Corporate and Financial Sector Reform: Progress and Prospects

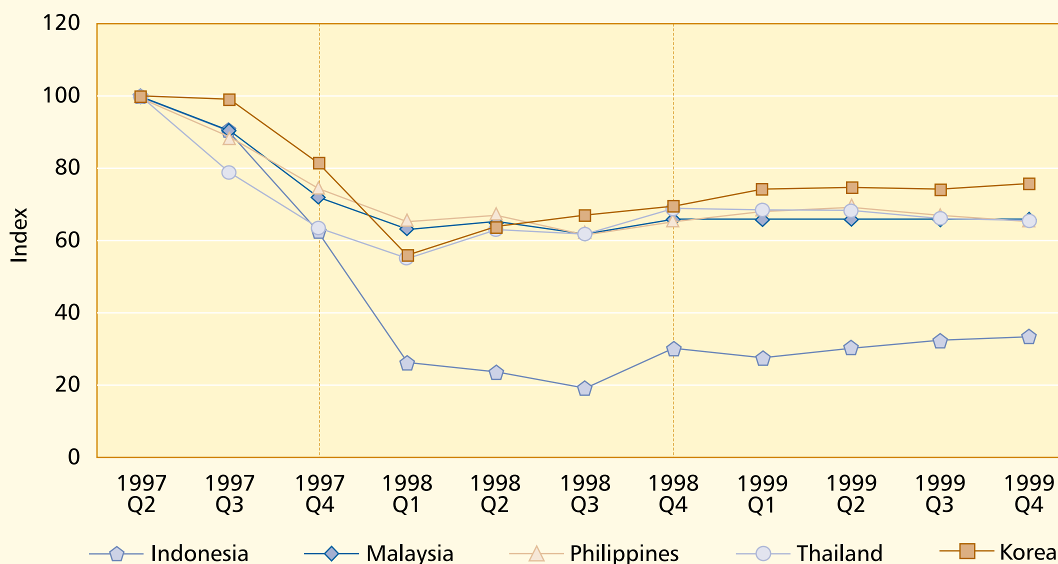
This chapter examines and appraises the corporate and financial sector reforms undertaken so far in the crisis-affected economies in Southeast Asia and East Asia. It considers what must be done—both in the short and medium term—to create vibrant and healthy corporate and financial sectors. The chapter concludes that sustainability of the region's short-term recovery, as well as its long-term economic prospects, depends largely on how effectively and comprehensively the corporate and financial sectors are restructured.

The 1997-1998 Asian financial crisis was the biggest economic and social shock to befall the region since the Great Depression. After decades of rapid growth, output plummeted. In little over a year, the five crisis countries—Indonesia, Republic of Korea (henceforth referred to as Korea), Malaysia, Philippines, and Thailand—saw their combined economic loss reach approximately 30 percent of gross domestic product (GDP). As a result, once again, the unemployment and poverty problems came to the fore. In Korea, for instance, where unemployment and poverty were almost nonexistent before the crisis, the unemployment rate almost tripled in 1998, while urban poverty incidence more than doubled at the peak of the crisis. Such a devastating economic shock, in turn, precipitated substantial social turmoil. The crisis-affected countries experienced food riots and labor unrest, and in Indonesia a dramatic political upheaval occurred.

Fortunately, 1999 brought a clear shift from crisis toward recovery. As current account balances improved while inflation remained subdued, investor confidence returned. This allowed the region's currencies to stabilize and interest rates to fall, which in turn fueled recovery in output. Estimates indicate that all the crisis countries except Indonesia saw substantial GDP growth in 1999, ranging from 3.2 percent in the Philippines to around 10.7 percent in Korea.

The improvement in financial market conditions has been particularly impressive. Most of the region's currencies have appreciated dramatically. The Indonesian rupiah and the Korean won, for instance, strengthened by 35 and 25 percent, respectively, against the dollar between early 1998 and the end of 1999 (see figure 1.8). Malaysia, which introduced capital controls in September 1998 and maintains a fixed exchange rate, is the exception. Yield spreads on international bonds issued by the crisis countries have

Figure 1.8 Nominal Exchange Rate Indices, Crisis Countries, April 1997 - December 1999 (1997 Q2 = 100)



Note: Exchange rates are in US$ to local currencies.
Source: Based on average-of-period data from BLOOMBERG.

fallen sharply (see box 1.4). Domestic short-term interest rates have also fallen. With the exception of Indonesia, where higher inflation and greater political uncertainty have kept rates high, interest rates in crisis countries are in line with their precrisis averages. Stock markets have soared. Since the fourth quarter of 1998, stock prices in these countries have increased, on average, by 50 percent in local currency terms. With currencies also appreciating, the rise has been even larger in dollar terms (see figure 1.9). Market capitalization in most crisis countries is now approaching or even exceeding its precrisis level.

