POWER GROUPS, FINANCIAL LIBERALIZATION, AND FINANCIAL CRISIS

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Abstract of the Dissertation

of

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This dissertation examines the role of power groups in the incidence of so-called *perverse* financial liberalization and the subsequent financial crisis. I first explore country-specific developmental mechanisms and the historical formation of concentrated power groups. Next, I investigate the channels through which power groups contribute to perverse financial liberalization. These include: (*i*) weak institutions and sub-optimal policies of governance; (*ii*) connective lending and preferential treatment; and (*iii*) moral hazard, a "systemic" risk because of the externalities generated by financial interdependence. I also calculate output losses during crisis periods. The results demonstrate strong support for the hypothesis of a positive relation between the power group influence, perverse financial liberalization, and the severity of financial crisis.

To my Husband

Doyle R. Nick

And my 3D's

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Finally, I would like to dedicate this work to my parents who have always believed in me and to my husband that has been an inspiration in my life.

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CHAPTER 1:

INTRODUCTION AND CONTRIBUTION TO THE LITERATURE

1.1. INTRODUCTION

Economic research has demonstrated that there is a strong relationship between financial liberalization and financial development, indicating that financial liberalization is followed by improved financial development and growth. Yet, evidence throughout the 1980s and the Asian crises in the 1990s give room to an alternate view that financial liberalization could also lead to destabilization and crisis.

The main focus of the literature regarding the political economy of reform has been the role that government intervention has played in the financial liberalization process. However, due to the recurring financial crisis in emerging and developing countries recent research has questioned the link between financial liberalization and developmental policies.

Traditionally government intervention was viewed as a venue for developing countries to become competitive in the international market. In this view, government policies were designed to strategically develop specific sectors through direct resource allocation and protection of industries. A possible rationale for government-directed strategies was to induce respectability and legitimacy of its political regime, while at the same time cultivating institutional infrastructure since only a few selected industries were seen as essential to economic development and economic stability.

Interventionist state-led strategies were often successful in the early stages of economic development in Asia. However, within a relationship business culture, interventionist policies developed risks and conditions that allowed a high concentration of private economic power to develop as economies grew. An intricate system of relationships fostered the concentration of special interest groups that used their political clout to influence policy formation and undermine policies of reform.

This dissertation explores economic policy development by considering the historical background in several Asian countries. Specific attention is paid to historical background, business culture values, and types of regimes, as factors that could influence the formation and implementation of reform policies. Emphasis is placed on the need to understand the origin of policy distortions and financial structural weaknesses found in the Asian financial crisis.

An overview of most Asian countries demonstrates that basic characteristics of a hierarchical and centralized system nurtured the development of a patron-client network through policies of protectionism, segmentalism, and preferentialism. These policies, by targeting specific industries and direct allocation of resources, allowed the rise of preferential sectors, ownership concentration, and corruption.

Thus, in an effort to generate economic growth, policies of connective lending and preferential treatment created perverse incentives in allocation of resources that contributed to an institutional structure vulnerable to pressures from vested interests creating weakness in a country's financial structure. As Denzau and North (1994) state, "The performance of economies is a consequence of the incentive structures put into place; that is, the institutional framework of the polity and economy. These are in turn a function of the shared mental models and ideologies of the actors." Ideological concepts of respect for authority and cooperative values were fundamental factors in the creation of a deeply embedded traditional cleavage between the government and selective economic sectors. The traditional "guanshi" concept of relationships in business contributed to the development of informal institutions based more on bargaining and collusion than on legal structure where enforcement of contracts, bankruptcy laws, and transparency are important.

Although Asian economies are fairly similar in cultural and hierarchical political structure, each country developed key differences according to country-specific strategies. In each instance, we find that the different countries' political and historical background was instrumental in the differences found in policy development and in the post-formation of power blocks. For example, Japan emphasized the financial system as a tool for centralization. This type of organization dates back to the Tokugawa period, when the Nakanas (or, a group of colleagues) were given the control to enforce agreements and tax collection for a specific business. They had the authority to manage business licenses and everything relevant to running a centralized system. Since then, the financial sector became very relevant to the industrial growth of the country, finding bank and industry organized in a hierarchical order with interlocking shareholding. In later years, with reparation money that Japan received from China during the Sino-Japanese war, and later from the United States, Japan's banking system became the main financial source for the industrialization and development of the heavy and chemical industrial sectors.

Korea‘s development, on the other hand, was centered more on the small businesses or groups that were organized for agricultural consumption or trading. Industrial policies had their roots from the colonial period. During the Japanese colonial rule, Korea’s agricultural growth was financed primarily by capital imported from Japan. Japanese investors financed agricultural projects in Korea that were later exported back to Japan and other countries. When the Japanese ceased to occupy Korea, the financial support also ceased to support the industry in Korea. However, Korea’s industry continued through familial networks and other groups that formed in order to finance their business. Thus, Korea emphasized industrial policies that promoted the development and growth of the agricultural and industrial sectors.

Taiwan, was colonized by different countries throughout history. Its legacy was one of a centralized system as well. However, it differs from the other countries in this study in that Taiwan’s strategy was centered more in creating land reforms and compensating landowners with commodities certificates and stocks in state-owned industries. It is argued that the last ruling regime that came from China, the Kuomingtang, nationalized all industries when they took over Taiwan. They also implemented policies of comprehensive land reforms in order to discourage an over concentration of wealth that would challenge the regime’s legitimacy

Unlike Japan, Korea, and Taiwan where we find a more homogenous type of population, Thailand, Malaysia, and Indonesia pursued economic development based more on a legacy of ethnic differences and conflicts that influenced their political and economic policies. In Thailand, the monarchy set the stage for the development of a centralized system. However, through the years, ethnic groups' conflicts and uprisings made Thailand's political structure into a weak and fragmented bureaucratic organization that became subject to frequents shifts in the control of economic policy. This was evident in the more than three decades of uprisings and coup d'etats that Thailand suffered, though more recently these shifts have also been characterized by lots of veto players and hence not so much change in policies. The instability found in Thailand's political party encouraged the formation of temporary alliances and a network of patron-client system.

In Malaysia, the British colonial system, established a centralized institutional framework with policies that encouraged immigrations of Chinese and Indians to develop commerce and provide cheap labor. This resulted in an unstable multi-ethnic society that came to be the legacy of a divided nation. In order to provide some stability, the Malays were given priority in the political sector while the Chinese retained their influence in the economic sector. Throughout the years, government sponsored business networks were established to advance the position of the Malays. This evolved into a system of economic patronage that has primarily benefited government-allied concentrated groups.

Indonesia's historical ethnic conflicts date back to the colonial times when the Dutch incorporated ethnic segmentation in the economic sector and developed a centralized bureaucratic political system. It presents a combination of a colonial legacy as well as post-independence, authoritarian regimes of Sukarno's Guided Democracy and Suharto's New Order. The long history of disputes between the different ethnic groups resulted in a highly fragmented society with social unrest and political instability. This instability provided the basis for the Sukarno's and Suharto's regimes to form a patronage-base system where the ruling party bestowed preferential treatment to family and close friends.

Thus, we find that different sectors became power groups in different countries. In each instance, the countries' political and historical development was instrumental in the the formation of strong group. For instance, Japan used the banking system to pursue economic development, while Korea developed a powerful industrial sector. In Thailand, a financial technocracy took the lead in economic development, while in Malaysia and Indonesia a combination of political bureaucracy and ethnic groups drove government policy and economic development. Taiwan, on the other hand, developed a fragmented industrial structure that led to the formation of small and medium size enterprises (SMEs).

Asian governments played a key role in the development of their countries' financial structure. The centralized hierarchical system created a structure for governmental decision-making. This type of system provides the government a central and unquestionable role in all aspects of government including financial control. Centralized control is also part of Western-type democracies, however, the process of government decision making differs from Asian countries due to specific historical, cultural, and geographic factors that add to the control that governments exert. Businesses, families, or other interest groups influenced decision-making through their support or withdrawal of support for certain types of policies enacted by governments.

Each Asian country discussed in this dissertation has had different types of interest groups who have had used their influence and power to legitimize the government or regime in power through their support. I describe the historical factors, development strategies, and power groups that created or influenced financial liberalization via policies made to accommodate their interests and to keep their support for the current regime, thus contributing to weaknesses in the liberalization process and the financial crisis. Weak institutions and sub-optimal policies of governance, connected lending and preferential treatment, moral hazard and "systemic" risk are the channels by which perverse financial liberalization takes place. The channels are discussed at length in the following sections of this dissertation.

The rise of power groups is sometimes the result of government policies. Each country differed in the policies that their political systems followed, but in each country these policies eventually fell prey to interest groups contributing to an institutional structure vulnerable to pressures from vested interests that influenced the formation and implementation of reform policies—a situation of perverse liberalization. This is not to say that all reforms stimulated by interest groups have perverse outcomes. Liberalization can be stimulated for different reasons and can be external as well as internally stimulated. This dissertation specifically views the internal stimuli coming from domestic factors that were prevalent in the reform policies that gave room to perverse incentives. Willett and Auerbach (2002) define perverse financial liberalization as liberalization that gives rise to perverse incentives generated either by pre-existing government policies or by the inappropriate sequencing of current reform policies.

We show that perverse financial liberalization can be explained at least in part by the way in which governments create policies that would legitimize them or keep them in power, often favoring interest groups. For example, interest group pressure in the Asian economies contributed to government decisions on economic policies that included import/export policies, foreign investment, banking/lending, and development plans. Some of these decisions were not based on the best possible economic development plan, but to appease interest groups that exerted their influence, which often led to output losses.

Financial liberalization can be defined as the elimination or decrease in interventionist regulations within financial markets, thus letting the market determine the price and allocation of resources. It follows that sound financial liberalization is good for economic growth because it leads to greater financial depth, increases savings and investment, and promotes economic efficiency in resource allocation. In contrast, perverse financial liberalization would mean a liberalization process encumbered by government intervention, policy capture, moral hazard, misallocation of resources, and eventually crises and output losses. In each country, perverse financial liberalization was present in different ways. This is discussed in further detail in each country's profile.

This dissertation differentiates between the different strategies that each country followed because it is how these strategies get implemented and the specific vehicles that they eventually use for development that determine or influence the formation of power groups; both the extent of power groups and the location of power groups. Ultimately, the reason why we should be interested in power groups is because the location and the extent of power in these groups interact with weak institutions and encourages perverse incentives in the liberalization process. To the extent that power groups are more concentrated in a particular sector, we can detect very little difference between Japan, Korea, Thailand, and Malaysia since they all end up promoting concentration in different sectors and have similar outcomes. The strategy that Indonesia followed was more politically driven than economic goal oriented, some (ie., Chalmers Johnson (1982)) may not even place Indonesia into the same category of economic goal oriented developmental state. However, Indonesia is included in this dissertation because it is found to have similar developmental strategies as the other countries. Although Indonesia's strategies were more politically driven, they ended up empowering groups to a concentration of power similar to Japan, Korea, Thailand, and Malaysia. Thus, it matters less whether the concentration of power was located in the economic or political sector because the point is that the concentration of power contributes to perverse outcomes. Certainly there could be differences in the levels of outcomes, some may be worse than others, such as in the case of Indonesia where we find the outcome similar, but worse, than the other four countries. Whereas if we look at Taiwan's state-led developmental strategies, we find that they encouraged the formation of a less concentrated power group and the outcome was relatively better. Thus, it is the strategy that was followed under state-led developmental countries that shaped the differences in the output losses when crises came.

To account for financial liberalization differences between Korea, Thailand, Malaysia, Indonesia, and Taiwan the conceptual framework is based on the origin and historical sources of financial liberalization policies. It investigates the extent to which policy divergence originated from country-specific strategies that shaped political and economic structures leading to the formation of concentrated interests. The theoretical framework builds on three variables: (1) the formation of concentrated groups, (2) the channels used by the power groups in creating perverse policies, and (3) the structure of regulations adopted by these Asian countries.

Building on the suggestion in Auerbach and Willett (2000) for a more detailed and analytical investigation of the various channels through which financial liberalization can be influenced, this dissertation explores the role of special interests (power groups) in a more systematic way and investigates the channels through which control is enhanced. In examining the role of special interests (power groups) in the incidence of so-called perverse financial liberalization and subsequent financial crisis, this study relies heavily on quantitative data, unlike the bulk of previous research on this issue. Major effort was devoted to collecting and analyzing data that could be used as proxies for power group influence, perverse financial liberalization, and the severity of financial crises. Since these proxies are not perfect indicators for the issues being studied in this dissertation, caution applies when interpreting the results. The dissertation is structured as follows.

The next subsection (subsection 1.2) discusses in more detail the contribution that this study makes to the literature. The main contribution is the empirical analysis of the role of power groups in financial crisis. I also study the relationship between channels of power group influence and output losses, which has not been done so far in an empirical manner.

Chapter 2 reviews the background research on the issues for this dissertation. I consider primarily two bodies of literature: the literature on political economy of interest group formation, and the literature on financial liberalization and financial crises. These constitute the building blocks of my analysis of power group influence on policy formation, financial liberalization, and financial crisis.

Chapter 3 is the central part of this dissertation. I first present the conceptual framework on which the subsequent analysis relies. Then I explore country-specific developmental mechanisms and the historical formation of concentrated power groups in six Asian countries. I continue by discussing in detail the channels through which power groups contributed to the incidence of perverse financial liberalization. The channels are (i) weak institutions and sub-optimal policies of governance; (ii) connected lending and preferential treatment; and (iii) moral hazard, a "systemic" risk because of the externalities generated by financial interdependence. The chapter ends with a presentation of empirical evidence on the links between power group influence and the extent of financial liberalization, and estimation of output losses suffered by Asian countries during the period 1998-2002.

Chapter 4 presents empirical evidence from a larger set of countries in order to control for macroeconomic conditions and to conduct a more elaborated econometric analysis. In this chapter, I relate output losses to a measure of power group influence and to measures for- institutional strength, connected lending, and moral hazard- channels used by power groups. The results support the hypothesis of the positive relationship between the interaction of the strength of the power groups and the strength of the institutions; channels through which power groups exert their influence in financial crises.

In Chapter 5, I provide additional light on the issues explored in the dissertation through a comparative analysis of financial liberalization in Korea and Taiwan. By doing this, I hope to provide deeper insights into issues that could not be explored sufficiently by the empirical analysis presented in Chapter 4.

Chapter 6 concludes the dissertation by delineating policy implications and by offering suggestions for further research.

1.2. CONTRIBUTION TO THE LITERATURE

Uncovering causes and effects of major changes in institutional structures is important. An understanding of the origin and make-up of the real causal factors, the context in which they emerged, and their historical development is also necessary. In this regard, the main contribution of this study is in exploring the channels through which power groups influenced the perverse financial liberalization and the subsequent crisis.

While the literature on the Asian financial crisis has extensively explored the institutional factors, financial fundamentals, and macroeconomic characteristics of the countries affected by the crisis, the issue of power group influence has received less attention. This is the first effort to explore the role of power groups in financial crisis empirically, that is, relying on empirical data as much as possible to investigate the channels through which power groups exert their influence.

While the empirical analysis is the center of attention, I begin with a qualitative analysis of the formation of power groups in six Asian countries. The rationale behind this approach lies in the need to focus not only on purely technical considerations but also on the political economy of financial liberalization. This has important policy implications. Financial liberalization should be carried out carefully and with full attention to the dangers of "capture" of the liberalization process by special interests.

Given the nature of the financial liberalization process that these countries followed, I emphasize the close ties between the government and the bureaucracy. At the initial stages, the government makes the rules and policies for sector development.

However, as these sectors realize gains from financial liberalization and become economically strong, they become more involved in policy formation and use their influence in key decisions in the liberalization process. At the same time as economic growth occurs, the rule of law and corporate governance infrastructure needed to sustain such growth does not develop fast enough clearing the way for vulnerable "pockets" of inefficiencies that are captured by some private and public sectors for their own advantage. As the financial liberalization process progresses, the "pockets" of inefficiencies become more obvious and thus make easier targets for a political group's exploitation.

This type of perverse liberalization gives room to weak political and financial institutions consequently leading to moral hazard, ineffective enforcement of property rights, political instability, and immature or fragmented financial markets. In this dissertation, there is an attempt to shed additional light on these issues by analyzing the role of power groups.

This study contributes to the literature by examining:

- the ways in which financial liberalization was influenced by historical factors endemic to certain Asian countries,
- the ways in which development strategies did or did not differ depending on the initial conditions and specific characteristics of each country,
- the channels through which power groups exert their influence on the process of financial liberalization,
- the forms in which perverse financial liberalization occurs as a result of internal and external influences, and

- the ways in which the above factors contributed to the Asian crisis.

This dissertation posits that the presence of weak institutions, policies of connected lending and preferential treatment towards interest groups, and risks taken by the government all contributed to the Asian financial crisis.

The dissertation also contributes to the literature by relating the output losses associated with modern financial crises to the channels through which power groups exert their influence. While there are quite a few studies that estimate output losses and other costs associated with financial crises (for example, Bordo et al., 2001; Hoggarth et al., 2002; Boyd et al., 2005; Honohan and Klingebiel, 2003; Angkinand and Willett, 2006), this dissertation is, to the best of my knowledge, the first attempt to explore empirically the relationship between output losses and power group influence. While many questions regarding this relationship remain unanswered and are left for future research, the findings of this study shed new light on an hitherto unexplored issue.

Though, this paper presents a plausibility probe to note whether consistency of the evidence exists in the interaction between interest groups and weak institutions, a further step will be to seek the explanatory power of this paper through the perspective of shared mental model presented by interest groups, the International Monetary Fund, or any other models.

CHAPTER 2:

LITERATURE REVIEW

The Asian financial crisis of 1997-1998 brought to the forefront the significance of a well-designed financial system and emphasized the need to reevaluate the institutions, structures, and policies aimed at crisis prevention and resolution. A well-structured financial system is central for economic growth given that it channels financial resources to the most productive uses (Schumpeter, 1911). The works of McKinnon (1973) and Shaw (1973) on financial repression emphasize the benefits of an effective financial system and the importance that economic reform has on long-term growth. Rosseau and Silas (2001) state that, because financial institutions are important in the development of a sound financial system, financial liberalization is initiated as a part of the process of economic reforms in order to help develop a more diversified financial system.

Some studies on financial reform present a positive view of the relationship between financial liberalization and economic growth while differing on the means to achieve it. For instance, Goldsmith (1969) empirically demonstrated that financial development leads to growth through the evolution of financial intermediaries. King and Levine (1993) argue that financial liberalization fosters financial development resulting in long-term growth. Specifically, King and Levine (1993) find that financial liberalization increases the long-term growth rate by channeling investment funds to more productive areas thus increasing capital accumulation. Moreover, according to Bekaert et al. (2001), financial liberalization leads to an efficient allocation of resources and in the creation of growth and financial stability. Thus, we find that all of the above studies state that financial liberalization leads to financial development, since it tends to improve financial markets.

