

FINANCIAL CAPACITY AND GOVERNANCE IN SOUTHEAST ASIA

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The currency and financial crises that broke in Asia in mid-1997 have provoked widespread re-evaluation of several orthodoxies in national and international finance. The severity and spread of the crises brought into the mainstream previously obscure and marginal debates, effectively undermining the 'Washington consensus' that had prevailed over the preceding decade. Some indication of the change in sentiment can be found in the report carried by a leading banking industry periodical, which featured comments by prominent economists on the dangers of unfettered financial markets (*Euromoney*, September 1998: 71-80). While debates on the currency crisis reveal more areas of disagreement than agreement, there seems to be one issue on which most are agreed: the need for more (or better) financial governance. The concept, however, is remarkably elastic and, in many formulations, approaches the tautological. This study aims to critically consider financial capacity and governance in the financial systems of the major Southeast Asian countries.

The current debate on the region's currency and financial crises has raised a number of questions about the wisdom and nature of the financial reforms carried out in the 1980s and early and mid-1990s. The defining characteristics of the various national financial systems in the years leading up to the crisis are not easily assessed. In some analyses, countries in the region had substantively liberalised financial systems. In other accounts, these same financial systems were substantively controlled. Many commentators have sought refuge in the assessment that financial reform in the region was 'incomplete'. This formulation usually suggests the desirability of further financial liberalisation, rather than liberalisation without adequate prudential regulation. However, the latter may explain much of the vulnerability to crisis displayed by countries in the region, but also raises more fundamental issues. Was the failure of national financial governance mere oversight on the part of national policy-makers? Or were there significant obstacles to better governance? How can one explain particular decisions that, even without the benefit of hindsight, were clearly costly or perverse? Finally, to what extent do external factors, especially internationally mobile finance, limit the effectiveness of even the most competent of national regulatory authorities?

Given the severe consequences of the region's financial crash, these questions are of great importance. It is hard to underestimate the severity of the crisis, even when the partial recoveries of stock markets and currency values towards the end of 1998 is taken into account. As shown in Table 1, the decline in the prices of financial assets was extraordinarily sharp for countries with low inflation. Banking system fragility remains a serious problem, ranging from high levels of non-performing loans in countries such as Thailand and Malaysia to virtual collapse in Indonesia. There are differences as to the severity of the banking crisis. Malaysia, for example, was confronting a large problem loan situation in the banking system as of late 1998, but a full-scale financial crisis was avoided: there was no serious foreign currency debt problem, and intervention by the authorities had ensured that credit did not entirely dry up. Indonesia was the worst affected country in the region, suffering a disastrous currency collapse and a grid-locked credit system. Although the Indonesian rupiah strengthened towards the end of 1998, some analysts considered this to be out of line with the country's likely prospects (*BT*, 21 November 1998).

Table 1. Asia-Pacific: Indicators of the Financial Crash, 1997-99

	Stock market*		Currency (units per U.S. dollar)**			GDP growth***	
	30.6.97	30.9.98	23.1.97	23.1.98	9.11.98	1998	1999
Australia	100	75	1.295	1.521	1.578	3.7	4.0
Indonesia	100	9	2393	12900	8200	-15.0	-0.6
Korea	100	26	855	1725	1321	-7.0	-0.7
Malaysia	100	23	2.491	4.499	3.79	-5.8	-0.7
New Zealand	100	50	1.447	1.732	1.875	-0.9	1.2
Philippines	100	26	26.33	42.16	39.84	-0.2	2.0
Singapore	100	39	1.407	1.763	1.647	-2.0	0.7
Thailand	100	28	25.81	54.22	36.78	-8.0	-1.0

Sources: * Value of US\$100 invested in stock exchange — Ross Garnaut, in *The Australian*, 20 October 1998.

** *FEER*, 5 February 1998; *FEER*, 19 November 1998.

*** Forecast growth rates — *FEER*, 19 November 1998.

The effects of the crisis have not been confined to the financial sector. It has had ongoing effects on the real economies of most countries in the region. By the third quarter of 1998, all the East Asian region's major economies except Taiwan and China were in recession and most 1999 GDP forecasts were for negative or low economic growth. Corporate bankruptcy rates rose dramatically in Hong Kong, Malaysia, Korea, Thailand and Indonesia during 1998. In Indonesia, problems with the banking system and the external indebtedness of the corporate sector were imposing severe costs on the country (Johnson 1998). According to an official survey, more than a third of Indonesia's key industries had been forced to close by October 1998, and of those remaining open, about 30 per cent had laid off workers, reduced work days and reduced shifts (*BT*, 7 November 1998). Unemployment and poverty levels in Thailand and Indonesia in particular rose precipitously during 1998.

These debacles in countries that had been seen as 'miracle economies' to emulate left the world asking what went wrong. 'What happened to Asia?' as Krugman (1998) put it. A slowdown might have been expected after a decade of economic growth rates that were (with the exception of the Philippines) among the highest in the world. Krugman, in fact, was one of those to foreshadow a reversion to slower growth (1994). But slower growth is one thing, no one expected a crash of such severity and speed. A few cautions had been sounded. For example, the IMF had reportedly warned the Thai authorities about Thailand's current account deficit and banking system fragility. But 'the warnings were made only in secret and cannot be verified. Moreover these warnings, if they were given, were inconsistent with published IMF commentary at the time, including that contained in the IMF's *Annual Report 1996* and its special 1996 report on the Thai economy' (Warr 1998: 59). Bad debt and regulatory problems in the Indonesian banking system had been public issues since the early 1990s. The high debt to equity ratios of Korean conglomerates were also well-known. Overall, however, positive assessments of the region's prospects predominated; spreads (the risk premium attached to international lending rates) on external borrowing by the region's banks and corporations actually narrowed in the years before the crisis; and inward capital flows remained strongly positive until their sudden reversal.

Table 2. Capital Flows to Five East Asian Crisis Countries^a (US\$ billion)

	1994	1995	1996	1997 ^b	1998 ^c
Current account balance	-24.6	-41.3	-54.9	-26.0	17.6
External financing (net)	47.4	80.9	92.8	15.2	15.2
Private inflows (net)	40.5	77.4	93.0	-12.1	-9.4
Direct equity	4.7	4.9	7.0	7.2	9.8
Portfolio equity	7.6	10.6	12.1	-11.6	-1.9
Bank credit	24.0	49.5	55.5	-21.3	-14.1
Non-bank credit	4.2	12.4	18.4	13.7	-3.2
Official inflows (net)	7.0	3.6	-0.2	27.2	24.6
Residents and other (net) ^d	-17.5	-25.9	-19.6	-11.9	-5.7
Change in reserves ^e	-5.4	-13.7	-18.3	22.7	-27.1

Notes: ^a Korea, Indonesia, Malaysia, Thailand and the Philippines.

^b Estimate.

^c Forecast.

^d Includes resident net lending, monetary gold, errors and omissions.

^e A negative value indicates an increase.

Source: Institute of International Finance, "Capital Flows to Emerging Market Economies", 29 January 1998 [<http://www.iif.com/PublicPDF/cf-0198.pdf>].

So what went wrong? Alternative explanations are discussed in a later section. At this stage, it is sufficient to say that the major disagreements reflect fundamental differences in opinion as to how financial markets operate and, consequently, the implications of different financial policies. If financial markets are assumed to be naturally tending toward Pareto-optimal equilibria, the origins of financial crises will be presumed as factors that interfere with market mechanisms in either the financial or real sectors. Such factors include policy-induced moral hazard, perverse incentives due to interference with prices, oligopolistic banking structures and government-mandated financial repression. On the other hand, when financial markets are seen as inherently imperfect, the origins of financial crisis are more likely to be traced to the inadequacy of private or public mechanisms to overcome market failure. In this view, the crisis and the severity of the crisis may be attributed to factors such as inadequate prudential regulation, uneven development of financial markets and poor policy responses.

One major conclusion presented here is that financial markets tend to allocate resources imperfectly even in the best of circumstances. Such problems are more serious in developing countries, which are also more prone to serious instability, particularly following substantial liberalisation. Managing financial markets is thus a demanding task for government, regardless of whether the policy regime aims at more market-based allocation or greater intervention is attempted. Largely bank-based financial systems in which competition is limited may in fact be appropriate for developing countries given the risks associated with more dynamic but unstable liberalised systems.

Our second major finding is that developing and maintaining appropriate financial governance is a crucial factor determining policy outcomes, since the main cause of failure is often in the implementation rather than the design of financial policy. Significantly, the scope for abuse by politically influential interests may not decline but may actually increase with financial sector deregulation. Indeed, the consequences of inadequate governance capacity to regulate such interests are likely to become more costly as the financial sector develops under liberalised policy regimes. The international openness of financial markets also increases the risk of instability associated with

financial liberalisation, creating additional demands on national — and international — governance systems.

The following section reviews some of the theoretical issues concerning financial markets and governance that have implications for policy in the financial sector. Second, the country cases are introduced with a presentation of pre-reform financial policies, structures and outcomes in Indonesia, the Philippines, Malaysia and Thailand. The next section discusses the financial reform experiences of these countries. The penultimate section draws on the information given in the country cases to assess contending explanations of the 1997-98 financial crisis in Southeast Asia. Some conclusions for financial policy and institution building in developing countries are offered in the final section.

Analytical Issues

Governments intervene in national banking systems and capital markets for a variety of reasons and with different consequences. It is widely accepted that a minimum level of intervention is required for prudential reasons. Beyond this, intervention may be primarily protective or redistributive, structured to favour particular constituencies. In certain cases, more strategic or developmental policies may be attempted. Each type of intervention has a different rationale in economic theory and, it is argued here, each requires specific capacities on the part of national regulatory authorities. The major theoretical and policy issues are reviewed here, including those associated with internationally open financial systems.

Finance and Development

The relationship between the financial system and economic development is contentious because different economic perspectives accord differing degrees of importance to three factors: information asymmetries, transaction costs and price incentives.¹ The degree to which intervention in financial markets is advocated partly depends on assumptions about the role of finance in generating economic growth as well as the relative weight accorded to each factor. Information asymmetries are a common feature of financial transactions. Simply put, borrowers will always have more information about their business than outside creditors will be able to gather. Creditors' imperfect information means that the price of a financial asset will only imperfectly reflect credit risk and credit can be inefficiently allocated. Of course, creditors can take steps to minimise gaps in their information, but some such efforts are costly.

As highlighted by the now substantial literature on transaction costs, organisations play a key role in reducing costs associated with information gathering, monitoring and analysis (Williamson 1975, 1985). Because they reduce transaction costs associated with transforming savings held by one economic agent into investment by another economic agent, specialised financial intermediaries such as banks ought to enhance efficiency. Hence, an early line of thought in the literature on finance and development held that increasing the degree of financial intermediation in a country would have positive effects on growth (Gurley and Shaw 1955).

The implications of these features of financial transactions and intermediation have developed into two increasingly divergent lines of analyses. On the one hand, followers of McKinnon (1973) and Shaw (1973) have emphasised the advantages of

¹ Fry (1995) provides a comprehensive review of the theory and evidence regarding finance and development and argues the case for liberalised financial systems. On market imperfections, see Stiglitz and Weiss (1981), Hellman, Murdock and Stiglitz (1997) and reviews by Chin and Jomo (1996), Lee and Haggard (1995) and Park (1994).

increasing the ratio of financial assets in the economy (financial deepening). Financial liberalisation, particularly the removal of interest rate controls and implicit taxes on financial intermediation, has been promoted as a means to financial development and the more efficient use of financial resources. In general, these models have moved away from Gurley and Shaw's original thesis regarding the advantages of financial intermediation, which has its rationale in the transaction costs associated with direct financial transactions between borrowers and lenders, to emphasise the conventional advantages of the price mechanism as an allocative device. In this view, encouraging the liberalisation of all financial markets, not just the development of intermediated finance, will yield efficiency gains as investment risks are most accurately priced in competitive, liquid and diversified markets for financial assets.

In contrast, various theories of finance and development have placed greater emphasis on factors that make entirely market-based financial systems sub-optimal. In this respect, early work by Gerschenkron (1962: 5-30) remains influential. In his account, countries which industrialised at a later date than the leading economy of the day needed to create systems for industrial finance that differed greatly from those in the leading economy. Thus, Germany developed a system of industrial finance in which banks (rather than the stock market) provided most of the capital for industry and, rather than remaining in their role as external creditors, the banks maintained close management ties to industrial firms. Russia, a case of even later development, adopted a state-financed path to infrastructure development, which was then succeeded by a more bank-based system. Different forms of financing emerged, partly because the optimum scale of industry, and thus the amount of finance required, tended to be much greater for late developers, at least for heavy industries. In addition, the credit infrastructure in less developed countries would not normally support the financing needs of industrial development. To mobilise sufficient resources and monitor their use, intervention by government or other authoritative organisations is required.

Essentially, Gerschenkron's analysis of late industrialisation suggests that in certain circumstances, market mechanisms for the provision of external finance for investment will fail, to some degree, and thus, the creation of 'quasi-internal' capital markets can be more efficient. This insight has been developed and expressed more formally by later economists, who have developed models of financial intermediation that incorporate information asymmetries and transaction costs.² In general, these models provide the bases for introducing certain non-market mechanisms for the allocation of finance. Internal capital markets for the purpose of allocating financial resources can become efficient because financial transactions 'are especially subject to moral hazard and costly contract enforcement' (Lee and Haggard 1995: 6). For this reason, individual firms often develop an internal capital market for their savings and investment decisions. However, given the need for a critical minimum capital market size for efficiency reasons, German-style universal banks — or even governments — may also replicate elements of an internal capital market.

The close ties between banks and industry promoted by universal banks have the effect of mitigating the information asymmetries associated with external finance. Close bank-industry ties are also associated with the provision of longer-term finance (Zysman 1983), which may be particularly important for late developers aiming to 'catch-up' with technological advances. Government intervention in the financial system can provide alternative forms of hierarchical credit allocation. Regulatory controls on the prices of financial assets resulting in below-market or even negative interest rates for certain

² Chin and Jomo (1996) review the major arguments in this area.

categories of borrowers have been used to influence investment and credit decisions. The rationale for this type of financial repression lies in the view that, in certain circumstances, a market-based financial system will not provide adequate incentives to invest in technological upgrading or industrial development. If the lead-time required for technology acquisition is significant, uncertainty will be high and credit risks priced accordingly, even if the projected investment has long-term or external benefits that would make it viable or desirable. In these circumstances, ‘getting prices wrong’ — including the price of credit — may be an integral part of development policy (Amsden 1989).

The record of attempts at this type of financial repression is quite chequered. Some degree of financial repression in Taiwan, Korea and Japan was consistent with excellent economy-wide performance and significant developmental success (Patrick and Park 1994). However, in many developing countries, developmental goals have not been realised and financial repression has merely created disincentives for financial savings and, very plausibly, grossly inefficient investment decisions. In part, the record is poor because this type of policy is particularly subject to implementation problems. It is also the case that advocates of financial repression have done a better job of explaining why market-based financial systems may fail in theoretical terms, than they have in clearly identifying the conditions in which alternative financial systems will allocate credit well.