This recovery, while impressive, masks substantial problems, particularly in the corporate and financial sectors. Distress in the financial sector and restructuring costs have proved far larger than anticipated. One estimate suggests that total financial restructuring costs for the four worst-hit countries will reach 58 percent of GDP in Indonesia, 16 percent in Korea, 10 percent in Malaysia, and 32 percent in Thailand.

The main problem is the overhang of corporate debt. Burdened with an enormous stock of nonperforming loans (NPLs), banks are undercapitalized and reluctant to lend. Saddled with heavy debt burdens, many firms are technically insolvent. Private sector financial analysts estimate that as many as 60-85 percent of loans in Indonesia are nonperforming, compared with 20-30 percent in Korea and Malaysia and 50-70 percent in Thailand (see table 1.2). Comparisons between countries must be made cautiously, because the definition and measurement of NPLs differ considerably. Official estimates of the share of NPLs are much lower, but even these indicate a dramatic increase since the onset of the financial crisis.

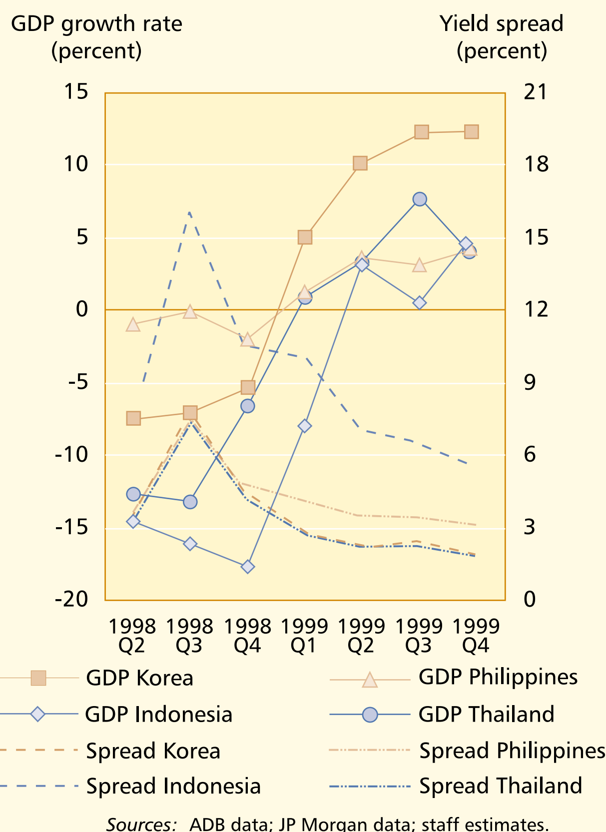
Overall, the sheer size of NPLs reflects the poor health of the corporate sector. However, all firms did not suffer equally. In general, export-oriented

Box 1.4 Improved International Confidence in Crisis Countries

The yield spread of a government bond is the difference between the yield on that bond and the yield on a "safe" instrument of similar maturity (usually US Treasury notes). The size of the yield spread represents the degree of international investor confidence in a country's economy: the higher the yield spread, the lower the investor confidence. Tracking yield spreads over time is therefore a useful gauge of how investor confidence shifts. Yield spreads tend to have an inverse relationship with GDP growth, so lower yield spreads suggest an improved economic outlook.

The government of the Republic of Korea issued two foreign currency bonds in April 1997 to mobilize foreign exchange: a five-year $1 billion bond and a ten-year $3 billion bond. At that time the spreads of these bonds over US Treasury notes of the same maturity were 3.35 percent and 3.55 percent per year, respectively. The yield spreads reached a peak of 7.2 percent in the third quarter of 1998 following Russia's debt moratorium.

Since then, the Republic of Korea's yield spreads have been on a broad downward trend. The same pattern is true for sovereign bonds in other crisis countries. Yield spreads peaked in the third quarter of 1998—16 percent for Indonesia, and 7 percent for both Philippines and Thailand—but have dropped significantly since. In the fourth quarter of 1999, yield spreads over comparable US Treasury notes for the Republic of Korea and Thailand were around 1.8 percent, while those for the Philippines and Indonesia stood at 3.1 and 5.5 percent, respectively.



