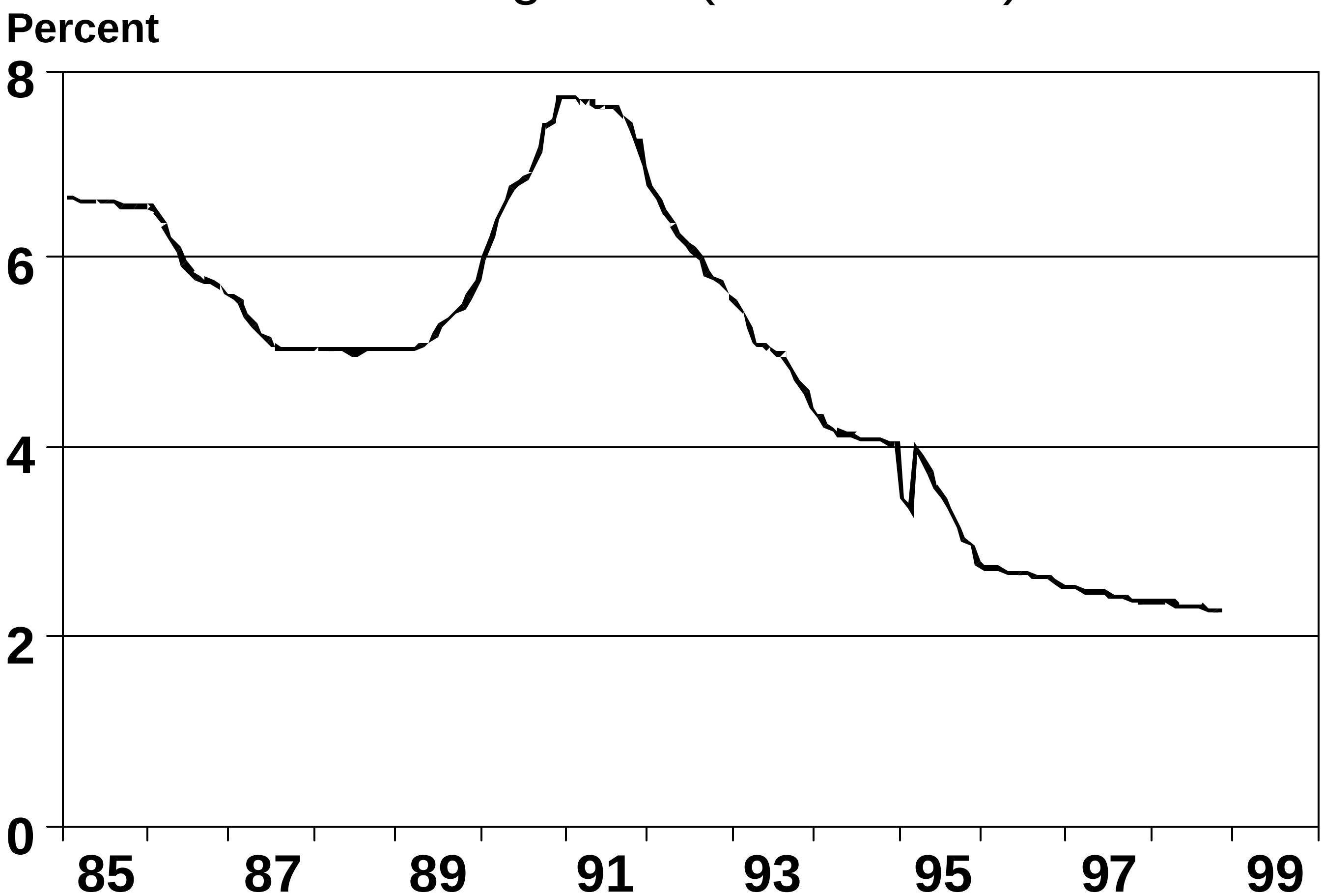
Yen per US Dollar



Source: IFS

Figure 1C. Japan - Interest Rate

Lending Rate (Prime Rate)



Source: IFS

Much of that did happen — and Asian government officials who studied the report appreciated the kudos. But, of course, much of it happened ultimately to a quite different effect than the World Bank anticipated. Here is what its sister organization, the IMF, had to say in its January 1999 assessment:

> Despite several differences in specific aspects of the crisis in Indonesia, Korea, and Thailand, some broad similarities are evident across the three countries. In all three countries, weaknesses in financial systems [the strong ones built according to the WB], stemming from inadequate regulation and supervision and (to varying degrees) a tradition of government guarantees and a heavy governmental role in credit allocation — and weaknesses in governance at a more general and fundamental level — had been reflected in the misallocation of credit and inflated asset prices ..... [sic]. Economic and financial data that were inadequate for making informed decisions [presumably the ones shared "widely between public and private sectors"] contributed to these imbalances.

In all fairness, it should be noted that not just the World Bank got things wrong. Markets did not do much better, nor did most of the world's financial institutions that continued to lend to East Asia at high volumes to the bitter end and beyond with little concern for due diligence and proper risk assessment. [1]

It all started innocently and beneficently enough, with the September 1985 Plaza Accords and MITI's (Japanese Ministry of International Trade and Industry) "Flying Geese" pattern of development. By 1985 the Japanese yen, which in 1945 had been valued at 360 to the U.S. dollar and was then still trading at 240, was greatly undervalued. The realignment decision by the major industrial powers was correct and by December 1987 a realistic yen value of 120 had been reached. Outflow of capital from Japan started in earnest; lead goose Japan provided the takeoff funds and showed the way to rapid industrialization, and the rest of East Asia followed suit. With the further opening of China decreed by Deng Xiaoping in 1984, overseas Chinese entrepreneurs abandoned their traditional risk aversion, deployed accumulated savings, and jumped into the fray: The motherland itself had set the strategic signal for capitalist economic expansion.

Korea and Taiwan (and with some delay Malaysia) produced virtual carbon copies of Japanese 1965–85 development; in Indonesia, Thailand, and elsewhere in Southeast Asia, family connections — whether the Suharto clan's or traditional Chinese *guanxi* — provided the channels of easy access to capital and monopoly contracts that governments would not as readily supply (though in Indonesia, of course, the Suharto clan indeed was the government). Things were much as the World Bank described and the results were impressive: Never have the lives and fortunes of tens of millions of people advanced as rapidly as in East Asia in the decade following 1985 (**Figures 2A–2C**).

What was missed — as so often when things go too well too fast — was the turning point, the point when governments and business in the region, multilateral institutions (World Bank, IMF, Asian Development Bank [ADB]) and international lenders should have realized that the gambling casinos called stock markets had to be properly regulated to become equity markets to raise business capital; that longer-term debt instruments and bond markets had to be created to tap into future household

[1]I know of only one book that early on questioned the assumptions behind the East Asian miracle and its

income streams of a rapidly growing middle class; that tighter banking supervision had to remove gross moral hazard and credit misallocation; that ever larger corporate leveraging induced uncoverable risk; and that keeping property and financial markets largely closed to foreigners ran the danger of creating illiquidity and foreclosed competitive innovation.

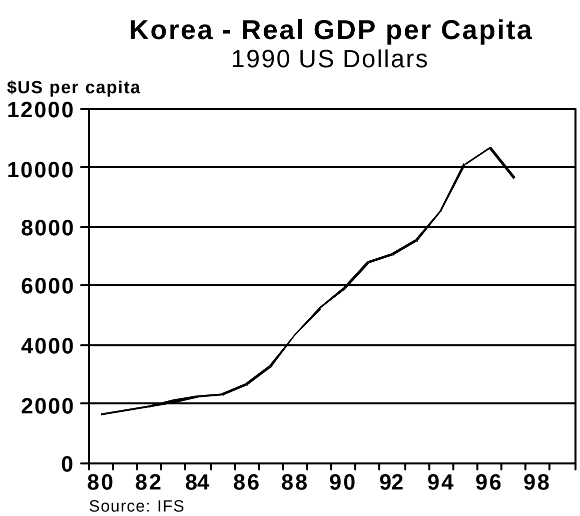
That point, varying from country to country, came in the early 1990s, when liberalization of their capital accounts and the temptation to satisfy rapidly growing domestic investment needs with lower-interest funds from abroad exposed the East Asian economies increasingly to volatile short-term capital movements. By 1990, the bubble was inflating. Overbuilding and excessive property loans continued. It would continue relentlessly through 1996. **Figures 3–7** tell the story better than words.

sustainability: James Clad, *Behind the Myth: Business, Money, and Power in southeast Asia* (New York: HarperCollins 1991).

Figure 2. Real GDP per Capita

A.

B.



C.

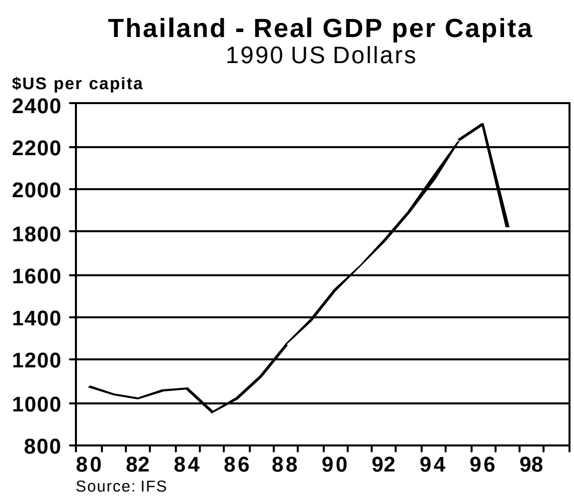
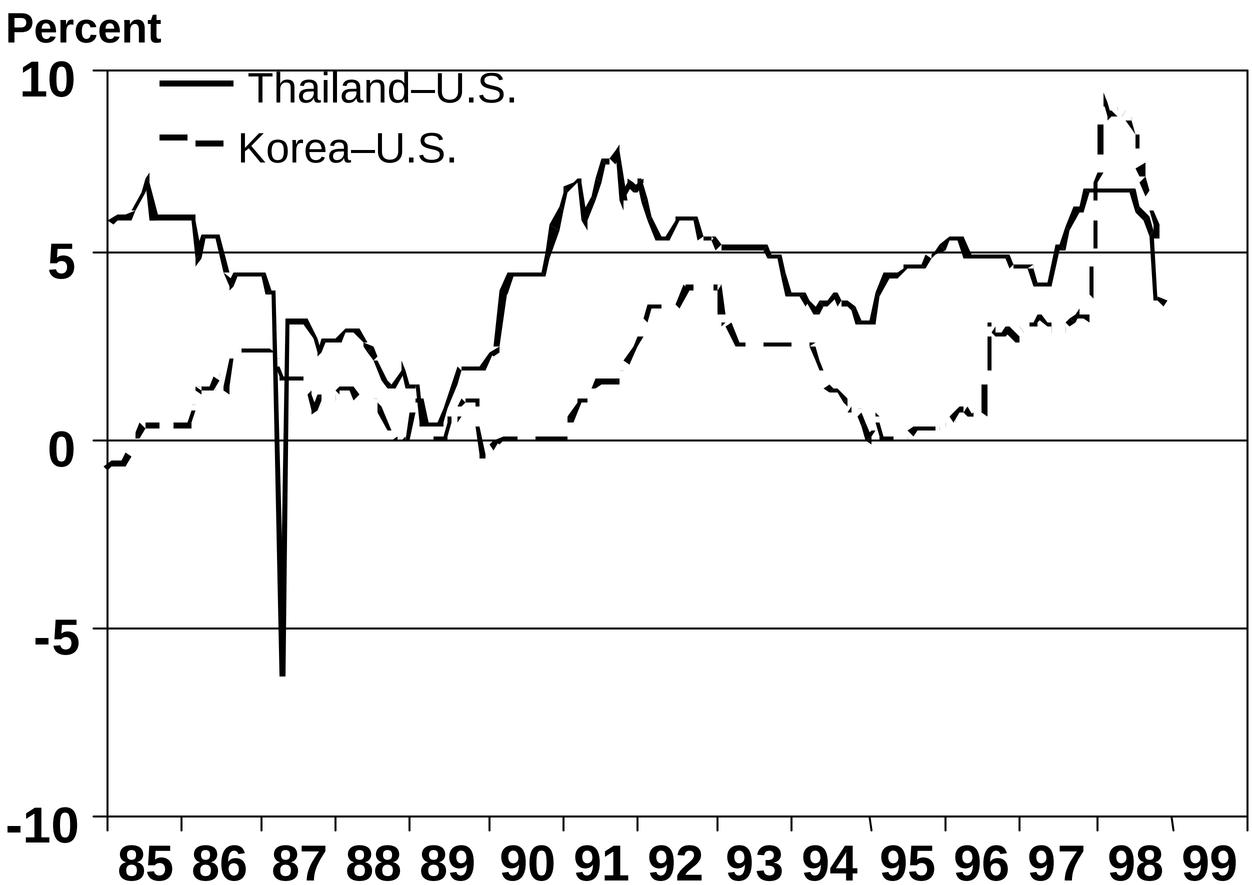