Aware of the theoretical and practical limitations of policies of financial repression involving explicit credit targeting, a theory of financial restraint has recently been advanced (Hellmann, Murdock and Stiglitz 1997). Financial restraint involves the inhibition of price competition among financial intermediaries while maintaining market-based incentives. Financial restraint and targeted credit subsidies are both attempts to channel rents to economic agents for the purpose of creating positive externalities for the economy as a whole. But while targeted credit subsidies provide economic rents to borrowers, financial restraint allocates rents to financial intermediaries, otherwise leaving specific credit allocation decisions to be guided by market-based incentives. Interest rate controls limit price competition for bank deposits, but as long as real interest rates remain positive, financial savings may still be encouraged through non-price competition and the confidence-enhancing effects of reduced competition in the banking system. Regulatory controls on lending rates are consistent with non-price competition among creditors since they still have an incentive to maximise earning assets. But reducing price-based competition means that long-term banking relationships are likely to be encouraged, mitigating the problem of imperfect information in financial transactions.

Financial Markets: Stable or Unstable?

Some degree of prudential regulation of financial markets is now accepted by most analysts, and virtually no national financial market operates without some prudential regulation. Two major rationales exist for some prudential regulation. In the first place, financial markets seem particularly susceptible to ‘irrational’ (that is, not justified by underlying economic realities) behaviour on the part of investors as self-fulfilling spirals of first enthusiasm and then panic can dominate credit allocation on the basis of an assessment of underlying factors. When the expected price of a financial asset in the future depends significantly on the behaviour of other investors, each investor will, quite rationally, pay more attention to investor behaviour than a company’s actual earnings

prospects.³ Regulations that attempt to minimise the scope for ‘irrational exuberance’ (to borrow a phrase from the current chairman of the Federal Reserve Board) and intervention in the form of lender of last resort facilities during a panic can dampen, if not avoid, these cyclical swings in financial markets.

Prudential regulation and a lender of last resort facility are also features of most financial systems because of the degree of systemic risk that is generally perceived to exist. Systemic risk, in this sense, is the risk that the failure of one agent in the financial system that results in default on its financial obligations will generate a chain reaction of default by other institutions, even though they may be solvent. An element of systemic risk exists in all economic systems, but in fractionally-backed banking systems or other financial markets where leverage is significant, systemic risk becomes particularly important. The degree to which systemic risk is an inherent problem in financial systems is debatable, and the remedies proposed to manage it may also exacerbate it. That is, the more regulatory authorities intervene to ensure the soundness of market participants, the less incentive financial actors have to carry out their own monitoring of those they transact with. Further, the more prudential regulations imply an engaged national authority with an interest in system stability, the more lender of last resort intervention will be expected. And as originally captured in Walter Bagehot’s *Lombard Street*, this situation creates moral hazard — the problem that actors who expect to be rescued from the consequences of risky behaviour have no incentive to minimise or provide for risks.

Financial Governance

The foregoing discussion demonstrates that some form of financial governance is a practical necessity. Even a deregulated, market-based financial system requires national authorities to play an active role in maintaining, if not also in establishing, such a system. Simply put, finance is a difficult sector that is demanding on government regardless of policy regime. In the event of a financial crisis, disengagement is not politically possible in any but the most extreme cases. Even if it were politically feasible for governments simply to stand back and allow widespread default to run through the financial sector and then the real economy, this would probably be an extremely costly course of action. Therefore, moral hazard problems, raised by many as behind East Asia’s recent crises, are unavoidable. As an increasing number of economists have argued, a market-based financial system requires adequate human resource development together with a system of law, regulation, information dissemination and prudential enforcement (McKinnon 1986; Hugh Patrick, cited in Lee and Haggard 1995).

It seems likely that some forms of ‘command’ in the allocation of credit will be especially advantageous when the institutional structure to support a competitive, market-based system does not exist. However, deficiencies in governance capacity will also be consequential in such hierarchical systems as they are subject to implementation problems. As the literature on rent-seeking reminds us, regulatory interventions tend to create openings for politically-influential actors to realise private gains at public cost. Any attempt to channel rents productively thus requires some capacity to discipline the economic actors that benefit from them. The more ambitious financial and industrial policy is, the more it appears that problems of discipline, design, information and policy rigidity will compromise actual outcomes, even if the original intervention is theoretically justifiable. However, as the cases of Indonesia and the Philippines discussed here show, when governance is severely defective, with administrative ineptitude common and

³ This is the ‘beauty contest’ described by Keynes. Kindleberger (1996) discusses the cycle of ‘manias, panics and crashes’ endemic to financial markets over the past centuries.

corruption virtually systemic, it is likely that these features of government will be of overriding importance whatever the financial policy regime. It makes little sense, for example, to debate the marginal effects of minor adjustments to interest rates when specially-favoured individuals avoid paying the principal on their loans.

This study shows the potential for systematic abuse of policy by rent-seeking groups both before and after reform aimed at substantial deregulation and liberalisation. If the costs of post-deregulation crises are taken into account, it is not at all evident that interventionist financial policies are easier for governments or that the costs of government failure are higher under interventionist policy regimes. Post-deregulation financial systems all over the world seem especially vulnerable to financial instability, which tends to be exacerbated by international capital flows (Diaz-Alejandro 1985; Park 1994; McKinnon and Pill 1996; Demirguc-Kunt and Detragiache 1998). Based on this evidence, liberalisation is not an easy or attractive option for governments with less than robust regulatory and surveillance systems.

This returns us to the question of what governance capacity in general and financial governance in particular consists of. It is not easy to make an *ex ante* specification of the factors producing 'good governance'. Books extolling the governance capacities of countries in Asia (Root 1996; Rowen 1997) were appearing as the crisis was brewing. One detailed study of Thailand singled out the financial sector as one where 'social capital' — a term used to describe the conditions conducive to effective governance — was particularly well developed (Unger 1998). Considering that poor governance in the Thai financial sector was the source of the region's meltdown, it should be quite clear that there are few areas of agreement on how one recognises governance capacity. It is tempting to conclude that the concept is meaningless: when East Asia enjoyed spectacular rates of growth, it had good governance; when it crashed, it was discovered to have flawed governance.

The country studies below show that there are particular institutional features associated with more or less effective financial sector governance. Democracy as such does not emerge as a necessary factor in effective governance; while political stability and limits to political competition seem to be important. Administrative organisations that enjoy high levels of staff expertise and relatively high prestige are often associated with more effective governance. Complete insulation of the administrative sphere from politics is not possible and has rarely existed, certainly not in the countries under study. It seems important for key administrators to have roles and (to some extent) interests that differentiate them from political and business actors. Further, the basis for interaction between different types of actors should be regularised rather than subject to personalistic criteria. Overall, attention to state-building along Weberian rational-legal principles emerges as an important condition of effective governance.⁴

Open Economy Financial Policy

An open financial system complicates the tasks of financial sector governance, considerably raising the demands on government. In an open system, government capacity becomes even more important at lower levels of policy ambition.⁵ Since international factors have been important for countries in this study — most dramatically with their recent currency crises — the constraints on government arising from financial openness are briefly reviewed here. One of the basic constraints of openness is described

⁴ See Hutchcroft (1998) for an argument along these lines illustrated by the Philippine case. Hamilton-Hart (1999) discusses the factors accounting for (or compromising) institutionalised governing systems in other Southeast Asian countries.

⁵ This argument is elaborated and assessed in Hamilton-Hart (1999).

in a well-recognised (in theory at least) axiom known as the Mundell-Flemming thesis.⁶ Simply put, it holds that under conditions of capital mobility, governments must choose whether they wish to control the external price of their currency (the exchange rate) or internal real interest rates. Monetary autonomy, stable exchange rates and capital mobility are not all simultaneously realisable. In this situation, national authorities are forced to make difficult trade-offs. As we shall show in a later section, the attempt to avoid such trade-offs was, to some extent, responsible for the region's currency crisis.

Financial openness places particular demands on government by tending to undermine national efforts at prudential regulation and lender of last resort functions. Singapore's relatively internationalised but comparatively stable banking system shows that national prudential standards are not necessarily compromised by openness. But, as shown by the Indonesian case, the ability to circumvent national regulations by going offshore was a major factor behind the failure of both public and private sector governance. While national regulators may be hampered in their prudential efforts, they are no less required to act as lenders of last resort when a financial crisis does occur. The same caveats about the risks of moral hazard apply, but sovereign guarantees are generally necessary to restore confidence in a real crisis. When a crisis of confidence revolves around the currency — rather than the domestic banking system — the national lender of last resort is only able to lend to the extent that its foreign exchange reserves allow it to do so. And to exacerbate the situation, the belief that the national authority may have to run down its foreign exchange reserves can itself further erode confidence in an economy and its currency. These are real problems raised by an international financial system that remains primarily regulated at the national level. The current debate about reforming international cross-border financial flows is beyond the scope of this study, but the issues raised by the debate are important in the cases presented here.

Pre-reform Financial Regimes

This section looks at banking and financial policy in four Southeast Asian countries — Indonesia, the Philippines, Malaysia and Thailand — in the years before they initiated major reforms in the financial sector. First, the major features of financial policy and financial system organisation are described. The degree of government activism in the financial system is assessed and, more specifically, the nature of government intervention. Second, monetary and foreign exchange policies are reviewed with the aim of summarising the major policy goals, mechanisms and outcomes. Third, we examine the underlying conditions that enabled — or compromised — national policy in these areas.

Indonesia

Of the countries covered in this study, Indonesia had the least developed financial system at independence (declared in 1945, ceded by the Dutch in 1949). Relatively sophisticated, internationalised foreign banks dominated the banking system until most were nationalised or brought under substantial Indonesian control in the late 1950s. These banks were, however, a small enclave in an economy that made very little use of banks or formal financial markets. By the end of the 1950s, the stock exchange was stagnant (Bank Indonesia, *Report for the Financial Year, 1959-1960*: 99-101) and, despite being re-opened in the 1970s, did not become active until the late 1980s. The inter-bank market in the 1950s was extremely limited and the financial sector remained comparatively undeveloped until the 1980s.

⁶ See Goodman and Pauly (1993) for a political economy account of this axiom.

Government-led financial development efforts in the early years of independence focused on the establishment of several state-owned commercial banks. In the late 1950s, the largest foreign banks, the Dutch banks, were nationalised and, in the early 1960s, the remaining foreign banks were also taken under national control. During the periods of parliamentary democracy (until 1957) and ‘guided democracy’ (until 1966) under Indonesia’s first President, Sukarno, the state banks largely functioned as a means of channelling government budget funds to political supporters and public sector projects.⁷ General policy disarray and adverse economic and political circumstances in the last decade of President Sukarno’s rule meant the complete breakdown of earlier attempts at a coherent industrial or economic development strategy. Hyperinflation in the mid-1960s saw the banking system, indeed the country as a whole, effectively bankrupted by the time General (later President) Soeharto’s New Order took power in 1966.

In the late 1960s, the new government’s economic policy efforts focused on bringing inflation down through quite drastic monetary levers, re-negotiating external debt and securing the financial resources needed for recovery (Arndt 1984: 135-59; Winters 1996). Foreign banks were admitted in 1968, but thereafter, entry into the banking sector was closed to foreigners and restricted for Indonesians until deregulation in the 1980s. The government was successful in its use of high interest rates to mobilise substantial savings from 1969 to 1972, but at the cost of negative interest spreads. For most of the time between 1973 and 1982, real deposit interest rates were negative (Cole and Slade 1996: 18) and bank savings growth limited (Atiyas *et al.* 1994: 97). In terms of banking offices per inhabitant, development was more or less stagnant from the early 1970s until 1989.⁸ Non-bank financial institutions (NBFIs) and private development finance companies were promoted in the 1970s and early 1980s (McLeod 1984), but they did not function as expected and the NBFIs (most in poor condition) were converted into commercial banks in 1992.

Together with a state-owned national development bank and a large number of regional development banks, the state sector accounted for most banking system assets from the late 1950s until reform in the 1980s. In the 1970s, state banks accounted for about 80 per cent of total bank assets (Chant and Pangestu 1994: 229). In addition, a number of subsidised lending programmes for small business and agriculture were developed from the late 1960s (Rahardjo 1995: 273-328). As part of these efforts, the central bank, Bank Indonesia, was used as an ‘agent of development’ to finance officially prioritised sectors and organisations.⁹ As well as providing rediscounting of commercial bank credits, direct credits from the central bank were used to fund high-profile government agencies such as the commodities board (Bulog), to bail out the state oil company after 1975 and to provide subsidised credit for favoured individuals. In this respect, the direction of subsidised credit changed noticeably over time. In the late 1960s, subsidised credits for rice stabilisation and farmers accounted for over 40 per cent of all bank credit, a proportion which declined fairly steadily to 13 per cent in 1975, 9 per cent in 1980 and 2 per cent in 1990. From 1975 to 1980, the single largest component of subsidised credit was accounted for by repayments on the state oil company’s loans, run up as a result of fraud and mismanagement in the early 1970s (MacIntyre 1993: 150).

An unusual feature of the pre-reform Indonesian financial system was that a heavily government-controlled banking system co-existed with an exceptionally open capital account. A complex system of foreign exchange allocation and multi-tier

⁷ On banking in the first decades of independence, see Emery (1970: 153-225), Nasution (1983) and Wardhana, in Glassburner ed. (1971).

⁸ Population per bank office remained around 18,000 between 1974 and 1988 (Pangestu 1996: 113).

⁹ On these functions, see Prawiro (1972) and Rahardjo (1995: 273-328).

exchange rates in the Sukarno period had been associated with frequent scandals involving the allocation of foreign exchange, widespread bribery and fraud, and a severe smuggling problem (Higgins 1957; Simkin 1970). With the new regime, a progressively simplified foreign exchange system was introduced from 1967, and in 1970, all capital account controls were eliminated. Since then, exchange controls have been practically non-existent, without even the reporting requirements imposed by other countries after liberalisation. Since 1974, overseas investment by Indonesian companies has been officially prohibited, but this has not prevented extensive investments being made through foreign-incorporated companies (Hamilton-Hart 1999: 77).

Despite this capital account openness before the 1980s, monetary policy showed some signs of independence. Since the late 1960s, containing inflation has been a priority for the monetary authorities, and in general, they have succeeded in this. Besides credit and interest rate controls until the early 1980s, reserve requirements were imposed on the banks, but the invariability of the reserve ratio meant that it was not a monetary policy lever. Negative real interest rates for most of the 1970s were maintained in conjunction with a relatively stable currency until 1978. Quantitative controls on credit and government spending were the main monetary policy levers in the 1970s.

In economic terms, financial policy outcomes in the pre-reform era can be categorised as a relative success for monetary control after the stabilisation efforts in the late 1960s, but a relative failure as regards the banking system. For most of the pre-reform era, the banking system had a limited ability to mobilise financial savings. However, it must be noted that in comparison with many other developing countries, bank stability due to government guarantee of the system did make bank-based savings secure. Combined with macroeconomic stability, this feature was probably behind Indonesia's relatively good national savings rate. By 1980, national savings were 33 per cent of GNP (Pangestu 1996: 101), which is not exceptional by regional standards but high compared with a wider sample of countries at similar levels of development.