Sources: ADB data; JP Morgan data; staff estimates.

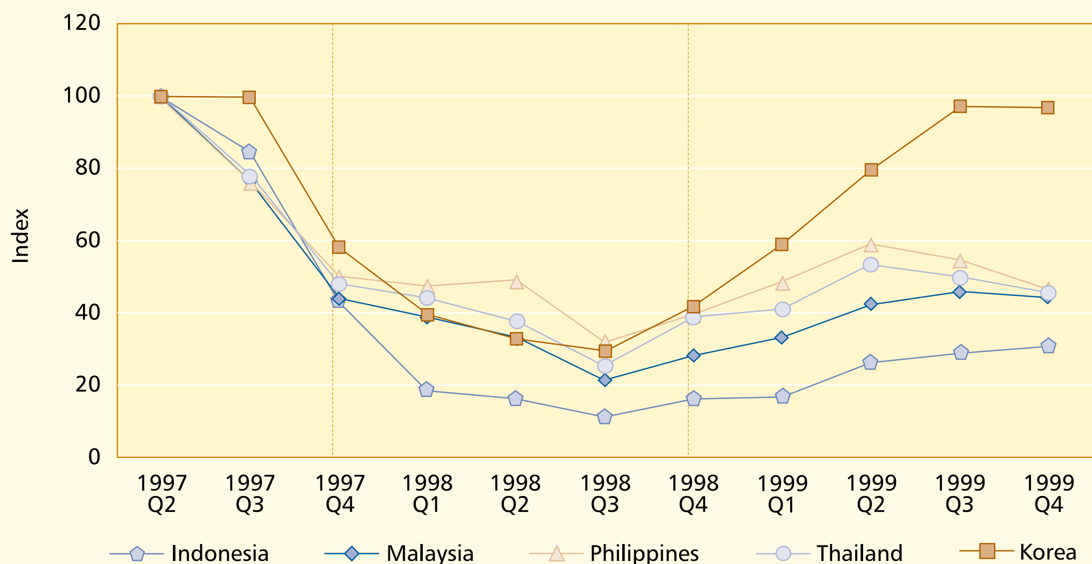
companies fared better than those that produce nontraded goods and services, and, except in Korea, small firms were hit harder than large firms. In Malaysia, for instance, about 75 percent of the NPLs are to firms in the nontradable sector. In Thailand, small firms and households account for 50 percent of the NPLs.

Each of the crisis countries has embarked on comprehensive restructuring strategies to deal with this financial and corporate distress. While considerable progress has been made, the magnitude of NPLs suggests that much remains to be done. The risk is that economic recovery will dull the momentum for restructuring. A variety of vested interests, including financial institutions, business corporations, labor unions, and politicians have exerted pressure to slow and limit structural reform.

FINANCIAL AND CORPORATE RESTRUCTURING

Plummeting currencies, collapsing confidence, and financial system paralysis characterized the early phase of the financial crisis. Uncertainties about the likely behavior of depositors and foreign creditors and fears about the financial health of borrowers led banks vir-

Figure 1.9 Composite Stock Price Indices, Crisis Countries, April 1997 - December 1999 (1997 Q2 = 100)



Note: Exchange rates are in US$ to local currencies.
Source: Based on average-of-period data from BLOOMBERG.

tually to stop lending. To prevent a complete collapse in bank intermediation, financial reform strategies initially focused on measures to restore market confidence and attract capital inflows. The most popular method was government guarantees, and in the early stages of the crisis, governments gave broad guarantees both to foreign creditors and depositors.

As the crisis deepened and the extent of corporate and financial insolvency became clear, the reform strategy shifted toward restructuring in the financial and corporate sectors. The goals were twofold: to escape from the crisis and to address the structural weaknesses that had helped trigger the financial collapse. The focus was on restructuring insolvent financial institutions by closure, merger, or recapitalization; improving corporate governance; reducing labor market rigidities; and deregulating domestic markets.