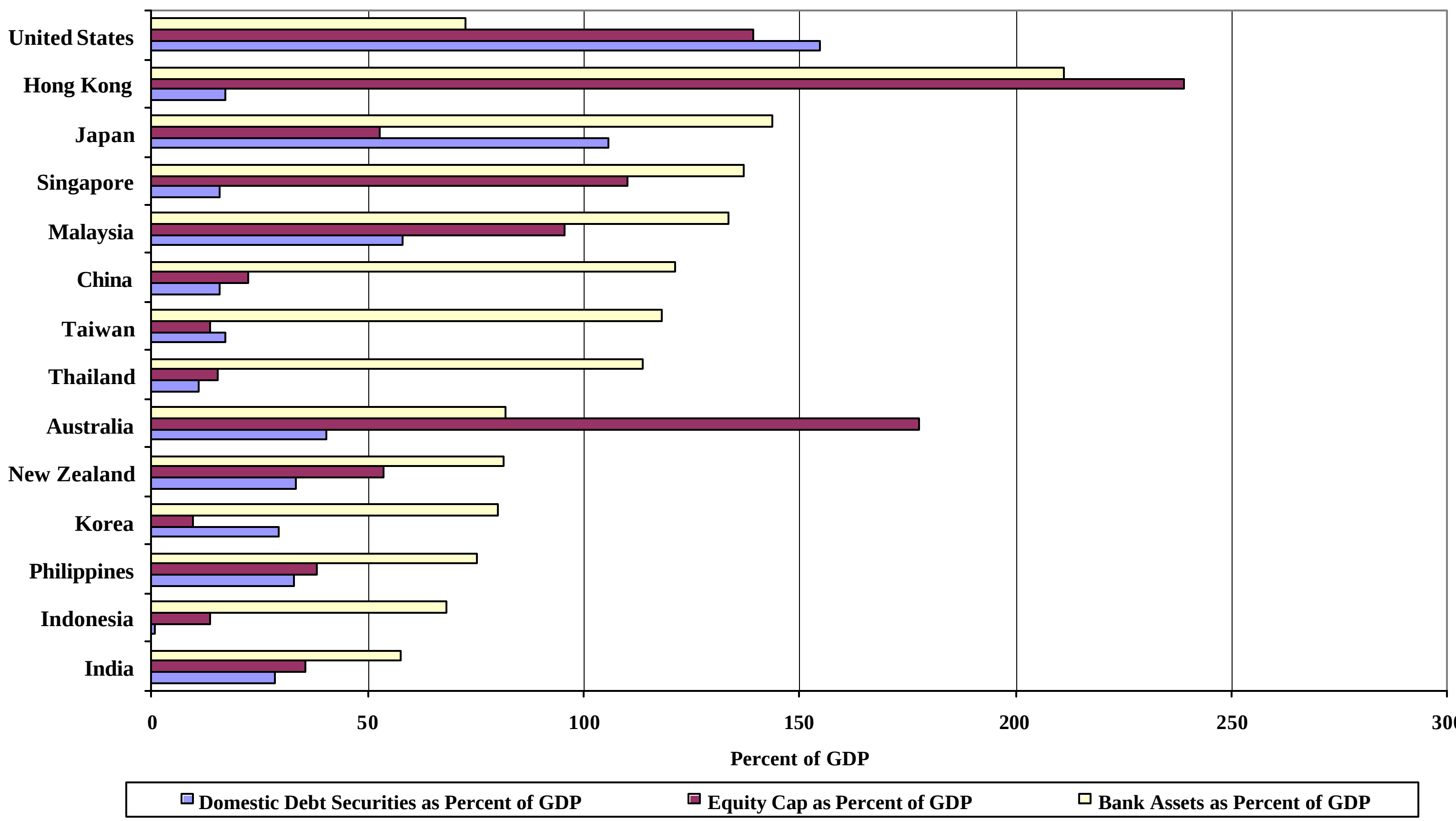
Figure 3. Lending Rate Spreads

Thailand and Korea vs. U.S.



Source: IFS

Figure 4. Size and Structure of Financial Markets



Source: Milken Institute

Figure 5. Short-Term Share of Total Debt

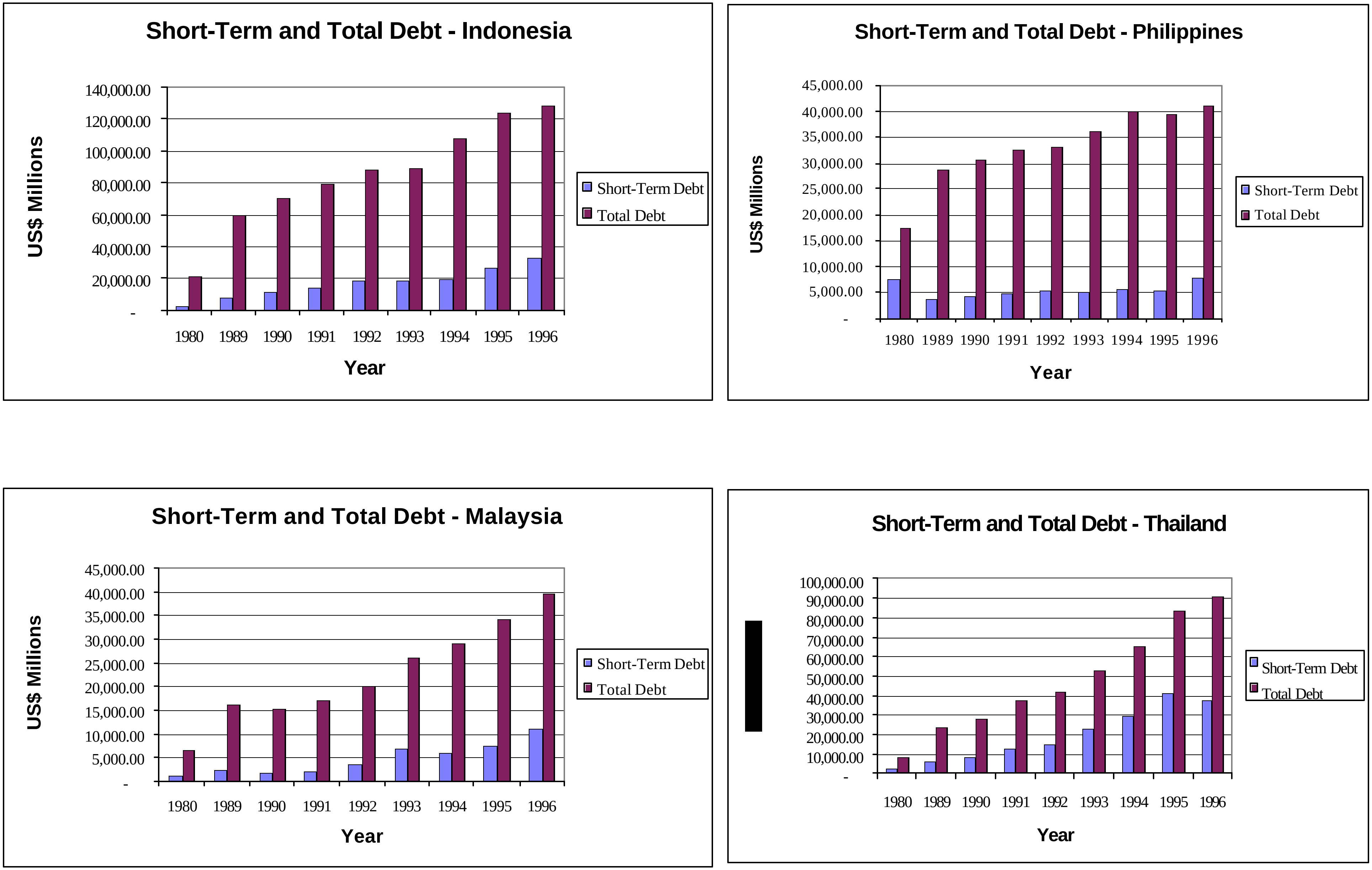


Figure 6a: Short-Term and Total Debt - Indonesia

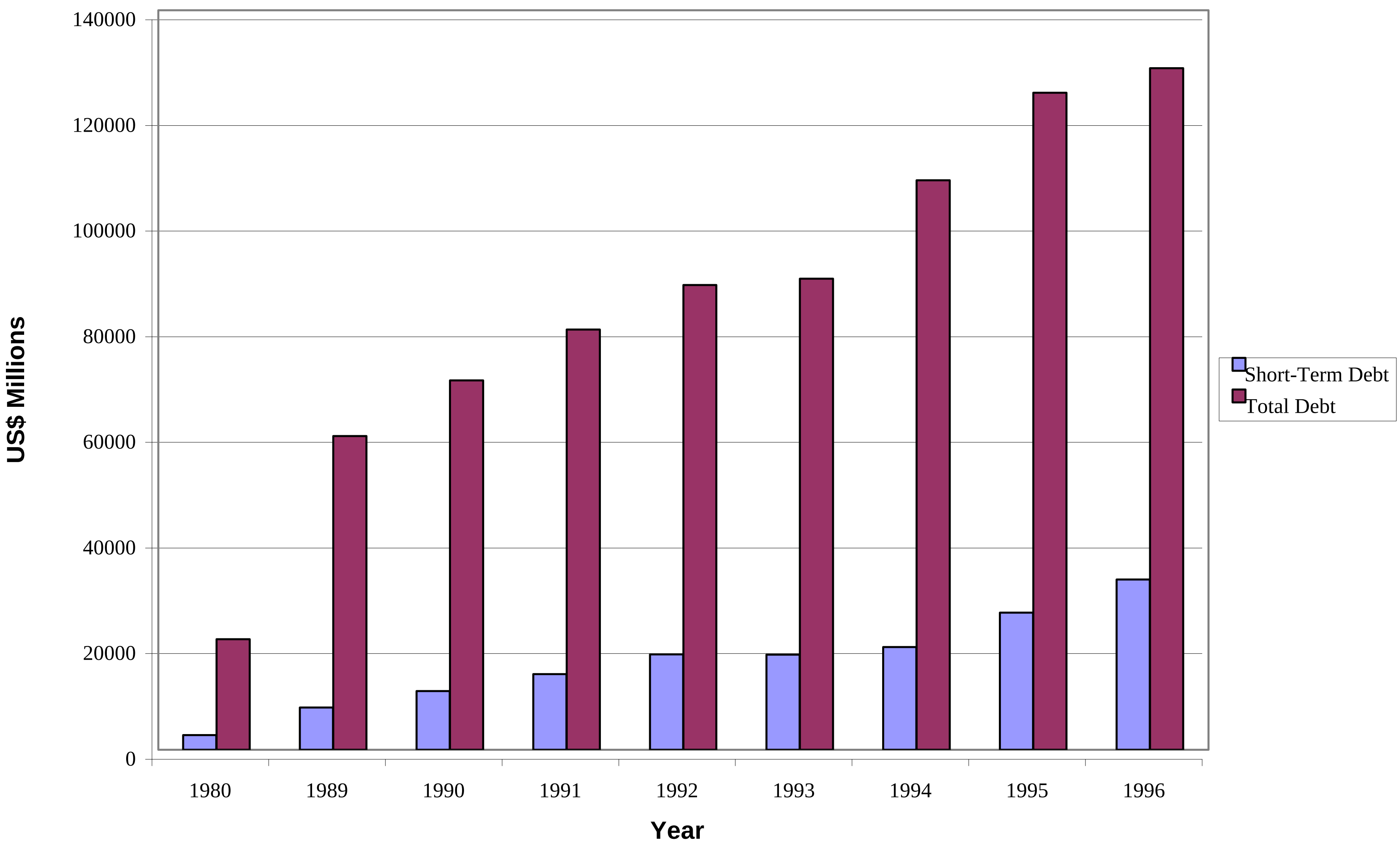
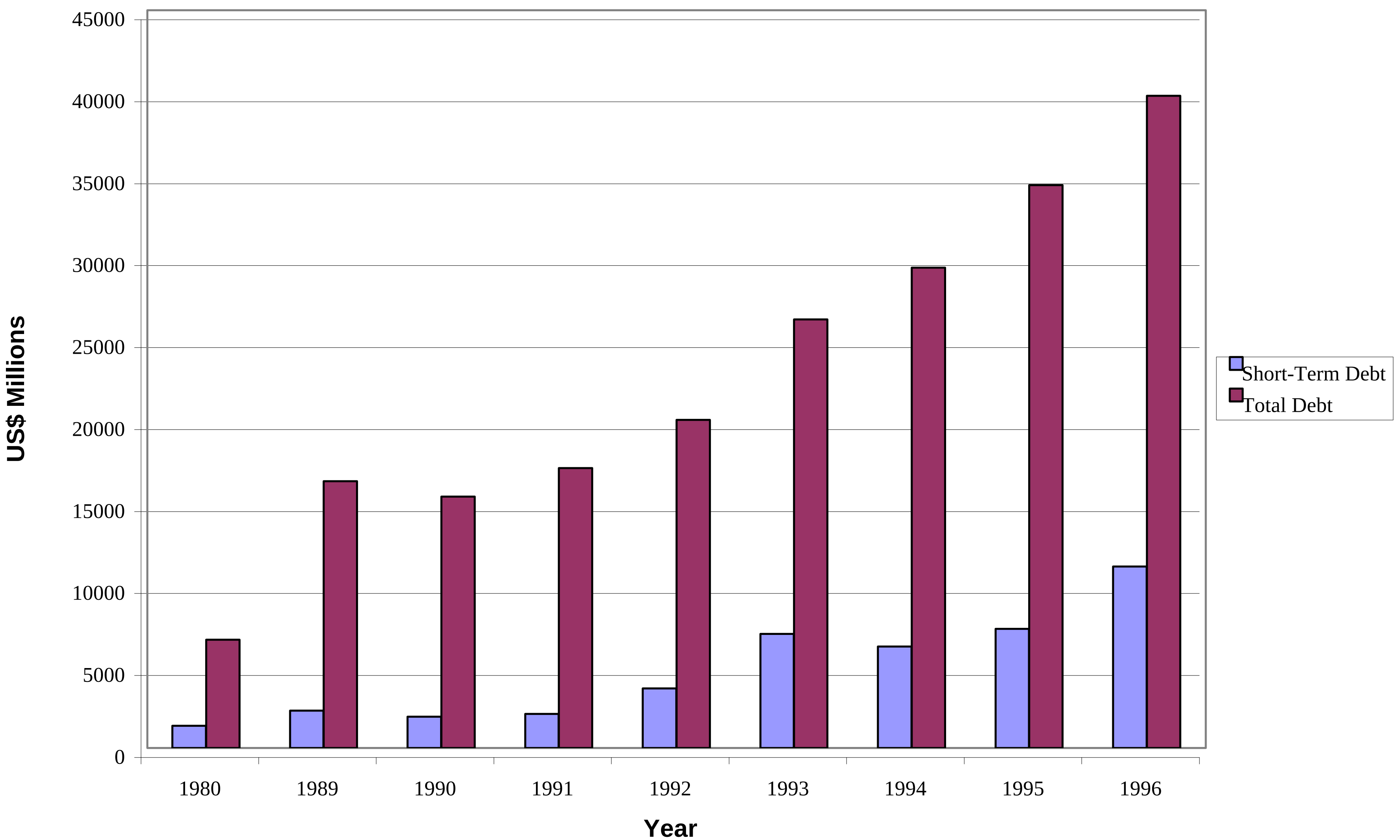