The government-controlled banking system was, however, a constant drain on the national budget. This was mainly due to the extensive direct and indirect credit subsidies channelled to high cost state enterprises and politically favoured private interests. In terms of realising economically sustainable developmental goals, there has been little observable return on these subsidies. Indonesia did achieve undoubted success in some areas, particularly in terms of relatively high overall growth rates, poverty alleviation and food production. To a great extent, however, rather than economic success being due to the government's financial and credit policies, aid and oil revenues fed the system. When oil prices fell in the 1980s, Indonesia came under strong pressure for reform.

By looking at the administrative capacities and governance structures behind policy, we can offer a partial explanation of Indonesia's mixed record. In terms of the overall institutional environment of financial policy, Indonesia's governing system since 1966 was politically stable throughout the pre-reform period, with little effective, organised opposition to the Suharto regime. The state, however, "has not been 'strong' or 'hard', but rather infused with patrimonial distribution networks linking officials and business people" (MacIntyre 1994: 244). However, while showing some similarities with Philippine-style 'booty capitalism' (Hutchcroft 1998), the governing structures of Indonesia have had a more solid institutional base in the state than those of the Philippines. The state apparatus has not been completely ineffective in its official tasks, and development policy from 1968 until 1997 led to improvements in a range of economic and social indicators.

The administrative structure of the governing system has often been weak in terms of the functional tasks it has had to perform, particularly when these tasks involved issues

other than regime security. Indonesia 'began its post-revolutionary existence with what was undoubtedly the weakest civil service by far of any contemporary major state' (Kahin 1967: 581). Corruption was common, as it had been under the Dutch, and was exacerbated by the hyperinflation of the mid-1960s (Smith 1971). The erosion of bureaucratic salaries due to inflation meant that non-salary sources of income became necessary. The armed forces in particular began to be extensively involved in business enterprises and also struck up relationships with businesspeople, often ethnic Chinese, who gained a measure of protection in return for financing (Crouch 1988). Despite official rhetoric about the rule of law brought in by the new regime in 1966, over the next decade, it continued to be the case that 'an official's real status depends not on his formal title but on securing wealth, clients and favour' (McVey 1982: 88).

In the financial sector, the pre-eminent organisation responsible for policy and implementation in the pre-reform period was the central bank, Bank Indonesia. Bank Indonesia had been established as the Javasche (Java) Bank in 1827 and full control over the bank by the independent Indonesian government was not secured until 1951.¹⁰ From 1955, Bank Indonesia had 'all the powers and prerogatives of a central bank', but limited ability to use them (Higgins and Hollinger 1960: 60). This is often attributed to the lack of an effective money market, but other central banks, including Malaysia's Bank Negara, have exercised monetary control despite this handicap. Continued commercial banking, which was supposed to end with the Central Bank Act of 1953, reduced the priority given to central banking functions and compromised standards for its own clients. It also contributed to the central bank's low standing among commercial banks (Nasution 1983: 60). Most obviously, the ineffectiveness of the central bank's monetary policy in the period to 1966 was due to the government's inability and unwillingness to restrain spending. The legal limits on central bank advances to government were repeatedly over-stepped.

Under the banking law of 1967 and the Central Bank Act of 1968, Bank Indonesia became more of a pure central bank with the transfer of its commercial banking department to other state banks. It did, however, hold shares in other financial institutions, either as a joint venture partner or as part of rescue packages for private banks (Nasution 1983: 63). The central bank's record with these institutions is not good, although details on credit support and equity financing are generally not made public. Bank Indonesia stood at the centre of the greatly expanded state banking sector from the early 1950s but, under both the Old and New Orders, was unable to stop the bribery, bad credit decisions and channelling of loans on the basis of political connections that were among the deficiencies of these banks (MacIntyre 1993). Low salaries in the central bank may have made regulators particularly susceptible to outside pressure, but the overall Indonesian context of personalised political authority and the use of official credit for patronage purposes would have compromised regulatory functions however skilled, motivated and well-paid the central bank staff. From the early New Order onwards, the Indonesian government has in fact had a sizeable pool of technocratic expertise available to it, suggesting that political, not technical, factors compromised financial policy in the pre-reform period.

It is perhaps surprising that the Indonesian regulatory context was nonetheless able to provide for success in terms of macroeconomic stability from the late 1960s onwards. During the 1970s and early 1980s, although inflation levels exceeded 10 per cent at times, inflation was not a major problem. In part, this record of success is due to the fact that macroeconomic goals, unlike micro-level credit policy, can be relatively

¹⁰ Bank Indonesia's history is given in Rahardjo (1995).

easily insulated from particularistic interests. Limiting political competition and excluding popular pressures from any influence over policy under an authoritarian regime that prioritised rural stability also reduced political incentives for overly expansive macroeconomic policy.

Responsibility for monetary policy under the 1968 Central Bank Act was accorded to the Economic Stabilisation Council, chaired by the President, with the central bank governor a member. The Monetary Board, still chaired by the Minister of Finance, is meant to assist the government in planning monetary policy. However, the formalised commitment to a balanced budget that was brought in by the new regime has institutionalised a block on central bank provision of credit to government. Efforts by Indonesian technocrats to maintain this conservative fiscal stance would have been greatly helped by the influence of external aid donors, who saw the prohibition on domestic financing of the budget deficit as crucial. Most of all, however, it is likely that the government's access to adequate financial resources through oil revenues from the early 1970s to the early 1980s made it possible to operate a patronage-oriented credit system without excessive domestic deficit financing.

The Philippines

Like the other countries in this study, in the period until financial reforms in the early 1980s, the Philippines had a bank-based financial system, at least as far as the formal financial sector was concerned. Even by the late 1970s, trading on the country's two stock exchanges was at relatively low levels and did not increase much over the latter half of the decade.¹¹ Commercial banks accounted for 46 per cent of total financial assets in 1970, reflecting a relatively large role for savings banks and private development banks at this time, as well as a large and increasing share of financial assets held by the central bank. Government commercial banks had a significant role to play in the early period, but they were never in the dominant position of Indonesian government banks. Foreign banks lost their pre-eminent position early in the twentieth century. From the early 1950s, the foreign share has been under 15 per cent of commercial bank assets. At first, the erosion of the foreign bank position was due to the expansion of government banks, but private domestic banks held half, or more than half, of all commercial bank assets from 1960 onwards (Hutchcroft 1998: 257). Private domestic banks thus emerged as significant actors comparatively early in the Philippines.

Table 3. Philippines: Commercial Banking Assets, 1970-1980 (%)

	1970	1975	1980
Private	59	66	61
Government	33	35	25
Foreign	8	–	14
Total (billions of pesos)			
Commercial banks	14.1	53.2	138.4
Central bank	6.0	26.0	65.4
Financial assets	30.9	122.7	313.1

Source: Montes and Ravalo (1995: 155).

¹¹ Total trading on the Manila and Makati stock exchanges rose in nominal terms from 3.1 billion pesos in 1975 to 4.7 billion pesos in 1980 (Lamberte *et al.* 1992: 203).

In the 1960s, there was particularly rapid growth and proliferation of domestic private banks. During this time, nearly every major business family diversified into banking (Hutchcroft 1998: 81). The central bank encouraged the development of private commercial banks, providing ‘subsidies on their initial capital and operational funds via the rediscount window’ (Montes and Ravallo 1995: 143-44). Family-based, sectorally-diversified conglomerates which included a group bank became the norm as Philippine industrialisation and financial development evolved from the 1950s onwards.

From 1972, there was a *de facto* prohibition on new entrants into the banking industry, and intra-industry co-operation through personal contacts and the Bankers Association of the Philippines was routinised. Interest rates were subject to official controls through the 1970s, with ceilings on loan and deposit rates. However, the ceilings on loan rates were effectively circumvented through the imposition of charges and the requirement to hold compensating deposit balances. Actual lending rates in the 1970s rose to twice the officially allowed rates (Hutchcroft 1998: 160-61). Deposit ceilings, in contrast, were effective and real deposit rates on bank savings were almost always negative. Non-bank financial assets, notably high denomination money-market instruments, were offered at much higher rates of interest, creating a two-tier system, in which large savers could benefit from market interest rates, but most households could not.

Selective credit allocation in the period to 1980 was mainly achieved through central bank rediscounting, allocation of foreign exchange and the government banks. The selective credit policy was operated on a system of priority lists, which described sectors eligible for subsidised funds. Allocation within the list was decided on a case-by-case basis, officially determined by the viability of the proposed project. In reality, the priority lists remained vague and virtually all-encompassing. Individual loan decisions were made on the basis of political connections or outright bribery, or both. As concluded by an extensive study of the Philippine banking system, there was no economic development rationale discernible in credit policy implementation (Hutchcroft 1998).

The allocation of foreign exchange emerged as an important source of official discretion in credit policy, although Philippine realities meant that the discretion more often lay with private sector borrowers than the officials administering the schemes. The establishment of the central bank in 1949 in the context of a balance of payments crisis was part of the reason why it emerged as the institution responsible for allocating foreign exchange via a system of foreign exchange swaps. These swaps effectively transferred the risk of currency movements from private borrowers to the public sector, and were an important source of subsidised development finance from the central bank. Limited controls on the remittance of export proceeds (20 per cent of which were to be surrendered to the central bank) were introduced during a period of balance of payments difficulties between 1959 and 1962. After that, virtually all exchange controls were removed until further balance of payments difficulties in the late 1960s (Emery 1970: 362).

Both public and private sector actors were able to borrow extensively from abroad during the 1970s. Recourse to external credit has been a long-standing feature of the Philippine financial system (Lamberte *et al.* 1992), reflecting the comparative ease of gaining finance through external borrowing rather than domestic mobilisation efforts. Many subsidised public sector loans were channelled through the central bank for lending on to Philippine businesses. The Philippine finance sector bureaucracy — the central bank and the finance ministry — had a particularly intimate and long-term relationship with the major multilateral lending institutions. Both the World Bank and the IMF were

heavily involved in, among other areas, financial sector policy from the early 1970s.¹² In addition, foreign borrowing and international capital flows were facilitated by the close ties between the local financial system and the international banking community (Santiago and Tagle, cited in Montes and Ravalo 1995: 145).

The exchange rate ceased to be officially pegged after devaluation in 1970, but remained relatively stable for the rest of the 1970s. In 1970, the peso was devalued to a rate of 6.02 pesos per dollar from the previous rate of 3.92. In the rest of the decade, it gradually depreciated to 7.38 pesos per dollar (Lamberte *et al.* 1992: 118). In real terms, the effective exchange rate appreciated by about 10 per cent over the decade, before dropping in 1979. The external value of the currency over the decade was consistent with the country's macroeconomic performance. Inflation peaked in the 1970s at 34.2 per cent in 1974, but was otherwise at moderate levels during the 1970s, averaging 14.5 per cent per annum over the decade as a whole (Lamberte *et al.* 1992: 11). External debt rose from US\$2.3 billion in 1970 to US\$13.5 billion in 1979, equal to 34 per cent of GNP in 1970 and 45 per cent of GNP in 1979 (Lamberte *et al.* 1992: 86). Economic growth was not spectacular, but was reasonably good during the decade, with real GNP growth averaging 6.2 per cent for 1970-79 (Lamberte *et al.* 1992: 10-12).

Despite these positive indicators, the Philippine economy was, in a sense, accumulating problems which would be more manifested in later years. Oligopolistic and monopolistic industry structures, high rates of protection and relatively low levels of public infrastructure and social spending contributed to a high cost economy, with growth in the external trade sector largely accounted for by resource exports. Exports as a percentage of GNP barely rose over the decade, moving from 13 per cent of GNP in 1970 to 14 per cent of GNP in 1979 (Lamberte *et al.* 1992: 111).

Even during this decade of relatively good growth, banking sector instability remained a problem, notwithstanding reform in 1972 aimed at reducing abuses associated with the plundering of bank resources by directors and owners (Hutchcroft 1998: 115-32). A lack of long-term finance for industry was cited as a problem in periodic external reviews of the finance sector, along with high costs to domestic bank users, particularly small and medium operators. Financial deepening, as measured by the ratio of M2 (currency in circulation, demand, savings and time deposits of the banks) and M3 (M2 plus banking sector deposit substitutes) to GDP barely rose over the 1970s. As one study concluded, 'it can be said that the financial system was not able to make a sustained increase in the flow of loanable funds' (Lamberte *et al.* 1992: 191-93). Severely negative deposit interest rates in the period are generally blamed for this lack of financial development, although banking instability is also likely to have played a part. Overall national savings have always lagged behind those of either Malaysia or Thailand. Gross national savings averaged 24 per cent of GNP for 1970-79 (Lamberte *et al.* 1992: 120).

The underlying governance structures in the Philippines in this period have been consonant with these observed outcomes. Consistently, state organisations have been used as instruments of private actors, subject to nepotism, manipulation and the political struggles of outsiders to gain the 'booty' accessible through public office (Hutchcroft 1998).¹³ The lack of an independent state tradition and an entrenched system of society-based government and politicisation of public office were legacies of the

¹² The relationships between the Philippine authorities, the World Bank and the IMF are covered in detail by Robin Broad (1988). Bello *et al.* (1982) provide a critical discussion of World Bank policies and the results of World Bank lending in the Marcos era.

¹³ The absence of a rational-legal Weberian bureaucracy or state system is most explicit in Hutchcroft's work, but almost any study of Philippine political economy will confirm these features. See Hawes (1987, 1992) and Hutchison (1993).

American colonial period that proved enduring (Anderson 1988). Whether government policy has tended towards openness and the promotion of exports or import-substitution, the result has been to channel large gains to favoured interests, with little consideration given to potential costs inflicted on either the public purse or less-privileged members of society (Dauvergne 1997: 133-63; Doner 1991: 158-89; Hawes 1987; Hutchcroft 1998). The Philippine case is also noteworthy because it demonstrates that governance is not a proxy for democratic institutions, formal checks and balances, levels of education or simply levels of wealth. In the 1950s and 1960s, the Philippines stood out from its Southeast Asian neighbours for being more developed on these measures than any other country of the region.

Politicised and weak public institutions subject to capture by external actors correspond with the oligarchic nature of the Philippine political economy. Unlike the other countries of Southeast Asia, the Philippines has long had a significant concentration of political power in the hands of a land-owning elite (Crouch 1985). As the Philippines industrialised, oligarchic land-owning families developed more diversified commercial interests but maintained their overlapping political and business roles. When President Marcos consolidated his power during the 1970s, he did so in the context of a system of elite politics and business in which the major families were long used to using public positions for personal gain. While authoritarian government under Marcos (the country was under martial law from 1972) apparently moderated the influence of the oligarchy, it became increasingly clear that Marcos basically centralised existing patterns of plunder (Anderson 1988). As long as he enjoyed a honeymoon period with multilateral lenders and most domestic business interests, favourable economic conditions and political stability, Marcos's own use of state resources remained at moderate levels compared to those that would be tapped in the later stages of his regime.