In all the crisis countries, three broad principles governed financial restructuring: (a) minimizing the risk of moral hazard associated with using public money for bank recapitalization by ensuring that government ownership increase commensurately with the infusion of public recapitalization; (b) maximizing the participation of the private sector by providing fiscal and administrative incentives; and (c) ensuring that the restructuring process was comprehensive and covered the institutional, legal, and regulatory aspects of the banking sector as well as its financial health. Banks were mandated to meet international standards of capital adequacy, loan classification, loan-loss provisioning, accounting, and disclosure.

Similar goals drove corporate restructuring efforts. It was necessary to find quick and effective ways of allocating losses and facilitating asset mobility to remove the paralyzing debt overhang that stymied the corporate sector. Developing an efficient bankruptcy regime and modernizing corporate governance were also critical.

Again, strategies were broadly similar across the crisis countries. All countries developed new out-of-

Table 1.2 Nonperforming Loan Ratios and Fiscal Costs of Restructuring, Crisis Countries
(percent)

Country	Share of nonperforming loans to total loans: Official estimate, End of 1997	End of 1998	September 1999	Unofficial estimate, peak level	Fiscal costs of restructuring as share of GDP
Indonesia	—	—	—	60-85	58
Korea	—	7.6	6.6	20-30	16
Malaysia	—	18.9	17.8	20-30	10
Philippines	5.4	11.0	13.4	15-25	—
Thailand	19.8	45.0	44.7	50-70	32

— Not available.

Note: NPLs are measured on a three-month basis, and the unofficial estimate includes assets carved out for sale by the asset management companies.

Sources: Central banks and financial supervisory agencies; World Bank (1999a); Deutsche Bank (1999); J.P. Morgan (1999); Bank of America (1999); staff estimates.

court systems to restructure the debts of large firms, variants of the London approach to corporate restructuring (see box 1.5). Indonesia set up the Jakarta Initiative, Korea and Malaysia set up corporate debt restructuring committees, and Thailand used a corporate debt-restructuring advisory committee. Tax incentives encouraged out-of-court workouts, while regulatory obstacles that hindered mergers and debt-equity swaps were removed. Simultaneously, the crisis countries strengthened domestic bankruptcy laws to accelerate resolving bankruptcy cases, protect creditors' rights, and discipline managers. Policies to improve corporate governance included attempts to reduce ownership concentration, increase market competition, reduce government monopolies, strengthen the rights of minority shareholders, and increase the transparency of financial reports and transactions.

An Individual Look at Crisis Countries

Though the broad principles of financial and corporate restructuring have been similar in the crisis countries, the details and rates of progress have varied considerably. Korea and Malaysia have gone furthest in restructuring their corporate and financial sectors, but with different approaches. Korea adopted tight macroeconomic policies under an International Monetary Fund (IMF) program and aggressively closed, merged, or suspended insolvent financial institutions. Malaysia declined an IMF rescue plan, opting for capital controls, and closed no financial institutions. After dramatically downsizing the financial sector by closing virtually all its finance companies, Thailand adopted a more gradual, market-based approach to restructuring, with banks allowed to raise equity capital over a long period through phased-in requirements for loan provisioning. Indonesia lags behind the other three countries, and has only recently taken steps to deal with banking problems and corporate distress. As a less severely affected economy, the Philippines adopted a market-led reform process, with the government and the central bank focusing on reforming the supervisory systems.

Indonesia. Indonesia's first step toward structural reform in the financial sector was to create new institutions. The Indonesian Bank Restructuring Agency was formed in January 1998 as an independent body to

Box 1.5 Models of Corporate Restructuring

There are three popular approaches to corporate sector restructuring: centralized, decentralized, and the London approach.

In the centralized approach, the government plays a leading role. This is effective when the size of problematic debts is small, corporate structure is simple, and the government enjoys high levels of confidence. Sweden in the early 1990s and Hungary in the mid-1990s used a centralized approach to corporate restructuring.

At the other extreme, interested parties use a decentralized approach to reach voluntary restructuring agreements. This is considered more useful than the centralized approach if the bad debts are large and the corporate structure is complex. Corporate restructuring in the United States tends to follow this model.

The London approach evolved in the United Kingdom when numerous firms faced bankruptcy in the recession of the early 1990s. During this period, more than 160 British companies used the London approach, in which creditor financial institutions and indebted firms work under the close coordination of a government institution (in the British case, the Bank of England), but outside the formal judiciary process. The London approach includes

- Full information sharing between all parties involved in a workout
- Collective decision making among creditor banks on whether and on what terms a company should be given a financial lifeline
- Standardized agreements between debtors and creditors and among creditors themselves
- A clear timetable to achieve timely resolution
- Binding agreements between banks and firms to participate in and honor the restructuring agreements
- The principle of "shared pain" in the allocation of losses, meaning equal treatment for all creditors of a single category
- The possibility of penalties if the agreements are not adhered to.