However, not all studies on financial reform share the same view. Stiglitz (2002) writes about the growing controversy in the literature regarding the link between liberalized markets and financial crisis. For instance, Rodrick (1998) finds no significant relationship between financial liberalization and economic growth. Other authors find that financial liberalization increases the frequency and severity of financial crises (see, for instance, Lindgreen et al., 1996; Demirguc-Kunt and Detragiache, 1998) and increases financial fragility due to structural problems found in the financial sector (Caprio and Kliengebiel, 1996). Kaminsky and Schmukler (2003) find that financial liberalization leads to financial crisis in the short-run since it induces changes in institutions supporting the functioning of the domestic financial market.

Some authors explore extensively the conditions necessary for a successful reform program. For instance, Arestis and Demetriades (1997) argue that policies and institutional quality are important in the financial development process of a country and its economic growth. Demirguc-Kunt and Detragiache (1998), International Monetary Fund (IMF) (1998), and World Bank (WB) (1998) find that unless a country emphasizes strong, prudential regulations and good supervision, financial liberalization can lead to financial instability. Corsetti et al. (1998) and Radelet and Sachs (1998) argue that structural and policy distortions cause structural weaknesses that can lead to financial crisis, specifically weakness in regulation and poor disclosure and transparency. Overall, these studies argue that policy distortions can be part of the reason that reform policies are poorly developed and poorly implemented, resulting in a crisis-ridden financial sector.

While there are many explanations for the Asian financial crisis, two are most often cited in the literature. One points to government corruption and the other emphasizes the role of interest groups. The first argument, sometimes referred to as "crony capitalism,"[1] (Corsetti et al., 1998; Krugman, 1998; Haggard, 2000) views excess power coming from the government through the implementation of policies of connected lending and preferential treatment. Corsetti et al. (1998) explain this as a moral hazard problem in that close links between public and private institutions led to financial and industrial policies entangled within a widespread network of personal and political favoritism. As a result, governments were willing to get involved in rescuing troubled companies, and the business and financial sector could operate under the deceptive impression of secured returns on investment. In Korea, for instance, the state failed to institute proper auditing and prudential regulation, and banks were not allowed to fail (Auerbach, 2001).

The second often-cited explanation for the Asian financial crisis emphasizes the role of power groups. This argument is based on the capacity of powerful groups to shape government economic policies and influence the development and implementation of reform programs through political influence, payments, or other channels, or what Hellman and Schankerman (2000) refer to as "state capture." Hellman and Kaufmann (2001) define state capture as the corrupt efforts of oligarchs to influence the formation of laws, policies,

[1] Cronyism is a term used where patron-client relations, family and personal relations, bribery and corruption exist. Hellman and Koffmann (2003) address cronyism as an unequal influence on public institutions that enables the lesser use of the courts, lowers enforceability, decreases compliance, and increases bribery, thus perpetuating institutional weakness and the likelihood for capture by the powerful.

and regulations. The authors argue that the use of influence to block any policy reforms means, that state capture is not just a fundamental cause of poor governance but one of its symptoms.

This dissertation draws from two bodies of existing literature: one from the political economy of interest group formation, and the other from the literature on financial liberalization and financial crises, in order to analyze how different groups influence policy formation. A vast amount of literature highlights the role of interest groups, institutions, and political market imperfections in shaping the actions of governments. However, how different groups influence policy formation has received less attention. As Hellman and Schankerman (2000) write, more research is needed on the channels used by interest groups to note their influence on implementation of reform processes or in policy development. Kroszner (1998) also suggests that more empirical research is needed on the effect of different groups on policy distortions—specifically, on their origin and background. He states, legislators and regulators are pressured into adopting policies that favor their interests and interest groups rather than what benefits the overall economy. The effects cause perverse impacts on chosen policies and their implementation.

Treverton et al. (1998) call these interest groups "commercial power centers"[2] which refers to centers whose actions affect economic policy. These centers can be any single institution, group of families, or the armed forces. Their study on Indonesia indicates that policy making and policies benefited specific groups' interests more than the country's overall economy. They explain that the Sino-Indonesian conglomerates have the

[2]Treverton et al (1998) defines Commercial Power Centers as any group, combination, or coalition that seeks to influence the design and implementation of government economic policies to suit its interests.

greatest "raw" power with about 70% of all private business in Indonesia, and consider these conglomerates to be the product of policy development from the Suharto's Regime (New Order), and the beneficiaries of deregulation in the 1980s.

There are a number of case studies describing the control structures of some of the largest business groups in Asian countries (for instance, Sato, 1993; Okumura, 1993; Taniura, 1993). These studies provide insight into the evolution and peculiarities of corporate control and power groups in Asia. In particular, most of these papers suggest that in these business groups, power arises via government protection from external competition, exclusive licenses for importation and exportation of goods, and favoritism in awarding large government contracts.

Furthermore, the government's policy to guarantee loans to friends and relatives, explicitly or implicitly, resulted in moral hazard that generated excessive, risky loans (McKinnon and Pill 1999). The implicit government guarantee of liabilities along with unregulated markets became subject to severe moral hazard problems in many Asian countries (Krugman 1998). Policies of connective lending and preferential treatment led to asymmetric information creating a concentration of ownership throughout Asia. Iskander (1998) found that many corporations in Asia are part of conglomerates that are controlled by families or small groups with close links to government and banks.

Asian countries display a significant concentration of ownership and corporate control. Control groups, however, differ significantly across countries. Claessens et al. (1999) find that ownership concentration is primarily enhanced by pyramid structures and through cross-share holdings. Their study indicates that the major ten families in Indonesia and Thailand control about 50 percent of the corporate sector. In Korea, on the other hand, the major ten families control 33 percent of the corporate sector. They also find that Korea has the highest use of pyramidal structures and cross-shareholding, while Thailand has the lowest. This reflects the informal alliances between the few controlling families in Thailand's economy. Indonesia has the highest concentration of ownership with the greatest number of companies controlled by a single family. Somewhat surprisingly, despite Japan's reputation of having the most widely held corporate sector among Asian countries, the data presented in Claessens et al. (1999) show that Japan has a similar concentration of ownership in large corporations as other Asian countries.

According to Malteni (2001), there is an intricate web of cross-share holding in Japan that is carried out via an elaborated system of complimentary and interlocking institutions, which can be viewed as lesser concentration of ownership. For example, Claessens et al. (1999) found that Automated Electronics corporation had, through a chain of ownership, two ultimate owners, the International Finance Corporation and Japan Asia Inc.

Claessens et al (1999) indicate,

> . . . this wealth concentration may be the reason for the weak evolution of institutional frameworks in corporate governance and a formidable barrier in policy reform. . . [and that]. . . particularistic forms of influence which are highly dependent on personal connections need to be replaced with a more institutionalized form of lobbying for policy formation in order to prevent future financial crisis. (pg, 31)

The literature on financial crises concentrates on the explanation of causes, processes, and effects of financial liberalization. Some authors have emphasized institutional weaknesses as a cause (Kane, 1998; Krugman, 1998), while others have focused on the very process of financial liberalization (Haggard et al., 1993; Keohane and Milner, 1996; Horowitz and Heo, 2001), and other groups have emphasized the importance of financial market developments (Cameron, 1967; Goldsmith, 1969; Shaw, 1973).

Some authors point to the lack of prudential regulation and supervision, weak legal structure, and poor corporate governance as severe weaknesses that were found in the Asian country's financial sector at the onset of the financial crisis (Corsetti et al, 1998; IMF, 1998; Willett, 2000; Lang and Leslie, 2000; Mishkin, 2006). Where the rule of law is weak, and contracts are inefficient and partially or not enforced, financial institutions are weak. In addition, inadequate attention paid to strengthening the regulatory framework, which includes monitoring and supervision, can lead to ineffective contract enforcement mechanisms (Fujita, 2000).

A weak legal framework allows financial institutions to take inappropriate corrective action in order to cover up institutional problems. A study conducted by Demirguc-Kunt and Detragiache (1998) demonstrates that, in countries where the rule of law is weak and corruption is widespread, where the bureaucracy is inefficient, and where contract enforcement mechanisms are ineffective, the institutional environment makes liberalization more likely to lead to a financial crisis.

Lang and Leslie (2000) point to poor corporate governance in most Asian companies due to concentration of ownership and extensive corporate pyramids that weakened the financial sector. And much of the literature in financial crisis states that the development of policies of connective lending and preferential treatment led to asymmetric information thus creating concentration of ownership. Thus, financial liberalization becomes based upon the concentration of ownership through the use of different approaches.

Studies that point to the wrong sequencing and piecemeal approach of financial liberalization result from the observation that financial crisis have often followed a country's financial liberalization. One argument is that liberalization tends to destabilize capital flows, because when liberalization occurs short-term loans are used more pervasively than long-term loans since short-term loans do not require the same guarantees as long-term loans. In addition, financial liberalization may destabilize capital problems because of market failures imperfect information that pervade international capital markets.

With imperfect information, investors may overact to shocks, withdrawing massively from countries at the first signs of economic problems or investing excessively at the first signs of economic boom (Kaminsky, 2005). Thus the capital account should not be opened up until current account and domestic markets are deregulated, and more specifically when in the presence of weak institutions. For instance, Radelet and Sachs (1998) and Stiglitz (2000) argue that accountability, transparency, and improvements in property rights should precede financial reforms. While many other studies present the need for a certain level of development of the financial system, which suggests the importance of the sequence in financial liberalization within the financial sector.

In a study of several developing countries, Caprio et al (1994) conclude that the sequencing of financial liberalization is a critical element in implementing successful financial reform. McKinnon (1993) emphasizes the need for a gradual implementation of financial liberalization in combination with adequate monitoring and supervision for economic stability. Limskul (2000) argues that the partially liberalized financial market in Thailand allowed large capital inflows through the Bangkok International Banking Facilities (BIBF) without proper supervision of the corporate sector, which created a large number of NPL's found during the Asian crisis.

The way implementation of reform policies occurred allowed former political elites the ability to capture and stall the reform process for their personal benefit. This resulted in vested interests becoming entrenched, blocking or stalling further significant reforms that are not to their own benefits. Incomplete reforms allowed market distortions, enabling the vested interests to influence and modify policies creating a piecemeal approach of the reform. Haggard et al. (1993), state that business can distort and capture policies of liberalization, which increases vulnerability to shocks that can weaken the regulatory process and shift risk back to the government.

Distortion in policies gives the wrong incentives for financial institutions to increase risk, moral hazard, and industry concentration, and is what Corsetti et al.(1998) refers to as "the interest group-institution incentives nexus" indicating that, although interest groups tend to pressure legislators, the structure of the institutions can provide the wrong incentives for groups to form. For example, Borensztein and Lee (1999) demonstrate that the Korean government used direct allocation of credit with preferential interest rates as a powerful incentive to promote key industries. On the other hand, Willett and Auerbach (2002) argue that perverse liberalization is not necessarily a result only of rent seeking behavior. Advocating liberalization without a good understanding of the economic theory and the legal infrastructure could lead to bad policies that weaken the financial system, even if government officials attempt to do a good job.

Furman and Stiglitz (1998) emphasize that the roots of the crisis rest in government's financial policy errors, such as weak supervisory capacity, and not being aware of the systemic risk that massive inflows of capital into their country would pose. Kane (1998) notes that along with these policy mistakes, the fact that regulators and politicians direct cheap loans to politically powerful parties and sectors in the hope of preserving rents earned in the past, promotes vulnerability and corruption in the financial system.

Wei (2000) argues that in countries where corruption is widespread, the country's composition of capital inflow can be affected, which can lead to higher incidence of currency crisis. In a study of 13 developed countries and 30 developing countries, he found that countries with higher corruption levels had higher foreign bank loans and lower long-term foreign direct investment (FDI), which makes the country more vulnerable to future crises. This, he explains is because foreign bank loans are a quick fix to generate money, making a government susceptible to corrupt practices. On the other hand, FDI is more likely to be used in long-term development that can produce externalities in the form of technology transfers and spillovers. Radelet and Sachs (1998) argue that financial institutions in many Asian countries incurred a significant amount of external liquid liability rendering them vulnerable to external economic shocks.

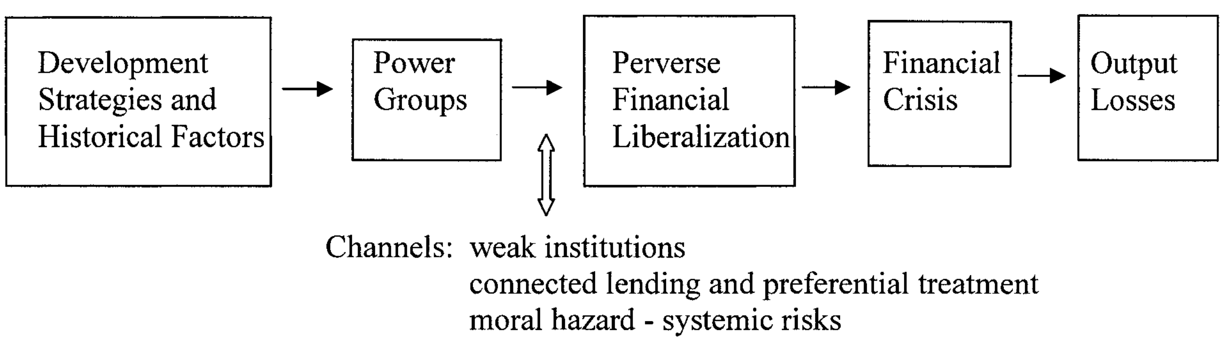
Brown and Raddatz (2004) indicate that a well-developed financial system enhances competition in the industrial sector by allowing easier entry. Because well developed financial systems reduce the correlation between credit allocation and a borrower's collateral, it facilitates the entry of new firms, thereby increasing the degree of competition, and decreasing the rents of incumbents (Phillips, 1995; Rajan and Zingales, 2003). More recent research stresses the importance of a well-developed financial structure in the quest for financial stability and economic growth (e.g., Rousseau and Sylla, 2001; Willett and Auerbach, 2002). This research indicates that a good financial system is a combination of government policies, legal system, market development, and proper incentive structure. This dissertation builds its analysis upon this latter research.

CHAPTER 3:

CONCEPTUAL FRAMEWORK AND EMPIRICAL EVIDENCE

3.1. CONCEPTUAL FRAMEWORK

This study investigates the explanatory power of power groups interacting with weak institutions, policies of connected lending and preferential treatment, moral hazard that lead to systemic risks:



This conceptual framework is elaborated in the following three subsections. First, factors that influence the power group formation are explained. Then the focus moves to the channels which power groups use to exert their influence and which could lead to perverse financial liberalization. Finally, the severity of the Asian crisis is explored via calculation of output losses suffered by Asian countries during the period 1998-2002. Financial crisis is likely to lead to output losses because a reduction in bank finance usually results in a decrease in capital accumulation, affecting negatively the output of the economy in the long run.

The framework above explored via close analysis of data and qualitative information for each country examined in this dissertation. Historical factors are similar in areas of paternalistic rule and hierarchical structure, the concentration of power occurred via bank lending and other preferential treatment, and risks taken by the government were aimed at maintaining or securing support of interest groups. Thus, changes in policies occurred to fill the need of the power groups that formed, causing development strategies and financial liberalization to become perverse as a by-product of satisfying the demands of these groups.

Systemic risks arise in many forms and fuel perverse financial liberalization just as control from power groups does in that, institutions become weaker to accommodate power groups and the current regime. For example, through perverse liberalization and pressure from power groups, banking institutions could become weak by having large debt overhang, having a large percentage of non-performing loans, or in the case of Korea, partial liberalization in short-term bank borrowing set above international market trends created a systemic risk demonstrated by set of bankruptcies at the onset of the Asian financial crisis. Capital adequacy and better provisioning practices could prevent or withstand shocks, as well as limiting foreign-exchange risk.

Policies distorted to meet the needs of interest groups are a part of perverse financial liberalization because the groups worry more about liquidity than negative risk. In addition, implementation of poorly developed banking policies help power groups to secure a tighter foothold in policymaking. More examples of the channels are discussed in the following sections as well as the country profile sections. The examples given here are risks that feed into power groups' interests that in turn create a weaker banking institution through the manipulation or coercion of government policy-making.

3.2. POWER GROUP FORMATION

This section introduces country-specific developmental strategies as well as historical and cultural factors that contributed to the formation of concentrated power groups.

There are a number of historical and cultural factors that contributed to the formation of powerful interest groups. The basic pattern within Asian culture has its origins from a centralized feudal system: a ruler or lord overseeing a large number of other sub-lords who in turn were in charge of their sectors. This hierarchical and centralized system depended on bonds of personal loyalty and respect to an established authority. This sets the beginning of a system based more on the relationship of interest groups with the government rather than on contractual law.

Hierarchical structures presuppose that both resources and needs can be managed and that important issues are assigned to experts and hierarchical organizations. Some basic characteristics of hierarchical economies are: status and rank as a medium for economic well being and power, collective form of ownership, a paternalistic view of corporate structure, and the development of informal institutions of traditions and beliefs. The scope for independent economic and political decisions increased with the rank within the hierarchy; lower echelons had few opportunities to control their superiors through a system of constitutional checks and balances (Rosenbaum, 2001).

A patrimonial state developed within a hierarchical social order provided employment, education, and health, which were contingent on loyalty and respect (Rosenbaum, 2001). The dominant political structure was deeply rooted in collectivism and under the principle of consensus building, resulted in the development of a collectivist approach to governance. Political and economic institutions emerged from the process of (human) interactions where the interests of the community are placed above individual rights. These hierarchical structures were highly dependent on government connections and personal relationships, allowing the creation of a highly interconnected form of economic development or what is often referred to as "embeddedness" in a system that breeds protectionism, preferential treatment, and corruption.

Hierarchical structures and collective forms of ownership gave room to the formation of pyramid structures where control was directed from the top owner or corporation controlling the structure. Within a corporate pyramid it is easier to increase indebtedness because the debt can be rolled over by group banks or be reshuffled ahead of auditors to other affiliates via intra-group loans or transfer pricing (Faccio, 2006).

The conventional diagnosis for the roots of the financial crisis in Asia was perceived as having its origins in institutional weaknesses in the financial sector and corporate governance.[3] The causes of the Asian financial crisis have fueled a lot of interest. The lack of corporate governance is one cause blamed for the crisis. However, the

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[3] There were additional reasons for the currency crisis, and of course the currency and financial crisis interacted. See the analysis and references in Willett (2005).

literature on this issue is not unanimous. Some research studies have pointed out that the Asian financial crisis has been attributed to the poor governance in the corporate sector due to the concentration of ownership. For example, Faccio et al. (2001a) point out that most of the companies in Asian countries are controlled by a few groups of families. These groups, using extensive corporate pyramids, exploited wealth from minority shareholders systematically. In sum, Faccio et al. (2001a) argue that there is a negative link between the ownership concentration and corporate governance.