The systematised manipulation of key regulatory agencies that continued under Marcos lay the foundations for long-term financial instability, which would become acute whenever external economic conditions became less favourable or when political instability threatened to erupt. Financial instability in the Philippines has been in part due to the vulnerability of the system to external shocks (Lamberte *et al.* 1992: 187), but it has also been a consequence of politically connected private banks being able to avoid effective government regulation. Rather, they have often been able to extract large public subsidies and bailouts (Hutchcroft 1998; IBON Databank 1983). In the pre-reform period, financial subsidies were largely channelled through government banks, central bank rediscounts and foreign exchange allocations, as well as via protection of the inefficient private domestic banks. The ostensible bank regulator, the central bank, was never able to assert its authority over the private banks or to end private extraction from the government banks. Problems in its operations during the 1950s were ascribed to the central bank's comparative inexperience as it had been established in 1950 (Castro 1960). But regulatory weakness remained an ongoing feature of the bank's operations. As well as outright political pressure on the bank, poor salaries and a legal framework that hamstrung the bank's investigative powers have also been important. Another major reason for the bank's ineffectiveness has been the continual exposure of bank staff to lawsuits launched by the interests against which they may have attempted to take action (Hutchcroft 1998). Regardless of the law, in no other country of the region would public norms allow private bankers to sue central bank officials.

Malaysia

Until the 1990s, Malaysia's financial system remained bank dominated, with most industrial and development financing sourced from the commercial banks. At

independence in 1957, foreign banks were the most significant actors in the financial system. Over time, their role has steadily decreased, with government-controlled banks playing an increasingly important role from the late 1960s, when the two banks that were to emerge as the country's largest, Bank Bumiputra and Malayan Banking (known as Maybank), were established or taken under effective government control. Domestic private sector banking interests up to the 1970s were primarily ethnic Chinese entrepreneurs who had ventured into banking. Government influence in the financial sector through financial policy in the pre-reform period (which, on most counts, extended to the end of the 1970s) was at moderate levels. Significant constraints on the banks included the requirement to hold government debt and the requirement to direct loans to certain categories of borrowers. Interest rates were set by the central bank, but were generally positive, set in relation to market rates in London. Controls on entry and restricted competition provided Malaysian banks with a relatively high degree of protection.

With the establishment of the central bank in 1959, the government moved to influence market structure and development. The change in the position of foreign and local banks was brought about through restrictions on the establishment and operations of foreign banks from the late 1960s. Regulations have limited the branching of foreign banks, their freedom to set interest rates that would undercut local banks, and their use of expatriate bank personnel. Foreign banks have also been under more stringent capital requirements than local banks, and since the introduction of the Banking and Financial Institutions Act (BAFIA), 1989, they were required to incorporate locally by 1994, leading one foreign bank to relinquish its license. Foreign investors have also been required to use local banks for a specified portion of locally raised funds.

The central bank placed an early priority on the development of the banking system and the mobilisation of savings. This included initiatives to upgrade the national payments system and encourage the spread of banking facilities nation-wide (Lee 1981, 1987; Singh 1984). The government was influential in generating confidence in the banking system since with the establishment of a central bank in 1959, the banking sector was for the first time subject to some prudential regulation and disclosure requirements. The central bank was also able to act as lender of last resort and has taken on this role during episodes of banking or finance company instability, e.g. in the second half of the 1980s..

The government also attempted to influence the spread of commercial bank branches. Until the late 1960s, this was done by exhortation and some use of incentives (Singh 1984; BNM 1989: 18). The early 1960s was a period of rapid bank branching, with the number of banking offices more than doubling between 1959 and 1963 (BNM 1994: 518). Much of the later spread of banking facilities into the smaller towns was due to government banks. The result was to alter the distribution of bank branches in the 1960s and 1970s, reducing the previous concentration in the major urban centres (Lee 1981: 38-41).

The mobilisation of savings through the financial system was encouraged through the state-run National Savings Bank, originally the Post Office Savings Bank. This bank has declined in importance now, but provided deposit services across the country at a time when much of the population did not have access to commercial bank offices. The government has also operated a compulsory savings fund, the EPF (Employees Provident Fund), to which all employees and employers contribute.

Rather than extensive use of 'policy loans' through the banks, the government has financed its industrial policy by appropriations from the budget, borrowing by state enterprises and direct loans to the private sector. In addition, the two largest commercial

banks are government owned. Until the 1990s, the commercial banks have generally accounted for around 75 per cent of credit to industry. While only making limited and generally indirect interventions in the credit decisions of the commercial banks, the central bank has at times urged banks to limit lending for property development and shares, and to increase lending to the indigenous ethnic groups, known as Bumiputeras, low-cost housing, small-scale enterprises, manufacturing (until 1984) and agriculture. In 1975, lending directives were formally introduced, stipulating minimum lending levels to different categories of borrower. The most significant directive mandated a minimum proportion of bank credit to Bumiputeras. Although the sectoral distribution of bank credit shifted over time, this was probably not a result of government banking policy or central bank ‘moral suasion’, which were said to be ineffective to justify directives being brought in for loans to Bumiputeras. Manufacturing’s share of bank credit increased through the 1970s, but agriculture’s share did not.

Table 4. Malaysia: Distribution of Bank Credit, 1966-1980 (%)

	Manufacturing	Property	Shares	Agriculture
1966-70	2.6	8.8	–	9.2
1971-75	8.5	17	–	8.6
1976-80	18.8	22.5	1.8*	7.1

Notes: * 1979-80.

Property includes loans for building, construction, real estate and housing.

Sources: BNM (1994: 506), BNM *Quarterly Bulletin*, BNM *Annual Report*, various issues.

Interest rate controls were not a major policy instrument. All interest rates were set by the central bank until 1972, when the rates on three-year fixed deposits were freed. In 1978, all interest rates were freed except for interest rates on loans to priority sectors. The rates on deposits were maximum rates intended to prevent ‘excess competition’ among banks — mainly to prevent foreign banks outbidding local banks (Lee 1981: 67). Lending rates set by the central bank until 1978 were mostly minimum rates, also aimed at limiting competition from foreign banks (Emery 1970: 279; Abang 1986: 306). The central bank also set a marginally cheaper rate for government borrowing (0.5 per cent less than the prime rate).

Part of the reason for maintaining near-market interest rates was the relatively open capital account in Malaysia. After independence, capital was free to move within the Sterling Area, with this discrimination in favour of the Sterling Area lifted in 1973. Malaysia, Singapore and Brunei had a single currency until 1967, after which their currencies were exchangeable at face value until 1973. For foreign investors, profits and capital have always been freely repatriated. The necessity of maintaining rough parity with rates in London is frequently referred to in early reports of the central bank. The desire for greater monetary autonomy was part of the reason why Malaysia ended the currency board system shared with Singapore and Brunei in 1967, and moved towards more flexible exchange rates in 1973 (Lee 1981; Lee 1990). But the openness of the economy meant that Malaysia consistently imported world inflation and interest rate trends. Foreigners seeking relatively liquid investment opportunities could, and did, invest on the stock exchange, which was active from the 1960s and amalgamated with the Singapore exchange until 1973. However, the foreign exchange market was quite small

until the 1980s. The greater part of foreign exchange transactions were trade-related throughout the 1960s and 1970s.¹⁴

Financial policy outcomes in Malaysia in the pre-reform period were generally positive. In terms of savings mobilisation, Malaysia has always performed well despite elements of financial repression, including required reserve ratios and moderate interest rate controls. Although Malaysia at independence had a more developed financial system than Indonesia, the formal financial sector was restricted to the major towns and larger businesses. The general population used the post office savings system and the central pension fund more than the banking system. Two decades later, with total financial assets at 139 per cent of GDP in 1980, Malaysia's financial system could no longer be called undeveloped. Meanwhile, the M2 to GDP ratio had increased from 0.28 in 1965 to 0.48 in 1978 (Skully and Viksnins 1987: 141).

Economic growth in Malaysia was high throughout the pre-reform period, averaging nearly 6 per cent per annum in the 1960s and 8 per cent in the 1970s (BNM 1994: Table 1.1). Inflation was low — less than 1 per cent in the 1960s and 5.5 per cent in the 1970s. Government debt increased significantly as a result of increased policy activism from the early 1970s — from 2.7 billion ringgit in 1965 to 23.4 billion ringgit in 1980. However, around 80 per cent of government debt in this period was financed domestically, primarily through the issuance of securities to captive institutions, mainly banks and the compulsory central pension fund (BNM 1994: Table A.37). Export growth was strong with exports, which had always been significant, increasing in value from 47 per cent of GNP over 1965-67 to 55 per cent of GNP in 1975-79 (BNM 1994: Table A.38).

Apart from the impressive record of macroeconomic stability, it is not likely that these outcomes were due for the most part to the government's financial policy. In the first place, the government's industrial finance policy and targeted credit initiatives were very limited. Even the specialised industrial finance organisations accounted for a very small share of lending to industry. Most industrial development in the 1970s was due to foreign investment, often in export processing zones, with little linkage to the domestic economy. Secondly, although the increase in economic growth rates in the 1970s coincided with an increased fiscal and policy role for government, it also coincided with an increase in natural resource revenues. In the early 1980s, the primary sector, although growing more slowly than the manufacturing sector, remained the single largest part of the economy (Jomo 1990: 42).

Malaysia's underlying governance capacities are in accordance with these outcomes. Macroeconomic stability cannot be taken for granted or simply attributed to fiscal conservatism. The government maintained stability in circumstances of greatly increased government spending and new initiatives in a variety of sectors, including the finance sector, in the 1970s. These initiatives were taken as a result of increased political demands for the state to play a greater redistributive and growth-enhancing role. They were introduced as a result of heightened ethnic tension, including rioting in the capital, and began to be implemented during a period when normal parliamentary government was suspended. Taken together, this would have been a recipe for severe monetary instability in most developing countries. That Malaysia avoided this outcome is something that can be directly related to the capacities of its government.

Malaysia's governing system in the 1970s remained highly bureaucratic, a legacy of the role that leading civil servants had played in the country's transition to

¹⁴ Figures on foreign exchange transactions are not available until the 1980s. Comments in the annual reports of the central bank suggest that before then, transactions were mainly trade-related.

independence. Partly as a result of traditions inherited from the colonial period, the civil service was relatively less corrupt and more efficient, maintaining fairly strong internal norms that constrained behaviour, including private money-making ventures or personal indebtedness (Federation of Malaya 1956; Tilman 1964). An orderly system of advancement by seniority was maintained through the 1970s and, although loyalty to the ruling party was taken for granted, in the context of a high degree of elite consensus, this did not translate into competing factional loyalties being played out in the bureaucracy.¹⁵ The civil service was, in contrast to the Philippines, a career service with few overt political appointees and very limited lateral entry. Tilman's (1964: 132) study concluded that bureaucrats were thoroughly imbued with the norms of rational decision-making and empirical observation. Through the 1970s, the civil service was able to recruit many of the country's 'best and brightest', although a shortfall in technical specialists was also observed, and rapid expansion meant that many who were not the best and brightest also entered the service. Nonetheless, the calibre of the country's officials meant that an outside observer could describe them as 'the indispensable steel frame which has held this precarious state together even when the political processes failed' (Esman 1972: v).

In the financial sector, the primary government regulator and policy maker was the central bank, Bank Negara Malaysia (BNM). Bank Negara was established as a new institution in 1959. Unlike Bank Indonesia, it did not therefore have the legacy of growing out of a colonial-era commercial bank. It had a planned and carefully structured birth, and assumed responsibilities gradually.¹⁶ Currency issue was left to the currency board until 1967; fixed exchange rates and the maintenance of exchangeability at par with the Singapore currency until 1973 meant that an active monetary policy was not attempted until the 1970s. This meant that after its establishment, the bank had more than a decade to concentrate on internal organisation as well as the regulation and development of the banking system. Bank Negara has developed as a strong institution. Internally, it has been meritocratic, and externally, it has been authoritative and insulated in many respects.

The external authority and internal discipline maintained by the central bank in the pre-reform era had much to do with the efforts of its first Malaysian governor, Ismail Ali (1962-1980). His competence, attention to detail, staff discipline and demands for high standards were legendary. He was also held in high respect, if not fear, by most of the banks. His friendship with the finance minister in the 1960s and family connections with other members of Malaysia's political elite added to the central bank's influence, as did the fact that its officers were among the best-trained economists the country could field. The position of private bankers *vis-à-vis* the central bank — that emerges from reading the bank's history (Singh 1984) — was the polar opposite of the relationship between regulators and bankers in the Philippines.

Malaysia's governing system was well suited to financial policies followed until the 1980s, providing for good regulation and stability, but failing on more developmental goals.¹⁷ The conservative, disciplined and bureaucratic element in government was oriented to maintaining macroeconomic stability. It was able to do this even when early fiscal conservatism gave way to significant government borrowing in the 1970s, largely because captive institutions — the banks and the central pension fund — could be pressed

¹⁵ The major studies of the bureaucracy, on which this account is based, are Tilman (1964), Esman (1972), Puthuchery (1978) and Khasnor (1984).

¹⁶ A World Bank mission in 1954 recommended establishing a central bank, more detailed plans for which were put forward in the Watson-Caine report of 1956 (Sherwood 1966). The primary study of central banking in Malaysia is Lee (1987).

¹⁷ This argument is elaborated further in Hamilton-Hart (1999, Ch. 4).

into holding large amounts of government debt. To make this system work, increases in spending had to remain controlled, financial stability maintained, and the manipulation of government-controlled central savings funds avoided. To maintain this discipline, however, more ambitious industrial finance schemes and targeted credit were to be avoided. Malaysia's most interventionist industrialisation and redistributive policies deliberately went outside the core civil service structures and the central bank, which were perceived as too cautious and insufficiently entrepreneurial.

A final feature of the Malaysian governing system that has greatly influenced economic policy is the ethnic dimension of almost all initiatives. After ethnic riots in 1969, the period of greater government activism that was ushered in always had an explicitly redistributive agenda. The New Economic Policy (NEP), that was officially embarked on in 1971, aimed at poverty alleviation in general, but also at changing the extant ethnically-based division of labour and ownership in the economy. Many government policies were aimed at raising the business strength of Bumiputeras relative to the local Chinese business community that, along with the significant foreign-owned sector, was economically dominant. Thus, from the start of its developmental phase, the government's economic goals were infused with a strong political logic, coloured in ethnic terms. From the point of view of this political agenda, industrial policy worked well (Jesudason 1989). In economic terms, it did not have an industrial finance system that even approached activist systems such as Korea's, in either design or execution. The goals and mechanisms employed in Korea were simply not in line with Malaysia's political economy or governing system.