To be successful, this approach demands strong confidence in the official mediating institution. In the British case, the parties concerned held the Bank of England in high regard, a crucial ingredient for success.

Superficially, the corporate debt workouts under government coordination in Indonesia, Korea, and Thailand resemble the London approach. However, the Asian countries lacked the equivalent of the Bank of England, a government institution with high credibility. They also suffered a lack of mutual trust and confidence between financial institutions. This process is now gradually changing, as both financial institutions and corporations become more confident in the ability of government to oversee corporate debt restructuring.

restructure troubled banks and their assets. Within this agency, a specific Asset Management Unit was created in April 1998 to acquire NPLs from troubled banks. By the end of 1999, it held around two thirds of all NPLs. So far, however, the Indonesian Bank Restructuring Agency has done little to recover these assets, although the legal, organizational, and regulatory framework is in place.

Greatest progress has been made in restructuring private banks. At the end of July 1997, before the onset of the crisis, Indonesia had 160 private banks. In September 1998, all private banks were classified into categories of A, B, or C, based on their capital adequacy. All group C banks and nonviable group B banks were closed in March 1999. In the span of one year, 66 banks were closed and 12 taken over by the state. Consequently, the state banking system accounts for 75 percent of the liabilities of Indonesia's banking system and 90 percent of its negative net worth. Unfortunately, the restructuring of these state banks has just begun. By some estimates, around 80 percent of all outstanding loans are nonperforming. As a result, most Indonesian financial institutions remain insolvent or undercapitalized, and lending operations are severely curtailed.

One of the major causes of the collapse of the banking system was the absence of an effective bank supervision system. Realizing this weakness, Indonesia has taken steps to improve prudential regulations, bank supervision, and enforcement capabilities. Nevertheless, bank supervision remains limited because of weak enforcement capacity and a lack of trained staff.

As in the financial sector, Indonesia's efforts at corporate reform initially focused on creating new institutions and improving legislation. First, the government set up the Indonesian Debt Restructuring

Agency in July 1998 to help restructure foreign debt. This agency allows debtors and creditors to insure themselves against exchange risks, once they have reached rescheduling agreements. Indonesia then created the Jakarta Initiative for out-of-court corporate settlements, following the example of the London approach to corporate workouts. Legislation to improve corporate governance included new bankruptcy and anticorruption laws. In August 1998 a new bankruptcy law was introduced, which modernized the legal infrastructure for bankruptcy and facilitated the rapid resolution of commercial disputes. In 1999 a law against corruption, collusion, and nepotism was passed.

Despite this comprehensive legal and institutional framework, the progress of corporate restructuring has been disappointing. The Indonesian Debt Restructuring Agency has registered little debt. By the end of June 1999, only 80 bankruptcy cases had been registered, although almost half of Indonesian corporations were insolvent and experiencing increased difficulties in meeting debt service obligations. One of the biggest constraints on the speed of corporate debt restructuring has been the lack of financial system reform. Weak undercapitalized banks lack the resources or technical skills to resolve corporate debts within the framework of the Jakarta Initiative. Another constraint is the enormity of Indonesia's foreign debt. Without relief from foreign creditors, including Japan, Indonesia probably cannot service this debt, in particular the $36 billion owed to foreign banks.

Korea. Korea's financial sector strategy initially focused on restoring market confidence with government guarantees to prevent a run on the banks. However, once the situation stabilized, priority shifted to restructuring or closing insolvent financial institutions and rehabilitating viable ones. At the same time, adoption of international standards of regulation and supervision was emphasized, as well as capital market development.

In December 1997, the Korean Parliament passed 13 financial reform bills, and streamlined bankruptcy law. In January 1998, the government, corporations, and unions agreed on a national council to discuss economic restructuring. A legal framework for corporate sector restructuring was created in February 1998. In April 1998 the powerful Financial Supervisory Commission was created to monitor and supervise all financial institutions. During the crisis, however, it focused on financial and corporate restructuring, accelerating the reform process.