Figure 6b: Short-Term and Total Debt - Malaysia



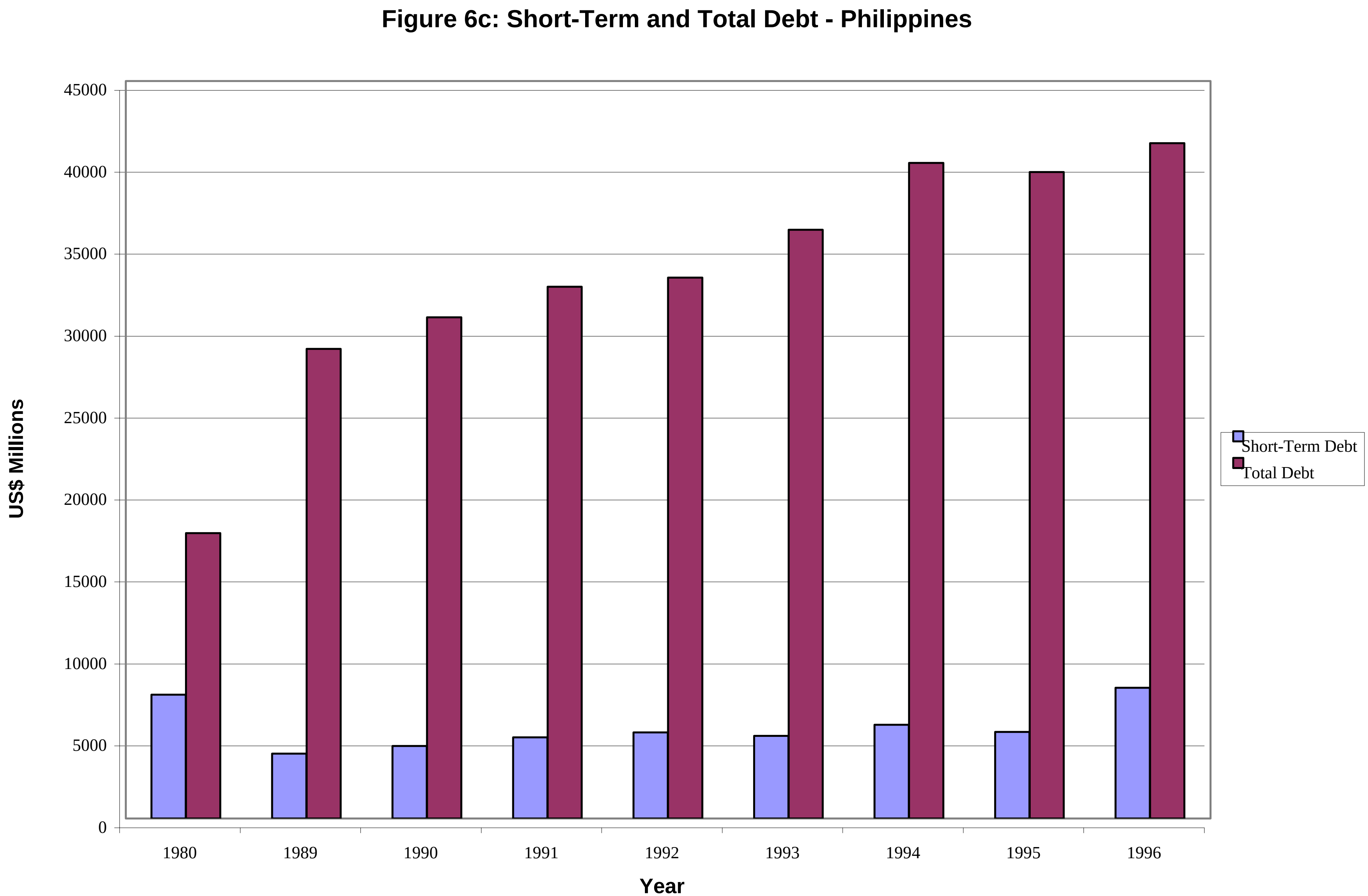


Figure 6c: Short-Term and Total Debt - Philippines
US$ Millions
45000
40000
35000
30000
25000
20000
15000
10000
5000
0
1980
1989
1990
1991
1992
1993
1994
1995
1996
Year
Short-Term Debt
Total Debt

Figure 6d: Short-Term and Total Debt - Thailand

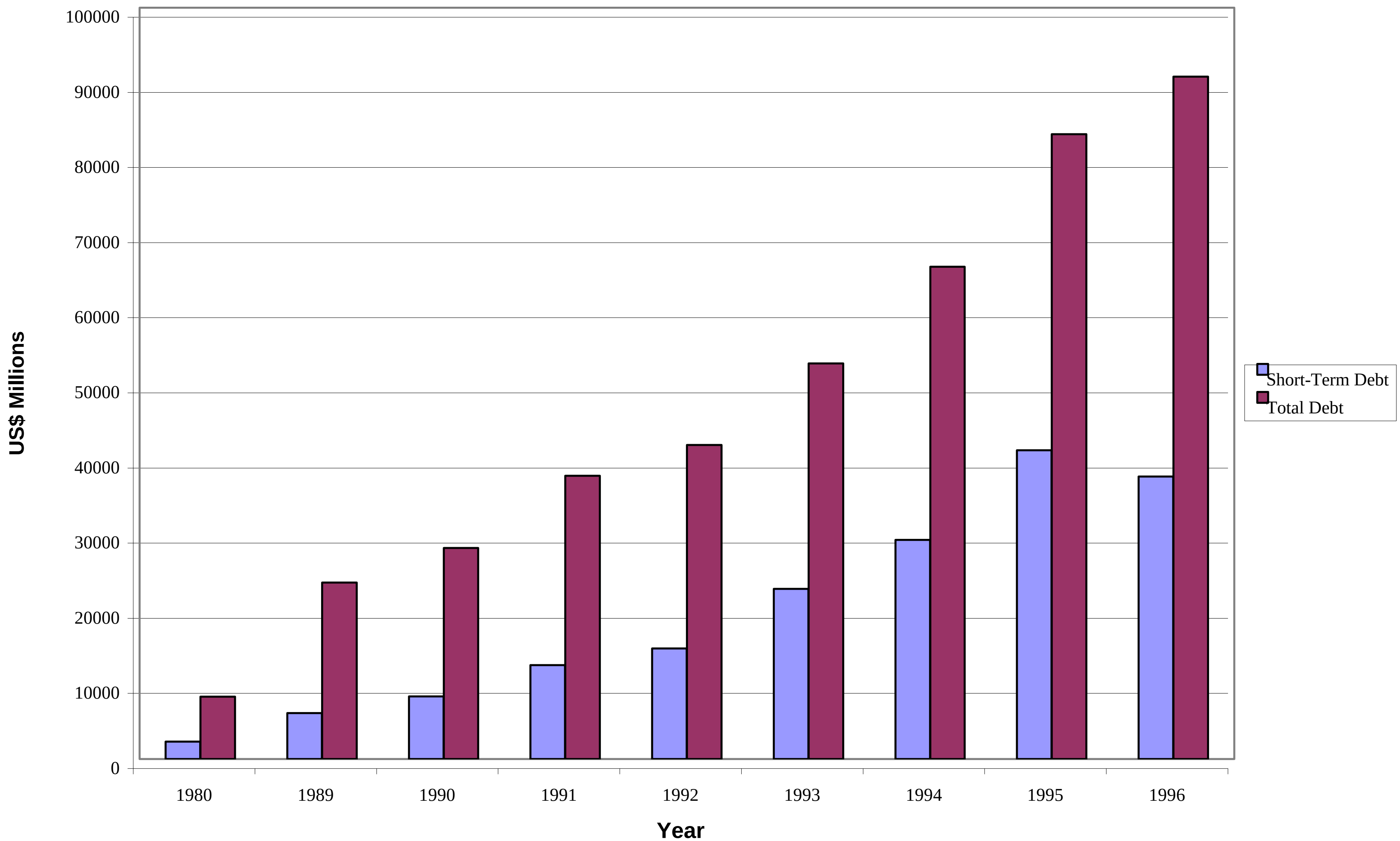
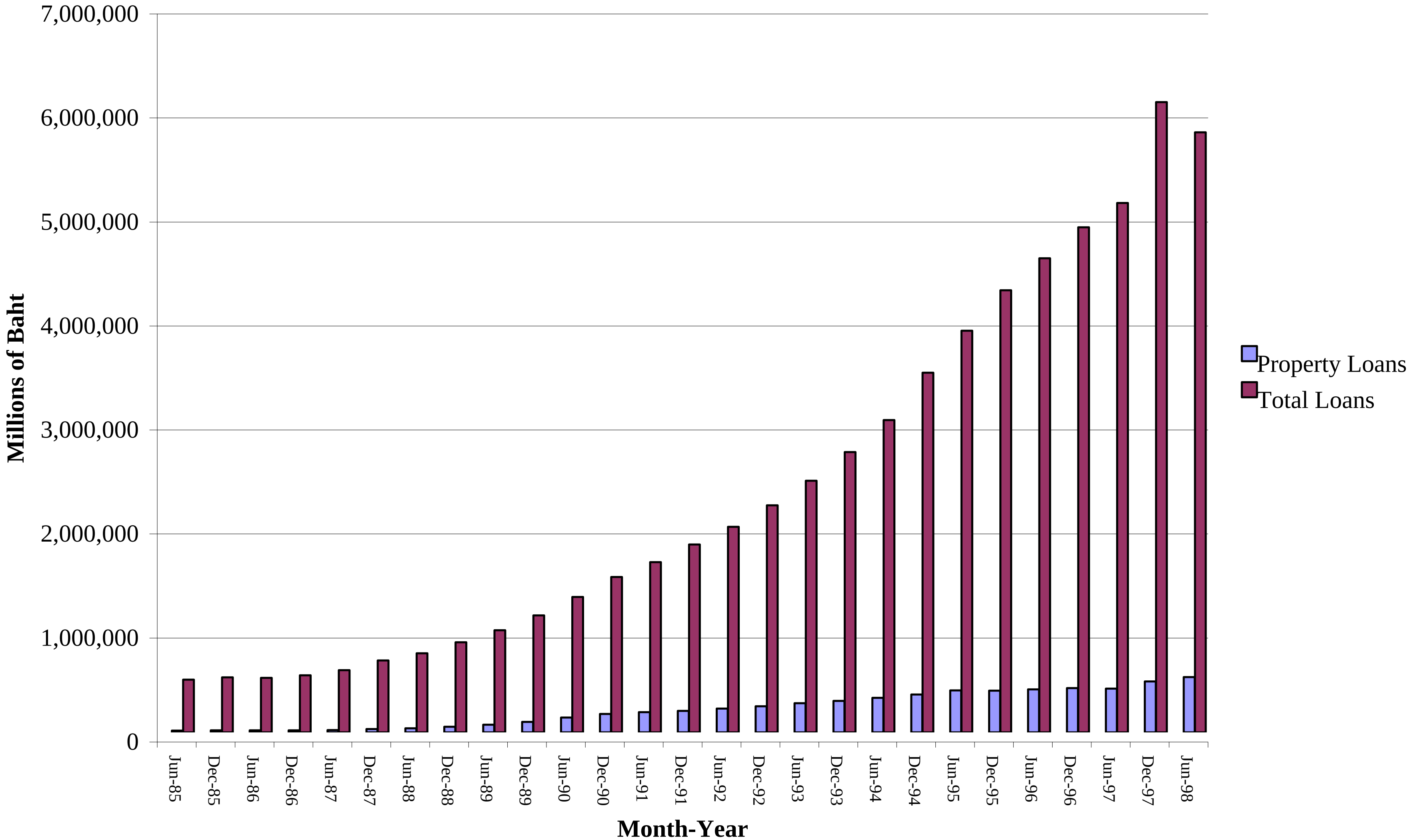


Figure 7. Thailand Commercial Banks' Loans - Property Loans vs. Total Loans



Backward markets

There are many reasons why the turning point from rapid to more sustainable growth, from indiscriminate credit growth and investment to more cautious allocation of resources, and from excessive reliance on foreign capital to controlled domestic sourcing, was missed. Among them, two — closely interrelated — stand out: backwardness of regional financial markets and banking systems and narrow oligarchic and political-clique control over both and over key corporations. Call it the exercise of Asian or Confucian values that emphasize closeness of families and clans, patron-client relationships and mutual obligations, obedience and trust. Or call it crony capitalism, as has now become fashionable among Westerners long baffled by Asian business practice. The outcome was the same: Urgent political and financial reforms aiming to develop more effective and competitive domestic markets and banks were blocked by narrow vested interests. Timely reform proposals were repeatedly proposed by responsible financial authorities, whether in Korea, Indonesia, or Thailand, only to be defeated by legislators and administrators with too much to lose.

One telling example will have to stand for numerous similar cases throughout the region. In the spring of 1991, when Thailand's economy had been growing at a higher than 10 percent rate for four years running and a year after the government had accepted Article 8 of the International Monetary Fund Agreement, the country embarked on an ambitious further financial liberalization policy with the aim of making Bangkok a regional financial center. By 1993, this had resulted in complete liberalization of the capital account and the establishment of the off-shore Bangkok International Banking Facility (BIBF) in which some 40 domestic and foreign banks participated. In March 1991, then Bank of Thailand (central bank) governor Vijit Supinit gave an interview to *Thaioil* magazine, parts of which are eminently worth quoting for the insight and foresight displayed.