Normally, an increased indebtedness by an affiliate should impede expropriation of minority shareholders by the controlling shareholder. Within a corporate pyramid, however, increase in debt of an affiliate need not necessarily constrain expropriation by the controlling shareholder. The debt can be simply rolled over by group banks, recycled into external loans guaranteed by other affiliates, or moved to other affiliates. All these actions could be performed ahead of auditors.[4] The default by the affiliate also need not harm the reputation of the controlling shareholder if the two parties manage to organize their affiliation through several opaque layers of the pyramid. Groups that are taken advantage of in that case are the creditors and minority shareholders, who are left with an uncollectible debt, and the taxpayers, who are forced to bail out the endangered financial system (Faccio et al., 2001b).

Group society is another characteristic of Asian culture perhaps based on the cultural influence of Confucian tradition. The group society creates conditions for informal institutional arrangements that influence an interpersonal structure of governance where a

[4] Backman (1999) explains in detail the way in which debt facilitates expropriation of minority shareholders by controlling shareholders in Asian corporate groups.

dense social network leads to the development of fairly stable informal structures, such as customs, trust, and normative rules that make up an informal institutional framework for organizing activities.

Perhaps because financial systems appear at different times and in different spaces they tend to differ from country to country (Vogel 1996). Building a finance system can be a country specific task, developed by different historical contexts, and formed by social and cultural specificities. The relationship between financial development and economic growth is difficult to generalize across countries because economic policies are country specific and their success depends, among other things, on the efficiency of the political institutions implementing them (Al-Yousif and Yousif Khalfa, 2002).

Corporations, government, and banks have close relationships in many East Asian countries. Conglomerates that are controlled by a small group, have nontransparent accounting, maintain interlocking ownership between corporate and financial sectors, and allow weak minority shareholder rights dominate many sectors of Asian economies. It is estimated that in 1997, the top 10 families in Indonesia controlled corporations worth more than half of the country's market capitalization. Comparable figures are one-half in Thailand, and one-fourth in Korea and Malaysia. Fundamental cultural and institutional changes are required if a new corporate governance structure is to be established with arm's-length, transparent relations between corporations, government, and banks (Iskander et al., 1998).

While there are many common features in the development of these Asian countries, the history of the crisis differs considerably among them. No single formula works for every country, but what is important is the formulation of country-specific and region-specific policies and cross-regional experiences that provided the background for the developmental process.

Summarizing the literature on Asian development and power-group formation reviewed above, I differentiate among the following broad categories of country-specific development strategies:

- Hierarchical-bank led (e.g., Japan)
- Hierarchical-industry led (e.g., Korea)
- Hierarchical-political bureaucracy led (e.g., Indonesia, Malaysia)
- Hierarchical-financial technocracy led (e.g., Thailand)
- Hierarchical-SME led (e.g., Taiwan)

The categories posited above are explain in further detail in the country's profiles that follow.

Japan

Japan has followed hierarchical-bank led development strategy, i.e., the developmental process in Japan emphasized the role of the banking sector in the formation of a financial system. The banking system became the engine of growth. This could be explained in the following way. The government policy was focus on allocation of resources to targeted industries through the banking system: funds were allocated to the investment and export sectors by means of various types of regulations, particularly interest rate regulations. Interest rate regulations promoted growth in the sense that they allowed indirect finance to flourish. In addition, the isolation of domestic financial markets from overseas markets prevented foreign influences from undermining various financial regulations (Tatewaki, 1991).

In creating the financial system as a tool for industrial policy, the Japanese government encouraged corporations to depend upon bank borrowing for their capital and thus reducing the corporate reliance on the stock market (Fujita, 2000). Banks and industries were organized into hierarchical orders with interlocking shareholdings, such as the *keiretsu* group systems.[5] The financial liberalization in the 1990s brought some changes by allowing for participation of non-financial organizations in the capital market and by broadening the sources for raising capital. Nevertheless, corporations have continued to depend upon indirect funds for raising capital.

These developments led to the formation of powerful concentrated financial interests in Japan. For instance, bank lobbying was crucial in blocking the formation of bond markets until the late 1970s and for a ban on issuing bonds abroad until the 1980s. Japanese banks have repeatedly used their considerable lobbying power to further their own interests at the expense of the economy in general (Morck and Nakamura, 1999).

[5] The roots of the *keiretsu* can be traced back to the pre-war *zaibatsu*: a group of enterprises that could rely on capital supply from within the group.

Korea

Korea is ethnically and linguistically a very homogeneous culture. This homogeneity legacy dates back to the Korean Chosun dynasty (1392-1910). Although Korea endured many invasions throughout their history, it remained culturally homogeneous. With Chinese power declining towards the end of the 19th Century, Korea began a 35-year period of Japanese colonial rule (i.e. they were invaded by Japan) where many political and economic institutions were developed such as legalization of property rights to land, and the Rice Production Development Program. Then, with the end of Japanese occupation in 1945, and the Korean War (1950-1953), Korea experienced several decades of autocratic and military rule under President Syngman Rhee and later under Major General Park Chung-hee, among others. Presidential elections were restored in 1987 with the election of Roh Tae Woo; however, it was not until 1992 that Korea elected a non-military president.

The legacy of autocratic rule set the stage for centrally planned, hierarchical political structure. Furthermore, the legacy within a culture where collectivism, respect for authority and social harmony are highly valued resulted in a state-led model of development with power being consolidated at the top of the hierarchical structure. Dependence on the government for economic development gave room to a system where the well-connected, family ties and collusion in business led to a high concentration of ownership and the formation of oligopolistic power centers.

The relationship between government and business associations in Korea had its roots in the period of Japanese colonial rule, when the governor general established the

Seoul Chamber of Commerce and Industry and other industrial associations as a means of communicating economic policies to the business community. Since 1952, all businesses were required by South Korean law to belong to the Korean Chamber of Commerce and Industry, the bylaws and initial membership of which closely paralleled those of the Seoul Chamber of Commerce and Industry from the colonial period. Since 1961, when the Park government began its economic development plans, the Federation of Korean Industry has represented the major conglomerates.

In 1961, General Park instituted centrally planned industrial policies to promote the construction of key industries through import substitution. Resource allocation and credit control were the tools employed through the government's industrial policy to promote key industries (Lee, 1996). By the 1970s, economic policy moved away from import substitution towards export-oriented industrialization. Greater emphasis was place on exports and labor-intensive light industries for economic growth. The export-oriented industrialization began by directing fiscal and financial policies towards the promotion of industries by subsidizing credits, tax exemptions, and allowing preferential interest rates, thus marking the beginning of a relationship bank system based on personal connections and political favoritism, resulting in the creation of an ownership concentrated industrial sector (Cho and Kim, 1995).

This strategy for economic growth with its preferential industrial policies and connective lending created an "embedded" system between big businesses and the bureaucracy. Since entry barriers, such as tariffs and import licenses, set by the government allowed only the existing big businesses to enter targeted industries, the already big industries were able to further diversify and become large manufacturing conglomerates (Jwa and Seo, 2000). Furthermore, these targeted industries also benefited from tax exemptions and financial resources at preferential and subsidized rates.

Thus, the Korean government-led model of economic development, where the government encouraged private and public investments into strategic sectors, used the banking system as a venue for industry growth. By targeting specific industries through policies of segmentalism, credit allocation, and interest rate regulation, the Korean government was rather successful in mobilizing and allocating resources, allowing the creation from scratch of an industrial base dominated by large firms, named *chaebols*[6] (Molini and Rabellotti, 2001). The traditional structure of chaebols is a closed concentration of family ownership and a highly diversified business structure.

The direct credit allocation with preferential interest rates that created distorted incentives in project selection had its roots in the model of relationship banking that emphasized semi-monopolistic relations (Corsetti et al., 1998). These directed developmental policies encouraged the rapid expansion of chaebols into a powerful oligopolistic position; by allowing them to pursue further market concentration through cross-debt guarantees providing powerful leverage over developmental and regulatory policies. For example, during the financial market reform of the 1990s, the chaebols used their leverage to delay and block regulatory policy change by decreasing preferential credit allocation, freeing interest rates, and decreasing cross-debt guarantees. This became evident in the fact that even though market concentration and cross-debt guarantee

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[6] *Chaebol* is defined as a business group consisting of several corporate enterprises engaged in diversified business areas, and usually owned and controlled by one single family or by two interrelated family groups.

regulations were introduced in the early 1990s, the chaebol's net assets and cross-debt guarantees more than doubled in the mid-1990s (Choi, 2000). As Walter (2003) writes, even when recommendations to enhance prudential supervision for reforms were being drafted such as the one submitted to the National Assembly on August 23, 1997, opposition instigated by major chaebols stalled them.

The high capital inflow that Korea experienced was mainly in the form of loans from foreign banks to domestic banks, where the proceeds were lent to the corporate sector. This made the domestic banks the venue for large corporations to secure more loans. Molini and Rabelotti (2001) state that because the domestic banks were only used as a channel for credit allocation, the development of the financial sector was institutionally weak and substantially subordinated to the corporate sector. In addition, Lee, Lee, and Lee (2002) argue that it was the regulatory process of the government's developmental policies in conjunction with its preferential allocation of loans and subsidies to selected industries that created the vis-a-vis relationship power between the bureaucratic elite and the increasingly powerful conglomerates which contributed to the weakness found in the financial structure.

The Korean government's long-lasting development strategy exerted crucial consequences on the development of the financial market and corporate governance. High corporate debts were incurred and higher still was the proportion of short-term debts that many of these large industries had due to overexpansion and diversification into other industries. The tight regulations on the banking sector created a segmented financial system, while the commercial banks were tightly regulated the non-bank financial institutions (NBFIs) were being deregulated and soon became the venues that many of the conglomerates used to finance their expansion and increased their economic power (Iskander, 1998).

The concentration of economic power provided chaebols with institutional resources assisting them in developing the capability to delay and block state efforts for financial reform.[7] They opposed any moves in decreasing preferential credit allocation and foreign entrance into the domestic market out of the fear of competition and diluted ownership control; however, since Korea had strict shareholding restrictions, and chaebols could not own or control commercial banks, they strongly supported measures that allowed the deregulation of entry barriers for non-bank financial institutions (NBFIs). More specifically, the deregulation of merchant banks that provided chaebols with enhanced access to cheap foreign loans (Haggard and Maxfield, 1996).

Merchant banks were introduced in 1970 as a non-bank deposit-taking/loan-granting financial institution. By the end of 1997, they incurred $20 billion in foreign debt, 64% of which was in short-term debt.[8] The major factor for this was that they did not have the same prudential supervision as commercial banks or the same lending restrictions. For instance, a merchant bank could lend as much as 150% of its equity capital to any single borrower compared to only 40% permitted for a commercial bank. Furthermore, since merchant banks did not have a limit on how much they could borrow internationally, they became highly leveraged with debt-to-equity ratios of over 500% by 1998 (Iskander, 1998). This, according to Nam (1999), was the result of the government's implicit risk

[7] See Business Korea 1988 (September 25)
[8] Bank of Korea 1998

sharing for chaebols and the government's frequent bailouts that became a serious moral hazard problem.

During the 1980s, the government began to focus on an anti-monopolistic policy to control overexpansion of the chaebols. The regulation on monopoly and Fair Trade Act in 1980 was enacted to limit diversification of big conglomerates.

Korea's financial liberalization started in the early 1980s with the privatization of commercial banks and the deregulation of entry barriers into the financial sector. However, Lee et al., (2000) argue that the Korean government's policy of deregulation and liberalization was endogenously determined, largely influenced by the interest politics of the chaebols. A very powerful interest group in Korea, these large family-owned conglomerates who were the product of developmental policies, later became less dependent on government finance and exerted powerful influence in shaping the course of financial liberalization reform.

Financial liberalization in Korea was manipulated by the large chaebols to serve their own interests. The economic success experienced by the chaebols allowed them to become a dominant force in the national economy to the point where the state not only lost control over chaebols, they became a hostage of their own creation. As Lee et al., (2000) state, Financial Liberalization reflected a shifting of the power relationship between the state and the chaebols.

Chaebols obtained controlling shares of non-bank financial institutions (NBFIs) allowing a close relationship to develop between merchant banks and chaebols that encouraged expansion and diversification into other industries. This created excessive debt financing, which in turn resulted in high leverage abilities and low profit levels. Chang and Hong (1998) conducted a study where they compared profitability and efficiency between the chaebol-affiliated firms and the non-chaebol affiliated firms. They found severe under-performance in the chaebol-affiliated firms and suggested that the under-performance and inefficiency was the result of too much lending to connected firms and the over expansion into other industries that lowered the profits of the affiliated firms. These structural weaknesses in the financial and corporate sectors were some of the most important contributing factors to the Korean financial crisis in 1997.

In sum, the high concentration of ownership found in the industrial sector, was the direct result of developmental policies on financial development, as Corsetti et al., (1998) argue, the direct allocation of credit and preferential interest rates that created distorted incentives in project selection had its roots in the model of relationship banking that emphasized semi-monopolistic relations. Therefore, it is important to consider the political, cultural, and institutional development in order to understand the reform process. The financial crisis provided evidence of the embedded weaknesses found in the Korean developmental model. A model that, under a growth-oriented developmental strategy with highly perverse industrial policies led to the formation of weak institutions, and where economic deregulation occurred among a politically distorted environment with rent-seeking and corruption leading to perverse liberalization in Korea.

Indonesia

Indonesia presents a highly centralized and authoritarian political structure. A long tradition of ethnic conflicts led to the development of a system highly dependent on government connections and personal relationships. A patrimonial hierarchical structure where the government has direct control over society, created a system of patron-client relationships where the political elite consolidated their political power (MacIntyre, 1994).

The historical ethnic conflicts date back to colonial times when the Dutch incorporated ethnic segmentation in the economic sector and created a centralized bureaucratic political system. Chinese immigrants were good merchants, and by establishing trade monopolies, were able to control the financial sector. Economic and political disputes among the different ethnic groups and primarily against the Chinese resulted in a highly fragmented society with a history of social unrest and political instability.

The institutional framework of economic development in Indonesia has been a combination of a colonial legacy as well as post-independence, authoritarian regimes of Sukarno's Guided Democracy and Suharto's New Order Regime. The political structure of a predominantly traditional hierarchical culture lend to a (patron-client) master-servant relationship based predominantly on patrimonial bureaucratic authority (Robinson and Rosser, 1998) where ethnic Chinese capitalists in cooperation with the political elite consolidated their political power to create private economic empires (ibid.).

In the early 1960s, General Suharto established a military-backed/based government and consolidated power in the name of social stability and economic development. To legitimize his regime, Suharto created a system of patronage by forming close relationships with the powerful armed forces, the wealthy Chinese, and selective Pribumi. Under Suharto's New Order Regime, policies of directed lending and preferential treatment were used to bestow privileges in order to maintain the loyalty of these groups (Hill, 1966). This patronage-based regime was not overly controversial since Indonesia never had a landed oligarchy (Niles, 2001). Nor was there a big economic group since the nationalization of all the industries under Sukarno's regime.

This system of patronage within a hierarchical structure set the stage for perverse interests, cronyism, and weak institutions to form. Suharto's authoritarian political system gave in more to pressure coming from personal relationships than from traditional interest group perspectives. For instance, Hill (1966) states that although the Chinese had special connections and considerable economic power, they were not allowed involvement in the political spectrum.

Thus, Indonesia's developmental strategy was to create wealth for the political, military, and economic powers and not to develop policies of economic growth. Among the elite, policy did not have the influence that the distribution of goods and power had over political competition (MacIntyre, 1994).

Before the 1960s, Indonesia was primarily an agricultural society and by the 1970s, oil and gas exports provided much of Indonesia's income, giving the patrimonial system the means to remain in power. The oil boom provided Suharto's regime with the resources to compensate groups whose cooperation was essential for political legitimacy. In contrast to Sukarno's Guided Democracy, whose support came from the masses, Suharto's new order established a government where a few favored elites kept him in power.

Throughout the 1970s, economic development was pursued primarily by the political elite, through the development of state-owned monopolies and in promoting big conglomerates. Many of these conglomerates were owned by the Chinese and selected Pribumi who enjoyed close or family ties with President Suharto. Close friends and family of the ruling regime, who owned big import monopolies, were favored with import licenses and directive lending. Military leaders were placed in charge of lucrative businesses in return for their support. For example, General Ibnu Sutowo was given directorship of the state-owned oil company Pertamina, which he used to channel funds to other companies (Hill, 1996).

By the 1980s, these large conglomerates diversified into different manufacturing and agricultural business, thus forming extensive networks throughout Indonesia (Turner, 2003). Due to the substantial decrease in oil export prices in 1982, Indonesian export income declined dramatically forcing Suharto to promote other industries (MacIntyre, 1994).

Policies of deregulation and reform were developed to promote export-oriented industries. Financial liberalization was initiated, at least in part, as a venue to keep the elite in power. State led reform strategies provided new opportunities that further concentrated ownership among the well-connected elite. State owned banks that owned a substantial proportion of the market were deregulated, import licenses and high tariffs on industrial imports generated profits for well-connected businesses, and entry barriers for foreign industries allowed favored companies to win lucrative government contracts.

Financial liberalization became more beneficial to the large corporations, which were of course the well-connected and family concentrated corporation. For instance, the corporations borrowed directly from international banks since the domestic interest rate was higher than the international rate.

Indonesia like many other Asian countries used the banking system as a venue to channel credit that financed industrial and infrastructure development. While direct control of resource allocation was intended to support Developmental Plans, it also allowed perverse incentives that strengthened the political power of the elite creating inefficiency in the regulatory system, and overall corruption. Indonesia's financial system developed through the domination of State-owned banks whose distribution of capital was primarily through connections with the government.

The financial reforms of 1983 and 1988 brought massive capital inflows, and the private banking system expanded rapidly from 1988 to 1996. The number of private banks grew from 77 to 236 without appropriate prudential regulations and supervisory functions. Financial liberalization reform removed credit controls and freed interest rates that allowed easier entry and mobilization of capital.

However, deregulation was pursued in an inconsistent and patchy manner due to institutional weakness and strong, vested interest groups. Financial liberalization opened the door for corporate access to loans from related parties that led to a rapid increase of bad debt and an unmanageable banking sector. Many scandals during the 1980s showed that connective lending and corrupt manner of business was prevalent in the financial sector.

With the end of the oil boom came the search for alternate sources of revenue, stimulating the need for deregulation and reform in the financial sector. This was supported and requested by the bankers and businesses since it allowed them to expand with minimal disclosure (Cole and Slade, 1996). Furthermore, not only were policies of reform influenced by the private power sector, but often interference in regulatory policies, led to delays and deletion of many proposed regulations that were never enforced (ibid.). The high concentration of power at the top of an authoritarian system allowed the formation of a very corrupt system where concentration of ownership through a network system had control of a large part of the Indonesian economy.

Malaysia

Malaysia's centralized institutional framework has been the result of its historical parliamentary political structure. This institutional framework gave way to centralized policy control where policies were easily swayed either by political party supporters or by the ruling regime. The institutional regime had its roots in the colonial system, which was established via British policy of granting pensions to the Malay ruling class in return for their withdrawal from political and economic governance, except for symbolic roles that helped the legitimacy of the colonial system.