In early 1998, two of Korea's largest banks, Korea First Bank and Seoul Bank, were recapitalized with public funds and effectively nationalized. Korea First Bank was subsequently sold to a foreign consortium. On 29 June 1998, the Financial Supervisory Commission announced that five insolvent commercial banks would be closed and absorbed by healthier banks. Mergers involving the five largest banks have been completed. Two years after the crisis, the number of banks has been reduced from 33 to 23 through closures and mergers. The government has also closed down or suspended 21 of 30 merchant banks, and 22 other financial institutions.

The public sector contribution to this restructuring has been huge. At the beginning of the crisis, the government earmarked W64 trillion ($53.3 billion) in public funds to support financial sector restructuring. By the end of 1999, the government had used the entire allocation of funds to purchase W20.5 trillion ($17.1 billion) in NPLs from banks and secondary financial institutions through the Korea Asset Management Corporation. It also provided W43.5 trillion ($36.2 billion) in recapitalization and deposit repayment support through the Korea Deposit Insurance Corporation.

Korea has taken a three-pronged approach to reforming the corporate sector. First, the four largest *chaebols* (conglomerates of corporations), known as the Big Four, were restructured through specific plans to improve capital structure. These required the four chaebols to reduce their debt-equity ratios to below 200 percent by the end of 1999, remove existing cross-guarantees between subsidiaries in different lines of business, and consolidate businesses by exchanging noncore businesses with other chaebols, a process known as "Big Deals."

Second, the mid-ranking chaebols and other large corporations have been subject to out-of-court workouts with their designated lead creditor banks, based on the London approach.

Third, the restructuring of small- and medium-size enterprises (SMEs) has been left to the creditor banks and largely postponed. To prevent insolvency and preserve employment, these firms were allowed

easy access to working capital loans. In Korea, compared with other crisis countries, SMEs account for a relatively small fraction of outstanding bank loans. While this justifies the delay in restructuring SMEs, a comprehensive program to work out these debts is urgently needed.

The restructuring of the Big Four and out-of-court workouts of other large corporations have had mixed results. The lead banks have been accused of including firms that should have been immediately liquidated. Given their financial fragility, the banks have been reluctant to absorb losses, and are trying to keep many troubled firms on their balance sheets that in fact are unlikely to survive the crisis. The lead banks have also been unable to devise a comprehensive set of workout criteria involving debt-equity swaps, debt write-downs, and debt rescheduling. The absence of comprehensive criteria has raised concerns about the fairness and effectiveness of using differential measures to support different firms in various industries. Disagreements over loan-loss provisioning, disputes over asset valuation, and managers' resistance to losing control all have further complicated the process. Consequently, many firms are likely to fail to meet their obligations to their lead banks.

The restructuring impact of the Big Deals is also mixed. Whether or not the excess capacity problems that plagued Korea's chaebols have been solved is not clear. Evidence is also mixed on whether the Big Four has fulfilled its commitments to improve corporate governance and slim down to a few core businesses.

Most of the banks, including restructured ones, have seen substantial improvement in the quality of their assets and profitability of their operations. Their lending capacity also has increased, supporting the ongoing economic recovery. However, financial restructuring is far from over. The Financial Supervisory Commission has been struggling to restructure the three largest investment trust companies, which hold many corporate bonds issued by corporations engaged in out-of-court workouts. Many nonbank financial institutions, including life insurance companies, also need rehabilitation.

The banks have faced major losses from the corporate workouts. For instance, the restructuring of Daewoo, Korea's second-largest chaebol until domestic creditors decided on a debt-rescheduling program for its subsidiaries, caused bank losses estimated at $10.4 billion. The requirement that the Big Four reduce their debt-equity ratio to less than 200 percent by the end of 1999 also led to debt write-downs and debt-equity swaps that cut the earnings of major commercial banks.

These costs made it difficult for Korean banks to build the capital and loan-loss provisioning needed to absorb the losses from further corporate restructuring. Some progress has been made, however. The average capital adequacy ratio of the commercial banks reached 10.5 percent by the end of 1999. Nonetheless, estimates suggest that the Korean government will need additional public funds besides the W64 trillion ($53.3 billion) already used for reforming the financial sector.

Malaysia. Malaysia's experience of financial restructuring differed from the other crisis countries in two crucial aspects. First, Malaysia began with a stronger financial sector. Before the crisis it had developed more effective bankruptcy and foreclosure laws, as well as a stronger supervisory capacity. The banking sector was also well capitalized, with capital-asset ratios exceeding 10 percent. Second, Malaysia altered its macroeconomic course in September 1998, choosing to impose capital controls rather than accept an IMF rescue package.