Asked about the growing imbalance between domestic savings and investment, Vijit said:

> This is a recurrent problem. Using foreign savings to support investment in our country is only a short-term solution; if continued without pause and over a long period, it will undermine the confidence in the country's monetary system because it will lead to chronic imbalances and a large debt burden.
>
> That's why we must help encourage [domestic] savings mobilization in various forms. The central bank has already worked out measures [to be implemented], including:
>
> - establishment of provident funds;
> - promoting and developing new financial instruments such as commercial papers, debentures, state-enterprise bonds, Bank of Thailand bonds, asset securitization;
> - establishing a secondary market to facilitate the trade of these instruments.

And asked about the banking system's readiness for total liberalization, Vijit said:

> The central bank will improve its supervisory system so it is more in line with international standards [drawn up by] the Bank for International Settlements. We will look at asset quality and capital adequacy. We will try to ensure reserve funds are sufficient but do not create too great a burden.

> We will discourage the use of loans to buy land and other immovable properties for speculation as this is unproductive and does not benefit national development.

Those Bank of Thailand (BOT) proposals were the right stuff at the right time. To the country's detriment, few were ever implemented. Governor Vijit has reported that he tried on four separate occasions to change commercial banking laws and was thwarted each time. (Several of the changes he had proposed were implemented by administrative (royal) decree in the fall of 1997, when it was much too late.)

No secondary bond market of any depth ever developed. Asset securitization, again on the agenda in 1996 and designed to relieve an already obvious property market crisis, got nowhere. Lack of transparency in the banking system and lack of appropriate bankruptcy and foreclosure laws prevented it from getting off the ground. But through the BIBF low-interest dollars kept pouring in. The very scenario the BOT had wanted to forestall was being played out — until the roof caved in. As for Governor Vijit, he was forced to resign in the summer of 1996 by a government that refused to understand that demands for defending a currency's strength and trading in a narrow exchange rate band and lower interest rates are policies that cannot go hand-in-hand. [2]

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[2] Governor Vijit was a guest speaker at the 1999 Milken Institute Global Conference. His comments can be found at wwww.milken-inst.org.

Oligarchic control

What sank needed financial system reforms in Thailand were the tight political controls exercised by some two dozen families that owned the country's 15 commercial banks, spin-off finance companies, and largest corporations, anxious to preserve their privileges and monopoly positions. What sank similar reform efforts in Korea were the two dozen or so families that owned the nation's large industrial conglomerates *(chaebol)* and major banks and enjoyed an even firmer grip on politicians and bureaucrats. What never even let serious reform proposals surface in Indonesia was the ever-present and overbearing Suharto family influence. What did it in Malaysia was the United Malays National Organisation (UMNO) that ran and continues to run the country and many of its largest companies and banks virtually unchallenged.

Karl Marx would have had a heyday with this: As the requirements of the economic "basis" come into conflict with vested political interests and the "superstructure," crisis inevitably ensues.

The extent to which control over East Asian corporations rested in the hands of a very small number of families before the onset of the Asian crisis (as of the end of 1996) is documented in a December 1998 paper by Stijn Claessens and Simeon Djankov of the World Bank and Larry H.P. Lang of the University of Chicago.[3] They found that in Indonesia, the Philippines, and Thailand, the top 10 families controlled half of the corporate sector (in terms of market capitalization), in Hong Kong and Korea one-third, and in Malaysia and Singapore one-quarter. When the top 15 families are considered, control

[3] Claessens, Stijn, Simeon Djankov, Joseph P.H. Fan and Larry H.P. Lang. 1999. "Corporate Diversification in East Asia: The Role of Ultimate Ownership and Group Affiliation," World Bank Policy Research Working Paper 2089.

percentages jump to well over 50 percent in Indonesia, the Philippines, and Thailand; to 35 percent and 40 percent in Hong Kong and Korea, respectively; and to 30 percent in Malaysia and Singapore.

The dominance of these top families over their countries' industries and financial institutions invariably resulted from their being granted exclusive exporting and importing rights and local market monopoly positions by government, from procurement of large government contracts, and from protection against foreign competition for extended periods of time — or any convenient combination thereof.

In turn, given their financial power, it is hardly surprising that those top East Asian families did not find it difficult to shape legal and regulatory environments to their liking and advantage and prevent institution of reforms that might undermine their positions. More independent and conscientious bureaucrats and politicians who proposed such reforms stood no chance.

Until the onset of the Asian crisis, most East Asian political parties were little more than business propositions of convenience to under the tight control of families or family alliances or else, as in Indonesia, Malaysia and Singapore, instruments of the ruling military or self-selected political and business elites. Their very purpose in existing was the preservation of the existing order. Occasional outbreaks of political revolt by the budding middle classes (Korea 1980 [Kwangju], Philippines 1986, Thailand 1992) effected few changes.

This is now changing. Ironically, the oligarchic families' and elites' very success in economic affairs in the boom years created and fostered the rapid growth of the middle classes that are now challenging their rule and will rule in their stead in East Asia in the future. In part, this shift will be assured by the fact that the crisis has greatly reduced the oligarchy's wealth and debt restructuring is very significantly diluting its holdings. The process remains incomplete; but some sample cases discussed below exemplify the point.

Bad debtors, careless lenders

Though backward, badly regulated, and badly supervised financial markets and banking systems are largely to blame for the Asian crisis, reckless disregard for due diligence in lending on the part of foreign financial institutions must be assigned a significant share of the blame. Lenders who now loudly bewail crony capitalist practices were only too happy to lend enormous sums without too many questions asked while the going was good. They must now carry their share of the costs.

"When the situation in Korea reached crisis proportions in late 1997," said US Treasury Secretary Robert Rubin on January 30, 1999, at the Davos World Economic Forum conference, "I was appalled, though not surprised, to learn how little some creditors seemed to know about the country and its banks to which so much had been lent." On a previous occasion (October 20, 1998; Woodrow Wilson International Center for Scholars), he had spoken of the "great excesses in credit extension and investment into developing countries with increasingly inadequate weighting of risk as good times continued."

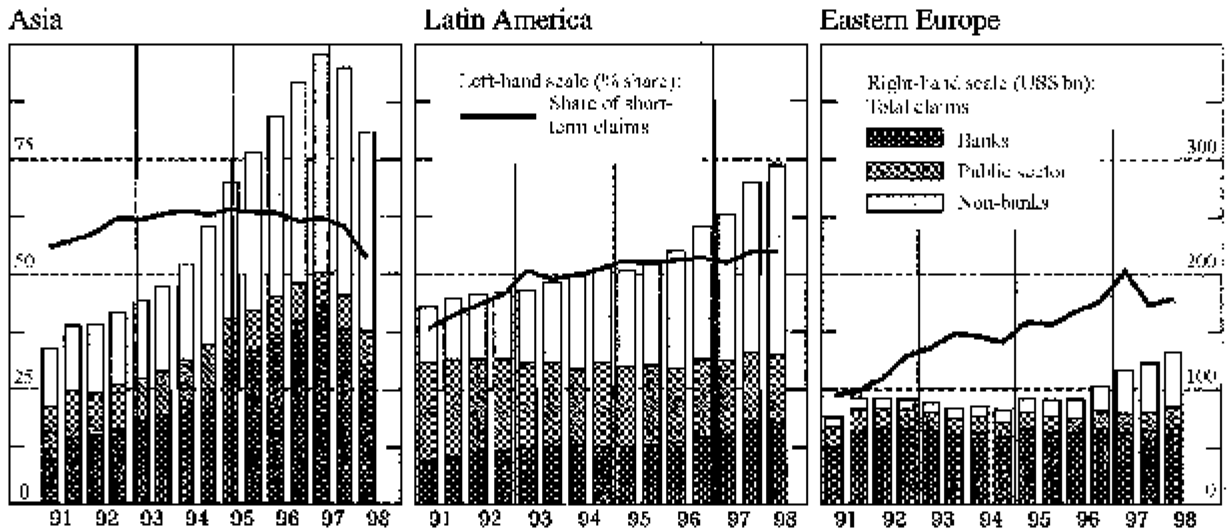
On this issue, the figures— drawn from the Bank for International Settlements (BIS) Consolidated International Banking Statistics (formerly the Maturity, Sectoral, and Nationality Distribution of International Bank Lending) — speak for themselves (**Figure 8** and **Table 4**). From the late 1980s onward, international bank lending to Asia far outpaced lending to other emerging markets and at an ever-accelerating exponential rate. Starved for acceptable yields at home, Western (and Japanese) banks' loans to individual East Asian countries, according to the BIS in May 1998, "were well sustained until the very last stage of the crisis. While flows to Thailand (the first country to be engulfed by the crisis) were reversed in the early summer, the shift occurred later in other countries." Further, "despite the 2 percentage point decline in the relative importance of the short-term [loan] category for the region, the share of the claims of 'less than one year' for Asia remained on average above 60 percent at the end of 1997."

And that's not all: The nationality composition of reporting banks' international claims reveals important differences in the behavior of major lending groups in the second half of 1997. Thus, whereas Japanese and North American banks reduced their outstanding claims on emerging economies in Asia, their European counterparts continued to increase their presence in the region. …There was, as a result, a further rise in the concentration of on-balance-sheet exposure towards European banks, which reached 47 percent at the end of the year. German, French and U.K. banks accounted for 13 percent, 11 percent and 8 percent of the total respectively. This compares with 30 percent for Japanese banks and 10 percent for North American banks.

Perhaps American banks were chastened by their late 1970s and early 1980s Latin American excesses and experience, which by 1982 and the time of the Mexican debt moratorium had brought even large players like Citibank to the brink. As for the Europeans, even small and medium-size enterprises in Thailand and Indonesia report that representatives of some large Dutch and German banks, 'till the very

Figure 8: International bank lending to Asia, Latin America and Eastern Europe by maturity of claims and type of borrower

In billions of US dollars and percentage shares



Source: BIS.

Table 4: Distribution of International Bank Lending by Nationality of Reporting Banks Positions: vis-à-vis Asia

	Total claims (in billions of U.S. dollars)	**European banks (%)**	**North American banks (%)**	**Japanese banks (%)**	**Other banks (%)**
Year-end-1996	367.0	42.2	11.0	32.3	14.5
Mid-1997	391.2	44.0	10.1	31.7	14.3
Yearend-1997	378.7	47.5	9.8	30.3	12.5
Mid-1998	324.8	49.6	9.0	30.3	11.1

Source. Consolidated International Banking Statistics, Bank for International Settlements end, “literally came knocking at our doors trying to convince us to take out 5 – 8 percent dollar loans so much cheaper than domestic ones at over 15 percent.” (**Table 4**).

And Then the Bubble Burst

By the end of 1996, as the result of unabated, indiscriminate borrowing and lending and haphazard asset allocation, corporations in Thailand and Korea were leveraged in the extreme. Corporate debt-equity ratios averaged 450 and 395 percent, respectively (by comparison, Japanese, German, and U.S. ratios are 194, 144, and 106 percent). Accurate Indonesian ratios are not available. Much of the corporate debt there was directly incurred by companies, without intermediation by the banking system, and undisclosed or grossly fudged.

Also, as demands for debt refinancing increased, an ever more marked shift toward short-term debt (especially foreign-currency denominated) ensued, most of it unhedged and no longer sufficiently covered by usable international reserves. In Korea, short-term foreign debt exceeded reserves threefold by the end of 1996.

Under such circumstances, corporations and lending institutions become highly vulnerable to even relatively small profit contractions. After strong GDP and export growth through 1995, such growth slowed throughout East Asia in 1996 — most markedly in Thailand, somewhat less so in Korea. Sharp price declines of key export products, most notably semiconductors, further ate into revenues and corporate earnings (**Figure 9**).

As local stock markets in Thailand and Korea early on got wind of declining corporate fortunes, those markets' precipitous 1996 declines (35 percent and 26 percent, respectively, in local currency terms) foreshadowed and in part accounted for rapid loss of confidence in financial institutions from the first quarter of 1997 onward: Much as most Japanese institutions, Korean and Thai banks have traditionally held substantial portions of their assets — 9–10 percent — in equities (**Figure 10**).

Illiquid property markets and the beginnings of deflation of the real estate and property asset price bubbles in 1995–96 constituted another proximate cause of the 1997 financial blowout, most immediately so in Thailand, but also in significant measure in Korea and Indonesia, and with delayed effect in Malaysia, Hong Kong, and Singapore.

Between 1992 and 1996, a total of 755,000 housing units were built in Bangkok, double the total projected in the National Economic and Social Development Plan. By mid-1996 the supply of housing was greatly outstripping effective demand, with vacancy rates in the 25–30 percent range, and the vacancy rate for offices in Bangkok stood at 15 percent. The market, at vastly inflated prices, was dead.