Thailand

Although some Thai commercial banks had been established in the pre-war period, the banking system in Thailand did not play a large role in the economy as a whole until the late 1960s. From 1957 to 1967, private sector borrowing amounted to, on average, only 12 per cent of private sector investment (Rozenal 1970: 45). Government savings banks played an important role in this period, accounting for nearly a third of all time and savings deposits in 1967 (Rozenal 1970: 44). In the formal financial sector, however, commercial banks were the most important institutions for the provision of external finance for business, and remained so until recently. Non-financial businesses became increasingly reliant on bank loans and commercial bills over the 1970s, with the role played by internal funds (share capital) undergoing a corresponding decline from 55 per cent of funds in 1971 to 17 per cent in 1983 (Thailand Development Research Institute, cited in Muscat 1995: 131).

Foreign banks established before the war were significant in the early post-war period, but domestically owned commercial banks grew rapidly and emerged early on as relatively sophisticated and internationalised financial intermediaries. As early as 1962, the share of total banking assets accounted for by foreign banks was only 19 per cent, falling to less than 15 per cent by 1966 (Rozenal 1970: 128-32), much less than in Malaysia at this time. Many of the local Thai banks were always relatively outward looking, particularly the largest, the Bangkok Bank. Banks and non-financial businesses in Thailand have for a long time been able to access foreign sources of finance, making use of informal ties among the region's ethnic Chinese as well as formal financial markets (Muscat 1995: 122).

Thai financial policies in the pre-reform period were the least interventionist of the countries covered here, but substantial liberalisation only occurred from the end of the 1980s onwards. As noted by Doner and Unger (1993), financial policy was unusually hands-off for a developing country. There were few compulsory credit requirements,

loose capital controls, positive interest rates and only a modest role for state-owned financial institutions. To the 'small degree that state officials have pursued an interventionist industrialisation strategy, they have tended to rely on fiscal rather than financial policy tools' (Doner and Unger 1993: 93). Financial subsidies through the rediscounting of credit were concentrated in the export sector (Doner and Unger 1993: 102). Export rediscounting started at the end of 1958 (Rozenal 1970: 200) and other interventions were later introduced. Despite relatively early central bank interest in directing a greater amount of credit to manufacturing, it did not begin to provide liquidity to commercial banks until 1959, and by 1967, claims against commercial banks accounted for less than 2 per cent of central bank assets, an amount that was even smaller relative to commercial bank assets (Rozenal 1970: 193-98). Later financial policy efforts 'have not, in practice, represented substantial departures from the conservative, non-interventionist traditions of the past' (Muscat 1995: 121).

Thailand did not, however, have a competitive, market-based financial system. In the first place, entry was controlled and interest rate regulations reduced price-based competition. Foreign banks were restricted in their ability to set up branches. The lack of competition among the banks was reflected in the fact that actual interest rates on deposits were at times lower than the official ceiling for deposit rates (Bhanupong 1993: 189). On the other hand, unlike the Philippines, real deposit rates were significantly negative only during 1973-74 and 1979-80, i.e. after the oil price shocks (Bhanupong 1993: 189). The second factor that reduced competition among banks was the oligopolistic structure of the industry (Unger 1998: 84). After a period of ownership concentration in the 1960s, the banking sector was controlled by 16 corporate and family groups (Hewison 1989: 179). By 1969, the two largest banks, the Bangkok Bank and Krung Thai Bank, accounted for 41 per cent of all bank assets (Emery 1970: 567). Finally, there was also no real competition from the capital market or non-bank financial institutions in the pre-reform period. The stock exchange was not a significant financial market, the long-term capital market only emerged in the 1990s, and secondary capital markets were all but non-existent. Non-bank financial institutions did exist in plentiful supply, particularly finance companies, from the 1970s onwards. The most significant of these, however, were all subsidiaries of the commercial banks or related to them by common ownership.

Although government credit directives were minimal, other forms of control did exist in the financial sector. With three major banks controlled by the government, the royal family and the military, the overall state presence in the banking sector was not insignificant. More importantly, the commercial banks, mostly owned by ethnic Chinese families, were not universal banks, but were in many ways similar to such banks, able to provide 'elements of private sector governance' (Unger 1998: 84). The banks were not owned by non-bank conglomerates; rather, the reverse pattern prevailed since most banks were established when the industrial sector in Thailand was still only nascent (Muscat 1995: 117). Overall, limits on entry, constraints on the foreign banks, and the inter-locking structure of Thai financial interests constituted a system in which informal collaboration was easy. As described in detail by Hewison (1989), the market operated in the context of a cosy alliance of domestic bankers, industrialists and a political-government elite.

Monetary and foreign exchange policy remained oriented to ensuring macroeconomic stability. The system was relatively open, with few controls on capital inflows. Banks often had significant recourse to borrowings from abroad, which were in fact higher in the 1970s than in the 1980s, due to increases in borrowings from the central bank in the 1980s (Naris 1993: 245-49). Monetary levers used by the central bank included interest rate controls and use of its own bank rate in its lending. Generally, the

central bank set rates close to foreign rates, but ‘from time to time the bank rate has been adjusted either to induce capital inflow or prevent capital outflow’ (Bhanupong 1993: 185). A stable exchange rate was long considered a normal feature of the Thai environment. From 1961 to 1980, Thailand’s exchange rate remained at roughly 20 baht per US dollar. In the early 1980s, the belief that an overvalued exchange rate was contributing to balance of payments difficulties resulted in devaluations in 1981, 1984 and 1985, bringing the rate to about 27 baht to the dollar. With these adjustments to the nominal rates, the real effective exchange rate followed a moderate depreciation path from 1984 to 1990, supporting the country’s export drive (Warr and Bhanupong 1996: 204-207).

Economic outcomes in Thailand were excellent throughout the three decades before financial reform began in 1990. Real GNP growth averaged 7.7 per cent per annum in 1960-68 (Emery 1970: 560), 7 per cent in the 1970s and 7.3 per cent in the 1980s (Warr and Bhanupong 1996: 43). Since inflation during the war and in the early post-war period, Thailand has enjoyed a low inflation rate — 1.9 per cent on average during the 1960s (Emery 1970: 560). Inflation rose briefly as a result of the oil shocks and external factors in the mid-1970s and early 1980s, but was otherwise relatively low and stable (Warr and Bhanupong 1996: 54). External debt was always moderate in the pre-reform period — 25.9 per cent of GNP in 1980 and 32.6 per cent of GNP in 1990 (Warr and Bhanupong 1996: 55).

Despite the anti-competitive banking structure, financial development was rapid, with quasi-money liabilities of the banking system rising from 9.4 per cent of GNP in 1960-64 to 50.3 per cent of GNP in 1985-86 (Jansen 1990: 71). The banking sector experienced periodic problems but relative stability in the early period. Emery (1970: 582) noted that there were ‘no reports of bank failures’ but a few ‘problem banks’. Relatively contained problems of bank instability in the 1970s, involving financial mismanagement of the banks, resulted in tightened regulations in 1979. In the 1980s, the situation was more unstable, with a major banking crisis in the middle of the decade. As with the later crisis in Thailand, this one had its origins in reckless lending by loosely controlled finance companies, generally bank subsidiaries (Lauridsen 1998: 141). As well as these finance company problems, insolvency crises — involving three commercial banks in the 1980s — required large-scale Bank of Thailand support, with other institutions also receiving aid (Muscat 1995: 120).

Thailand’s underlying governing capacity has been ambiguous for most of the post-war period. It had elements of a heavily bureaucratic system — Thailand was, after all, the original ‘bureaucratic polity’ (Riggs 1966). There was certainly a tradition of the civil service being an elite occupation, and the fiscal conservatism of this bureaucratic elite is often noted as a key explanatory variable in accounts of Thai economic policy. The elite’s aversion to inflationary policies was supposedly based on its historical experience of inflation and the detrimental impact it had on the material interests of civil servants (Warr and Bhanupong 1996: 19-27). Since the late 1950s, commitment to macroeconomic stability has been a pillar of government policy and this bureaucratic orientation may be a factor accounting for this.

One of the guardians of macroeconomic stability has been the Thai central bank, the Bank of Thailand. Established in 1942 as a means of deflecting Japanese moves to take over the management of the currency, the bank focused on economic stabilisation from 1959 onwards, prioritising the maintenance of the external value of the currency and internal price stability (Rozenal 1970: 191). The conservative macroeconomic outlook, relatively high level of cohesion and acknowledged expertise of central bank staff have no doubt helped policy implementation on this score. However, macroeconomic stability

in the 1960s at least was considered to be largely due to the government's fiscal conservatism. Despite the Bank of Thailand having 'the necessary monetary and credit instruments to maintain stability, it has made very little use of them' (Emery 1970: 582). On the other hand, central bank influence may still have been important, via the informal influence it has exercised over government spending, drawing on its assets of prestige and respect within the government (Maxfield 1997: 71-90).

One of the reasons why the government has, for most of the time since 1960, been able to stick to its cautious fiscal stance is that it has faced few political demands for greater activism. Thus, the same political economy factors identified as behind the absence of major preferential credit programmes also largely account for fiscal restraint. That is, the dominant private actors had interests concentrated in externally oriented commercial and financial activities, with relatively good access to credit without need for subsidies from the state. There were also relatively few politically significant interests to be dealt with and competition among them was restrained (Doner and Unger 1993).

The influence of this business elite has been important despite Thailand's image as a bureaucratic polity. The government elite has always had ties with business, which, contrary to Riggs's expectations, has developed healthily in post-war Thailand (McVey 1992). Private sector business has enhanced its influence by organising, both through formal sectoral associations and informal collusion. Business-government relations evolved into a collaborative partnership, not top-down government dominance (Anek, in MacIntyre ed. 1994; Doner 1991). In the banking sector, the close links between officials, bankers and politicians were even greater than in other sectors. There was regular interaction and a high degree of co-operation between officials and bankers (Unger 1998: 83-108). Bankers also often moved on to 'leading positions in political parties' (Unger 1998: 85). This amalgamation of interest is consonant with Hewison's (1989: 174-213) study of banking in Thailand.

Establishing the direction of predominant influence in the relationship between officials and the banking community is, in this context, almost impossible. The policy preferences of the Bank of Thailand (BoT) have been 'largely consistent with those of Thailand's most powerful business interests, which have been linked to the country's commercial banks' (Unger 1998: 95). In contrast with the autonomy and influence of the Bank of Thailand in relation to the Thai state (Maxfield 1997: 71-90), autonomy from Thai business is 'relatively weak and less important for the pursuit of open financial policies. Indeed, part of the BoT's strength derives from the congruence of its views with those of the commercial banks and other major business interests' (Unger 1998: 122). While Unger viewed this as a productive partnership, the ambivalence of the central bank as regards its regulatory role may have been a factor behind banking instability in the 1980s. At the time, management of the crisis was considered successful, but it was noted that while 'government authorities will prevent a bank going bankrupt, they lack the authority to (take the) necessary actions against problem banks' (Naris 1993: 264) — a comment that would have particular resonance less than a decade later.

Financial Reform

This section briefly discusses the financial reform experience of each country. In most cases, reforms were initiated in the 1980s and continued in the 1990s. The major domestic policy changes and outcomes are summarised. The effects, both intended and unintended, of these changes on pre-reform governance systems are analysed, along with other changes to financial governance in each country that may have occurred. Finally, an attempt is made to weigh the relative importance of structural economic motives (or

systemic imperatives) for reform in each country against the political forces influencing the reform agenda with redistributive or rent-seeking motives.

Indonesia

Indonesia's financial reforms in the 1980s drew much attention and commentary, almost all of it overwhelmingly positive. Substantial deregulation of the financial sector began in 1983 and was stepped up in 1988 and 1989.¹⁸ Restrictions on branching by local private banks were eliminated, reserve ratios cut to minimal levels, restrictions on the establishment of new banks were considerably eased, and credit subsidies via state banks cut back. As can be seen from Table 5, previously wide-ranging credit subsidies were practically eliminated.

The role of state-owned banks declined markedly in the 1990s with the rise of many new private banks and the rapid expansion of older private banks. The state share dropped from 76 per cent of all lending in 1984 to 56 per cent in 1990 and 37 per cent in 1996 (MacIntyre 1993: 138; Bank Indonesia, *Indonesian Financial Statistics*, January 1997). Concurrently, from 1988, deregulation and heavy promotion of the stock market was carried out by government officials. Regulation of the stock exchange was light, to the point of prompting concern by brokers (*FEER*, 14 September 1989). The initial idea was for a self regulating market and the government regulatory agency did not get legislation enabling it to investigate improprieties until 1995 (*FEER*, 18 May 1995).

Table 5. Subsidised Credit through Bank Indonesia, 1953-1996

	Liquidity credits	Direct credits	
	(% bank lending)	Rp. billion	(% bank lending)
1953	—	0.511	22
1959	—	1.955	18
1965	—	1.992	77*
1970	39	97	34
1975	30	894	48
1980	32	2454	45
1985	36	964	5
1990	14	718	1
1996	7	37	0

Note: * 1965 refers to new credit (increase in advances outstanding) and includes lending to government and banks. If lending to government and bank are excluded, BI direct credits are Rp. 217 million, or 27 per cent of all lending to the public (Arndt 1984: 142). Currency revaluation in 1965 saw each 1,000 old rupiah become 1 new rupiah.

Source: Hamilton-Hart (1999: 94).

The result of these policy changes was a huge rise in the rate of financial sector growth and financial development. The revival of the stock exchange in the late 1980s was, on its own terms, very successful.¹⁹ The rapid growth of the market provided a strong incentive for firms to list, and borrowing privileges were also accorded to listed firms by the central bank (*JP*, 23 September 1995). The banking sector grew rapidly in

¹⁸ The financial sector reforms have been discussed by many authors. Cole and Slade (1996) are the most comprehensive. See also Binhadi (1995), Chant and Pangestu (1994), MacIntyre (1993) and McLeod, ed. (1994).

¹⁹ On the development of the stock exchange, see Cole and Slade (1996: 153-85).

terms of total assets and number of banks. After 1988, the number of local and foreign (including joint venture) banks grew rapidly to reach 164 and 41 respectively by the end of 1996. This growth occurred despite frequent calls for rationalisation made by Bank Indonesia and outside commentators. A few mergers did take place, and some small problem banks were placed under the management of larger banks, but the general situation of a very large number of mostly very small banks did not change. Two banks were allowed to fail, one of which, Bank Summa, was a medium-size bank which closed in 1992 with much publicity. For the most part, problem banks continued operating, often with the help of the central bank, until closures were forced during the currency crisis.

Amidst much publicity about bank instability and speculation over the quality of loans made by the state banks, reforms aimed at prudential re-regulation were introduced from late 1990. These included limits on lending to related parties and on the concentration of loans to a single business group, an increase in bank soundness requirements, prudential limits on foreign exchange exposure, and more comprehensive reporting requirements. Of course, the extent to which changes in regulation are meaningful depends on implementation. Most accounts of financial reform in Indonesia conclude that deregulation in the 1980s was genuine. The effectiveness of moves to exert more control over the financial sector in the 1990s, on the other hand, was much more limited.