However, like the other countries, Malaysia began its financial and corporate restructuring effort by creating new institutions. In June 1998, the authorities set up Danaharta, an asset management company (AMC) to acquire nonperforming bank loans. In August 1998, Danamodal was created to recapitalize financial institutions whose capital adequacy ratios fell below 9 percent. In the same month the Corporate Debt Restructuring Committee was established to facilitate the out-of-court restructuring of corporate debt.

Both Danaharta and Danamodal made significant progress in restructuring banks. Danamodal injected $1.6 billion into ten financial institutions, while Danaharta purchased 50 percent of outstanding NPLs, about the same ratio as Korea. The level of NPLs appears to have peaked in mid-1999 at over 20 percent of total loans. The total fiscal cost of the restructuring is estimated at around 10 percent of GDP.

In an effort to accelerate the rationalization and consolidation of the banking system, instead of closing affected institutions as in Korea and Thailand, Malaysia continued to encourage financial institutions to merge and consolidate. The central bank approved the formation of ten banking groups and the selection of the anchor banks and their respective partners in January 2000. Accordingly, 54 domestic banking institutions—reduced from 88 at the end of 1997—will be further consolidated. With a relatively sound legal system and a good institutional framework for financial restructuring, the prospects for Malaysia successfully restructuring its financial system seem bright.

Before the crisis, Malaysia's corporations were less heavily indebted than firms in other crisis countries in East Asia. Consequently, corporate distress in Malaysia was less acute than elsewhere, although firms were hit hard by the rise in interest rates because of heavy dependence on bank financing. Malaysia's troubled firms are concentrated in the real estate, construction, and infrastructure sectors.

Nonetheless, debt workouts and operational restructuring through the Corporate Debt Restructuring Committee have been slow, partly because of a lack of adequately trained staff. To address the problem, the government has established agencies to deal with corporate restructuring: the Loan Monitoring Unit of the central bank assists small corporate borrowers in restructuring, a rehabilitation fund helps viable SMEs restructure, and the Finance Committee on Corporate Governance works on reforming corporate governance practices.

Philippines. While the Philippines was affected by the Asian crisis, it suffered significantly less than the other four crisis economies. No broad banking crisis occurred and no emergency rescue assistance from the IMF was needed. The country was resilient because it had virtually no short-term foreign currency borrowing, its banks were well-capitalized after two decades of financial sector reform, and its manufacturing sector was smaller and less leveraged than the other economies.

The mildness of the Philippines' crisis affected the scope and nature of the country's financial and corporate reforms. Compared with the four worst-hit crisis economies, the Philippines followed a market-led reform process with less government involvement. Its major reform elements included (a) strengthening the prudential and supervisory systems overseeing the financial sector, (b) adopting an early intervention system to deal effectively with problem banks and keep the banking system sound, (c) strengthening and modernizing state banks through privatization, (d) reducing the intermediation costs of financial institutions, and (e) improving the legal and regulatory framework.

To improve the supervisory framework, the central bank required banks to set up 2 percent general loan-loss provisions, as well as increasing specific loan-loss provision on individual loans, which reached 2 percent by 1 October 1999. The central bank also limited banks' exposure to the real estate sector to 20 percent of total loans, and reduced the allowable loan value of real estate security from 70 to 60 percent. It imposed a 30 percent liquid cover on all foreign exchange liabilities from foreign currency deposits.

To deal more effectively with problem banks, the central bank adopted an early warning system that included formalizing sanctions on undercapitalized banks. To strengthen and modernize state banks, the government concentrated on selling shares to private investors. Statutory reserve requirements were reduced from 10 to 8 percent in May 1998 to reduce the costs of financial intermediation.

Regulatory improvements have been significant. The central bank has proposed major revisions to key banking laws to (a) limit the ability of universal and commercial banks to invest in firms; (b) redefine the functions, authority, and minimum capitalization of trust entities; (c) adopt the Basle Capital Accords, a set of standards for measuring capital adequacy; (d) strengthen provisions to guard against bank over-exposure to risky assets; (e) guard against credit concentration among borrowers; (f) grant the central bank the right to examine banks once a year; and (g) authorize the central bank to issue regulations requiring bank subsidiaries and affiliates to maintain a balanced position in foreign exchange transactions.