Culturally, Malaysia is a multi-ethnic society that resulted from the colonial period when Chinese and Indians immigrated to do commerce and provide cheap labor. Sixty percent of the population is comprised of indigenous Malays ("Bumiputeras") who are the largest ethnic group. They were government employees and became more involved in Malaysian politics. The ethnic Chinese, who comprise about 30% of the population, became the main traders and were very successful in business, while the Indians worked for the major industries and were the minority ethnic group[9] at 10% of the population. Throughout the years, ethnic cleavages became more entrenched, with each ethnic group hanging on to their own culture and religious beliefs.

In 1957, although Malaysia gained its independence from British rule, it was left with the legacy of a divided nation. Even after Malaysia gained its independence from the British, the ethnic tensions continued especially with the "Bargain of 1957" when the Malays where given prominence over politics, and the Chinese continued their dominance in the economic sector[10]. Organized along racial lines, Malaysia has suffered from the legacy of ethnic politics. The United Malays National Organization (UMNO) has been the single dominant party since its independence in 1957. Therefore, we find the present political system to be a product of its colonial experience, and its economic and socio-cultural background. Thus, Malaysia's political system is known to be semi-authoritarian and whose regime's political legitimacy is based primarily on its ability to provide stability by avoiding ethnic conflicts.

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[9] Source: Economist Intelligence Unit, 2004.

[10] An example of the special political rights enjoyed by the Malays is that the prime minister position would be reserved for the Malays only. The British left a legacy upon which all modern Malaysia is built--a legacy of "communalism" (divisions into Malay, Chinese, and Indian communities). By Benjamin Asare and Alan Wong.

Although, "The Bargain of 1957" was established primarily to help build a better balanced developmental institutional structure and a more cohesive Malaysia; instead, it created further inequalities in income distribution among various ethnic groups. This led to the riots of 1969 and the shaking of the original Malay-Alliance Political Party, which lost a significant number of seats in the 1969 election to the Chinese-based opposition parties (Drabble, 2000). The riots highlighted the need for a change in government policy to close the economic inequalities present among the different ethnic groups. The government assuming a more active role in the economic sector, embarked on long-term economic development under the New Economic Policy (NEP), and promoted strategic sectors of the economy from 1970-1990. The NEP (New Economic Policy) was used primarily to transfer resources to the Bumiputera. Public corporations and private companies with government connections serve as access points and incentives for Bumiputera (Toyoda, 2000).

The government sponsored business networks to advance the position of the Malays. The constitutional framework kept the Chinese dependent on the Malay who centered a system of economic patronage and policies developed to primarily benefit the government-allied, concentrated interest groups. Drabble (2000) states, the New Economic Policy created a Malay rentier class based on political and government patronage.

Malaysia's developmental model was similar to other Asian countries in their pursuit of economic growth in that it developed policies of protectionism for domestic industries; it also had policies of direct lending to build up the corporate private sector. The development of the corporate sector was done mainly through bank borrowing, where most bank lending was to selective groups and conducted on the basis of "family" relationship or government "connections;" however, the government also started state projects in partnership with a private corporation that later was allowed to become privatized to favor the private corporation.

While developmental policies provided for subsidies to specific government industries such as oil and gas for exportation, direct resource allocation to strategic industries allowed the formation of large industries in the private sector, particularly in electronics and textiles. These well-connected large-size enterprises were given lower credit costs on average and were almost 11% lower than the small and medium-sized enterprises. By the 1970s, the government–connected elites with the Chinese and overseas Chinese owned 82% of the manufacturing sector, 76% of the financial institutions, and 94% of trade.[11]

By the mid-1980s, major "Bumiputera" controlled conglomerates that emerged primarily as a result of powerful politicians' connections, "soft" loans from state-owned banks, and the award of major projects and licenses. The capital inflow increased dramatically with the large companies and commercial banks borrowing heavily from abroad. Their net foreign liabilities increased from RM 10.36bn at the end of 1995 to RM25.2bn in June 1997, while their net external reserves decreased from –RM5.3bn to –RM17.7bn over the same 18 month period (Jomo, 2000). Most of these corporations had ties back to the UMNO through its main investment arms such as the Fleet Group Sdn Bhd and Hatibudi Nominees Sdn Bhd among others (Toyoda, 2000).

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[11] Source: Snodgrass, 1980.

Thus, Malaysia's hierarchical political structure and interventionist developmental policies led not only to concentration of market power but it also contributed to the formation of a system of patronage where rent seeking and corruption became common activities.

Although Malaysia has had economic booms in the past, business cronies of those in power, who in turn contributed to growth by re-investing in the 'protected' domestic economy, captured much of the wealth generated. This "economic boom" of the eighties was built on a shaky and unsustainable foundation (Jomo, 2000).

By the late 1980s, due to economic difficulties and fractionalization within the UMNO, due to different business interests and conflicts between the large and medium-sized companies, members stated the need for more economic openness. Policy changes were initiated to privatize previously owned government financial institutions and open financial markets to foreign capital. However, traditional Malay oligopolists, and their long-term silent Chinese partners, resisted many of the changes. Ethnic politics intervened in the liberalization process primarily because financial liberalization was seen as favoring an elite few. Thus ethnic cleavages and the government trying to maintain political power affected financial liberalization (Toyoda, 2000).

Jomo (2000) argues that responsibility for the vulnerability found in Malaysia's financial crisis is due to "crony capitalism." Interests influenced government policy responses, and "crony capitalism" does not explain the origin of the crisis; however, crony financial interests were responsible for the financial policies from the mid-nineties, which led to the crisis, and certainly exacerbated the crisis in Malaysia.

Ang et al. (2005) argue, for the need to have a more careful approach in financial sector reform before liberalizing it. Financial liberalization cannot have the positive results of higher economic growth without an efficient and well-functioning financial system. The functioning of the financial system is important in Malaysia since the banking system does not allocate resources efficiently and there is no well-developed stock market. Their results suggest that Financial Liberalization in Malaysia was not carefully planned, timed, or closely monitored and it was burdened with an improper regulatory system and weak financial structures.

Thailand

The historical development of the Thai State dates back to the centuries of monarchical rule. Khan (1999) stated that the monarchy set the stage for the development of a centralized state where the bureaucracy, feudal peasantry, and Chinese traders molded a loosely integrated nation state. It was under King Chulalongkorn's reign (1868-1919) that Thailand developed into a more centralized and bureaucratic political structure. In 1932, following a bloodless coup d'etat, Thailand became a constitutional monarchy when the Monarchy was forced to establish a Constitutional and Parliamentary Democracy. This was the first of many coups that Thailand suffered throughout the years making it a politically unstable country. In 1973, the military government of Charusathien was overthrown by student demonstrations, and by 1976, another coup overthrew Charusathien and established a civilian regime under Thanin Kraivichien that lasted only a year. This was followed by another military regime under General Kriangsak Chomanand who was then replaced by yet another General in 1980. Again, in 1991, another coup d'etat established a new regime under General Kraprayoon.

These uprisings demonstrate the instability found in Thailand's political parties. Thailand's political parties are a network of patron-clients that come together as a group to form temporary alliances in order to compete during elections. MacIntyre (1999) states that because Thailand's political structure developed more as candidate-based rather than party-based, it led to frequent party switching making the party system a very weak and fragmented institution. Hewinson (2001) argues that Thailand developed a highly fragmented political system due to the historical hierarchical structure that allowed binding of the masses to the bureaucracy through a vast patronage network.

Political formations where party and prestige are located within the bureaucracy have sometimes been called "Bureaucratic Polity" in reference to the predatory attitude of the civil and military elite. Through the control of politics, these elites were able to dictate policy, and establish corrupt patron-client relationships that feed on economic development (Riggs 1966). A weak and fragmented bureaucratic organization can become subject to favoritism and rent-seeking activities.

Hicken (2004) emphasizes that given the fragmented nature of Thailand's political parties, it was not a surprise to see that they were more likely to channel benefits to a smaller group of voters or individuals that helped them get elected. Thus, policies also became very fragmented. Christensen et al (1993) state that the rent-seeking activities found in Thailand's fragmented organization was a major factor in the evolution of its political economy from a bureaucratic polity to semi-democracy.

From the 1930s-1950s Thailand's state-led developmental strategies involved the development of monopolies in state-owned enterprises such as the tobacco industry and most public utilities. However, by the mid-1950s due to highly fragmented industrial policies and gross malfunctioning of the state's industries, the government started to rely more on the private sector for economic growth. It developed institutions for macroeconomic management and through policies of segmentalism and preferentialism led to the formation of large industries creating concentration of ownership between the bureaucratic elites and wealthy Chinese families. In addition, the fragmentation found in the political system led to instability within the bureaucratic elite, thus an unstable political economy developed under both the authoritarian and democratic regimes.

Although, political legitimacy for this particular political economy had its beginning from the monarchic years and the hierarchical social structure where patron-clients are interlinked in a set of reciprocity, the subsequent shift in the control over economic policy to technocrats from the 1960s, further reinforced the centralized structure, a weak political party system, and unstable democratic institutions.

The state-led developmental model pursued by Thailand, emerged as an adjunct to "import-substitution" from the 1960s, due to the country's abundant natural resources. As with most state-led developmental strategies, the Thai government intervened heavily in the allocation of resources through the banking sector. Credit was channeled first to specific agricultural export businesses, which were primarily family owned local firms. Later, with economic growth, the export-led manufacturing sector took the lead in the local economy. Hutcroft (1999) argues that Thailand exhibited the characteristics of "bureaucratic capitalism," where the state was relatively stronger than business interests, and where the state was "relatively more patrimonial." However, by the 1980s, Thailand's rapid economic growth gave rise to a powerful and increasingly independent business class, and the decline of the military saw the military bureaucracy being replaced by a system where business had far more influence.

This framed an institutional design that developed into the formation of a financial technocracy, that is, a nexus between the bureaucratic elite and the private banking sector. This private banking sector developed from an ownership link between the banking sector and the banking families that were the main owners of the oligopolistic business groups, which led to the formation of the business-government relations in Thailand. The boom saw business establish its common interests over those of the state.

This financial technocracy emerged into a powerful oligopolistic group, which under the umbrella of the influential Thai Banker's Association, was successful in opposing and delaying various reform policies such as: policies for reducing entry barriers, policies for reducing related party lending, and policies for the development of bankruptcy laws (Zhang, 2002). Financial liberalization, in the late 1980s, without adequate supervision and prudential regulations helped to further expand the financial sector.

Early in the 1990s, the Thai government created the Bangkok International Banking Facility (BIBF); an off-shore banking facility whose initial purpose was to make Bangkok an international financial center in order to access foreign capital. This purpose, however, changed as it went through the Legislative process and the BIBF became mainly the venue through which foreign capital was directed to the domestic market at interest rates below local market rates. This foreign capital became concentrated in banks, finance companies, and the real state market (LoGerfo and Montinola, 2001). By mid-decade, this cheap credit had introduced the massive construction of a huge number of empty apartments and other buildings with high levels of the nonperforming loans held by banks and finance companies.

The government's inability to adequately supervise the financial industries led to not only financially weak institutions but to downplay cover-up exercises that led to riskier behavior and moral hazard. Market liberalization, with little attention in building appropriate institutions, occurred together with an increasing tendency for bureaucrats to enhance their patronage thus expanding patrimonialism beyond democracy making the Thai system more like a patrimonial oligarchic state.

Thailand's history of political instability demonstrated by several military coups led to a weak political structure and a fragmented party system that became vulnerable to power groups so they could legitimize their regime. MacIntyre, (1999) states that the problems with the financial sector were primarily due to the inability of the government to deal with the finance companies. Finance company leaders in connection with political elites were able to block financial restructuring. For example, during the financial crisis of 1997, they were not only successful at preventing the suspension of 16 finance companies they were able to influence the central bank to continue injecting money into these insolvent financial companies.

Financial liberalization was looked upon by some government officials as a way to destroy the hold of financial companies on the Thai economy, but banking families were able to evade ownership concentration measures by using related firms, and their organizational strength allowed them to shape or evade legislation. Poor financial sector supervision in Thailand was primarily due to the weakness of the Thai state in the face of an oligarchic and concentrated financial sector. As long as the Thai party system remains highly fragmented, the state is likely to remain weak vis-à-vis the financial sector.

Financial liberalization with little attention to building strong institutions, maintain appropriate governance, and allowing a weak legal structure set the scene for the financial crisis. Thailand had gone through a fundamental transformation from a situation where the state was relatively strong, to one where powerful special interests established their collective interest over the state.

Taiwan

Taiwan's historical development is similar to many Asian countries. It was colonized first by the Dutch, then the Spaniards, later ruled by the Chinese, followed by the Japanese from 1895-1945. The 50 years of colonial rule by the Japanese helped in developing many of the institutions and infrastructure that formed Taiwan's economy. With the Japanese losing the War in 1945, and the civil war in China ending with Chiang Kai-shek's Nationalist Chinese (KMT) government fleeing to Taiwan in 1949, the Chinese once again ruled Taiwan. The KMT government took control of Taiwan's monopolies and state-owned industries previously under Japanese rule, allowing the KMT to establish a strong regime.

Culturally, Taiwan is primarily a homogeneous race, made up of aboriginal people (Austronesian) and Chinese people with similar language and with strong belief in Buddhism, Taoism, and Confucianism. Although it did not face multi-ethnic tensions, Taiwan presented bouts of mainlander-islander tension due to the imposition of the KMT regime.

From the 1950s until 1986, the Kuomintang (KMT) was the primary party controlling Taiwan's political system. The KMT maintained political control by directly appointing positions from within the political party, by having an official ban on forming new political parties, and through an emergency decree granted virtually unlimited power to the President (since 1948). This decree provided the basis for nearly forty years of martial law and the highly centralized system that Taiwan presents to this day.[12]

Taiwan's centrally planned economy developed policies of protectionism and directed special funds to subsidize and promote strategic industries and favored groups. These policies in turn led to a concentration of ownership by an already established group of influential families. Cleassens et al. (1999), note that similar to other Asian countries, Taiwan also presents a pyramidal corporate structure where power and wealth was concentrated in the hands of a few families that influenced government policy development.

However, Taiwan differs from other countries in the degree of concentration of ownership. Taiwan's economic development centered more on creating competition between family groups and between industries. Thus, the impact of the power group influence over financial reform was less significant. The KMT regime, although

[12] See Bureau of East Asian and Pacific Affairs. December 2005

hierarchical and centralized in nature, did not pursue a highly concentrated approach to industrial development. Instead of following the "selective" few policies of development, it facilitated wider private ownership of financial and industrial institutions through developmental strategies.

Taiwan's state-led model centered more in developing, implementing, and creating successful land reforms and compensating large landowners with commodities certificates and stocks in state-owned industries. This became the venue for many to start commercial and industrial enterprises in a rather fragmented industrial structure. Some argue that one of the main reasons for the development of a fragmented industrial structure was the historical experience of the ruling party. Tan (2001) notes that historical as well as institutional development mattered in the case of Taiwan.

In order to legitimize its regime the KMT established the political and economic developmental structure that had a lot of influence in the economic performance of the country. Tan (2001) argues that the KMT did not want to repeat what they considered the failure to carry out effective land reform in China, and the main reason for their political loss and eventual exit from mainland China. Furthermore, by implementing policies of comprehensive land reforms, the KMT was discouraging an over concentration of wealth thus limiting challenges to its political power. An important factor in the developmental strategy of the KMT was to not allow any strong group to challenge the Regime's legitimacy

During the 1950s, because the KMT did not want to develop a strong industrial sector, it developed policies of segmentalism and credit allocation that were more diverse resulting in the formation of a dispersed power group. This was evident in the industrial formation of small and medium size enterprises that became the heart of Taiwan's economic growth. In addition, later, by adopting export-oriented developmental strategies and policies of liberalization, Taiwanese industry became internationally competitive and a leader in the world economy.[13]

Taiwan's financial system has gradually changed from a state controlled system into a more liberalized system. Financial institutions have been slowly liberalized. Many private banks have been established since 1990, creating competition in the banking sector (Yu, 1999). Traditionally Taiwan established a specialized banking system with special funds to subsidize and promote strategic industries. There are three types of specialized banks: specialized commercial banks, medium-and small-business banks, and community financial institution.

The commercial banks primarily assist the larger companies and the medium- and small-business banks (business banks) assist the SMEs. Special funds were set up to assist specific lines of business. The Small and Medium Business Credit Guarantee Fund (SMBCGF) was set up in 1974 to provide SME's with credit guarantee to help them gain access to financing. The Farmers Credit Guarantee Fund (FCGF) guarantees credit to farmers and fishermen. The Overseas Economic Cooperation and Development Fund (OECDF) provided guarantees to finance exports of technology and capital goods (Yu, 1999).

By 1998, there were 36 domestic commercial banks forming the backbone of Taiwan's financial sector. In Taiwan, although financial liberalization and deregulation

[13] See Bureau of East Asian and Pacific Affairs. December 2005.

have been implemented over the years, the political link that exists between the government, local politicians, and community financial institutions at times hindered regulators from effective supervision.

Nevertheless, Taiwan's decentralized industrial structure discouraged the concentration of wealth and prevented the rise of strong concentrated special interests, thus allowing the government to develop policies of reform that were able to be more easily implemented without the strong interference from concentrated interest groups. Taiwan's financial reform emphasized the liberalization of the domestic financial market, with gradual reductions of restrictions on foreign capital movements. This conservative nature of financial liberalization and the traditional reliance of SMEs on equity financing rather than debt financing is a clear difference between Korea and Taiwan (Heo and Tan, 2000).

Overall, Taiwan's GDP has grown almost fourfold during the eighties and nineties and has kept the growth rate around 10% for most years. Although, the Asian financial crisis in 1997 led to a decrease in GDP growth rate, this however was also due to currency fluctuation. Thus, we find that Taiwan though was affected by the Asian financial crisis, its lower reliance on debt financing allowed it to weather the crisis better than some of the other Asian countries.

3.3. FROM POWER GROUPS TO PERVERSE FINANCIAL LIBERALIZATION

The traditional view of sound financial liberalization is to provide alternative sources of capital as well as lower restrictions on trade through removal of interventionist regulations. This dissertation proposes an alternative view of financial liberalization, that is, the possibility of perverse financial liberalization.[14] By perverse financial liberalization I mean liberalization that either generates or gives private sector actors greater scope to respond to incentive structures that give distorted signals from the standpoint of overall efficiency (for more on this issue, see Willett and Auerbach, 2002).

In subsection 3.1, I suggested that country-specific developmental mechanisms and historical factors influenced the formation of concentrated power groups. These power groups in turn set the pre-condition stage (or basis) for: (*i*) weak institutions and sub-optimal policies of governance (proxied by governance indicators); (*ii*) connected lending and preferential treatment (proxied by the share of non-performing loans); and (*iii*) a "systemic" risk because of the externalities generated by financial interdependence (proxied by the ratio of short-term foreign debt to international reserves). These three channels through which power groups contribute to perverse financial liberalization will be the main focus of this analysis.