Besides prudential regulation, some elements of redistributive policy and politically-motivated lending continued. Regulations were introduced in the late 1980s requiring local banks to direct 20 per cent of all credit to small businesses, and foreign banks to direct 50 per cent of all credit to the export sector. In 1997, the requirement that 20 per cent of all credits go to the small business sector was explicitly extended to foreign banks. Whether and how these regulations would be enforced was not clear. An increase in central bank liquidity credits in the 1990s was also observed (McLeod 1996) but, as can be seen from Table 5, this increase represents a declining share of bank credit. Two well-known cases of central bank financing during the 1990s were central bank loans to the president's son for his clove monopoly and for his highly-protected 'national car' project (Schwarz 1994: 153-57; *Bisnis Indonesia*, 28 April 1997). Bank Indonesia also subsidised interest rates to support the country's export drive in the 1980s.

Financial reform, along with more cautious reforms in other sectors, was initially driven by fairly clear systemic imperatives. The collapse in oil prices in the 1980s, combined with pressure from aid donors, meant that the government had very few options for mobilising finance and stimulating growth (Haggard and Maxfield 1996; Hill 1996; Pangestu 1996; Soesastro 1989; Winters 1996). Because of Indonesia's underlying governing system, however, political considerations influenced the course of reform and the way it was implemented. Far from leading to a shake-out in the banking sector, only one of the ten largest private banks in 1982 had lost market share by 1994, and none of the regime's favourites have suffered. Instead, they have been major beneficiaries of reform as banking activity grew enormously after deregulation. Until 1997, the only loss in the banking sector to cause significant change in the ownership of economic assets was the 1992 collapse of Bank Summa, owned by the Soeryadjaya family who also owned Astra, Indonesia's second largest conglomerate.

Lax enforcement of prudential regulations also compromised the reform process. Poor quality loans at both state and small private banks grew over the 1990s, despite being a high priority for the central bank.²⁰ The situation persisted despite changes aimed

²⁰ Among the numerous accounts of the post-deregulation financial system, Nasution (1992) provided the earliest academic note of caution. See also MacIntyre (1993), Suwandi (1996) and Cole and Slade (1996: 81-146).

at improving the soundness of the banks and a common perception that these changes were the right ones. Despite central bank efforts, disregard of lending limits was routine, incestuous lending 'rampant', and accounting cheating to cover bad loans by lending more to these customers was very common at the private banks, according to the president of Thomson Bankwatch Asia, an affiliate of a New York bank rating agency (*JP*, 10 January 1996). The limits to government-related overseas borrowing introduced in 1991 could be side-stepped with political support (Schwarz 1994: 151-53). Many banks exceeded the credit ceilings issued by Bank Indonesia and continued to expand at extraordinary rates. Bank Danamon, for example, posted loan growth of 41 per cent in 1995 and 56 per cent in 1996 (*BT*, 23-34 August 1997).

After the banking deregulation of 1988, there was a common perception that the central bank did not have the professional expertise to cope with the new growth in the sector, and that its auditing procedures were cursory and overly concentrated on liquidity ratios, rather than portfolio soundness and managerial competence (*FEER*, 12 October 1989; *FEER*, 20 December 1990). There was, however, quite widespread consensus that the major obstacles to better performance by the central bank were not technical. In a critical review of bank practices, the president of Thomson Bankwatch Asia said that blame for not doing more to address banking problems did not lie with Bank Indonesia (*JP*, 10 January 1996). The basic problem was that Indonesia's patrimonial governing system had not fundamentally changed and administrative capacity remained weak in many areas (MacIntyre 1994: 260-62; Dauvergne 1997: 60-69).

In addition, monetary policy became increasingly difficult as a result of the increased capital flows that were encouraged by deregulation. An open capital account was not a new phenomenon, but growth and deregulation in the late 1980s and early 1990s made the inter-bank market much more attractive. Another major financial market to open up for foreign investors was the stock market in the late 1980s. Foreign purchasers led the revival on the Jakarta Stock Exchange and were still significant through the 1990s. During 1996, trading transactions involving only domestic parties accounted for 24.5 per cent of the total, while transactions involving only foreign parties accounted for 45 per cent of the total (Jakarta Stock Exchange, *Yearbook 1996*). Capital inflows from 1989 were significant and much of the inflow was portfolio rather than long-term investment. In addition, direct lending to Indonesian non-financial companies, often through international financial centres, emerged as much higher than had been reported.

For a variety of reasons, monetary policy reacted to the increased liquidity in the system by sterilising a large part of capital inflows through the issue of central bank bonds, known as SBIs. One reason for this was the desire to maintain the slow devaluation of the currency in support of the export sector. The exchange rate had long reflected an apparent policy to re-distribute income to producers of traded goods. This concern meant that even during periods of balance of payments surpluses, the currency was devalued.²¹ Large inflows of capital into the domestic financial system were thus not absorbed by an appreciating exchange rate, although from 1996, the rate of devaluation was allowed to slow. Rather than capital flows returning to equilibrium through a lowering of domestic interest rates, which would have been the result in the absence of sterilisation, domestic interest rates remained high. This only provided an additional incentive for capital inflows and a strong reason for Indonesian companies to raise funds offshore. In this rather perverse policy stance, Indonesia was no different from most of

²¹Cole and Slade (1996: 44, 78) cite studies by Woo and Nasution, Warr, and Woo, Glassburner and Nasution on this point.

the other countries in the region. However, poorer control over the domestic banking system, weaker monitoring capacity and fewer regulations over private sector borrowing meant that the consequences were particularly severe. Ultimately, Indonesia's personalised governing system meant that political instability followed economic collapse, further exacerbating the economic situation.

The Philippines

The Philippine financial reform programme began in 1980, but major instability in the decade meant that rapid financial sector growth and more significant liberalisation did not occur until the 1990s. In addition, liberalising reforms remained more limited than in other countries. Interest rate liberalisation was introduced in 1980 and completed by 1985 (Montes and Ravalo 1995). Formal liberalisation, however, had little effect on lending or deposit rates. As noted in the previous section, lending rates had already exceeded official interest rate ceilings, and deposit rates remained low due to overt collaboration among the commercial banks, with the effective support of the central bank. Again, interest rates in the money market, accessible only to large operators, were much higher, and a two-tier system remained in place (Hutchcroft 1998: 161).

Another reform introduced from 1980 was aimed at increasing the supply of long-term finance for industry. The new banking laws allowed commercial banks meeting minimum capitalisation requirements to become 'Expanded Commercial Banks' — with the right to own up to 35 per cent of the equity in non-financial businesses and to operate as investment houses. The move to create what were effectively German-style universal banks was instigated by Philippine technocrats and the multilateral lending institutions (Broad 1988). For most of the 1980s, however, the change in legal regime had little effect on the operations of the major banks.

The selective credit system was also reformed in the 1980s. The proportion of total commercial bank assets financed by central bank loans and rediscounts dropped from 20.3 per cent in 1984 to 6.5 per cent in 1985, and became progressively even less important over the decade (Hutchcroft 1998: 183). By 1992, outstanding central bank rediscounts amounted to 5.3 billion pesos, 60 per cent of which was directed to export financing and 27 per cent to rural banks (BSP *Annual Report 1993*, Table A-08). The total amount of rediscounted financing was less than two per cent of total loans and advances by the commercial banks that year. For most banks, foreign exchange swaps as a source of funds also became less important from 1984.

Further reform was initiated in the early 1990s. In an effort to boost competition, restrictions on entry by foreign and domestic banks were loosened. New entrants into the banking sector were not established until 1994, and there was little actual increase in the level of competition, especially in the retail market. Foreign banks were restricted in their branching, and most of them also had little interest in lending to small and medium size enterprises or collecting high street deposits. The domestic banks were thus able to continue their cartel-type practices (Hutchcroft 1998: 213-20). Real interest rates on deposits, however, did increase in the 1990s to become positive. Real interest rates on time deposits averaged 2.8 per cent during 1992-96 (BSP 1998).

Table 6. Philippines: Post-reform Distribution of Commercial Banking Assets, 1983-1995

	1983	1985	1988	1995
Private	57%	58%	75%	91%
Government	26%	27%	13%	0%
Foreign	17%	15%	12%	9%
<i>Total</i> (billions of pesos)				

Commercial banks	247.9	285.7	299.3	1282.2
Central bank	130.4	251.6	349.9	501.9
Financial assets	553.9	751.5	850.2	–

Sources: 1983-1988: Montes and Ravalo (1995: 155); 1995: Hutchcroft (1998: 257) and *Philippine Statistical Yearbook 1997*, Table 16.9.

Overall changes in banking structure can be seen in Table 6. Commercial banks accounted for 60 per cent of financial system assets (excluding the central bank) in 1988, compared to the pre-reform (1980) figure of 56 per cent. However, a notable feature of the post-reform period is the large amount of financial assets held by the central bank. If these central bank assets are taken into account, the proportion held by commercial banks falls to 35 per cent by 1988, compared to 45 per cent in 1980. When the central bank was closed and re-established as the *Bangko Sentral ng Pilipinas* (BSP) in 1993, it was made plain that these central bank ‘assets’ represented unrequited transfers to the banking system.²²

Arguably, the financial sector reforms of the 1980s never had a chance to prove themselves as they were almost immediately overtaken by a series of crises. However, what is apparent is the underlying continuity in the direction of state subsidies to the sector. The early and mid-1980s were a period of severe banking instability. First, in 1981, the financial sector was shaken by the default of businessman Dewey Dee on his money market debt that exposed a number of banks. Then in 1983, the banking system suffered from large-scale withdrawals of deposits, capital flight and a balance of payments crisis triggered by the assassination of Marcos’s main political rival, Senator Benigno Aquino, and subsequent political instability.

A major clean-up was attempted by the new Central Bank Governor, Jose Fernandez, from 1984. In a situation of extreme financial sector distress and macroeconomic instability, the primary mechanism he employed to deal with both the balance of payments and the banking crisis was the floating of high interest rate bank bills, popularly known as ‘Jobo bills’ starting in March 1984. These bills soaked up liquidity, stabilised the currency, curbed capital flight and provided banking sector (and other large asset-holders) with high-interest, low-risk investments (Hutchcroft 1998: 172). The bills achieved these aims, but made credit even more difficult for most borrowers and many of the country’s non-financial businesses experienced huge difficulties at this time. The major conglomerates, however, were protected by their diversification into banking. Unlike in the earlier period, there was no clear division between financiers and manufacturers (Hutchcroft 1998: 173). Not all banks came through unscathed — three were closed down between 1984 and 1986, and another in 1987. In each case, abusive in-house lending practices were cited (Hutchcroft 1998: 175). Equity infusions and emergency loans were also received by other banks (IBON Databank 1983).

Later in the 1980s, with rediscounting and credit subsidies curtailed, government largesse went directly to the banks through the issue of high-yielding treasury bills. The government’s domestic debt expanded over threefold between 1986 and 1990, and 30 per cent of the government budget was spent on interest payments on this debt by 1990. The favoured banks received a further boon from 1987, when government deposits were transferred to the five largest banks, initially interest-free, then at a low 5 per cent interest. The banks could turn around these funds and invest them in government securities yielding 20 per cent or more (Hutchcroft 1998: 194-95), at a time when inflation averaged less than 6 per cent between 1986 and 1989 (Lim 1998: 201).

²² The balance sheet of the old central bank is included in the 1993 *Annual Report* of the new BSP.

Some indication of the cost of rehabilitation measures came in 1993, when the Central Bank itself, labouring under an increasingly precarious balance sheet, was closed down. Its debts of P331 or US\$12 billion were transferred to the national government. Most of the central bank's debt was due to its largesse in the 1980s (Hutchcroft 1998: 206-07). In addition, in the early 1980s at least, the main state-owned banking institutions — the Philippine National Bank (PNB) and the Development Bank of the Philippines (DPB) — continued to be used as cash cows. When they were rehabilitated in the wake of Marcos's ouster in 1986, it was estimated that the two banks had bad loans of P119 billion, or US\$5.9 billion. When their non-performing assets were transferred to other government bodies, PNB's balance sheet was reduced by 67 per cent and DBP's by 86 per cent (Hutchcroft 1998: 188).

In other respects, the financial system and the economy performed dismally in the 1980s. Gross national savings averaged 19 per cent of GNP in 1980-89 (Lamberte *et al.* 1992: 120), which was low by regional standards and even lower than the Philippine record in the 1970s. Real GNP growth averaged 2 per cent in 1980-89, mainly due to poor growth performance in 1982-86, including sharp contractions in 1984 and 1985 (Lamberte *et al.* 1992: 10-12). GNP per capita remained stagnant in real terms between 1981 and 1997 (Lim 1998: 201). External debt rose from 49 per cent of GNP in 1980 to peak at 94 per cent of GNP in 1986, before dropping to 61 per cent in 1990 and 48 per cent in 1996 (Lamberte *et al.* 1992: 86; BSP 1998). For most of the 1980s, the Philippines was effectively experiencing a prolonged foreign debt crisis, with debt service levels as high as three times national exports and never less than twice the value of exports (Lamberte *et al.* 1992: 86). Extraordinarily rapid growth in exports during the 1990s (from US\$9.8 billion in 1992 to US\$20.5 billion in 1996), combined with a major exercise in debt rescheduling and reduction, including debt-for-equity swaps in the early 1990s, saw overall debt levels fall to 12 per cent of exports by 1996 (BSP *Annual Report* 1993; BSP 1998).

Significant growth in the financial sector did not occur until the 1990s. The rapid increase in commercial bank assets is clear from Table 6. Stock exchange activity also picked up from 1986, with turnover reaching 31.4 billion pesos in 1987 and 18.3 billion pesos in 1988 (Lamberte *et al.* 1992: 203). This moderate growth was completely outpaced in the 1990s, when stock exchange turnover rocketed from 77 billion pesos in 1992 to 669 billion pesos in 1996 (BSP 1998). Large capital inflows, however, did not occur until 1996. The Philippine offshore banking system's loans to residents were US\$462 million in 1993 (BSP *Annual Report* 1993: Table A-22) — significantly less than the 1989 figure of US\$981 million in loans to residents (Lamberte *et al.* 1992: 186).

The exchange rate reflected the macroeconomic instability and then stabilisation of the 1980s. From P7.9 to the dollar in 1981, the currency declined to P11.11 to the dollar in 1983 and reached P20.39 to the dollar in 1986. Low inflation stabilised the currency for the rest of the decade, until it declined again from P21.74 to the dollar in 1989 to P27.48 in 1991 (Lim 1998: 201). The value of the peso was maintained at about this level until a major devaluation was forced in the midst of the region-wide currency crisis from 1997.

Malaysia

Financial reform in Malaysia was incremental, starting with interest rate decontrol in 1978 followed by increased prudential standards from 1989.²³ Deregulation and active promotion of the financial sector produced significant growth (Lin 1993). Credit through

²³ A concise overview of financial policies over time is given by Zainal *et al.* (1994).

the banking system increased rapidly, although not at unprecedented rates. There was a stock market boom in the early 1980s, and even more rapid growth in stock exchange turnover and inter-bank assets occurred in the late 1980s and early 1990s. The government also led the effort to establish and promote an offshore banking facility located in Labuan Island, off Sabah in East Malaysia from 1991. Malaysian companies began to source significant amounts of capital from the equity market in the 1990s. Specialised industrial finance and development banks became even less important from the 1980s, as the assets of development finance institutions declined from an already low 2.9 per cent of total financial assets in 1983 to 1.6 per cent in 1995.