Lester Thurow has described the problem of inflated land and property values which stand in no reasonable relationship to underlying earnings potentials: "Bangkok, a city whose per capita productivity is about one twelfth that of San Francisco, should not have land values that are much higher than those

Figure 9. Export Growth - Korea, Malaysia, Thailand

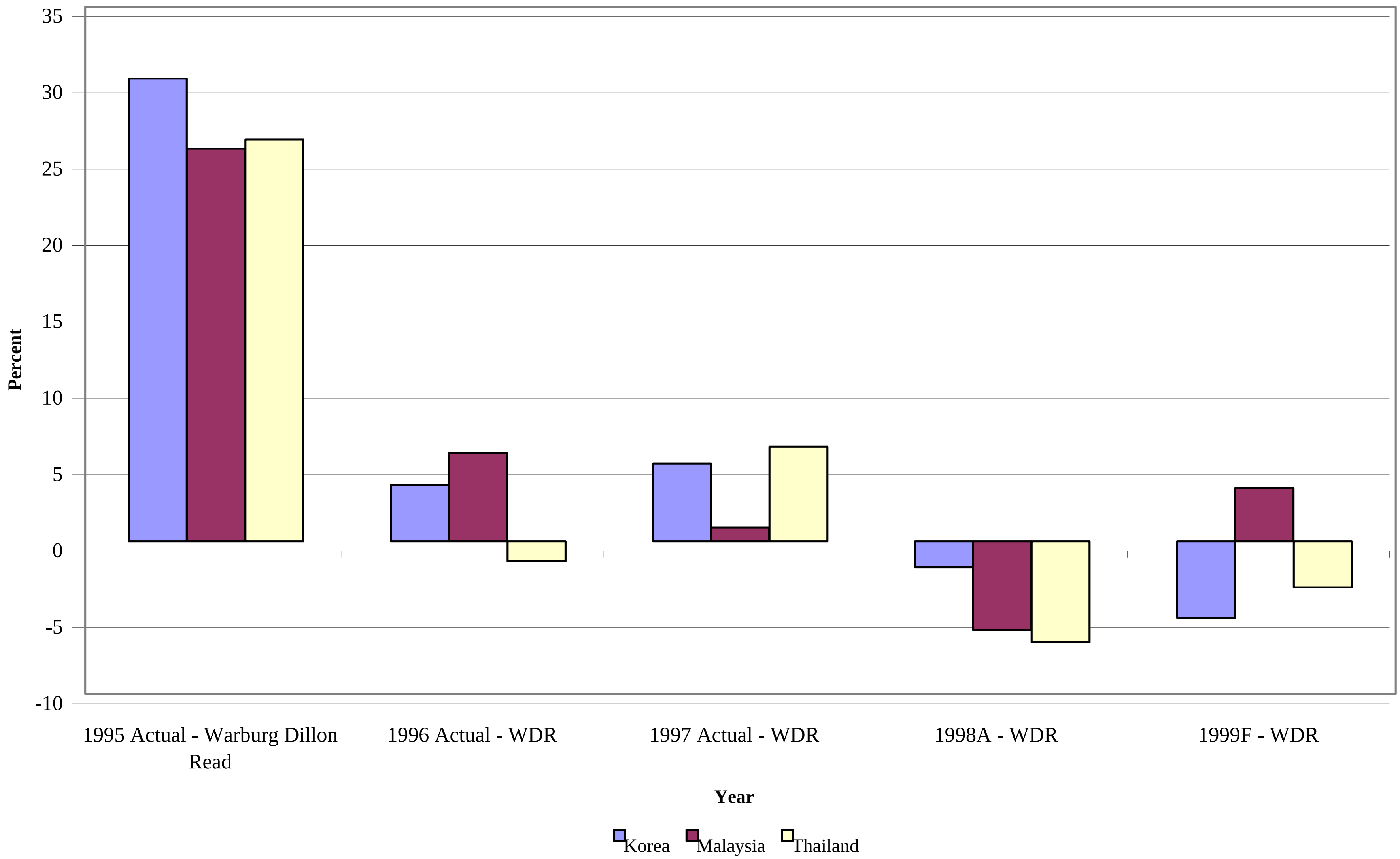
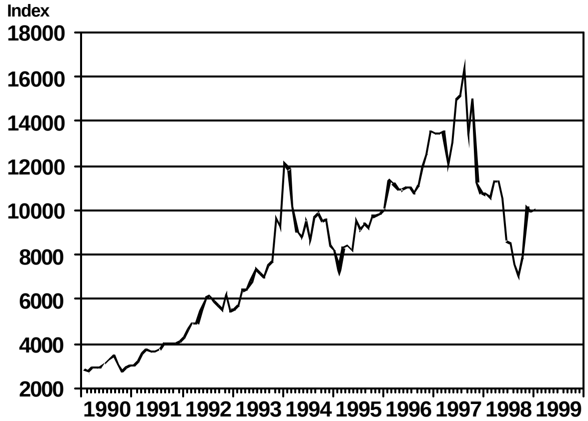


Figure 10. Market Indices

Hong Kong - Equity Index

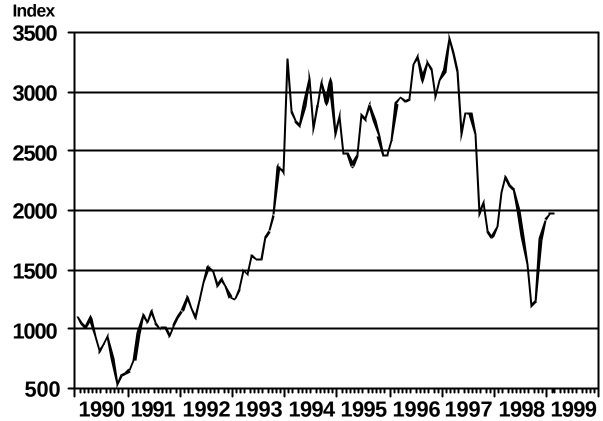
Hong Kong Hang Seng Index



Source: Datastream

Philippines - Equity Index

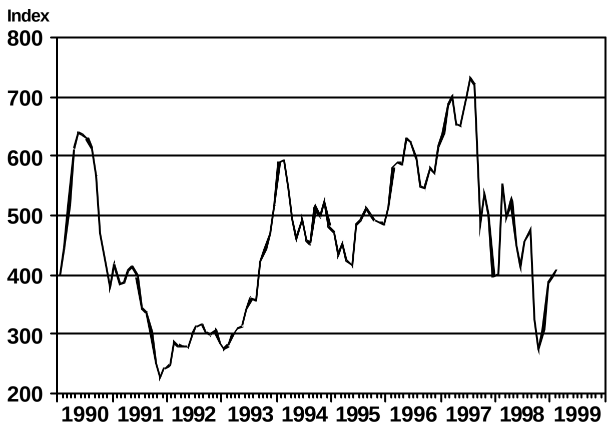
Philippines Manila SE Index



Source: Datastream

Indonesia - Equity Index

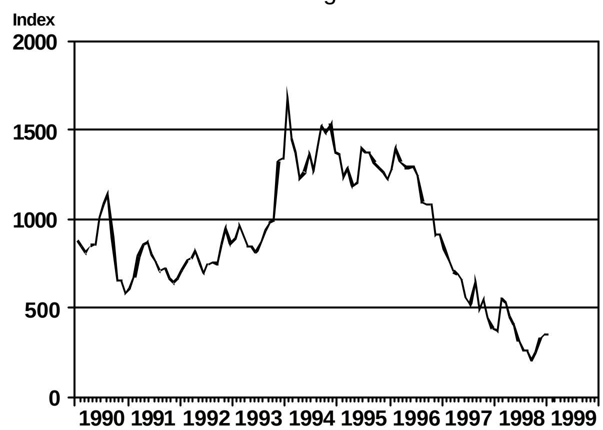
Indonesia Jakarta SE Index



Source: Datastream

Thailand - Equity Index

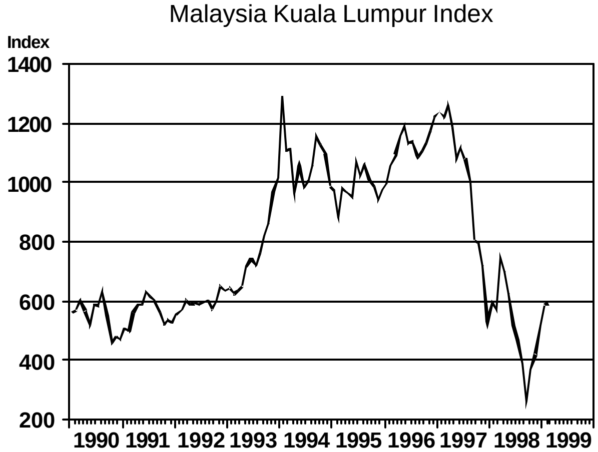
Thailand Bangkok SET Index



Source: Datastream

Malaysia - Equity Index

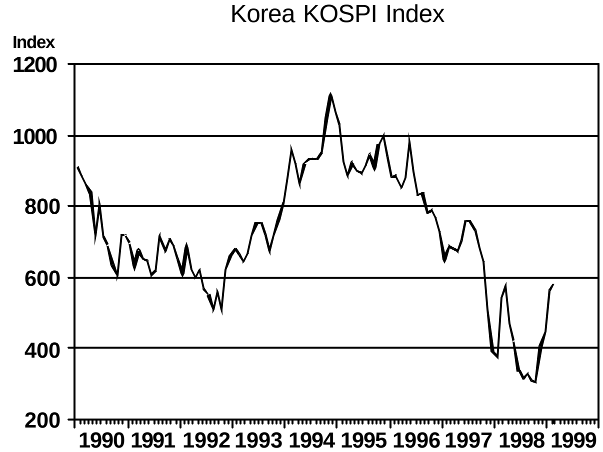
Malaysia Kuala Lumpur Index



Source: Datastream

Korea - Equity Index

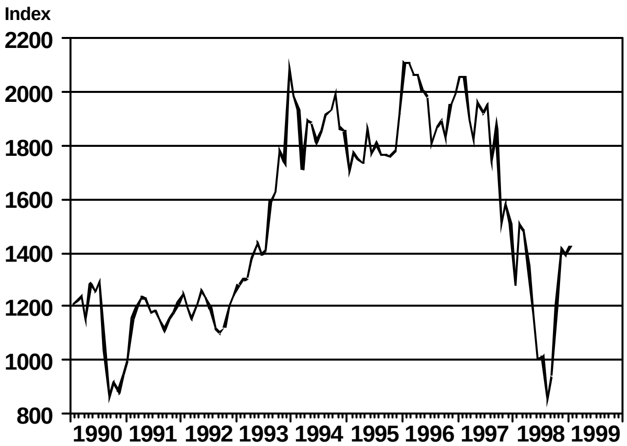
Korea KOSPI Index



Source: Datastream

Singapore - Equity Index

Singapore Straits Times Index



Source: Datastream

of San Francisco. But it did — as did other Southeast Asian cities. Grossly inflated property values had to come down."[4]

Well, down they came—and started to take financial institutions with high property loan exposure down with them. The common East Asian practice of granting loans based not on individuals' or corporations' cash flow projections but on real estate collateral only compounded the problem. According to the BIS annual report, inflation-adjusted residential property prices fell by almost 50 percent between end-1991 and end-1997 in Thailand; by about one-third between late-1992 and mid-1997 in Indonesia; and by about one-fourth between mid-1990 and end-1997 in Korea.

As oversupply and declining prices took their toll in February 1997, the property development firm Somprasong Land Plc, listed on the Stock Exchange of Thailand, became the first major Thai company ever to default on a foreign debt payment when it failed to meet a $3.1 million interest payment on its $80 million euro-convertible (ECB) bond issue.

The default had a critical signal effect. It immediately put the spotlight not just on other highly leveraged property developers but also on the financial condition of their lenders and later widely came to be seen as the event that lit the fuse on the Thai debt bomb.

Official and private estimates differ enormously, but by the end of 1996, the 15 Thai commercial banks and 91 smaller finance companies had lent anywhere from 800 billion baht (US$31 billion at the then

[4] Lester Thurow, "Asia: The Collapse and the Cure," *New York Review of Books*, February 5, 1998.

prevailing exchange rate) to 2 trillion baht (US$77 billion) to real estate companies, with much of that loan total now in doubt. The run on the smaller finance companies that between them held nearly half of those loan totals, and the countdown to the July 2, 1997, forced baht devaluation, were on. Some 430 billion baht (US$16 billion) in emergency liquidity injections into smaller banks and 58 finance companies (of which 56 ultimately failed) by the Bank of Thailand's Financial Institutions Development Fund did nothing to stop the mudslide. The Fund's losses are now the taxpayers' burden. [5]

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[5] The Somprasong Land case highlights the entire gamut of shady entrepreneurial practice, political loans and connections, reckless foreign lending, and regulatory failure increasingly prevalent in the East Asian boom years. In 1994, when Somprasong floated its US$80 million in ECBs in London, the impending Thai property market glut was already widely discussed locally. But foreign investors who picked up 20 percent of the issue obviously didn't bother to check on market conditions, on the bona fides of Somprasong itself, or on the Thai bank, Bangkok Bank of Commerce (BBC), that picked up much of the US$64 million remainder of the bond issue. In May of that year, the bank's chief financial adviser, Indian national Rakesh Saxena, and bank president Krirkkiat Jalichandra, absconded abroad with — allegedly — 1.7 billion baht (US$65 million) in their pockets. Later the sum was found to be closer to US$300 million, and bad loans at BBC were estimated to total 78 billion baht (US$3 billion). A large portion of those loans had allegedly been provided with no collateral or vastly overstated real estate collateral to companies owned by the bank's top executives and top advisers as well as to a group of politicians , the so-called Group of 16 faction of former prime minister Banharn Silpa-archa's Chart Thai Party. In late 1996, Somprasong Land CEO Prasong Panichpakdee was arrested by the Thai authorities for allegedly falsifying Somprasong's books and later released on bail. Sometime in 1997, much like his bankers, he fled to Taiwan, which has no extradition treaty with Thailand. None of these culprits has been brought to justice to date. Meanwhile, 120 billion baht in Thai taxpayer money was spent in the attempted rescue of BBC before it was finally closed in November of 1998. "In Thailand, if you're rich, you can always flout the law. The BBC episode is yet another example of Thailand's moral decadence, even worse than some notorious Latin American banana republics," read a commentary by Bangkok English-language daily, *The Nation*, at the time.

In Korea, the financial blowout and steep decline of usable international reserves to US$6 billion (some US$30 billion in reserves, it was later disclosed, were not usable because they had been turned over to commercial banks that had in turn lent them out or used them in international speculation) forced the country to seek IMF assistance in November 1997; it was precipitated by the effects on the banking system of the 1997 bankruptcy of six of the country's top 30 conglomerates *(chaebol).*

In Indonesia, the dramatic collapse of the stock market immediately following the Thai baht devaluation did the trick.

In Malaysia, though external accounts were relatively sound, a domestic debt to GDP ratio in excess of 160 percent, caused loss of confidence in and collapse of the ringgit.

The rest is well-known history.