Data

In order to test the validity of the power-group hypothesis, we need to rely on empirical evidence collected from various sources.[15] A major challenge has been to develop an adequate dataset since institutional variables, such as power group influence government effectiveness, are difficult to observe and measure directly. The data compiled, which are used as the basis for the analysis that follows, are presented in Table 1.

[14] Most of the literature has focused on the causes of financial liberalization without differentiating between perverse and benign forms of liberalization.
[15] The definitions of variables and the data sources are given in Table A.1 in the Appendix.

Whenever possible, I use pre-crisis data, that is, data for 1996 as the goal is to uncover relationships between variables that are not affected by crisis.

The first issue to address was finding an appropriate indicator of power group influence. Power (interest) groups vary in terms of their lobbying efficiencies and capacities for rent seeking.[16] In line with other research, I assume that concentrated power groups are more effective in exerting political influence than power groups that are more dispersed. Therefore, I proxy the intensity of power group influence by the level of ownership concentration. This variable is taken from Claessens et al. (1999), who argue that a meaningful way of looking at corporate control in East Asia - especially if we are concerned with issues of market entry, access to financing, and government policy – is to look at the pattern of control of the corporate sector by family groups. To capture this, Claessens et al. (1999) measure wealth concentration as the share of total market capitalization held by the top 1 family, top 5 families, top 10 families, and top 15 families. The data reported in the first row of Table 1 show that significant cross-country differences exist in the ownership concentration in East Asian corporations. Corporations in Taiwan, for example, are generally widely held, while corporations in Indonesia, the Philippines, and Thailand are mainly family controlled. The top 15 families in Indonesia, the Philippines, and Thailand control more than half of the corporate sector (62 percent, 55 percent, and 53 percent, respectively) in terms of market capitalization.[17] In contrast, family control in Japan is insignificant – the largest 15 families own only 3 percent of market capitalization.

[16] The literature tends to use the terms "power groups" and "interest groups" interchangeably.
[17] At the extreme, 16.6% and 17.1% of total market capitalization in Indonesia and the Philippines respectively can be traced to the ultimate control of a single family (Claessens et al., 1999).

Another proxy of power group influence is a measure of ownership concentration taken from La Porta et al. (1998), who assembled data of ownership stake of the three largest shareholders among ten largest (by market capitalization) non-financial, domestic, totally private, publicly traded companies in 45 countries. The second row in Table 1 presents this concentration variable for each country that I study. As argued by La Porta et al. (1998), in the world as a whole, the average ownership of the three largest shareholders is 46 percent. Compared to this yardstick, Hong Kong, Indonesia, Malaysia, the Philippines, and to certain extent also Singapore and Thailand, have significant ownership concentration. Dispersed ownership in large companies is present only in Japan, Korea, and Taiwan.

Both measures of ownership concentration, that is, the measure taken from Claessens et al. (1999) and the measure taken from La Porta et al. (1998), are, as expected, positively correlated: the correlation coefficient of .69 is statistically significant at the 5% level (p-value = 0.40). Both measures of ownership concentration suggest that a relatively small number of families or shareholders effectively control most East Asian economies. The question is then whether these families or shareholders have a strong effect on the economic policy of governments and on government effectiveness.

To explore this issue, I use governance indicators from Kaufmann et al. (2005), who measure the following six dimensions of governance: (i) voice and accountability; (ii) political instability and violence; (iii) government effectiveness; (iv) regulatory quality; (v) rule of law; and (vi) control of corruption. Data in the middle panel of table 1 present governance estimates that are normally distributed with a mean of zero and a standard deviation of one. This implies that all estimates lie between -2.5 and 2.5, with higher scores corresponding to better outcomes. Although, as emphasized by Kaufmann et al. (2005), cross-country comparisons of levels of governance using these data should be made with due caution, the data reveal interesting insights into the quality of governance across East Asia. While Indonesia and the Philippines score consistently low on most governance indicators, Hong Kong, Japan, Singapore, and Taiwan seem to have good governance. Korea, Malaysia, and Thailand lie mostly in the middle of the distribution.

In the analysis that follows I also use financial indicators, which are taken from Corsetti et al. (1998). In particular, I use the share of non-performing loans in total lending as a proxy for connected lending and preferential treatment. As reported in the bottom panel of Table 1, the pre-crises share of non-performing loans as a proportion of total lending was particularly high in Indonesia, the Philippines, and Thailand. On the other hand, Hong Kong and Taiwan had an insignificant share of non-performing loans.

Another financial variable taken from Corsetti et al. (1998) is the ratio of short-term debt to foreign reserves. The ratio measures a country's vulnerability to outside capital flows: if a liquidity crisis occurs, foreign reserves must be large enough to cover a country's debt service obligations (including the roll-over of short-term debt). As shown in Table 1, the ratio of short-term debt to foreign reserves was particularly high in Korea and Indonesia, making them more vulnerable to international capital flows. Singapore, on the other hand, had quite low short-term indebtedness in 1996, which probably enabled the economy to go through the crisis largely unaffected. Then, I consider the ratio of private sector lending to GDP. This variable could be understood as a proxy for overall financial lending. Measured this way, the lending boom in Asia seems to have progressed by most in Hong Kong, Taiwan, and Thailand.

Finally, I use a newly constructed financial liberalization index from Abiad and Mody (2005). The index takes into account the multifaceted nature of financial reform along six dimensions (directed credit/reserve requirements; interest rate controls; entry barriers and/or lack of pro-competition policies; restrictive operational regulations and/or lack of prudential regulations; the degree of privatization in the financial sector; and the degree of controls on international financial transactions). The index takes values between 0 and 18, with 0 denoting full financial repression and 18 denoting full financial liberalization. I take this index as a proxy for the progress of financial liberalization, since it allows for a more precise determination of the magnitude and timing of various events in the financial liberalization process.

Data shown in the last row of Table 1 indicate that the steady pace of financial reforms in East Asia has resulted in most of these economies being largely or fully liberalized. Taiwan is the only exception with a quite low value of the financial liberalization index. This seems somewhat surprising, taking into account the high ratio of private sector lending to GDP. Apparently, Taiwan managed to sustain private lending expansion without opening up its financial sector. I will return to this issue later.

***(i)* Weak Institutions and Sub-Optimal Policies of Governance**

I begin by examining the first channel through which power groups could play a role in creating perverse financial liberalization, that is, weak institutions and sub-optimal policies of governance. The endogeneity of institutions implies that the institutional and governmental structure in most Asian countries will likely not be independent of ownership structures and wealth concentration. One direct measure for such an effect would be the extension of preferential treatment to family members of senior government members.[18] Another mechanism would be indirect control of companies by the ruling political parties. In the absence of more precise data, I rely on governance indicators taken from Kaufmann et al. (2005) as a measure of institutional quality.

In Table 2 we present correlations of a measure of ownership concentration (Claessens et al., 1999) and indicators of quality of governance (Kaufmann et al., 2005). The concentration of ownership is significantly negatively correlated with most of the governance indicators: the correlation coefficients range between -.42 and -.84. This suggests that institutional developments in Asian may have been impeded by the concentration of corporate wealth and the tight links between corporations and government, either directly or indirectly.

Figure 1 illustrates further the negative correlation between the concentration of ownership and government effectiveness in particular.[19] Countries with less concentrated ownership (thus, presumably with less concentrated and less influential power groups), such as Japan, Taiwan, Hong Kong, or Singapore, were ranked higher in terms of government effectiveness in 1996. At the other end of the spectrum, Thailand, the

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[18] Claessens et al. (1999) emphasize the case of Suharto family in Indonesia, which controlled 417 companies through a number of business groups led by children, other relatives, and business partners, many of whom also served in some government function.

[19] I pick the government effectiveness among the six indicators of governance to illustrate graphically the relationship with ownership concentration. Using the other five governance indicators produce similar picture, which is not surprising given the high level of correlation between the indicators.

Philippines, and Indonesia are characterized by a high level of ownership concentration and low government effectiveness. This is in line with the widely held view in these countries that politicians are heavily involved in and influenced by business. While this argument has been frequently advanced by scholars in the wake of the Asian financial crisis, little evidence has been collected to support it.

(*ii*) Connected Lending and Preferential Treatment

The second channel through which power groups could influence the incidence of perverse financial liberalization is connected lending and preferential treatment, which in turn leads to misallocation of resources. One of the main problems faced by the countries in the sample was that many loans made by banks and non-banks in the wake of the Asian crisis were of low quality and were directed towards investments of questionable profitability or towards speculative purchases of financial assets. In particular, connected lending gave incentives to financial institutions to increase their risk position.[20] As a proxy for these incentives, I use the share of non-performing loans in total lending (Corsetti et al., 1998). Table 2 shows that the concentration of ownership (Claessens et al., 1999) is positively correlated to the share of non-performing loans, thus producing a highly significant correlation coefficient of .83 (p-value = 0.12).

As Figure 2 further illustrates, in 1996, Indonesia, the Philippines, and Thailand had highly concentrated ownership structure and, at the same time, the highest shares of

[20] And clearly the governments had a lot to do with these incentives. The crucial role played by the banking sector would lead any government to take steps to avoid the failure of large banks. This is the "too big to fail" form of moral hazard. But while some moral hazard in the banking sector is inevitable, in the Asian crisis countries there was much more than necessary.

non-performing loans.[21] At the opposite end, Taiwan and Hong Kong had low shares of bad loans and more dispersed ownership. Although the reliability of the estimated shares of non-performing loans varies across countries there is, as I will demonstrate later in this dissertation, a strong correlation between the amount of pre-crisis bad loans and the extent of the subsequent financial crisis.

(iii) Build-up of Short-Term Debt

The third channel of interest is the systemic risk caused by externalities generated by financial interdependence during crisis. Namely, private actors have incentives to worry about their liquidity situation. They typically do not have incentives, however, to worry sufficiently about systemic negative risk externalities. I proxy this type of systemic risk by the ratio of short-term foreign debt to international reserves. This is based on the reasoning that power groups may affect a country's composition of capital inflows in a way that makes it more likely to experience a currency crisis. That is, countries with stronger power groups would tend to have a particular composition of capital inflows that is relatively heavy in short-term maturity. For instance, Willett and Auerbach (2002) argue that the liberalization of the short-term credit market in Korea was an understandable outcome of interest politics.

To illustrate how power groups in a country may affect the composition of capital flows, we begin with a simple two-period model (see, for instance, Wei, 2000). For

[21] It should be kept in mind, however, that the reliability of these estimates varies across countries. As argued by Willett and Auerbach (2002), the published statistics on non-performing loans in Thailand failed to give an accurate picture of the extent to which the loan and investment portfolios of many Thai banks were in bad shape.

simplicity, two types of capital inflows are considered: with long-term and with short-term maturity. Suppose that a bank in the capital-importing country maximizes the following two-period profit function:

$$\Pi[A(1)] + \delta\Pi[A(2)]$$

Where $A(1)$ and $A(2)$ are assets of the bank in period 1 and period 2, respectively, and δ is the subjective discount factor. For simplicity, it is assumed that the deposits and other revenues in the two periods, $D(1)$ and $D(2)$, are exogenously given. Let S and L be the short-term and long-term borrowing by the bank from international banks in the first period. To abstract from unnecessary complications, it is assumed that the short-term and long-term borrowing from abroad are the only two forms of funding sources. That is:

$$A(1) = D(1) + S + L$$

In the second period, the short-term international credit has to be repaid and a part, p, of the long-term credit.

$$A(2) = D(2) - R(S)S - R(L)pL$$

$R(S)$ and $R(L)$ are the gross returns the international creditors would require. Suppose R^* is the gross return on the risk-free bond. Then,

$$R(S) = R^* + \theta S$$

and

$$R(L) = R^* + \theta L + pL$$

Both θ and p are positive. θ is the rate of returns on bank credits above the return on risk-free bond. p appears in the return in long-term credit to reflect the implicit lowering of the perceived costs of short-term borrowing by the liberalization of the short-term loan market. In a way, p should be thought of proportional to the pressure by interest groups.[22] This is in line with research arguing that the liberalization of the short-term credit market in Asia was often a result of interest politics (e.g. Willett and Auerbach, 2002; Lee et al., 2002)[23].

As a result, credit became concentrated with the largest thirty business groups receiving over 70% of total short-term credit.[24] So at the very least, deregulation of the financial sector in the early 1990s together with ongoing features of the government-banking-*chaebol* relationship increased Korea's vulnerability to outside capital flows creating the incentive for short-term indebtedness (Haggard and Mo, 2000).

Another way to explain p as proportional to the pressure of interest groups would be to look at the support for liberalization of the short-term loan market coming from concentrated financial interests in the context of an already weakened banking sector. Weakened banks face strong perverse incentives to load up on short-term debt as means of gambling for redemption in a liberalized short-term loan market. That is, if the banking

[22] The addition of this term in the long-term interest rate equation means that the long-term interest rate is higher than the short-term interest rate, (ie., it was cheaper to borrow short-term than to borrow long-term). This was a result of the fact that the short-term credit was liberalized first, and in many countries, this was done because of the pressure of power groups.

[23] Willett and Auerbach (2002) discuss the 'perverse' liberalization of the short-term credit market when they state that short-term borrowing was frequently given indirect subsidies through exchange rate pegging as well as government giving tax incentives that encouraged short-term borrowing. Lee et al. (2002) also indicate that the hasty and inadequate liberalization of the short-term credit market, made short-term borrowing quite cheap leading to over-borrowing.

[24] Ironically, policy makes suggested that one of the strongest reasons for introducing competition in the market for bank loans was to mitigate the considerable economic power and influence of the *chaebol*.

system is unsound due to a large debt overhang or a large percentage of non-performing loans, these banks have very little to lose by loading on more risky but potentially highly profitable new loans made accessible as a result of liberalization.[25]

The bank's maximization problem yields the following first-order conditions:

$$\Pi'[A(1)] - \delta\Pi'[A(2)][R^* + 2\theta S] = 0$$

and

$$\Pi'[A(1)] - \delta\Pi'[A(2)][R^* + 2\,\theta pL + 2\rho pL] = 0$$

This implies a particular relationship between the composition of capital inflow and the strength of power groups:

$$\frac{S}{L} = \frac{(\theta + \rho)p}{\theta}$$

It follows from the equation above that $\frac{\partial S/L}{\partial \rho} > 0$. Thus, the more influential the power groups in a country, the more short-term credit would be received relative to long-term borrowing.

The high inflow of foreign capital between 1990 and 1997 played a major role in the Asian economic crisis.[26] Between 1990 and 1997, an inflow of foreign capital in the form of loans to Asian banks increased from $110 billion to $390 billion with almost two thirds having short-term maturity (Bank for International Settlements 1998). Indeed, as illustrated in Table 2, data taken from Claessens et al. (1999) and Corsetti et al. (1998) show that the concentration of ownership is significantly and positively correlated to the

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[25] This is especially true when viewed in conjunction with the "too big to fail" form of moral hazard.

[26] Several studies (e.g., Frankel and Rose, 1996; Radelet and Sachs, 1998; Rodrik and Velasco, 1999) have shown that that the inflow of foreign capital and, in particular, the *composition* of international capital inflows is correlated with the incidence of currency crisis.

short-term indebtedness: the correlation coefficient is .63 (p-value = 0.98). As further illustrated in Figure 3, in 1996 the problem was most evident in Indonesia, Korea, Thailand, and the Philippines.[27]

3.4. POWER GROUPS AND FINANCIAL LIBERALIZATION

The preceding investigation has suggested channels through which power groups may generate incentives for (perverse) financial liberalization. In fact, what rational rent-seeking actors would like is not full but partial liberalization that gives them increased freedom of action to pursue profit opportunities while retaining barriers in competition with others, access to subsidized inputs, and protection against losses. There is no available quantitative measure of perverse liberalization. Instead, I use two proxies for financial liberalization.

First, I utilize a proxy for "full" financial liberalization. Pill and Pradhan (1995) argue that the variable that best captures the extent to which (full) financial liberalization has progressed is the credit to the private sector as a share of GDP. To the extent that the partial and the full financial liberalization are negatively correlated, it is expected that there is a negative correlation between the lending to private sector (as % of GDP) and the strength of the power group influence.

[27] It should be mentioned here that in the two-period theoretical model, I relate power group influence to short-term borrowing, not to short-term borrowing relative to foreign reserves. In Table 2 and in Figure 3, I use short-term borrowing relative to foreign reserves. The reason for this is that the ratio of short-term debt to foreign reserve is a better proxy for a country's vulnerability to international capital flows: if a liquidity crisis occurs, foreign reserves should be large enough to cover a country's debt service obligations.

In Table 2, I relate the lending to the private sector (Corsetti et al, 1998) to the level of ownership concentration (Claessens et al., 1999): the correlation coefficient is -.65 (significant at the level of 10 percent). As illustrated further in Figure 4, the lending boom was particularly pronounced in Hong Kong, Taiwan, Singapore, and Malaysia, where the governments might have been less strongly beholden to concentrated interests and thus presumably less susceptible to perverse liberalization.

The second proxy for financial liberalization used in this dissertation is the recently constructed financial liberalization index by Abiad and Mody (2005). This index is not significantly correlated with the concentration of ownership (Table 2). A closer inspection of the relationship in Figure 5 reveals that the lack of significant correlation stems from Taiwan being an outlier, that is, a lagger in financial liberalization reform.[28]

While in the last quarter of the twentieth century all the other Asian countries moved from government ownership or control of their financial sectors toward greater private provision of financial services under fewer operational restrictions, Taiwan is an obvious outlier. How could Taiwan sustain the high level of lending to the private sector without opening its financial sector is left for future research.

[28] Once Taiwan is excluded from the dataset, the correlation between correlation of ownership and financial liberalization index becomes negative and statistically significant (Correlation coefficient = 0.53, p-value = 0.08).

3.5. SEVERITY OF THE ASIAN CRISIS: SOME EMPIRICAL EVIDENCE

Although there is now a substantial amount of empirical literature on the Asian crisis and its causes, until recently there have been fewer studies measuring the potential financial costs of financial system instability. This subsection presents estimates of costs for eight Asian countries. In particular, the focus is on broader welfare costs, approximated by output losses associated with the crisis. I adopted this broad measure of crisis costs because the costs of bank failure can emerge in a variety of ways. In particular, if investment is impaired by a reduction of bank finance, capital accumulation will be reduced and thus, the productive capacity, therefore output of the economy in the longer run will be adversely affected.

There are a number of difficulties in measuring the costs of a banking crisis. First, defining a crisis is not straightforward.[29] Second, even when defined, measuring the costs imposed by banking crises on the economy as a whole is also a complicated issue. Most cross-country comparisons of costs focus either on immediate crisis resolution costs proxied by the fiscal costs incurred, or on the overall impact on economic welfare proxied by the divergence of output from trends during the banking crisis period. I will follow the latter approach although caution should be taken when interpreting the results. This is particularly due to the fact that estimates of output losses during crises refer to the output loss *during* the banking crisis rather than necessarily the output loss *caused by* the crisis. In chapter 4, an attempt is made, using a larger cross-country dataset, to separate declines in

[29] See, for instance, Caprio and Klingebiel (1996) for qualitative definitions that differentiate between "systemic" and "border line" crisis.

output during periods of banking crisis attributable to the crisis itself from declines due to other factors.