Certain forms of intervention continued. Besides the compulsory pension savings fund, voluntary savings institutions were set up and encouraged, including rural co-operatives and the national unit trust schemes.²⁴ Special credit funds for particular borrowers or activities established in the 1970s were maintained in the post-reform period, with some new funds set up in this period.²⁵ The special credit directives brought in during the 1970s continued to operate but, while significant at the time, they were of little significance by the 1990s. The most significant directive mandated 20 per cent of bank credit to Bumiputeras. In 1975, lending to Bumiputeras was low, but by the 1990s, it was well over the stipulated 20 per cent. For the other designated sectors, the amounts required were negligible. Some control of interest rates was re-instituted during the 1980s when banks were required to publish their 'base lending rates', determined in relation to the cost of funds, and specified types of loans were not to deviate more than a set amount from the base rate. This system continued until 1991 (Zainal *et al.* 1994).

Government influence over the sectoral distribution of credit remained minimal. Property loans did not moderate in the 1980s despite being frequently cited as problematic. The central bank often stated that lending for property and share purchases was too high in the first half of the 1980s, but such lending increased in the second half of the decade both absolutely and relatively. Even directives on the direction of lending could be peripheral. For example, the 1989 banking law limits exposure to property and shares, but lending to these sectors in the 1990s was similar to what it was in the early 1980s, later judged to be too high. Considering the string of troubled banks in the mid-1980s, mainly due to overexposure to property and shares, more stringent limits might have been expected.

Table 7. Malaysia: Distribution of Bank Credit, 1981-1996 (%)

	<i>Manufacturing</i>	<i>Property</i>	<i>Shares</i>	<i>Agriculture</i>
1981-85	21.1	32.0	1.8	6.5
1986-90	20.1	33.5	2.4	5.6
1992-96	22.6	30.5	3.8	2.9

Note: Property: loans for building, construction, real estate and housing.

Sources: BNM (1994: 506), BNM *Quarterly Economic Bulletin*, BNM *Annual Report*, various issues.

Government transfers and lending to the private and state enterprise sectors have been significant (Zainal *et al.* 1994: 287; Kanapathy and Ismail 1994: 107), but in line with the policy to reduce the state's role in the economy, these transfers became less significant from the mid-1980s. However, one of the largest state-owned banks, Bank Bumiputra, required bailouts twice during the 1980s. Other banks required extensive liquidity support in the late-1980s. An undisclosed amount of public money was spent

²⁴ Savings through the ASN and ASB schemes amounted to over RM12 billion between 1981 and 1992 (Khalid, in Al Alim 1994: 171).

²⁵ These funds are described in BNM (1994: 164-83).

overcoming the banking crisis of the late 1980s. In general, this episode was considered well managed and, with the exception of the Bank Bumiputra bailouts, not an excessive burden on public finances.

Foreign borrowing by Malaysian companies was not high. Permission was required for loans above a certain size, but this was readily given (Awang 1986). However, the availability of domestic credit meant that incentives to borrow offshore were not great. In the 1990s, the most significant Malaysian issuers of foreign debt were some large public enterprises. Recently, restrictions on foreign currency debt acquisition by Malaysian companies received more emphasis (BNM *Annual Report*, 1997: 192-93). The current account remained generally open, although reporting requirements were significant. The major control that continued until the period of strong capital inflows in the 1990s was that trade-related foreign currency earnings were to be repatriated within six months. Until the reversals in mid-1997, the 1990s saw an absolute and relative increase in the size of portfolio flows, largely due to mutual funds from developed countries turning their attention to emerging markets in Asia (Khan and Reinhart 1995). In 1993 in particular, capital inflows were very high. In early 1994, temporary controls aimed at limiting portfolio inflows were put in place, but were removed by the end of the year.

Efforts to maintain monetary autonomy with exchange rate stability continued in the 1990s. Over the period 1990-93, the currency hardly moved at all against the US dollar, despite the extremely large capital inflows.²⁶ The currency strengthened slightly over 1994-96, before dropping precipitously in the regional currency crisis of 1997-98. Given the large inflows of capital and rapid growth in the economy, keeping the currency undervalued contributed to excess domestic liquidity and inflationary pressures. The central bank attempted to deal with these pressures by targeting interest rates, a monetary policy lever that only began to be employed seriously from 1990 (BNM 1994). The massive sterilisation efforts required by the central bank's monetary policy saw official external reserves increase by 55 per cent in 1992 and 62 per cent in 1993. The cost of these efforts remains undisclosed, but were probably high (Kahn and Reinhart eds. 1995). Further, the expectation of eventual appreciation further enhanced capital inflow, compounding the effect of continued high interest rates due to sterilisation. The ringgit did appreciate against the US dollar in 1994 and 1995, but remained below what many market analysts saw as realistic.²⁷

Reforms in Malaysia were driven by political considerations more than by systematic imperatives. The moderately high levels of state debt run up in the early 1980s were certainly not sustainable, and some measures, such as the more permissive foreign direct investment regime, were probably necessary to pull Malaysia out of recession in the mid-1980s. However, many of the measures to deregulate the financial system and withdraw the state from the economy either occurred before the slow-down in the early 1980s (e.g. interest rate decontrol) or in the context of high growth with little fiscal pressure on the government from the late 1980s (e.g. promotion of the offshore capital and equity markets, extensive privatisations).

Clear political favouritism can be seen in the implementation of many economic reforms of the 1980s and 1990s. Privatisation, which has been extensive, has been

²⁶ The end-year rates are slightly deceptive. From December 1992 to September 1993, the currency did appreciate 2 per cent but dropped nearly 6 per cent in the last quarter of 1993, due to heavy selling by the central bank to reduce the Malaysian-currency value of its foreign exchange losses.

²⁷ The assessment that the currency was undervalued was made by the IMF Managing Director in July 1996. A Morgan Stanley report predicted in 1994 that the ringgit should trade at RM2.00 to the dollar by 1996. See Ong (1996: 10) and Zeti (forthcoming).

associated with significant favours to politically connected private interests (Jomo ed. 1995). Many changes in the ownership structure of the banking sector correspond with the rise of Bumiputera interests in general and politically connected interests in particular (Gomez and Jomo 1997). Certainly, interests close to the ruling party have benefited extensively from banking sector development and from the robust growth of the equity market. Favoured individuals have made huge windfall profits from preferential allocation of new stock market issues (*AWSJ*, 19 June 1995) while political party fundraising efforts were probably behind stock market manipulation in 1993 (Gomez 1996). This may explain the strong official promotion of the stock market in a country that does not have a mature banking system (Chin and Jomo 1996).

An increasingly close identity of political and business interests emerged from the mid-1980s. Although not unknown earlier, the high proportion of politicians and ruling party officials with extensive business involvement is a development from the 1980s (Doh 1985: 109-15; Leigh 1992; Bowie 1994). There has also been the growth of money politics within UMNO and the divestment of party assets to trusted individuals (Gomez and Jomo 1997). Mahathir has also had an explicit policy of reducing the role of the state, especially the size of the bureaucracy, and implementing reforms to make the civil service more efficient and responsive to the private sector (Root 1996: 65-89). Downgrading the public sector, combined with extensive new opportunities in the private sector, resulted in some reduced administrative capacity in government, as talented and capable personnel moved to the private sector. Some regulatory agencies became less effective due to reduced powers, demoralisation, personnel changes and other factors. The Capital Issues Committee was removed from the relatively efficient and effective central bank in the mid-1980s to be reconstituted later within the Securities Commission set up in 1993.

It would be an exaggeration to conclude that politics and favouritism dominate financial policy to the exclusion of other considerations. Corruption and the manipulation of government policy for private purposes were a long way from reaching levels seen in Indonesia in the 1990s or the Philippines under Marcos. In comparative surveys of corruption, Malaysia is consistently in the middle ranks, among countries such as Japan and South Korea (Root 1996: xv). Allegations of corruption and influence mostly involve politicians, not civil servants — which may be an indication of where the centre of decision-making is, but it also means that when political interest is not high, the interests motivating bureaucratic action can be reasonably independent, making for a moderately regularised and coherent administration.

The central bank is not untainted by scandal, but was considered to be one of the more competent, more meritocratic and independent government bodies. It has, at various times, been tasked with cleaning up private and state sector institutions not at the time under central bank supervision. This includes involvement in the aftermath of a corruption and mismanagement scandal of a state development bank in 1978, and failures of deposit-taking co-operatives and problem banks in the mid-1980s and the insurance industry in the late 1980s. Most accounts of the central bank's resolution of these problems concur that the bank did reasonably well in these instances. Doubts about whether some private shareholders were sufficiently punished have been voiced, but it is significant that the financial problems of the institutions under Bank Negara's supervision were mostly resolved, which stands in contrast to Bank Indonesia's record of ongoing deterioration of the banks under its management. On the other hand, political constraints have probably deterred BNM from taking tough disciplinary action against favoured interests.²⁸

²⁸ Details are given in Hamilton-Hart (1999, Ch. 4).

Thailand

Thailand's major financial reforms did not occur until the 1990s. Until the financial crash of 1997, it was considered a successful case of financial reform. Beginning in 1990, interest rate controls were removed, controls on the capital account were lifted and efforts were made to increase competition in the banking sector (Unger 1998: 95-99).²⁹ In addition, an offshore banking system was promoted and received *de facto* subsidies. Partly due to promotion efforts and partly due to external interest, the stock exchange also experienced unprecedented growth in the 1990s (*Euromoney* 1996).

According to a reasonably detailed study of the reforms, the government was able to engage in 'ambitious and coherent' efforts at financial sector promotion and to implement the new policies 'with an unusual degree of coherence' (Unger 1998: 86). Unger's study offers two explanations of the financial mess that ensued. First, in retrospect, he acknowledges a 'design flaw' in the policies. Second, Unger points to signs of conflict and a breakdown of previous governance mechanisms in the relationship between the Bank of Thailand and the Ministry of Finance. This was exacerbated by political intrusion and heightened political competition, which increased pressure on extra-legal fundraising sources, which included the vibrant financial sector. There was an increase in political competition in the 1990s, with the political bases of support drawn most from 'those interests which stood to suffer the most damage from necessary political adjustments' (Unger 1998: 99).

In many ways, however, these were not new developments, and therefore it is hard to ascribe to them alone the poor state of the financial sector that became apparent in 1996. As discussed in the preceding section, political-business collusion and the support of political actors by financial and commercial interests was not new. Neither was banking instability. What was new was the relative size of the financial sector, which had grown in importance as a result of a policy of developing finance *qua* finance. The increased competition and internationalisation that this involved meant that the sector was no longer protected by the patterns of informal collusion that had previously operated. And failures became much more costly.

Currency and Banking Crises, 1997-98

The recent decade-long Southeast Asian economic boom has now come unstuck owing to the economic consequences of and policy reactions to the massive asset price deflation - due to panic ('irrationally' pessimistic herd behaviour) greatly exaggerating the impact of successful currency speculation against untenable virtual currency pegs against the US dollar. Such market behaviour sought to gain advantage or minimise losses from some unintended consequences of the region's currency appreciations. The over-valued regional currencies had emerged from partial financial liberalisation, which had also created the conditions for the asset price inflationary bubbles that burst in mid-1997 with such devastating consequences for the region. Such problems were further exacerbated by un-judicious official policy responses at both national and international levels. Failure to recognise the nature of the processes of accumulation and growth in the region had generally prevented the design and implementation of appropriate and adequate pro-active strategies of well-designed and sequenced deregulation in the face of growing pressures for apparently inevitable financial liberalisation.

²⁹ Although in some respects open before then, a number of direct and indirect controls meant that the capital account was not really open (Warr and Bhanupong 1996: 1769-71).

There is now little serious disagreement that the Southeast Asian economic turmoil since mid-1997 began as currency and liquidity crises. It is also increasingly agreed that the crises were principally due to the undermining of previous systems of financial governance due to deregulation and other developments associated with the growing influence of financial interests at both international and national levels as well as other pressures for financial liberalisation and globalisation. Such developments have included the subversion of effective financial governance at both international and national levels, which has created conditions increasingly vulnerable to financial crisis. It is now also increasingly acknowledged that the currency and liquidity crises became crises of the 'real economy', mainly due to inappropriate government - and IMF - policy responses as the problems emerged (e.g. Radelet and Sachs 1998a; Jomo ed. 1998).

High growth rates and high rates of return on capital (high interest rates as well high returns to portfolio investments) plus predictable exchange rates (with currencies in the region pegged to the US dollar) as well as eased regulations on capital flows attracted enormous short term capital flows of two types. On the one hand, international banks were especially keen to lend to both banks as well as corporations in the region. To minimise risks, they tended to lend short, but borrowers in the region were quite happy to deploy such borrowed funds for long-term purposes. On the other hand, foreign portfolio investments were attracted by national as well as international (official) promotion of newly emerging securities markets, buoyant conditions in the region and government guarantees of ease of exit.

Meanwhile, large current account deficits in some countries (notably Malaysia and Thailand) were being financed by short-term capital inflows into the fast-growing domestic securities markets and by borrowings from abroad. The current account deficits were partly due to the growing proportion of 'non-tradeables' being produced in the region, much of which was related to accelerated construction activity in response to real property booms. These flows were 'sterilised' to minimise consumer price inflation, as desired by the financial community, but instead fuelled asset price inflation, mainly involving real estate and share prices.

Despite official claims that the region's currencies were pegged to baskets of currencies of their main trading partners, for all intents and purposes, they had been virtually pegged - within narrow bands - to the US dollar for many years. Such quasi-pegging had offered certain advantages, including the semblance of exchange rate stability against the US dollar so much desired by financial interests. The 1994 devaluation of China's renminbi put greater competitive pressure on Southeast Asian economies, especially Thailand, which had been producing for similar export markets. As the US dollar strengthened against the Japanese yen from mid-1995, Southeast Asia's dollar-pegged currencies followed suit, adversely affecting the region's export competitiveness.

This was exacerbated by the region's failure to progress more rapidly to higher value-added production, mainly due to inadequate and inappropriate public investments in education and training as well as limited indigenous internationally competitive industrial capabilities. This state of affairs also reflected the political weakness - compared to the financial community in terms of influencing economic policy-making - of exporting manufacturer interests in the region, where most internationally competitive industrial capability outside of resource-based manufacturing has been foreign-owned. The high investment rates apparently also led to production over-capacity as well as declining 'investment quality and productivity', though these notions are somewhat nebulous and may refer to the increasing share of 'non-productive' investments, e.g. in

real estate, and sometimes to poor rates of return after the bubble burst (i.e. actual rates of return turn out to be well below expected rates of return to investments).