FINANCIAL REFORMS AND RESTRUCTURING

At a Hong Kong Asian Debt Conference in July 1998, a participant in a seminar on non-performing loans at one point cried out in exasperation, "What …good are banks anyway if all they do is take their countries' hard-earned 30 percent [of GDP] national savings and convert them into non-performing loans?!"

A good question indeed, and exactly what has been happening in much of East Asia for the past year and a half. Even as interest rates have been falling throughout the region since early last fall (in Thailand, for example, they are now at a 30-year low), bank lending has continued to contract and NPL percentages of bank loan totals have continued to increase – for example, to 50 percent in Thailand and around 80 percent in Indonesia. Easier money has at best been facilitating debt rollover. Banking systems have all but ceased to function as financial intermediaries to supply credit for production and commerce. Under these circumstances, the burden of and expectations for gradual real sector recovery (and the credit for initial steps toward it in Korea, Thailand, and Malaysia) have been on the external (dollar-earning) sector of the economy and on public finance (deficit spending).

Clearly, however, that is insufficient to kindle sustained recovery. For that to occur, the thorny political problems of loss allocation (of who is to take the hit for bad-loan liquidation), of corporate debt restructuring, and of simultaneous financial-intermediation system reform must be tackled. By fits and starts, that process in now under way. Let us review the progress made to date and likely to be achieved in the course of this year in debt liquidation and restructuring and in systemic reform.

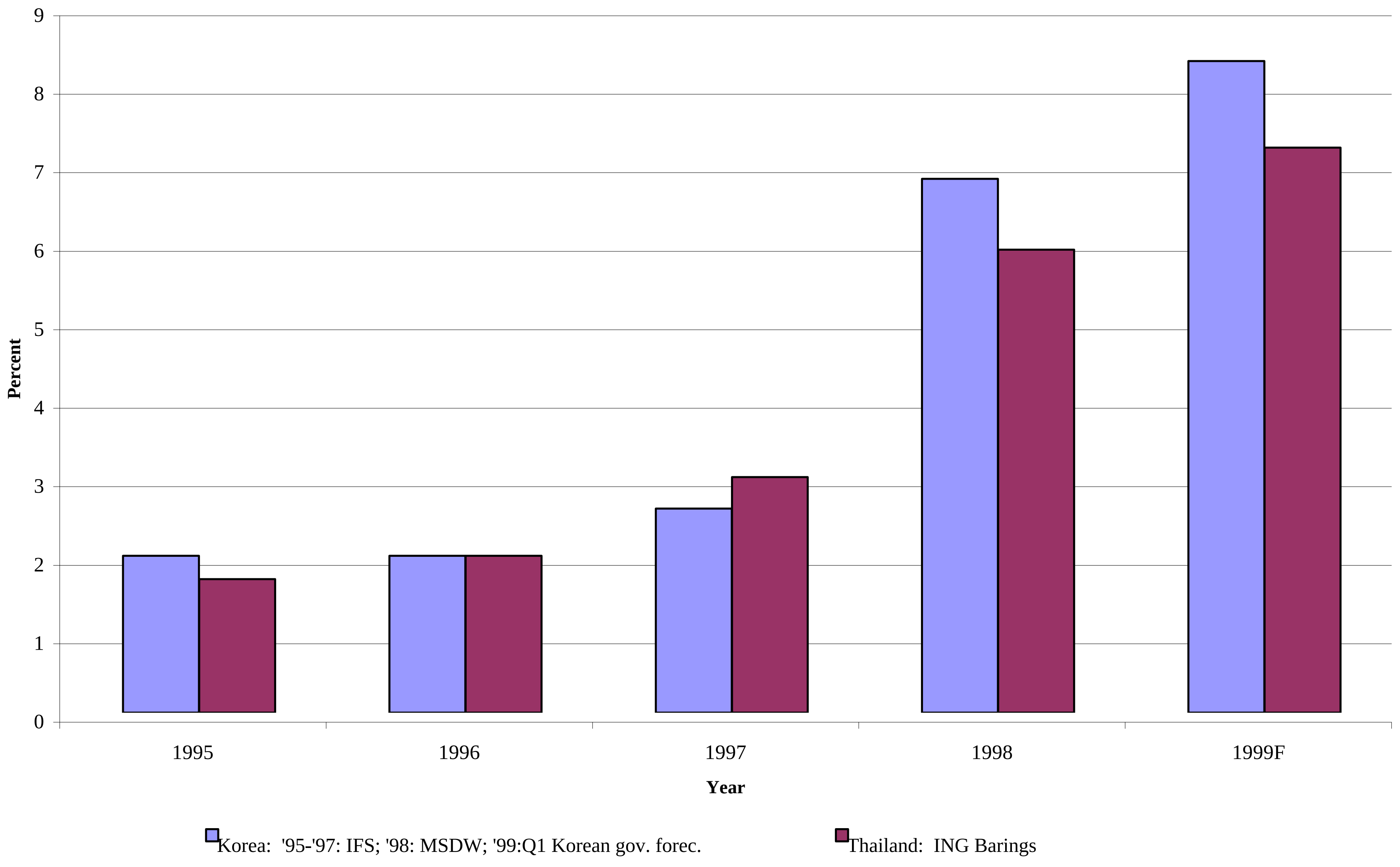
Loss allocation

GDP, equity markets, and foreign exchange losses in the one trillion dollar range, as estimated above, are a fait accompli and will not be recovered. Forex losses show up on companies' ledgers, can be used to smooth disgruntled shareholder sentiment, and — carried forward — to keep the taxman at bay. As for the rest of those items, losses show up in the form of social costs: millions of added unemployed (**Figure 11**), new graduates without jobs, hundreds of thousands of young children pulled out of schools (some one million among urban youth in Indonesia and Thailand alone), creation of new slums, and all the uncounted and unquantifiable hardships and heartbreaks that go along with that. It is a no small miracle that such social displacement and disruption has not engendered greater political upheaval.

But the politically most contentious issue remains, loss allocation of some $400 billion in bad loans among contending financial interest groups — owners of assets, creditors, borrowers, consumers, taxpayers, foreigners, and future generations.

For a while, through the spring of 1998, it appeared that Asia's political systems would prove themselves as inefficient at loss allocation as they had previously been at resource allocation. Although the markets had already drastically marked down asset prices, the holders of these discounted assets steadfastly refused to accept the markets' verdict. As a result, only two types of banking activity were in evidence: continuous rollovers of bad debt and ever-growing rounds of negotiations in search of bailout schemes. As politicians stood by and fiddled, all that private debtors and creditors could agree on was that losses would best be off-loaded either on local taxpayers and consumers, or on foreign taxpayers

Figure 11. Unemployment - Korea and Thailand



via the IMF. It also soon became obvious that existing supervisory, regulatory, and legal regimes — in particular, lack of effective bankruptcy and foreclosure laws — made an early end to the debtor-creditor standoff impossible.

Happily, new governments in Thailand (November 1997), Korea (February 1998), and Indonesia (April 1998) — and governments elsewhere, in Malaysia, the Philippines, Hong Kong, and Singapore, as they observed closely and saw the handwriting on the wall — began to change that and set up institutional arrangements and decree and legislate structural changes to get things off dead center. IMF prodding in the countries under the Fund's aegis helped the process along.

We review and assess progress on debt restructuring and bad loan disposal with detailed attention to the exemplary cases of Thailand and Korea below.

Thailand (US $1.00 = 37 baht)

Within days of the July 2, 1997, baht devaluation, the Thai government suspended operations of 42 finance companies above and beyond the 16 institutions it had locked up in late June. It was an excellent and resolute initial assault on the country's bad debt mountain, but for political reasons progress then stalled. Only in mid-October were two institutions, the Financial Restructuring Authority (FRA) and the Asset Management Corporation (AMC), established to review finance company assets and rehabilitation plans and to dispose of their bad loans. And it took a new government, installed in mid-November, to finally lower the boom on all but two of the suspended institutions and close them permanently. The book value of the 56 closed finance companies' assets came to some 860 billion baht

($23 billion at the current baht-dollar exchange rate) or 17 percent of Thai GDP. Only a fraction – 35 percent to 40 percent — of those assets has by now been auctioned off, at some 30–35 cents to the dollar. The FRA, however, remains confident of total asset disposal by mid-1999.

The bad-loan problem of the country's 16 commercial banks poses an even larger challenge: After reclassification mandating loans to be designated as nonperforming if not serviced for six instead of the previous 12 months, NPLs now total nearly 2.5 trillion baht ($67.5 billion) or about 50 percent of loan total. Even if half of that were recoverable (which is doubtful), a staggering write-off of 1.2 trillion baht ($32 billion), equaling 24 percent of GDP, would be necessary.

To cope with this, the government de facto nationalized ("intervened in") six banks and 12 of the remaining 33 finance companies in 1998. Of the six banks, one — the notorious Bangkok Bank of Commerce — has been closed for good, three have been absorbed by other institutions, and two are being put up for sale. To minimize moral hazard, registered capital of the nationalized institutions was written down and management was removed before new capital (to attain 8.5 percent capital adequacy ratios) was injected through debt/equity swaps into the merged banks and those now up for re-privatization.

For the 10 commercial banks that had remained solvent, a private/public sector recapitalization plan was adopted in August 1998 for which the government has set aside 300 billion baht ($8.1 billion). Since by year-end 1998, banks had privately raised some 400 billion baht ($10.8 billion) for recapitalization and the NPL ratios in the system appear to have peaked, resolution now seems within reach. By the end of 1999, Thailand will have 13 solvent commercial banks and 24 finance companies operating at international capital-adequacy standards.

Corporate debt restructuring got under way in earnest in August 1998 when creditor and debtor representatives under Bank of Thailand (BOT) aegis formed the Corporate Debt Restructuring Advisory Committee (CDRAC) and targeted 353 major companies with debts totaling 675 billion baht ($18.2 billion) for restructuring. In addition, under the direct supervision of lead creditor financial institutions, some 3,000 smaller restructuring cases with debt totaling 600 billion baht ($16.2 billion) have been identified and are moving ahead.

Progress to date has been slow. Only 50 or so of the major cases, representing 17 percent of the total debt, and some 30 percent of the minor ones have been settled. But the process should speed up significantly: In March a new bankruptcy law and new foreclosure procedures (held up in parliament for six months by the non-elected Senate in protection of its vested interests) came into force. The BOT estimates that by year-end at least half of the major, and virtually all of the minor, debt workout cases will be concluded.

Korea (US$1.00 = 1,200 won)

The nature of the bad debt problem faced by Korea and — due in part to IMF coordination — the approaches taken to resolve it are quite similar to Thailand's. But, naturally, because Korea's economy is three times the size of Thailand's, the scope of the problem is larger.

By mid-1998, the government estimated the nonperforming loan total at 111 trillion won ($92.5 billion), but that figure found few adherents. The Korea Economic Research Institute, the research arm of the Federation of Korean Industries, using international loan classification standards, estimated the bad debt total in all financial institutions at 300 trillion won ($250 billion), about 100 trillion of which was sustained by non-bank institutions. The Korea Institute of Finance (KIF), the research arm of the Korea Federation of Banks, tallied the bad debt figure at 219 trillion ($182.5), including 160 trillion won ($133.3) in the banking sector. Given that strict international standards were to be applied starting January 1, 1999, foreign bankers in Seoul regard the KIF figures as most realistic.

To deal with this, the government has to date earmarked 64 trillion won ($53.3 billion) in fiscal aid and disbursed about 40 trillion won ($34 billion) for purposes of bad loan purchases by the Korea Asset Management Corporation (KAMC) and bank recapitalization. However, if the KIF NPL figures are used, and even taking into account some 20 trillion won ($16.6 billion) in new capital raised by individual banks, the government-earmarked sum will be insufficient. The KIF has argued that fiscal aid should be increased to 87 trillion won ($72.5 billion), and indications are that the Financial Supervisory Commission that oversees finance sector rehabilitation is ready to concede the point.

The Korean finance sector shakeout since January 1998 is on the same significant scale as Thailand’s. Some 60 financial institutions have been closed, including five of the country’s 16 nationwide commercial banks, 14 merchant banking corporations, four security companies, and two investment trust companies. Another two commercial banks had their capital written down, have been recapitalized with government funds, and are in the process of being sold to foreign investors. The Bank of Korea said in January that finance sector rehabilitation, with the aim of reaching 10–12 percent capital adequacy norms (well in excess of BIS standards) will be completed before the end of 1999. As of this writing, the process appears on target. The recent S&P and Moody's upgrading of Korean debt is an independent vote of confidence.

Corporate debt restructuring in Korea is of a different nature than in Thailand. Six out of the top 30 *chaebol* went bankrupt in 1997 and helped trigger the country's financial crisis. The rest are saddled with average debt ratios that jumped from 347.5 percent in 1995 to 386.5 percent in 1996 and 518.9 percent in 1997. As of the end of 1997, the top 30 groups' combined capital and debts amounted to 68.9 trillion won ($57.4 billion) and 357.4 trillion won ($297.8 billion), respectively. But many of those *chaebol* are world-class companies with large export earnings and cash flow and few are on the verge of insolvency as are the major Thai companies under restructuring programs.

The key issue is to what extent they can (or should be required to) reach a debt/equity ratio of 200 percent by the end of 1999 as they have pledged and the government demands. On the condition that their capital remains unchanged, the groups would have to pay back 219 trillion won of their debts, or, conversely, should the debt volume be unchanged, expand their capital base by 178 trillion won. Neither figure is anywhere near realistic. The Korea Economic Research Institute regards debt reduction in the 50 trillion won range as feasible, and even that appears high.

A reasonable compromise capable of safeguarding a rehabilitated banking system against the excessive *chaebol* loan demands of the past now seems to have been reached. In the context of the government agreement with the top five chaebol to realign those groups' business lines to focus on core competence, a "Capital Structural Improvement Plan" (CSIP) has been adopted that makes newly formed ventures emerging from the realignment subject to the maximum 200 percent debt ratio from the outset and gives specified other merged ventures until the end of 1999 to attain the same ratio.