Cross-country comparisons of broader welfare economic loses to the economy associated with a banking crisis are usually proxied by losses in GDP, that is, comparing GDP during the crisis period with some estimate of potential output. However, there are a number of issues in the construction of measures of output losses. First, everything else being equal, the longer the crisis lasts, the larger the cumulative output losses. The size of the measured cumulative loss will therefore be sensitive to the duration of the crisis period. Unfortunately, it is not straightforward to define either the starting or the end point of a crisis.[30] Therefore, the period from 1998-2002 is taken as a basis for estimations of output losses for all countries included in the analysis.

Second, in order to measure the output loss during a crisis it is necessary to measure actual output compared with its trend, or potential. The most straightforward way of estimating output potential is to assume that output would have grown at some constant rate based on its past performance. However, the appropriate number of years to use in estimating the past trend is not clear-cut. Following Hoggarth et al. (2002), I estimate the output trend, or potential, using a ten-year pre-crisis period.

The cumulative difference between the level of potential output and actual output over the crisis period is used as a measure for output loss. Output potential is based on the trend growth over the ten-year pre-crisis (that is, pre-1997) period using the Hodrick-

[30] See Hoggarth et al. (2002) for an extensive discussion of the problems related to determining the beginning or the end of a crisis.

Prescott filter.[31] Table 3 shows the results of the estimations. The average cumulative loss suffered by Asian countries during the period 1998-2002 is roughly 9 percent. There is, however, significant variation in output losses incurred during the crisis. The largest output losses, that is, the most severe crises were experienced by Thailand, Indonesia, and Malaysia. The Philippines and Singapore, on the other hand, seem to have suffered relatively smaller output losses.

In parallel with this research, recent papers have estimated output losses of financial crisis using alternative methodologies. It could be illuminating to compare our estimates of output losses with those of other studies. The estimates, however, are not directly comparable, since different studies tend to use different methodologies to estimate the losses, and different definitions of the beginning or the end of a crisis. IMF (1998), Aziz et al. (2000) and Bordo et al. (2001), for instance, measure output loss by summing up the differences in output *growth rates* between the pre-crisis trend and the actual rates during the crisis period.

These studies find that output losses during crises are, on average, in the range of 6-8 percent of annual GDP. My estimates, on the other hand, sum up the differences in the *levels* of actual output from its trend. That said, it is worth noting that my estimates of output losses are almost perfectly correlated (correlation coefficient of 0.98; p-value = 0.003) with the estimates by Honohan and Klingebiel (2005), who also use the IMF(1998) methodology (last column of Table 3). It should be also mentioned that although I use the same methodology as Hoggarth et al. (2002), my estimates are not comparable to their

[31] This is a smoothing method widely used to obtain an estimate of the long-run component of a series.

estimates since they measure the losses only up to 1998 and as such do not capture the total losses associated with the Asian crisis.

Relating the cumulative output losses from Table 3 with the data on ownership concentration produces a (marginally) significant and positive correlation coefficient of 0.53 (p-value = 0.108). In other words, stronger power groups seem to work in the direction of a more severe crisis.

It should be noted that the overall impact of a banking crisis on the economy depends, amongst other things, on the manner and speed of crisis resolution by the authorities. For example, a policy of forbearance by regulators could increase moral hazard and harm output over an extended period, whereas a rapid clear out of bad loans might be expected to improve the performance of the economy over the longer term. That said, such longer-run benefits need to be weighted against any potential short-run costs of strong policy action.[32] A more detailed analysis of this issue is discussed in chapter 5 through comparing the experiences of Korea and Taiwan.

[32] A study of the relationship of veto players and policy risks in the Asian financial crisis by Angkinand (2005) finds that in a political system lacking veto players or with excessive veto players output losses are greater during banking crisis since this results in a lack of policy flexibility and credibility.

CHAPTER 4:

POWER GROUPS AND OUTPUT LOSSES: EVIDENCE FROM A LARGER CROSS-COUNTRY DATASET

A critical issue covered in this section is whether reductions in output are caused by banking crises or vice versa. Banking crises often occur in, and indeed may be caused by, business cycle downturns. Therefore, some of the estimated decline in output calculated in chapter 3 could have occurred anyway. Using larger cross-country dataset, this dissertation attempts to separate declines in output during periods of banking crisis that are attributable to the crisis itself.[33] To do this, benchmark countries are needed that, in principle at least, are similar in all respects to the crisis countries in the sample other than they did not simultaneously face a banking crisis (or at least, not to the same extent). Since the Asian countries considered so far differ substantially in many regards, including the level of economic development, the set of other countries included in the following analysis also displays significant variations in all indicators (Table 5).

Data

The first challenge has been to collect the appropriate data for more countries. Since Claessens et al. (1999) provide data only on Asian countries, the power groups' influence is proxied by an alternative measure of ownership concentration taken from La Porta et al. (1998). The measure is available for 45 countries and assesses the stake of the

[33] Bordo et al. (2001) attempt to address this problem by comparing, for their sample of countries, the amount of output losses during recessions that are accompanied by banking crises with those which are not.

three largest shareholders among the ten largest publicly traded companies. The governance indicators for the 45 countries were again taken from Kaufmann et al. (2005). Because of the high positive correlation of the six governance indicators (Table 2), I calculated the average indicator "good governance" as an average of the six governance indicators. Data on non-performing loans were collected from the databases on Bank Regulation and Supervision (Barth et al., 2001; 2003). For the countries where observations for 2001 and 2003 were available, the average was taken of the two data points. Data on financial liberalization index were taken from Abiad and Mody (2005). Data on short-term indebtedness, bank lending to the private sector, and real GDP per capita were all gathered from the World Development Indicators database (2004).

Data on output losses (gains) during the period 1998-2002 were calculated using the same procedure described in chapter 3.[34] While the average cumulative output losses for the eight Asian countries were 8.8 percent, the other 37 countries in the dataset experienced on average output gains of 1.7 percent. Table 4 presents data on output losses for various groups of countries.

I classify the countries as follows. No-crisis countries include countries that did not go through financial crisis during the period 1998-2002. The group of 'Asian-crisis' countries include countries that went through financial crisis beginning 1997 or later. Crisis countries include countries in which financial crisis started before 1997 and continued after 1997 (for detailed list of these countries refer to Table A.2 in the

[34] The list of 45 countries together with the estimated output losses (gains) during the period 1998-2002 is given in Table A.2 in the Appendix.

Appendix).[35] As shown in the upper panel Table 4, the highest output losses of 7.65 percent on average were suffered by the 'Asian-crisis' countries. When we add the countries that were already in crisis before 1997, the average output loss decreases to 5.10 percent. This indicates that countries that were already going through a financial crisis before 1997 experienced lesser output losses during the period 1997-2002.

While the crisis countries were suffering output losses, the no-crisis countries experienced mean output gains of 1.8 percent during the period 1998-2002. The lower panel of Table 4 demonstrates that the difference in means between the no-crisis countries and the 'Asian-crisis' countries as well as the difference in means between the no-crisis countries and the crisis countries are statistically significant from zero.

Before continuing with the empirical analysis, I present in Table 5 descriptive statistics for dependent and independent variables for 45 countries. The number of observations in the Table and in the analysis that follows may differ, however, depending on data availability.

Empirical results

Table 6 presents the correlation coefficients between the variables used in this chapter. As expected and consistent with the analysis in Section 3, ownership concentration is strongly and positively related to the share of non-performing loans, while it is negatively related to the governance indicators and to bank lending to the private sector. The correlation with the short-term indebtedness (measured as short-term foreign

[35] The dates of crises for different countries are taken from Hogarth et al. (2002) and Honohan and Klinegebiel (2003).

debt as % of foreign reserve) is insignificant, which might be a result of the limited number of observations.[36] In other words, the conceptual framework about the channels through which power groups exert their influence is also, to a large extent, confirmed using a larger set of countries. The ownership concentration itself does not seem to be significantly correlated with the output losses, but the channels of the power groups' influence, or the indicators of governance and non-performing loans, exert the expected and statistically significant signs.

In particular, weaker institutions and more widespread connected lending seem to result in more severe output losses. To wit, both the banking sector and the real economy may be better able to withstand shocks because of more robust banking and regulatory systems, including better provisioning policies and capital adequacy practices. Output losses seem to be larger in countries where bank intermediation, proxied by bank credit to the private sector, is higher (although the correlation coefficient is not statistically significant).

Another interesting insight from Table 6 is the negative correlation of the governance indicator with the share of non-performing loans and the positive correlation of the governance with both measures of financial privatization (credit to the private sector and the financial liberalization index). In other words, countries with good institutions tend to have better financial indicators and to be more financially liberalized.

On the other hand, the share of non-performing loans is negatively correlated with both indicators of financial liberalization, indicating that connected lending might be less

[36] Data on short-term debt to foreign reserves are reported only for developing countries.

of a problem in countries with a more liberalized financial sector. As expected, the two measures of financial liberalization are positively and significantly correlated.

Next, a preliminary, first-cut empirical evaluation of the relationships among output losses, ownership concentration, and the channels of power group influence is presented. Table 7 displays regression coefficients of estimations using output losses as a dependent variable. Because of the small number of observations and the significant correlations among most of the independent variables (Table 6), I first regress the output losses on each separate independent variable, with the level of economic development controlled for, that is, I include the level of real per capita GDP as a control variable. In the last column of Table 7, I present results of regressing output losses on all the independent variables. Heteroscedasticity-consistent standard errors are reported for the regression results.

The regression results in Table 7 confirm the previous conclusions drawn from the simple correlation analysis (Table 6). It seems that it would be difficult for someone to argue confidently that higher ownership concentration leads to higher output losses, even when controlling for the level of economic development. However, the channels of power group influence, that is, the quality of governance and the share of non-performing loans in total lending, exert the expected and statistically significant signs.

The results indicate that countries with weaker institutions and more widespread connected lending experience higher output losses. The insignificant coefficient on the third channel of power group influence, the short-term indebtedness, should be interpreted with caution taking into account the very low number of countries for which data is available. Somewhat surprisingly, the coefficient on the bank credit to the private sector is positive and statistically significant. Whether this result is robust to extending the sample to more countries, remains an issue for further research.

The results from the individual regressions are confirmed when regressing output losses on all the independent variables together (the last column of Table 7). Again, these results should be taken with extreme caution taking into account the very low number of observations.

The results in Table 7 are not necessarily indicative of the fact that the power groups use the channels assumed in this study to exert their influence. To test this hypothesis, I run a new set of two-stage regressions. In the first stage, I regress the variables for channels of power group influence that are statistically significant in Table 7, - the "good governance" and the share of non-performing loans in total lending - on the concentration of ownership, controlling for GDP per capita.[37] In both cases, I obtained a statistically significant coefficient on the concentration of ownership, indicating that these two variables (institutional quality and connected lending) could be relevant proxies for the channels through which power groups operate.

In the second stage, I use the predicted values of the "good governance" and share of non-performing loans from the first stage regressions, and regress the output losses on the predicted variables. Since the results of the first-stage regressions include the effect of ownership concentration, using the predicted values in the second-stage regression could be understood as including the indirect effect of power group influence on output losses. The results of the two-stage regressions are presented in Table 8. Taken together, the

[37] I leave out the short-term indebtedness because of the small number of observations.

results again confirm that the channels of power group influence have the expected effect on output losses: strong institutions lead to lower output losses, while connected loans and preferential treatment work in the opposite direction.

CHAPTER 5:

THE PATHS AND POLITICAL ECONOMY OF FINANCIAL LIBERALIZATION: THE CASES OF KOREA AND TAIWAN

In this section, I try to shed additional light on the issues discussed thus far through a comparative analysis of financial liberalization in Korea and Taiwan and the way that the political economy can help explain the severity of the negative shocks during the Asian crisis. In particular, the focus is on pre-existing government policies, sequencing of reform policies, institutional set-up, power group influence, and a number of other policy-oriented explanations. The two countries were chosen because of the relative differences in their performance and resilience during the crisis, despite the relative similarity in their level of economic development. The question is why Korea went through a near financial meltdown, while Taiwan remained relatively insulated from the regional turmoil.

It should be noted that the analysis cannot include *all* factors that could have possibly played a role in explaining the diverging experiences of Korea and Taiwan. The facts and examples herein are, of course, by no means exhaustive. Rather, the goal is to try to disentangle the liberalization process further using the political economy approach and to find out whether, by adding this approach to some purely technical economic considerations, an additional contribution can be made to the existing literature. The issues considered and some data used in the comparative analysis are summarized in Table 4.

5.1. THE CASE OF KOREA

According to Table 4, Korea has a higher concentration of ownership than Taiwan, regardless of the measure used. In fact, government relaxation of controls over entry and ownership has led to the largest business groups dominating both the ownership of commercial banks and non-bank financial institutions. Bank privatization allowed big business groups to capture an increasing proportion of the banking sector, thereby fortifying their position in relation to government control. This created a fruitful ground for big businesses and banks to influence the sequence of reform in the loan market. By 1993, Korean government officials came under significant pressure from the *chaebol* to liberalize short-term finance (Lee et al., 2002). Indeed, the *chaebol* saw short-term borrowing as a way to get around government restrictions on borrowing and investment decisions as well as on capitalization restrictions. It is important to note here that credit became concentrated for the thirty largest business groups they received over 70% of total short-term credit (Rhee, 1994). The issue of short-term indebtedness as mentioned above will be revisited later in the text.

The share of bad loans in Korea in 1996 was twice as high as the share of bad loans in Taiwan (Table 4). It should be noted here, however, that there was a considerable variation in the share of bad loans across different types of Korean financial institutions. Amsden and Hikino (1998) note that financial institutions in those areas subject to minimal regulations, such as merchant banks and securities and leasing firms, had the highest percentage of non-performing loans at the end of 1997. Merchant banks turned in the worse performance of all, with 18.6% of total non-performing loans. On the other hand, where regulatory controls were greatest, such as in commercial banking, non-performing loans constituted only 6% of total loans.

To a certain extent, the relatively high share of bad loans in Korean banks was a result of a shortage of risk-management knowledge and experience, since the state-bank-*chaebol* relationship led to the creation of a banking system that served mostly as a means of policy loans. The poor quality of bank supervision led to a sharp deterioration in the quality of the banks' loan portfolios (McLeod and Garnaut, 1998). Not only was the pre-crisis share of non-performing loans higher in Korea, the problem was further exacerbated by explicit government guarantees during the crisis. In August 1997, the Korean Ministry of Finance announced that it would guarantee all foreign debt creating a moral hazard problem (Demetriades and Fattouh, 1999).

In addition, as a part of financial reforms undertaken in Korea in 1993, banks were allowed to open and expand operations overseas.[38] Consequently, banks increased their foreign currency denominated business as forcefully as their domestic loan portfolios. The end result was an increase in foreign currency liabilities for foreign branches that was almost as large as the external debts of domestic branches (Dooley and Shin, 2000). Korean banks were over-exposed to foreign-exchange risk and a high proportion of foreign liabilities had relatively short maturity.[39]

[38] Prior to 1993 the Korean government maintained strict control over the foreign borrowing activities of domestic financial institutions. This was particularly effective in ensuring that foreign funds were allocated to state-designated strategic industries.
[39] In a three-year period alone leading up to the crisis, merchant banks acquired USD 20 billion in foreign debt (Chang et al., 2001).

It is striking that in 1996 the ratio of short-term debt to Korea's foreign reserves was ten times as high as the corresponding share in Taiwan (Table 4). One of the reasons for such a high level of short-term indebtedness was that the liberalization of the short-term market occurred in the framework within an already vulnerable banking sector.[40]

Some Korean banks actually had a negative net worth when the loan market was liberalized. As argued by Auerbach and Willett (2002), the fact that banks with negative net worth could continue to operate was mainly a function of inadequate prudential regulation. The down-side risks of taking on more short-term loan risk for these banks was considerably discounted in comparison with the upside of redeeming a failing business enterprise with the infusion of fresh capital. This behavior was to be expected from inexperienced financial operators, lured by the promise of expanding opportunities and profits presented by liberalization, but lacking the expertise required for adequate risk management.

Excessive risk and short-term borrowing was not just an oversight issue. The sequencing of reform itself also played a role. In Korea, short-term bank lending was liberalized while maintaining restrictions on the long-term loan market. It should not be surprising that this partial liberalization led to perverse incentives for short-term borrowing far above the international financial market trends.

The end result is well known: financial institutions that had borrowed short-term on the international market poured funds into long-term domestic projects, mainly in industrial sectors already burdened by overcapacity. When falling profits eventually

[40] Besides the *chaebol*'s pressure, President's Kim desire to join the OECD, combined with pressure from the IMF and the US government, may have also led to the liberalization of domestic financial markets before the existing weaknesses in the baking system could be addressed.

resulted in firms' inability to meet their financial obligations, Korean banks were left with a significant share of non-performing loans, leading to the near collapse of the entire financial sector.

5.2. THE CASE OF TAIWAN

Contrary to the Korean case, financial liberalization in Taiwan was more cautiously considered and carried out in conjunction with the maintenance of the state's capacity to intervene strategically in the economy (Thurbon, 2001).[41] The capital market played an important role in accommodating the funding needs of enterprises in Taiwan, being about the same size as the bank lending market in market value terms. At the same time, the concentration of ownership has been relatively low (Table 9). This created less fertile ground for power groups to exert their influence.

In addition to lower concentration of ownership, Taiwan demonstrated a strong pre-crisis institutional capacity. Table 9 indicates that most of the governance indicators in Taiwan were significantly higher than in Korea (except for the voice and accountability indicator). This suggests that the Taiwanese government was better equipped to take an active position to minimize the nation's exposure to speculative pressures and to deal with the financial crisis more swiftly and competently.

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[41] The slow and steady pace of financial liberalization in Taiwan was partly a historical legacy of the rampant inflation suffered under the Kuomintang on the mainland and the desire to avoid the negative economic and political ramifications of inflationary pressures in the future.

The liberalization of Taiwan's banking system began in 1991 with the issuance of new licenses for private banks, and continued with easing the restrictions for setting up new branches by existing financial institutions in 1993.[42] Nevertheless, the supervisory and regulatory mechanisms were vigilantly preserved in order to ensure the viability of financial institutions. These included a high amount of minimum paid-in capital required to establish a commercial bank, an obligation that banks must satisfy the Bank of International Settlements (BIS) capital adequacy requirement of 8%, and a requirement to secure loans with sufficient value of collateral.

As a result, when the Asian crisis hit, Taiwan's banking sector was relatively sound: the share of non-performing loans in total lending was only 4% (Table 9). Even in 1997, Taiwan's non-performing loan rate remained at 4%, much lower than that of the other affected countries.