Meanwhile, the more rapid growth of equity (as opposed to debt) finance - probably involving some relative, if not absolute financial disintermediation - grew in significance in the nineties, especially with the active official promotion of stock markets, encouraged by private financial interests and multilateral institutions such as the International Finance Corporation, a subsidiary of the World Bank. The establishment of various new international banking facilities in the region to ease access to foreign funds also undermined financial governance, especially prudential banking regulation, at the crucial national level. Such reforms, the growth of 'private banking' and 'relationship banking' in the region as well as intensified competition among 'debt-pushing' competitors had also weakened the scope and effectiveness of national financial governance. Other domestic as well as international financial sector reforms had also considerably reduced the powers and jurisdictions of the region's central banks.

The difference between the Philippines and other Southeast Asian countries with regard to financial development, disintermediation and internationalisation may help explain why the Philippines was not as badly hit by the crisis as its neighbours. In terms of their level of financial development, Thailand and Malaysia showed much higher levels of intermediation as well as stock market capitalisation. Stock market capitalisation in Malaysia in particular had reached very high levels, with some relative disintermediation especially apparent in the 1990s, with active official promotion of the Kuala Lumpur Stock Exchange (KLSE). Table 8 summarises some relevant indicators.

Table 8. Pre-Crisis Financial Development and Internationalisation
(billions of U.S. dollars and as a percentage share of GDP³⁰)

	<i>Credit</i> ^a		<i>Money</i> ^b		<i>Stocks</i> ^c		<i>Capital inflows</i> ^d	
	\$bn	%	\$bn	%	\$bn	%	\$bn	%
Indonesia	123.9	55	94.9	42	43.5	19	10.8	4.8
Philippines	40.5	49.0	36.1	43	31.3	38	7.7	9.3
Malaysia	92.2	93.5	67.1	68	223.5	227	9.5	9.6
Thailand	185.0	100.0	130.3	70	142.0	77	19.5	10.5

a. Claims on private sector held by deposit money banks, end 1996.

Source: IMF *International Financial Statistics* (November 1998).

b. Quasi-money. Source: IMF *International Financial Statistics* (November 1998).

c. Stock market capitalisation, December 1995.

Source: Crosby Research figures cited in *Euromoney* (1996: 84).

d. Net inflows of capital: financial and capital account of the balance of payments, 1996.

Sources: IMF *International Financial Statistics* (November 1998) except Philippines: preliminary figures from *Philippine Statistical Yearbook 1997*.

In Thailand and Malaysia, unlike the Philippines, capital inflows had been high throughout the 1990s – inflows to Thailand averaged 10.2 per cent of GDP each year from 1990 to 1996 (Montes 1998: 19), while in the Philippines, they averaged 5.6 per cent of GDP during 1991-96. Recorded inflows to Indonesia in 1991-96 averaged 4.1 per

³⁰ Calculated according to the following exchange rates and GDP values:

	1996 GDP (billions, local currency)	Exchange rate per US\$, end 1996
Indonesia	532,631	2383
Philippines	2171.9	26.288
Malaysia	249,503	2.529
Thailand	4689.6	25.343

Source: IMF, *International Financial Statistics* (November 1998).

cent of GDP (IMF, *International Financial Statistics*, November 1998), but recorded flows are now known to have greatly underestimated the foreign currency liabilities of the country. While the capitalisation of the Indonesian stock exchange compared to the size of the economy was lowest in Indonesia, its growth from 1990 to 1995 was 781 per cent - the highest by far of the four countries (Euromoney 1996: 84). Also not shown in Table 8 is the discrepancy in the Thai case between bank credit to the private sector and credit to the private sector by the financial industry as a whole, which increased from 72 per cent of GDP in 1990 to 142 per cent of GDP in 1995 (Montes 1998: 12-13). Another factor that distinguished the Thai financial sector was that just one per cent of total foreign exchange liabilities of commercial banks in Thailand was owed to residents - as compared to about 52 per cent in the Philippines, as of the first quarter of 1996 (Intal *et al.* 1998: 155).

Finally, the Philippines can be differentiated from the other countries for being at a much earlier stage in its export-led, high-growth spurt. While in the other countries, export-led growth had begun in the second half of the 1980s, in the Philippines, it did not commence until the mid-1990s. Thus, some of the problems experienced by the other countries in the region were effectively 'nipped in the bud' in the Philippines by the advent of the crisis; thus, it is suggested that 'the Philippines has weathered this crisis relatively well partly because it was not experiencing economic "success" in comparison with the very high growth rates of the previously high-performing East Asian economies' (Intal *et al.* 1998: 161). In addition, growth in the Philippines may have been more robust because the country's exports have been more heavily oriented to markets outside the region, and hence, have not suffered as much from the 'implosion of intra-regional trade' (Garnaut 1998).

In the immediate aftermath of the outbreak of the crisis in mid-1997, many economic observers immediately assumed that the crises in the countries of the region were due to poor macroeconomic management, as suggested by the second generation of currency crisis theories. After the outbreak of the crisis, it soon became clear that all the Southeast Asian governments affected had been maintaining decent macroeconomic balances except for large balance of payments' current account deficits for Malaysia and Thailand, which had been financed by massive, mainly short-term capital inflows. With the debt - including foreign borrowings - mainly involving the private sector, and with continued high savings and growth rates as well as low consumer price inflation, most monetary and financial authorities in the region were being enthusiastically encouraged by the international financial community.

The recent currency and financial crises clearly suggest that Southeast Asia's economic boom had been built on some shaky and unsustainable foundations. Much of the retained wealth generated had been captured by those in power and their business cronies, who in turn contributed to growth by re-investing much of their captured rents, mainly in the 'protected' domestic economy, e.g. in import-substituting industries, commerce, services and privatised utilities and infrastructure. Despite various weaknesses, this Southeast Asian brand of ersatz capitalism - involving changing forms of *rentier cronyism* - had sustained rapid growth for three to four decades.

Business organisations, relations, practices and norms that had previously been credited with the Southeast Asian miracle, have since been condemned as the sources of the debacle. It also became fashionable in some quarters to suggest that such practices and developments had their roots in Japanese-type or more generically East Asian culture, norms and relationships that influence relations between the state and the private sector as well as among businesses, invariably involving welfare-reducing, if not downright debilitating rent-seeking behaviour. In so far as such relations are believed to exclude

outsiders, their elimination is believed to contribute to levelling the playing field and bringing about an inevitable convergence towards supposedly Anglo-American style arms-length market relations.

Such arrangements and institutions - previously celebrated as part of the basis for the phenomenally rapid growth in the region - are now derogatorily referred to as elements of crony capitalism and rent seeking. In themselves, however, it cannot be shown that they have actually precipitated the crisis nor do they satisfactorily explain its bases and origins. Cronyism (and nepotism) certainly influenced official policy responses to the crises in Malaysia and Indonesia before Soeharto stepped down as president in May 1998 (Jomo 1998b; Pincus and Ramly 1998). More importantly, such influences - real as well as imagined - may well have exacerbated the crises and are likely to continue to undermine confidence in government efforts, and thus delay recovery.

Once it was clear that the region's macroeconomic indicators were not seriously awry, and in the wake of the recent debate on Asian values and other cultural, institutional and behavioural differences, many commentators increasingly invoked Southeast Asian cronyism and its alleged consequences as new explanations for the crises. Most such critics condemned some caricatured image of rent-seeking in the region - as reflected in various alleged departures from some 'market fundamentalist' ideal - to explain the crises, usually ignoring all the subtlety and nuance of extant analyses of rent-seeking in the region. Thus, Southeast Asia's financial turmoil came to be portrayed as having been induced by alleged crony capitalism and rent seeking in the region.

With the benefit of hindsight, it is now widely agreed that IMF policy responses exacerbated, rather than ameliorated the crises in the region as well as in South Korea (Radelet and Sachs 1998b). It appears that the Fund initially saw the currency crises as similar to earlier ones in Latin America and elsewhere (Kregel 1998). Even though most Southeast Asian governments had not run fiscal deficits for some time, the IMF insisted on fiscal spending cuts, which exacerbated the deflationary effects of the sudden massive currency devaluations related to panic and capital flight. In Thailand and especially in Indonesia, such cuts adversely affected public welfare, leading to economic distress, social unrest and regime change more conducive to policy reform. Given their generally sound fiscal positions, temporary counter-cyclical budget deficits could have helped to counter the deflationary impacts of the crises.

The Fund also insisted on raising domestic interest rates, ostensibly to try to immediately reverse capital outflows, even though there was little immediate prospect of success while panic was still the order of the day. The high interest rate policies adopted throughout the region did little to stem the capital flight, but instead imposed crushing debt burdens on most enterprises, and consequently exacerbated the banks' bad debt problems. Since the vast majority of growing businesses were in debt (this being a common feature of corporate expansion in Southeast Asia), the increased interest rates rendered the region's private sectors - already beleaguered by the currency collapses and their consequences - even more vulnerable to collapse. To make matters worse, the credit ratings of both countries and their corporations were adversely affected, further raising the cost of badly needed external funds.

The IMF also exacerbated the situation by insisting on immediate drastic actions against problematic financial institutions in the region, which has been compared to 'shouting fire in a crowded darkened theatre'. While structural reforms would, in any case, have been necessary in the medium term to rebuild stronger financial systems, the timing of these actions generally undermined remaining confidence in domestic financial institutions, causing runs on many of them, thus inadvertently increasing the fragility of these financial systems. Almost inevitable government interventions - as lender of last

resort to save these systems - have since been denounced as evidence of government policy contributing to moral hazard, although there is little real evidence of explicit government guarantees that can be construed as the bases for such claims. In other words, the fact of subsequent government intervention to save drowning financial institutions does not, in itself, prove that the governments had contributed to moral hazard by explicitly making such guarantees before the crises.

Other IMF demands for immediate structural adjustments and systemic reforms - previously prescribed elsewhere over the medium term (e.g. with the short-term stabilisation measures introduced in the wake of the 1980s' debt crises) - only worsened the situation by overloading the reform agenda at a time of chaos and uncertainty as well as depleted capacity and resources. In some cases, the conditionalities imposed were not even relevant to solving the immediate problems at hand, but instead reflected particular (usually 'market fundamentalist') views of how Southeast Asian economies should be reorganised. For example, the Malaysian authorities redefined 'non-performing loans' more stringently, reducing the grace period from six to three months, as the effects of the worsening financial crisis were reverberating through the economy.

In the third quarter of 1997, the Japanese Government offered US\$100 billion for the establishment of some kind of Asian monetary facility to address the region's rapidly unfolding crisis. This initiative was blocked by opposition from the Clinton administration as well as the IMF, which may have felt that its existing (monopolistic) authority would be undermined by the advent of alternative sources of emergency credit accessible on less onerous terms. The lukewarm US response to the East Asian regional crisis contrasted with its earlier intervention to save Mexico from going under in 1995 as well as its virtually unconditional support for the Yeltsin regime in mid-1998. In the last quarter of 1998, however, the Clinton administration did not openly oppose the Miyazawa initiative to provide US\$30 billion towards East Asian credit needs, but instead tried to gain some credit at the Asia Pacific Economic Co-operation (APEC) Forum in Kuala Lumpur in early November by offering to top up the Japanese offer with a much more modest financial aid offer of its own.

Thus, during the crucial first year of the regional crisis, Southeast Asian economies only had limited access – on very tough conditions – to the badly needed credit required to check the fast-growing liquidity crisis and thus contribute to recovery. This has been variously attributed to, among other factors, the limited funds at the disposal of the IMF (in contrast to Keynes' original funding recommendations in 1944 as well as the enormity of the problem in East Asia), political divisions in the US over IMF funding, the declining strategic significance of Southeast Asia to the US after the end of the Cold War (compared, say, to the importance of 'saving' US neighbour Mexico in 1995, especially so soon after the advent of the controversial NAFTA, the North American Free Trade Area), and failure to recognise the serious systemic implications of the crisis, especially by those who felt it represented a long overdue comeuppance for the increasingly cocky East (including Southeast) Asians who had become smug with their apparent economic success.

[While flawed in both design and implementation, the Malaysian currency controls since September 1998 have provided a critical window of opportunity by restoring greater government control over monetary policy, enabling the authorities to lower interest rates (previously subject to offshore currency trading) and stabilise the exchange rate (ironically, against the US dollar). By moving briskly to take over non-performing loans and to re-capitalise the banks, the Malaysian authorities may well

succeed in salvaging the banking system and restoring financial confidence fairly soon. Unfortunately, the failure to draw meaningful policy lessons from the late 1980s' banking crisis for subsequent prudential regulation – or perhaps the failure to sustain the greater prudence which initially emerged after that episode - casts doubt as to whether the financial system is able to effectively internalise lessons from previous failures.]

Conclusion

This study has argued that the institutional foundations of the financial policy regime matter, though this does not mean that financial policy design is unimportant (e.g. Chin and Jomo 1996). Particular strengths and weaknesses stem from particular organisational and political settings. The institutional foundations of governance that work relatively well in sheltered, marginally inefficient systems, may fail when the policy regime favours greater financial development. Poor governance is likely to produce policy failure no matter what particular policies are attempted. In other words, financial governance is important, and good policy design, in itself, cannot guarantee good outcomes. Good policy can fail because of poor political implementation or enforcement.

This study has also highlighted the particular pitfalls of financial liberalisation, internationalisation and unregulated capital mobility in the absence of robust regulatory regimes. The consequences of regulatory failure appear to be much less serious in protected financial systems. Some degree of international openness may be a salutary source of discipline, but this discipline will tend to be ambiguous, post-hoc and counterproductive since international financial markets often respond to market sentiment rather than economic fundamentals.

The governance structures that prevailed in Thailand, for example, worked relatively well when the financial sector was protected, but failed in the face of exposure to international financial flows. Malaysia's governance capacities were well suited to relatively conservative bank-based financial development. The breakdown from the 1980s of its previously strong regulatory record and exceptional financial stability (by developing country standards) corresponded with the changed orientation of the country's financial policy (e.g. stock market promotion involving financial disintermediation), increased political subversion of regulation and a rise in private sector influence over policy.

Indonesia's administratively weak and patrimonial governing capacities meant that both its phase of state-led financial policy and deregulated financial development proved unsustainable. The Philippines has also had failures in governing capacity. It escaped the crisis relatively lightly, largely because it had already rehabilitated its banking system after an earlier, very severe and prolonged crisis, and lagged behind other countries in the region in terms of growth and attracting massive capital inflows. In all these cases, the problem of over-exuberance followed by panic - that seems to be a common feature of financial market behaviour - was exacerbated by the internationalisation of financial market activity.

The cases also show that undue influence exerted by special interests often distort policy and its implementation in both state-led and ostensibly market-based financial systems. The inherent imperfections of financial markets mean that there is a strong case for some government role, both for prudential regulation and to take a more pro-active role in better allocating financial resources to ensure desirable, sustained and equitable development. In both cases, more attention needs to be directed to building the necessary governance capacity. In some cases, this may be achieved by private sector mechanisms for controlling financial transactions, but the broader policy framework, together with a country's political and administrative conditions, must be conducive to private sector

governance. It is unlikely that relatively efficient financial markets can be sustained in the absence of un-compromised and regularised government authority. It is not simply a matter of making the right prudential policies, but also of ensuring that they are effectively implemented or enforced.

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