There are loopholes in the CSIP and the Financial Supervisory Commission will have its hands full plugging them; but the requirement that combined financial statements be filed starting this year will help supervision. The mandated unraveling of financial cross guarantees will further enhance transparency and creditor banks will benefit from the agreed plan for the top five to raise funds of about 20 trillion won "by self-rescue efforts" and to be used to repay debt obligations.

Questions have been raised as to the advisability and market conformity of the "Big Deals" realignment of the top five chaebols' business lines. At this stage, the only possible answer is, time will tell. However, the included CSIP appears sound and constitutes an important step forward toward transparency, sounder chaebol finances, and improved corporate governance.

Democratization of capital

Bankruptcies, asset seizures and auctions, state-mandated capital write-downs and mergers, bank nationalization, debt restructuring, and bank recapitalization have brought about very significant changes in ownership and shareholding structures in East Asia, roughly in proportion to the depth of crisis to which a given country had plunged. Control by just a few families has loosened substantially, ownership has become much more widely dispersed, and, in particular, outright foreign ownership of and shareholding in corporations have increased dramatically.

This process remains as yet incomplete and it is too early in the game to assemble comprehensive data. But enough representative preliminary information is available now, even discounting future buy-backs by former owners, to be certain that the outcome will be far broader distribution of wealth than in the pre-crisis period. Government programs to provide easier access to capital by start-up ventures and small and medium-size enterprises and to create second boards on stock markets will augment this.

At the end of 1997, when all that could go wrong was going wrong with the Thai economy, the head of Bangkok Bank (the country's largest), Chatri Sophonpanich, invited members of the best-known business families to a party. He greeted them not as his present-day fellow "jao sua" (tycoons), but as the "millionaires of yesterday" (though billionaires would have been more appropriate).

Of Thailand's top 20 business families, none had been reduced to beggars by then (or by now). But their total wealth by most counts has been reduced to between 10 and 20 percent of what it once was; one after another, they have lost majority interests in companies they once controlled and have lost major shareholdings in others; and, as new bankruptcy and foreclosure laws come into effect, they will likely lose large chunks of property serving as loan collateral.

To repeat, no complete picture can be drawn at this point. But some telling examples will provide useful evidence of major shifts in wealth distribution and what brought them about.

The family of liquor tycoon Charoen Sirivadhanabhakdi

The liquor industry in Thailand is government controlled, with concessions handed out to the highest bidder or bidder with the best connections. In the legendary liquor wars of the late 1970s and early 1980s, Charoen won out and got control of the hugely successful "Mekhong" local whisky brand. With the money he made, hand over fist, Charoen bought a 35 percent stake in First Bangkok City Bank (FBCB) and other sizeable stakes in Bangkok Bank of Commerce, Bank of Asia, Bank of Ayudhya, Bangkok Metropolitan Bank, and Siam City Bank. That proved a bad mistake: Four of those banks, including FBCB, were shut down by the government in 1998 and their capital was written down to 0.01 satang (1 baht = 100 satang). But don't cry for Charoen: With other cash he had stashed, he reportedly conducted major dollar/baht interest arbitrage operations (to the tune of some $4 billion) and with the profits bought a house in London and a luxury hotel in New York. And, of course, he still runs the profitable Mekhong distillery.

The Kanjanapas family, property developers

Owners of two of Thailand's largest property companies, Bangkok Land and Tanayong, the Kanjanapas built several of the Bangkok metropolitan areas' largest and most prestigious projects, including an entire satellite city. In the early to mid-1990s, their stocks traded at over 200 baht per share. Now they trade at less than 10 baht. With a debt of 25 billion baht in 1997 and sales of just 3.7 billion baht, Bangkok Land is at the end of the road; Tanayong in no better off. After debt restructuring, the family will have lost control of the two companies and little to show for it in remaining assets.

The Leophairatana family, owners of $4 billion Thai Petrochemical Industry PLC

Since February 1999, owners no longer: the Leophairatanas built Thailand's largest petrochemical company, but ran up a debt of $3.2 billion which is now being restructured. Creditors have agreed to a $300 million debt/equity swap which reduces the family to minority shareholders, with the likely consequence of loss of management control. When they look back, they will have one record in the books: In 1997, with a loss of 70 billion baht they did what no other Thai corporation had ever managed before.

One could continue this dismal saga: To raise $1 billion each in foreign funds for recapitalization, Bangkok Bank's Sophonpanich family and Thai Farmers Bank's Lamsam family had to reduce their control to razor-thin margins; the families that formerly owned Bank of Asia and Thai Danu Bank ceded control of their banks to ABN-Amro and the Development Bank of Singapore, respectively; and so on. In all, 18 out of 20 families have come out losers in the crisis; only two — in the telecom and hotel businesses — have held their own.

To date, the principal beneficiaries from the families' calamities have been foreigners — provoking a hue and cry from opposition politicians who have discovered the populist appeal of nationalist rhetoric and are accusing the government of a wholesale sellout. It will not likely succeed as the new middle class sees its opportunity and as foreign competition creates a more level playing field.

At the two auctions conducted so far by the Financial Restructuring Authority (FRA) selling off property and business loans, Goldman Sachs and Lehman Brothers have concentrated on acquiring property for purposes of mortgage securitization. It will be a boon to the domestic bond market and, of course, to families who will be able to acquire homes and real estate at reduced interest costs.

Another encouraging sign in the aftermath of crisis, and as stock prices are at record lows, is that increasing numbers of new individual investors, including salaried employees, are entering the market. With interest rates on deposits falling below 5 percent, savings are being converted to equity. And, with the stock market's new second board for small and medium-size enterprises having opened on April 1, bringing new investment opportunities, this trend will continue — in the longer term, thus enhancing wealth distribution.

Bond market development

The collapse of Asian equity markets, the drying up of bank credit as nonperforming loans proliferated, and the process of loss allocation and bad loan resolution had a largely unintentional (but most welcome) by-product. New life has been breathed into regional debt markets and the opportunity to create deeper bond markets now exists.

Hong Kong Financial Secretary Donald Tsang Yam-kuen commented on the matter in a July 6, 1998, Asian Debt Conference speech titled "Asia's Reckoning: Bonds Can Free Asia's Economy." Failure to establish a strong and robust Asian bond market, he said, is among the reasons why, despite high growth, savings in excess of 30 percent of gross domestic product and almost no fiscal deficits, Asia managed to stumble into a world-class liquidity crisis.

By over-reliance on equity markets and banking systems, Asian corporations borrowed too much, incurring huge liquidity and currency risks.…Once bank credit shrank and stock markets collapsed, overseas investors could not diversify into bonds even if they wanted to. The only alternative they had was to withdraw their capital.

Now is the time to create a real Asian bond market. The economic crisis has damaged the corporate and banking sectors in some economies so much that the public sector has been forced to absorb part of these losses. From Japan to Indonesia, governments are issuing sovereign or government-guaranteed debt as they try to bail out the banking sector. This approach is modeled on the experience of the U.S. and the Scandinavian countries, which used their deep bond markets to assist in the corporate debt restructuring that came after.

What Tsang called for and forecast is now happening.

Because there was no government deficit spending to speak of in most of East Asia, even the Korean bond market, the region's second largest next to Japan's, remained small and relatively illiquid through 1997. The ratio of government bonds to GDP stood at 7 percent (compared to 54 percent in Japan and 69 percent in the United States). But the need to finance restructuring of the banking sector and projected budget deficits, in combination with sharply lower interest rates, is now effecting rapid change in Korea. The government is in the process of issuing some 50 trillion won ($42 billion) in new bonds, and the trading value of bonds (according to the Bank of Korea) increased by a whopping 283 percent in 1998 to 15 trillion won from 4 trillion won in 1997. Total lifting of the foreign ceiling on bond purchases in May 1998 helped and by the end of the year foreigners held five times the amount of bonds as in 1997. On the corporate bond side, junk bonds (BBB rating and below) have become all the rage as the government clamped down on new bond issuance by the country's largest conglomerate: New issuance in that field increased to 80 percent of the total in December 1998, up from 64 percent in November (**Figure 12**).

In Thailand the picture is similar. Through 1996, the small bond market had remained almost totally illiquid and without a benchmark because the government, by law, was prevented from issuing bonds while not in deficit and private corporations preferred the Euro-market to a moribund domestic one. But as in Korea, government financing needs — including some 800 billion baht ($21.6 billion) for finance sector restructuring — and record low interest rates now make the difference. Through consistent monthly government issuance of bonds in the longer-maturity range (7 to 10 years) a benchmark is being established; since July 1998, respectable monthly trading values in the 10 billion baht ($270 million) range and jumping to nearly double that (18 million baht) in December 1998 have been realized — nearing an unprecedented one-third of stock market volume on a daily basis. A market boost as well has come from the decision of local companies and banks to enter the domestic debt market with sizeable offerings; the country's two largest commercial banks alone are in the process of raising a combined 80 billion baht ($2.1 billion) to increase their tier-one capital (**Figure 13**).

By contrast, the never significant Indonesian debt market is continuing to languish, urgent government fund-raising needs notwithstanding. Currency volatility and high interest rates made it unattractive, although June 1999 the People's Consultative Assembly election results might clear the air.

Figure 12. Bond Trading Value - Korea

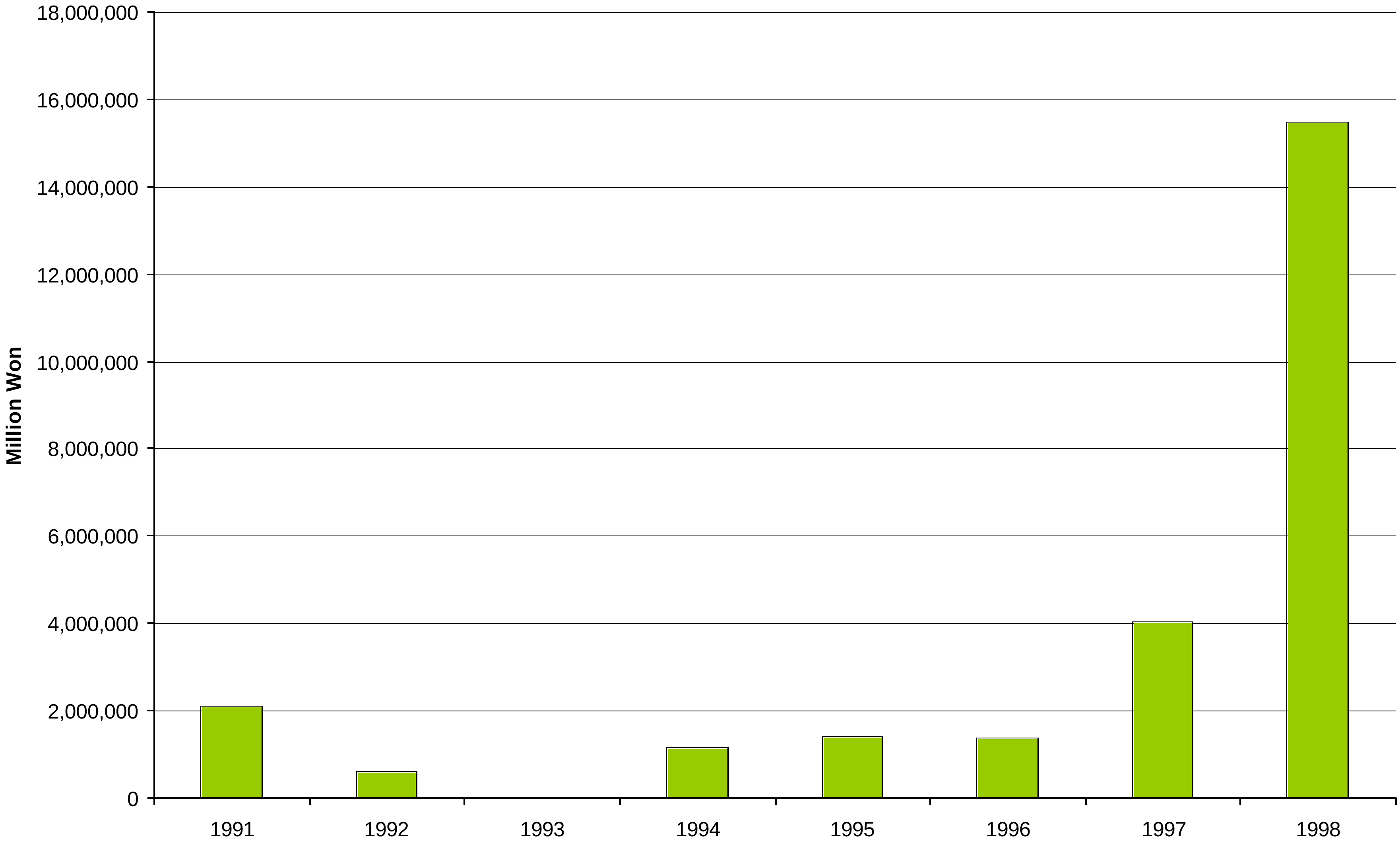
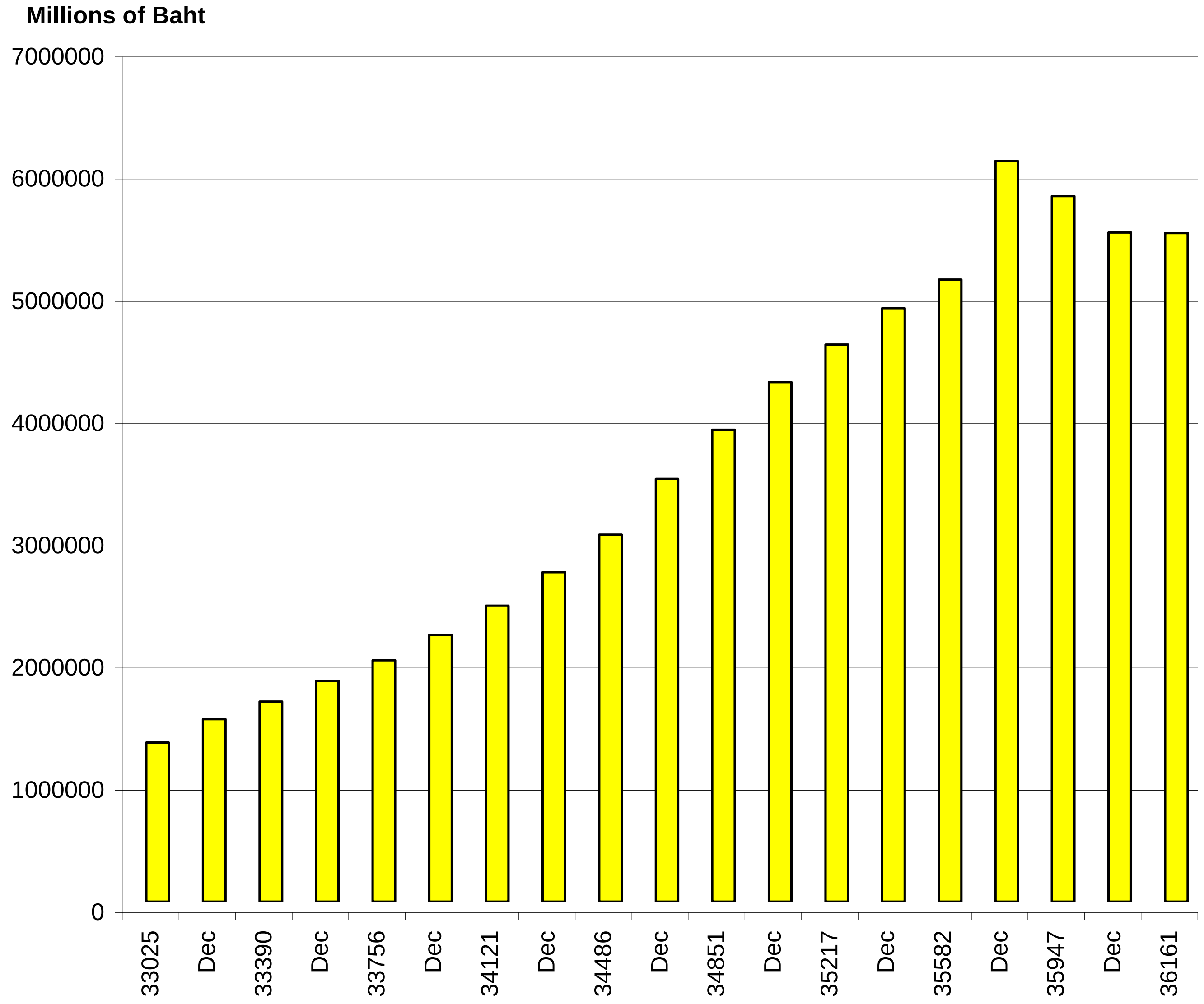