Taiwan's decentralized industrial structure help developed a strong and diverse economy. The emphasis placed on small and medium sized enterprises (SMEs) made for a stronger state and weak concentrated interest group formation. These SMEs domination of Taiwan's economy provided the ability to respond with more flexibility to fluctuations in the international economy during the financial crisis.

[42] Whilst the government liberalization plan for the banking sector also included the privatization of state-owned banks, the first banks were privatized only in 1998. As such, the government's privatization plan had little impact on financial stability in Taiwan.

CHAPTER 6:

CONCLUSION

This dissertation analyzes the links among power group influence, financial liberalization, and financial crisis. While each of these issues has been extensively explored in the literature, this is the first attempt to put these topics in a unified framework. The analysis mainly focuses on Asian countries and is mainly conducted against the background of the Asian 1997-98 crisis.

The dissertation first considers power groups, financial liberalization, and the subsequent financial crisis in Asia from a historical perspective. The historical legacy of state-led economic policies, hierarchical political structure, and a group oriented (family-based) economy presented in this study are appropriate for this type of analysis. In particular, the centralized hierarchical structure played an important role in the initial phase of economic development in Asian countries. The group-oriented/family-centered system of governance compounded issues of inadequate regulatory structures and low accountability and transparency, which led to adverse selection and moral hazard problems that arise from asymmetric information due to selectivity and favoritism in economic decision-making.

The legacy of central planning created a foundation for distortion of policies and structural weaknesses that became evident in 1997 during the Asian financial crisis. The crisis demonstrated that although all the countries studied featured similar state-led economic development, the crisis was presented differently in the uniquely diverse countries. Thus, we cannot generalize across nations because economic and financial development can be a country-specific phenomenon that needs to be addressed on an individual basis.

In order to illustrate the causal relationship between the differences in liberalization patterns and uneven responses to the Asian crises by the countries in this study, this dissertation explored the sources of economic development and the differences in financial reforms that several of these countries followed. Domestic elites, with personal or business interests, seized the opportunity to exploit financial liberalization thus opening the closed economies in many Asian countries because of the international pressure exerted upon them. The problem of capture stemmed from deep institutional failures.

I present an extensive analysis of the above issues for each country. The results of this part of the dissertation can be shortly summarized as follows.

In Korea, business-government relations were structured in ways that granted the highly organized *chaebols* a way to influence financial policymaking. The economic success that the *chaebols* achieved through the government's policies of preferential loans and subsidies allowed them to become a dominant force in the development of the Korean financial structure

In Thailand, the powerful private sector developed a close relationship with the bureaucracy. This resulted in a business-government structures that engaged in rent-seeking behavior. Reforms were often stalled due to recurrent intervention and corruption practices. Taken together, these problems stood in the way of the policy making process and effective implementation of policies, and had a negative effect on financial stability and economic performance, leading at the end to a severe financial crisis.

In Malaysia, patronage networks led to concentrated interest groups who controlled the banking sector and the financial system. The Malaysian government sponsored business networks primarily to advance the political position of the Malay and to keep the economically wealthy Chinese dependent on the Malay. The ownership of politically connected businesses were the result of government policies issued in order to close the economic inequalities present among the different ethnic groups. Thus, Malaysia's political system and the regime's political legitimacy were based more on its ability to provide stability by avoiding ethnic conflicts. Such ethnic politics consolidated market power which influenced the development of the financial system and were successful in resisting many of the changes in the financial liberalization process.

In Indonesia, the political bureaucracy, formed between the military and the business elites, played a significant role in the development and implementation of developmental policies. The Suharto regime, with its preferential treatment to family and close friends, led to a concentration of ownership thereby allowing them the continuation of political and economic power even though the country was going through a financial liberalization process. The liberalization process became highly segmented so as not to damage Suharto's family and close allies' economic interests.

Taiwan's economic development centered more on creating a fragmented industrial structure. Though it presents a hierarchical and authoritarian political structure, the government did not pursue the highly concentrated approach to industrial development like other Asian countries followed. That is, developmental policies provided for a wider private ownership of financial and industrial institutions. An important contribution to this developmental strategy was the desire by the ruling party (KMT) not to develop any concentrated political or economic group that would challenge the Regime's legitimacy.

Authoritarian regimes in Asia played a pivotal role in economic development through interventionist policies that fostered a concentration of interest groups who garnered preferential treatment and who became influential in the creation of policies in specific sectors. Through this process, the selected sectors in turn led to a concentration of ownership and power that took advantage of developmental policies. Such concentration of power blocked and/or implemented reforms that further maximized the interest groups' position through their political connections. This kept compounding the circumstances that fueled the crisis. Policies of protectionism led to the wrong incentives being implemented so that legitimacy and growth could be created and maintained. Inefficient regulations lead to an increase in interest group power with the increased concentration of power leading to state capture.

In summary, this dissertation shows how economic development and financial reforms were shaped by historical circumstances in combination with cultural and social situations. Often times these governments allowed the formation of concentrated ownership in order to have an economic sector that would perpetuate the continuation of political power and its supporters. In addition, it presents historical and cultural factors that generated perverse incentives leading to sometimes fragmented, partial, and/or captured financial reform. Over a few decades, several Asian countries achieved rapid economic development and their financial systems have gradually transformed from a controlled system to a liberalized one; however, this came at the price of crisis because reforms were often ones of capture instigated and supported by different special interests.

After conducting an extensive analysis of state-led development strategies and power group formation, the dissertation moves on to a quantitative analysis of the power influence on the financial liberalization and financial crisis. This is a significant step forward compared to previous studies. It is at the same time a challenging step to make, taking into account that the influence of power groups is very difficult to measure and to analyze quantitatively.

Based on an extensive survey of the literature, I first develop a conceptual framework that specifies the role of the power groups and the channels through which they exert their influence on financial liberalization. I categorize these channels into three broad categories: weak institutions, connected lending, and systemic risks. The next step is to obtain appropriate proxies for the power groups and for the channels of their influence. This has been a pain-staking process of data collection from different sources. In line with arguments of other researchers, I proxy the strength of power groups by the concentration of ownership: the higher the concentration of ownership, the stronger the power groups. The channels of power group influence are measured in the following way. Institutions are proxied by indicators of governance constructed by the World Bank research staff. The share of non-performing loans in total lending is used to measure connected lending and preferential treatment. The third channel, systemic risks, is proxied by the short-term indebtedness of a country.

Using the quantitative indicators described above, I first focus on Asian countries and explore basic relationship among variables. Correlation analysis leads to interesting insights for the countries studies. First, the strength of power groups is negatively correlated with institutional quality. Second, there is a negative relationship between the strength of power groups and connected lending (as proxied by the share of non-performing loans). Third, the strength of power groups is negatively correlated with the short-term indebtedness.

A closer inspection of the data reveals that Asian countries can be categorized in a few groups based on their characteristics along the dimensions discussed above. The first group includes countries with relatively dispersed ownership, good institutions, and a low share of bad loans. Hong Kong, Japan, Singapore and Taiwan are included in this group. The second group includes countries with opposed features: concentrated ownership, low institutional quality, and widespread connected lending. This group comprised of Indonesia, the Philippines, and Thailand. Korea and Malaysia constitute the group of countries, scoring well on some indicators and not so well on others (see table 1).

After exploring the relationship between the concentration of ownership as a measure of power group influence and the hypothesized channels of power group influence, the next logical step is an investigation of the link to financial liberalization. I measure financial liberalization with two proxies: bank credit to private sector (as % of GDP) and a financial liberalization index constructed by the IMF research staff. The first measure is negatively correlated with the concentration of ownership, indicating that more powerful interest groups could stall the process of financial liberalization in Asia.

The final goal of the quantitative analysis is to link the power group influence to output losses suffered as a result of the Asian crisis. For the purpose, I first estimate output losses as a difference between the predicted and the actual trend of the GDP. Estimations show that Indonesia and Thailand suffered the greatest output losses. Second, to be able to perform regression analysis, I extend the dataset to more countries for which data are available. Needless to mention, the data collection process was again quite challenging. Correlation and regression analysis of output losses and other variables gives the following main conclusions of this research. While the direct influence of the power group influence is not present, the effect of the channels through which power groups exert their influence is at work. In particular, weak institutions and connected lending seem to result in greater output losses. Taking into account the small number of observations, the effect of these variables on output losses is surprisingly robust to different specifications of the regressions and to application of different regression methods.

Recommendations for Future Research

The consideration of interest groups should be weighed with other conditions or variables when examining success and failure in financial/economic growth in Asian countries. Alliances among a country's power elites could drastically impact a given country's decision-making, or alliances between countries and/or interest groups could be in place within ASEAN countries. The research involved in examining success and failure must consider these issues when evaluating Asian economic growth.

Prudent steps should be taken to ensure that policies are not created or implemented to indulge the aspirations of interest groups to control power. Governments may yield to interest groups in order to stay in power, which in turn brings about political uncertainty and policies that do not benefit the country. Therefore, future researchers should take into account the make up of a country that could foster development of power-elites. It is important to differentiate what scholars have called state-led development. Some have generalized it too much, and often gets treated as one kind of policy.

The level of commitment for success will also vary across cultural and interest groups based on the projected outcome. Future research should include these variables to determine projected success and failure rates, since these variables will tend to impact a plan's effectiveness and long-term success.

Conditions that fueled the Asian crisis could be avoided in the future by instituting policies that consider the cultural, social, and historical background/issues in developing countries. An illustration might be a government policy that recognizes the traditional respect for authority but at the same time allows for a diversification of power centers. In addition, steps should be taken to ensure that political elites, moneyed interests, or familial influence do not assume control of business sectors or trade through pressure exerted on governments/regimes.

Because data is difficult to find or in some cases does not include certain areas that could produce insight on historical information that could influence economic development and growth, implications could arise. Furthermore, some of the data to be examined may not include certain aspects such as the level of trust that could be critical considering the value that Asian countries place on trust behavior in their everyday business culture. What people think and feel makes a difference in the success or failure of economic plans.

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Table 1. Institutional and Financial Indicators for East Asian Countries

	HKG	IDN	JPN	KOR	MYS	PHL	SGP	THA	TWN
Concentration of ownership									
share of total market capitalization that top 15 families control	0.34	0.62	0.03	0.38	0.28	0.55	0.30	0.53	0.20
ownership of 10 largest nonfinancial firms by 3 largest shareholders	0.54	0.58	0.18	0.23	0.54	0.57	0.49	0.47	0.18
Governance indicators									
voice and accountability	0.62	-1.15	1.08	0.71	-0.05	0.17	0.40	0.01	0.55
political stability	0.30	-0.45	1.08	0.16	0.95	-0.12	1.39	0.20	1.01
government effectiveness	1.78	0.18	1.36	0.64	1.07	0.19	2.51	0.47	1.42
regulatory quality	2.07	0.27	0.84	0.69	0.86	0.45	2.29	0.49	1.17
rule of law	1.71	-0.36	1.60	0.81	0.85	-0.11	2.13	0.49	1.02
control of corruption	1.50	-0.47	1.22	0.54	0.51	-0.40	2.18	-0.32	0.74
Non-performing loans as % of total lending	3	13	na	8	10	14	4	13	4
Short-term debt as % of foreign reserves	22.4	176.6	na	203.2	41.0	79.5	2.6	99.7	21.3
Bank lending to private sector as % of GDP	162.4	55.4	na	61.8	93.4	50.0	96	101.9	146.1
Financial liberalization index	18	11	14	10	12	11	16	13	6

Notes: na – not available.
Sources: Claessens et al. (1999) for the share of total market capitalization that top 15 families control; La Porta et al. (1998) for the ownership of 10 largest nonfinancial firms by 3 largest shareholders; Kaufmann et al. (2005) for governance indicators; Corsetti et al. (1998) for non-performing loans, for the ratio of short-term debt to foreign reserves, and for the bank lending to private sector as % of GDP; Abiad and Mody (2005) for financial liberalization index. Most of the data are for the year 1996.

Table 2. Correlation among Institutional and Financial Indicators for East Asian Countries

	Conc. of ownership	Voice & account.	Political stability	Govern. effective.	Regul. Quality	Rule of law	Control of corruption	Non-perf. loans	Short-term debt	Bank lending	Fin. lib. index
Concentration of ownership	1										
Voice and accountability	-0.76**	1									
Political stability	-0.84***	0.58	1								
Government effectiveness	-0.65*	0.52	0.82***	1							
Regulatory quality	-0.42	0.44	0.61*	0.94***	1						
Rule of law	-0.75***	0.72**	0.81***	0.95***	0.86***	1					
Control of corruption	-0.70**	0.63*	0.78**	0.97***	0.91***	0.97***	1				
Non-performing loans	0.83**	-0.66*	-0.67*	-0.89***	-0.88***	-0.89***	0.90***	1			
Short-term debt	0.63*	-0.39	-0.74**	-0.75**	-0.72**	-0.65*	-0.62	0.56	1		
Bank lending to private sector	-0.65*	0.49	0.49	-0.64*	0.65*	0.65*	0.56	-0.75**	-0.68*	1	
Financial liberalization index	-0.07	0.17	0.14	0.48	0.58	0.54	0.52	-0.25	-0.33	0.24	1

Notes: three stars indicate significance at the 1% level, two at the 5% level, and one star indicates significance at the 10% level.
Sources: Claessens et al. (1999) for the concentration of ownership; Kaufmann et al. (2005) for governance indicators; Corsetti et al. (1998) for non-performing loans, for the ratio of short-term debt to foreign reserves, and for the bank lending to private sector as % of GDP; Abiad and Mody (2005) for financial liberalization index. Most of the data are for the year 1996.

Table 3. Output Losses in East Asia

Country	From 1998-2002 (in %)			Output growth dip (% GDP)
	# of years with output losses	Cumulative output losses	Average (annual) output losses	
Hong Kong	3	6.70	1.34	-
Indonesia	5	19.62	3.92	33.0
Japan	4	3.59	0.72	-
Korea	2	8.31	1.66	16.5
Malaysia	4	9.31	1.86	22.8
Philippines	2	0.24	0.05	7.5
Singapore	3	2.39	0.48	-
Thailand	4	19.95	3.99	31.5

Source: Author's calculations for the first three columns based on data from the World Development Indicators database (2004). Honohan and Klingebiel (2003) for the output growth dip in the last column.

Table 4. Output Losses by Groups of Countries (1998-2002)

	All countries	No-crisis countries	'Asian crisis' countries	Crisis countries
Mean	0.24	-1.81	7.65	5.10
Number of countries	45	32	9	13

T-tests for differences in means (p-values)

No crisis countries vs. 'Asian-crisis' countries	0.003
No crisis countries vs. crisis countries	0.017

Notes: Negative signs denote output gains. No-crisis countries include countries that did not go through financial crisis during 1998-2002. 'Asian-crisis' countries include countries that went through financial crisis beginning 1997 or later. Crisis countries include countries in which financial crisis started before 1997 and continued after 1997. For detailed list of these countries refer to Table A.2 in the Appendix.
Sources: author's own calculations of output losses.

Table 5. Descriptive Statistics

	N	Mean	Std Dev	Minimum	Maximum
Output losses	44	0.24	5.78	-8.85	19.95
Concentration of ownership	45	0.46	0.13	0.18	0.67
'Good governance'	45	0.81	0.90	-1.27	1.92
Non-performing loans as % of total lending	42	6.17	6.05	0.10	28.10
Short-term debt as % of foreign reserves	19	162.31	265.27	13.65	1152.03
Bank lending to private sector as % of GDP	44	72.92	45.80	8.93	202.43
Financial liberalization index	32	12.72	3.70	6	18
GDP per capita	44	15.07	12.95	0.26	43.62

Notes: GDP per capita is in USD 1,000. Most of the data are for the year 1996. Output losses are calculated for the period 1998-2002.

Sources: La Porta et al. (1998) for concentration of ownership; Own calculations of for "good governance based on Kaufmann et al. (2005);" Barth et al. (2001, 2003) for non-performing loans; World Development Indicators (2004) for short-term indebtedness, for credit to private sector, and for GDP per capita; Abiad and Mody (2005) for financial liberalization index; author's own calculations for output losses.

Table 6. Correlation Coefficients for a Larger Set of Countries

	Output losses	Ownership concentration	Good governance	Non-performing loans	Short-term indebtedness	Credit to private sector	Financial liberalization index	GDP per capita
Output losses	1							
Ownership concentration	0.13	1						
Good governance	-.036***	-0.42***	1					
Non-performing loans	0.50***	0.33**	-0.70***	1				
Short-term indebtedness	-0.08	-0.21	-0.05	-0.12	1			
Credit to private sector	0.21	-0.42***	0.59***	-0.38**	0.34	1		
Financial liberalization index	-0.16	-0.19	0.74***	-0.58***	0.51**	0.62***	1	
GDP per capita	0.31**	-0.51***	0.85***	-0.58***	0.05	0.61***	0.66***	1

Notes: three stars indicate significance at the 1% level, two at the 5% level, and one star indicates significance at the 10% level.
Sources: La Porta et al. (1998) for concentration of ownership; Kaufmann et al. (2005) for "good government;" Barth et al. (2001, 2003) for non-performing loans; World Development Indicators (2004) for short-term indebtedness, for credit to the private sector, and for GDP per capita; Abiad and Mody (2005) for financial liberalization index; author's own calculations for output losses.

Table 7. Regression Coefficients for a Larger Set of Countries

	Dependent variable: Output losses						
Ownership concentration	0.91 (7.38)						-27.92 (16.27)
Good governance		-3.86* (2.31)					-7.19 (4.25)
Non-performing loans			0.54*** (0.18)				0.61** (0.19)
Short-term indebtedness				-0.00 (0.01)			-0.13 (0.09)
Credit to private sector					0.07*** (0.02)		0.14*** (0.03)
Financial liberalization index						-0.29 (0.49)	0.36 (0.69)
(ln) GDP per capita	-1.11* (0.64)	1.06 (1.44)	0.46 (0.74)	0.95 (1.76)	-2.45*** (0.64)	0.06 (1.24)	3.40 (1.76)
Number of observations	43	43	40	18	43	30	17
R-squared	0.08	0.14	0.25	0.15	0.54	0.16	0.88

Notes: three stars indicate significance at the 1% level, two at the 5% level, and one star indicates significance at the 10% level. All regressions include a constant. Standard errors are in parentheses.
Sources: La Porta et al. (1998) for concentration of ownership; Kaufmann et al. (2005) for "good government;" Barth et al. (2001, 2003) for non-performing loans; World Development Indicators (2004) for short-term indebtedness, for credit to the private sector, and for GDP per capita; Abiad and Mody (2005) for financial liberalization index; author's own calculations for output losses.