Figure 13. Commercial Bank Loans: Thailand



As Korea and Thailand lead the way toward the long overdue bond market and longer-term money challenge to equity markets and banks, domestic and foreign investors will benefit. Bond markets provide a reliable source of information on the state of a country's economy. The stock markets are indicators of current market confidence. Long-bond spreads, such as the one between 10-year sovereign Yankee bonds issued by governments over their U.S. Treasury counterparts, are key indicators of the credit risks in their domestic economy.

In pre-crisis days, Asian issuers were reluctant to subject themselves to the stringent disclosure rules covering debt securities. Asian corporations also preferred bank debt because that way owner-families retained control. Thus, the fact that bond markets are now beginning to take off, with more regional companies apparently willing to subject themselves to their discipline, means that there is an implicit and growing commitment to more adequate corporate governance and transparency.

ASSESSING THE CHANGES: LEGAL, REGULATORY, AND POLITICAL

A New Openness

The most far-reaching and, in the longer run, most important impact of the Asian crisis is the near-revolutionary change in legal and regulatory regimes that has occurred to date or is in advanced stages of the legislative process. The “New Openness Index” details the most significant of those changes by country (year-end 1996 versus. yearend 1999) and summarizes and rates them. (**Table 5**)

To assign openness and adequacy ratings and country rankings, each category was evaluated by comparison to international (e.g., BIS) and U.S. standards on a 0–10 point scale, 0 being the lowest, 10 the highest. The choice of U.S. legal and regulatory standards as a yardstick may appear problematical, given state-to-state variations and categories in which US standards may not be optimal. By and large, though, the U.S. economy is the world's freest as well as the best regulated and supervised one. In any case, these ratings do not aim for or claim unassailable mathematical accuracy, but to convey an adequate and useful summary account of change in East Asia over the past two years. Since popular and political support for legal and administrative reform will remain crucial, a political-risk ranking of the seven East Asian regimes follows the Openness Index (**Table 6**). Table 6 rates this risk — ranging from destabilizing political turmoil to "reactionary" government change to reversal or undue delay of reform legislation and reneging on international policy commitments — on a scale of 0–10; the lower the number the lower the risk:

Critics have warned that legislative changes alone will not suffice and ultimately will mean little if not accompanied by equally far-reaching changes in administrative procedures and attitudes. For every new

Table 5: Regime Changes Between 1996 and 1999

A. Foreign Business and Capital Markets Shifts

	Foreign business access		Capital markets openness		Capital markets regulation	
	1996	1999	1996	1999	1996	1999
Thailand	5	8	5	8	3	6
Korea	5	8	2	9	5	7
Indonesia	2	6	3	5	2	4
Malaysia	5	5	5	5	7	7
Philippines	3	7	4	6	3	5
Hong Kong	9	9	10	10	9	9
Singapore	8	8	10	10	8	9

B. Equity Market, Debt Market and Banking Shifts

	Equity markets		Debt markets		Banking system	
	1996	1999	1996	1999	19996	1999
Thailand	3	5	2	6	2	7
Korea	6	7	6	8	2	6
Indonesia	2	3	2	3	1	3
Malaysia	5	5	6	7	5	5
Philippines	2	4	2	3	5	6
Hong Kong	9	9	6	7	8	8
Singapore	8	9	6	7	10	10

C. Legal, Foreign Ownership and Real Estate Shifts

	Legal		Foreign ownership		Real estate acquisition	
	1996	1999	1996	1999	1996	1999
Thailand	2	8	3	8	2	6
Korea	5	7	2	8	2	9
Indonesia	1	3	1	5	2	3
Malaysia	6	7	3	3	2	3
Philippines	5	5	3	7	2	3
Hong Kong	9	9	9	9	7	7
Singapore	10	10	8	8	7	7

D. Total Scores and Relative Ranking

	Totals		Difference	Ranking	
	1996	1999		1996	1999
Thailand	27	62	35	6	4
Korea	35	69	34	4	3
Indonesia	16	35	19	7	7
Malaysia	44	47	3	3	5
Philippines	29	46	17	5	6
Hong Kong	76	77	1	1	2
Singapore	75	78	3	2	1

Note. Thailand and Korea have made the most important strides in reform and now rank above Malaysia, where few changes have occurred since 1996. With further improvements of its capital markets, Singapore moves ahead of Hong Kong. For definitions of categories and comments on individual countries, see Appendix A.

law, it is said, a clever and unreconstructed bureaucrat with the tacit backing of vested political and business interests (and enjoined by the cultural force of the patron-client relationship) can erect a new set of administrative barriers to its implementation.

In light of previous experience, such criticism and cautions are well taken. Continuing vigilance, assessment, and reassessment are in order. It should be noted, however, that in four of the five most troubled Asian nations (Indonesia, Korea, Malaysia, the Philippines, Thailand) new governments have come to power since the onset of the crisis. In the May 1998 Philippines presidential election, crisis issues were not central or critical to the outcome. But in the November 1997 ouster of the government of Prime Minister Chavalit Yongchayud in Thailand and the December 1997 Korean presidential elections, they were essentially the only issues, as, of course, in the May 1998 ouster of Indonesian President Suharto.

The new governments of Prime Minister Chuan Leekpai and Presidents Kim Dae-jung and B.J. Habibie knew full well who installed or elected them, on what grounds, and with what expectations. Public support for reform and vigilance by a freer and more outspoken press are at continuing high levels and will not countenance backsliding. That an unprecedented number of bureaucrats, bankers, businessmen and politicians are being put on trial on malfeasance and corruption charges is an important part of the picture and of the cleanup process. Accountability to investors, consumers, workers and all citizens is now part of the Asian agenda.

APPENDIX A

The variables listed in Table 5 are evaluations based on the following criteria:

Legal. Bankruptcy and foreclosure laws and procedures, including enforcement.

Foreign ownership rights. Percentage of foreign-owned corporations and financial institutions.

Real estate acquisition rights. Level of foreign access to the property market and foreign real estate ownership rights.

Foreign business access. Degree of access by foreigners to different business categories.

Capital markets openness. Degree of access by foreigners to equity and debt markets (investment limits).

Capital markets regulation. Quality of regulatory and supervisory regimes.

Equity markets depth and diversity. Market capitalization relative to GDP, liquidity, and diversity of tradable instruments (e.g., derivatives).

Debt markets depth and diversity. Market size relative to GDP, diversity, liquidity, availability of benchmarks, and ratings systems (agencies).

Banking system. Capital adequacy ratios, loan classification, foreign share in assets, and transparency (ratings requirements).

Country notes

Full reform accounts for Thailand and Korea are available upon request.

Thailand. Financial reform in Thailand started in earnest in the fall of 1997. Shortly after the Financial Restructuring Authority (FRA) was established in October, a series of royal decrees got the ball rolling, including: tightening of bank loan classification to shorten the period after which a loan is nonperforming from 12 to 6 months to keep a high capital-to-risk assets ratio (12–15 percent, compared to the BIS international norm of 8 percent); new rules allowing foreigners to take majority stakes in all financial institutions for a 10-year period, after which their share has to be lowered to less than a majority through capital increases available only to Thais; and rules allowing the Bank of Thailand to take control over troubled financial institutions, order changes in management, and write down shares to pay for losses.

Since then, further sweeping changes governing reform of bankruptcy and foreclosure laws and procedures, property ownership by foreigners, the alien business law dealing with business categories open to foreign investment, and banking system and capital markets regulation and development (including derivatives trading, asset securitization, and bond market decontrol) have been enacted or are in varying stages of the legislative process. This process will be largely completed before or by the end of 1999.

Korea. In April 1998, the Korea Development Institute (KDI) published a study of financial reform in Korea and Thailand and concluded that, "compared to Thailand, reforms in Korea have not even gotten to first base." That changed dramatically in May of that year in preparation for President Kim Dae-jung's June visit to the United States. Jacques Beyssade, Korea country manager of French bank Credit Lyonnais and vice president of the EU Chamber of Commerce, recently spoke of a "sea change'" in the Korean business environment. Some Gallic exuberance aside, it is a correct assessment.

In the banking sector, the Financial Supervisory Commission now enforces strict adherence to the BIS 8 percent minimum capital adequacy standard and has introduced a "prompt corrective action framework" to enhance transparency of financial information by setting exacting new standards for accounting and public disclosure.

Capital markets are now almost entirely open to foreign investors. The previous 26 percent ceiling on aggregate foreign investment in the Korean stock market has been abolished, as have ceilings for investment in the bond and futures and options markets. Only a 30 percent ceiling on aggregate foreign investment and a 3 percent investment limit in individual publicly owned enterprises remain.

Revision of the Foreign Exchange Control Act will completely liberalize capital transactions by January 2001, with Phase 1 taking effect as of April 1, 1999.

A new "Foreign Investment Promotion Act" completely liberalizes mergers and acquisitions and land acquisition by foreigners, opens 98.4 percent of domestic businesses to foreign direct investment (FDI), drastically minimizes FDI authorization and approval procedures, and empowers the Korea Investment Service Center (KISC) to provide one-stop service for foreign investment; and some 250 additional technologies are now eligible for tax incentives. Foreign investors will also receive financial assistance and government subsidies for employment and job training.

Capital and property markets liberalization have already shown very significant effects: the value of foreign-held bonds at the end of 1998 was five times the amount at the end of 1997; foreign stockholdings were up 5 percent; and foreign real estate purchases since market liberalization in June 1998 total 2 trillion won ($1.7 billion), up 400 percent compared to the same eight-month preliberalization time period.

Indonesia. If Korea at first was slow to react, restructuring and introduction of new laws and regulations in Indonesia was slower still in the initial crisis period. No significant reforms were introduced before the ouster of Suharto in May 1998. A flirt with a projected currency board exchange-rate regime came to naught. Even in the country's November 1998 letter of intent to the IMF, numerous restructuring initiatives remain formulated in the future tense.
And yet, considering the pre-crisis state of lawlessness, lack of regulation, and top-down, above-the-law control of the economy by the Suharto family and a handful of Chinese-Indonesian families with close ties to the Suharto clan, significant reform progress has been made.

New banking laws strengthen the autonomy of the central bank, eliminate restrictions on foreign investment in listed banks, and enable state bank mergers and privatization. New prudential regulations on connected lending, capital adequacy ratios, and the semiannual publication of financial statements have been issued. A new bankruptcy law replacing an antiquated and never used 1905 law from the Dutch colonial period has been enacted, and the Commercial Court, which exercises jurisdiction in bankruptcy matters, is operational. A master plan for the restructuring and privatization of all state enterprises over the medium term, has been adopted and publicly released. Complete divestiture of at least four state enterprises is in the final phase of completion.

The reform process is still far short of what has been accomplished in Thailand and Korea, but the above measures are indicative of progress in the right direction.

Philippines. Within months of the onset of the Asian crisis, the Ramos administration — after four years of struggle with Congress — completed a comprehensive tax reform program. It came none too early and allowed for a measure of fiscal consolidation even under fast deteriorating economic conditions.

Impending liberalization of the retail trade sector opens an important business sector to foreign investment. Investment houses have been opened up further to foreign, based on a law passed in late 1997 which raises the foreign equity participation from 49 percent to 60 percent of voting shares.

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