Table 8. Regression Coefficients of Two-Stage Estimations

	Dependent variable: output losses		
Good governance	-4.06^{**} (1.35)		-6.91^{*} (3.95)
Non-performing loans		0.45^{**} (0.18)	0.52^{**} (0.21)
(ln) GDP per capita	-1.45^{*} (0.84)	1.60 (1.55)	-1.06^{***} (0.33)
Number of observations	43	40	40
R-squared	0.15	0.41	0.62

Notes: The variables non-performing loans and credit to the private sector are instrumented in the first-stage regressions, the non-performing loans and credit to the private sector were regressed on concentration of ownership and (ln) GDP per capita. Three stars indicate significance at the 1% level, two at the 5% level, and one star indicates significance at the 10% level. All regressions include a constant. Standard errors are in parentheses.

Sources: Barth et al. (2001, 2003) for non-performing loans; World Development Indicators (2004) for short-term indebtedness, for credit to the private sector, and for GDP per capita;; author's own calculations for output losses.

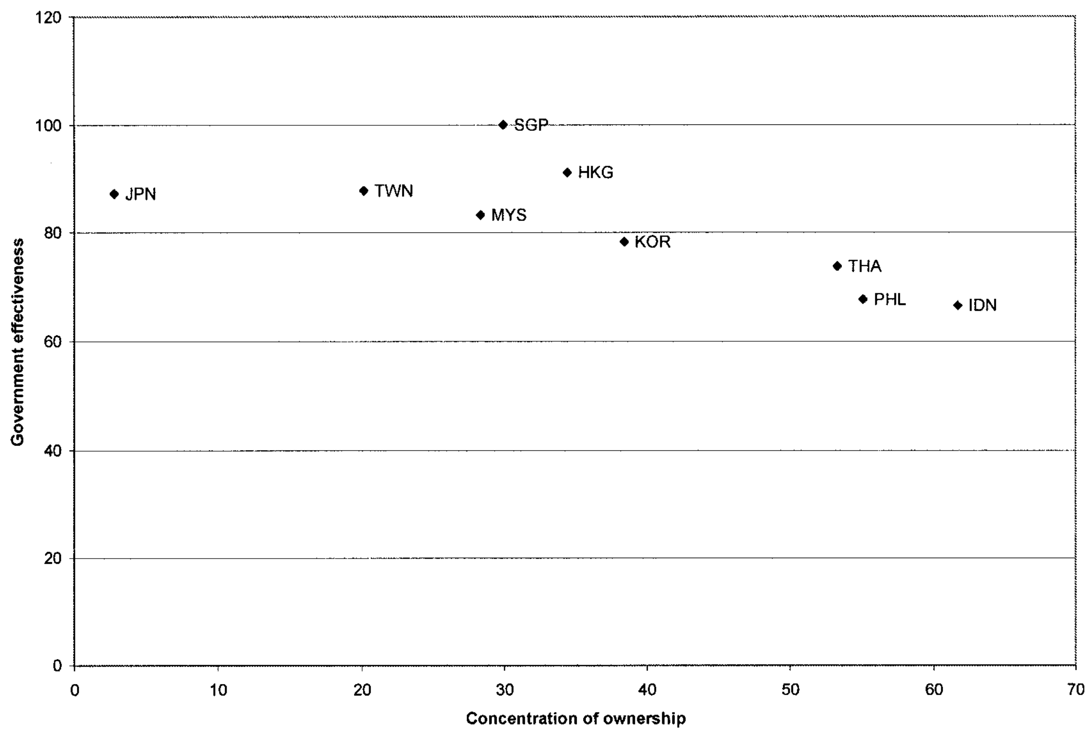
Table 9. Summary Statistics for Korea and Taiwan

	Korea	Taiwan
Concentration of ownership		
share of total market capitalization that top 15 families control	0.38	0.20
ownership of 10 largest nonfinancial firms by 3 largest shareholders	0.23	0.18
Governance indicators (1996)		
voice and accountability	0.71	0.55
political stability	0.16	1.01
government effectiveness	0.64	1.42
regulatory quality	0.69	1.17
rule of law	0.81	1.02
control of corruption	0.54	0.74
Change in governance indicators (1996-2000)		
voice and accountability	0.05	0.26
political stability	0.33	-0.24
government effectiveness	-0.01	-0.36
regulatory quality	-0.22	-0.22
rule of law	-0.17	-0.16
control of corruption	-0.17	-0.07
Non-performing loans as % of total lending (1996)	8	4
Short-term debt as % of foreign reserves (1996)	203.2	21.3
Bank lending to private sector as % of GDP (1996)	61.8	146.1

Sources: Claessens et al. (1999) for the share of total market capitalization that top 15 families control; La Porta et al. (1998) for the ownership of 10 largest nonfinancial firms by 3 largest shareholders; Kaufmann et al. (2005) for governance indicators; Corsetti et al. (1998) for non-performing loans, for the ratio of short-term debt to foreign reserves, and for the bank lending to private sector as % of GDP.

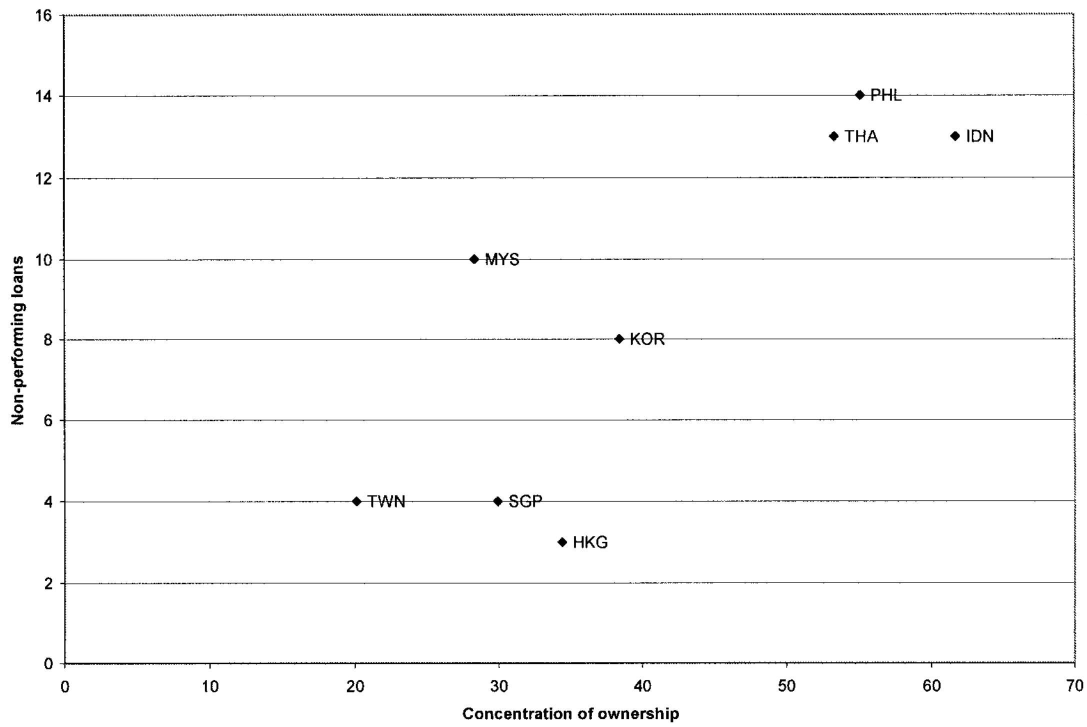
Figures

Figure 1. Concentration of Ownership and Government Effectiveness, 1996



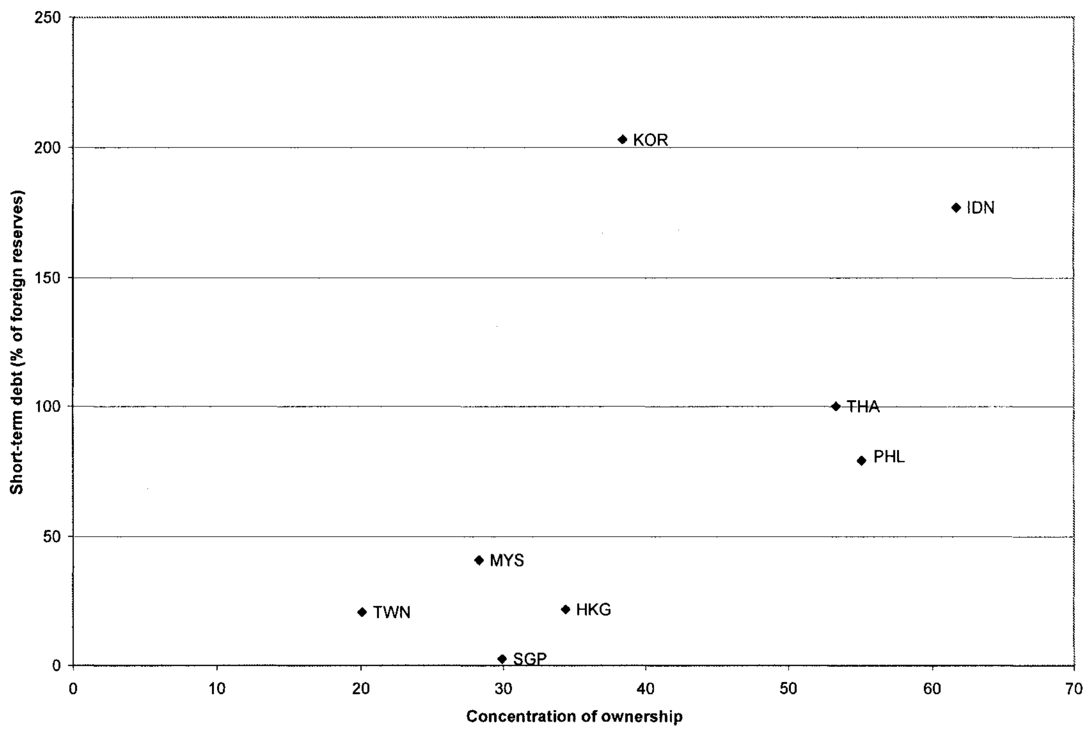
Sources: Claessens et al. (1999) for concentration of ownership; Kaufmann et al. (2005) for government effectiveness.

Figure 2. Concentration of Ownership and Non-Performing Loans, 1996



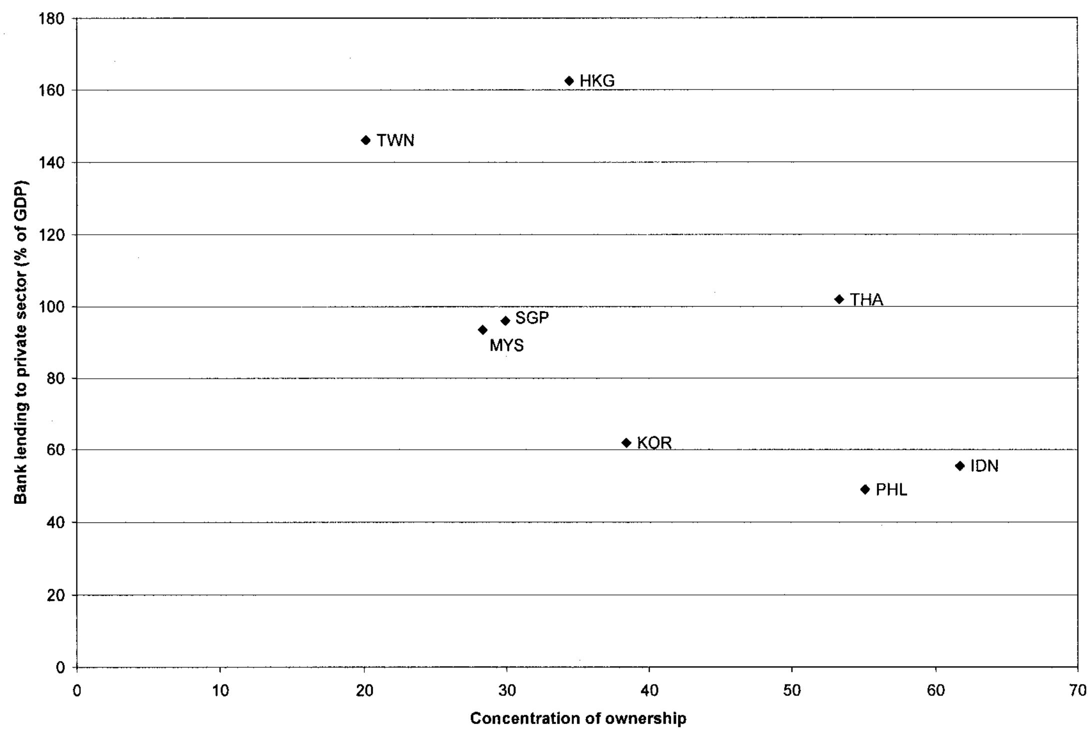
Sources: Claessens et al. (1999) for concentration of ownership; Corsetti et al. (1998) for non-performing loans.

Figure 3. Concentration of Ownership and Short-Term Indebtedness, 1996



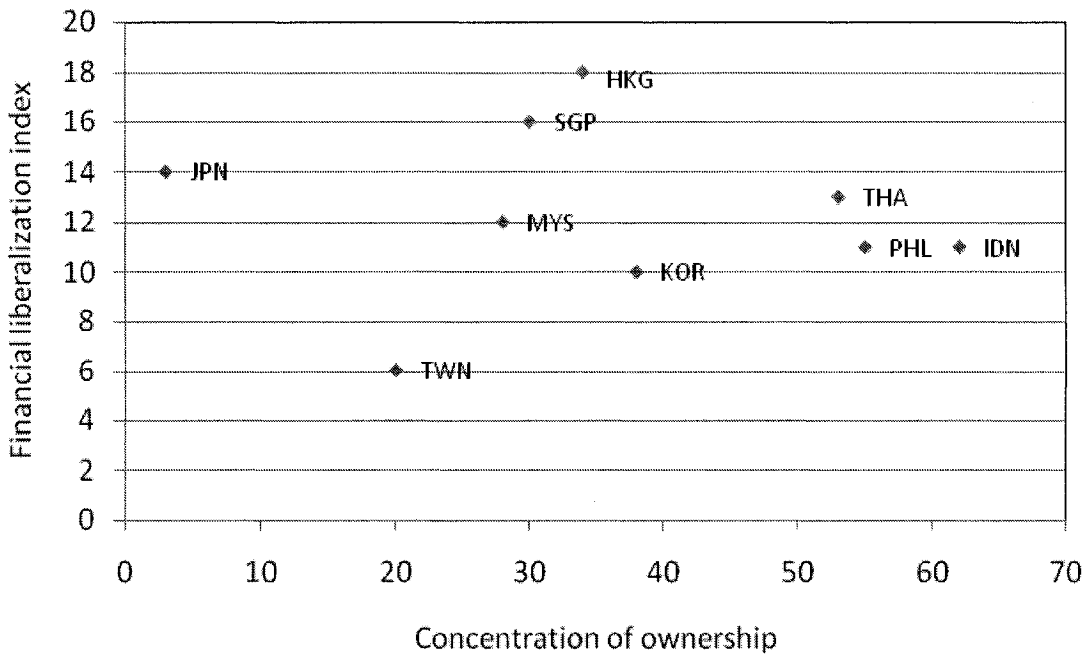
Sources: Claessens et al. (1999) for concentration of ownership; Corsetti et al. (1998) for the ratio of short-term debt to foreign reserves.

Figure 4. Concentration of Ownership and Credit to Private Sector, 1996



Sources: Claessens et al. (1999) for concentration of ownership; Corsetti et al. (1998) for the bank lending to private sector as % of GDP.

Figure 5. Concentration of Ownership and Financial Liberalization Index, 1996



Sources: Claessens et al. (1999) for concentration of ownership; Abiad and Mody (2005) for the financial liberalization index.

Appendix

Table A.1. Variables and Data Sources

Variables	Definitions	Sources
Concentration of ownership	% of total market capitalization that the top 15 families control	Claessens et al. (1999)
	The stake of the 3 the largest shareholders among the 10 largest publicly traded companies	La Porta et al. (1998)
Voice and accountability	Includes in it a number of indicators measuring various aspects of the political process, civil liberties and political rights, measuring the extent to which citizens of a country are able to participate in the selection of governments.	Kaufmann et al. (2005)
Political stability	Combines several indicators which measure perceptions of the likelihood that the government in power will be destabilized or overthrown by possibly unconstitutional and/or violent means, including domestic violence and terrorism.	Kaufmann et al. (2005)
Government effectiveness	Combines responses on the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies.	Kaufmann et al. (2005)
Regulatory quality	Includes measures of the incidence of market-unfriendly policies such as price controls or inadequate bank supervision, as well as perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development.	Kaufmann et al. (2005)
Rule of law	Includes several indicators which measure the extent to which agents have confidence in and abide by the rules of society. These include perceptions of the incidence of crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts.	Kaufmann et al. (2005)
Control of corruption	Measures perceptions of corruption, conventionally defined as the exercise of public power for private gain.	Kaufmann et al. (2005)
Non-performing loans	Non-performing loans as % of total lending	Corsetti et al. (1998), Barth et al. (2001, 2003)

Table A.1. (Continued) Variables and Data Sources

Variables	Definitions	Sources
Short-term debt	Short-term foreign debt as % of foreign reserves	Corsetti et al. (1998) WDI (2004)
Financial lending	Bank lending to private sector (% of GDP)	Corsetti et al. (1998), WDI (2004)
Financial liberalization index	Includes six dimensions of financial liberalization: directed credit/reserve requirements; interest rate controls; entry barriers and/or lack of pro-competition policies; restrictive operational regulations and/or lack of prudential regulations; the degree of privatization in the financial sector; and the degree of controls on international financial transactions	Abiad and Mody (2005)

Table A.2. Extended List of Countries

Country	Crisis in 1997 or later	Crisis before 1997 and ongoing	Output losses (1998-2002)
Argentina			1.95
Australia			-4.00
Austria			-1.35
Belgium			-1.74
Brazil			0.07
Canada			-4.89
Chile			1.77
Colombia			5.57
Denmark			-2.56
Egypt.			-3.64
Finland			-8.85
France			-2.37
Germany			0.98
Greece			-3.16
Hong Kong	Yes		6.70
India		Yes	-3.31
Indonesia	Yes		19.62
Ireland			-8.55
Israel			0.45
Italy			-1.01
Japan		Yes	3.59
Malaysia	Yes		9.31
Mexico		Yes	-4.69
Netherlands			-3.52
New Zealand			0.13
Nigeria	Yes		1.93
Norway			-1.86
Pakistan			1.83
Peru			-2.24
Philippines	Yes		0.24
Portugal			-3.81
Singapore			2.39
South Africa			-1.78
South Korea	Yes		8.31
Spain			-3.77
Sri Lanka			-2.63
Sweden			-5.08
Switzerland			-1.91
Taiwan	Yes		na
Thailand	Yes		19.95
Turkey	Yes		0.44
United Kingdom			-0.04
United States			-4.06
Venezuela, RB			4.07
Zimbabwe		Yes	1.88

Notes: na – not available. Negative signs denote output gains.
Sources: author's own calculations for output losses; Hogarth et al. (2002) and Honohan and Klinegebiel (2003) for dates of crisis.