These reforms contributed to the early recovery of financial markets. Nonetheless, problems remain. First, many of the new prudential norms and international standards are poorly implemented. Second, banks still hold many real estate NPLs, which continue to curtail banking sector operations and stall

overall economic activity. The illiquidity of property markets also means that loan-loss provisioning may not reflect all real losses. Informal loan-for-property swaps without formal legal foreclosure proceedings pose an additional problem.

Thailand. Like other crisis countries, Thailand began structural reform in the financial sector by creating new institutions. In October 1997, three months after the onset of the financial crisis, the government established the Financial Sector Restructuring Authority to organize the workout of failed finance companies, and the Asset Management Company to buy nonperforming assets and recover them. In December 1997, the Financial Sector Restructuring Authority closed 56 of 58 suspended finance companies, and since then has been disposing of their assets. The Asset Management Company purchased its first NPLs at a Financial Sector Restructuring Authority auction in March 1999.

After closing the finance companies, to help regain investor confidence the government adopted a market-based approach to restructuring and recapitalizing the remaining financial institutions. By gradually introducing stricter loan classification and loan-loss provisioning requirements, the Thai authorities hoped to give private investors the incentive—and time—to provide fresh capital.

However, this strategy did not succeed because private investors had little incentive to invest in those banks and in other financial institutions that were amassing large numbers of NPLs because of continuing recession. The government shifted to a more interventionist approach in August 1998, announcing a new comprehensive financial restructuring package. This package allowed viable financial institutions to recapitalize using public funds under clear safeguards. It offered incentives for accelerating corporate debt restructuring and promoting new lending to the private sector. It also created a legal basis for establishing private AMCs and clear resolution strategies for financial institutions in line with the government's long-term objective of strengthening the financial system.

Even this interventionist approach faced problems. Thai bank owners remain as reluctant to take advantage of public funds as they were determined to maintain ownership and control of their institutions. By January 2000, only four banks had accepted the government's recapitalization scheme, and most banks limited new lending and resorted to complex private arrangements to raise capital. The level of NPLs in commercial banks is so high—as much as 50 percent of total loans or more—that for banks to recapitalize through normal business operations seems impossible.

Thailand's strategy for corporate restructuring, like that of the other countries, consisted of new institutions, better incentives, and improvements in the legal framework. In August 1998, the government created the Corporate Debt Restructuring Advisory Committee. It also endeavored to create an effective legal framework for recovering debt through bankruptcy legislation, and provided tax and other incentives to encourage corporations and banks to restructure bad debt.

Progress has been made, and the results of the corporate restructuring account for about 25 percent of NPLs. The growth of NPLs has outpaced the rate of corporate restructuring completion. SMEs account for more than two thirds of this aggregate corporate debt, which makes restructuring complex: transactions are small, costly, and diffuse, with firms scattered over the country. Banks have also been reluctant to deal with the debts of SMEs, preferring to scale back lending.

Thailand has made greater progress in improving the supervisory and regulatory framework surrounding the financial sector. The authorities are enforcing new loan classifications and provisioning requirements, and the supervisory functions of the Bank of Thailand are being strengthened. All financial institutions have signed a memorandum of understanding that describes their plans to raise capital. The more stringent provisioning requirements for nonperforming assets are being phased in from the second half of 1998 until the end of 2000. The Bank of Thailand also began implementing a modernization program aimed at redesigning the bank's organizational structure, streamlining work processes, and improving corporate governance. As part of these efforts, experts from some central banks of industrial countries have offered recommendations on strengthening central banking and bank supervision. The Bank of Thailand has also set up a school for bank examiners.

Assessment of Reforms

Almost three years after the onset of the Asian crisis, financial and corporate restructuring is best seen as a work in progress. All the crisis countries have begun to lay the foundations for stronger financial and corporate sectors. Throughout the region, new accounting standards, improved disclosure requirements, and better rules for corporate governance were introduced. However, effective implementation and enforcement of these rules are still lacking.

Similarly, all the crisis countries have made progress in the immense task of financial and corporate restructuring, but much remains to be done. Banks remain undercapitalized and still hold large amounts of NPLs on their balance sheets. The ratio of NPLs to total loans remains well above 20 percent in all the crisis countries, far higher than in any previous major emerging-market banking crisis. Public sector involvement has been much higher than anticipated: while restructuring, governments nationalized many weak financial institutions. Although all the region's governments have placed a high priority on divesting state-owned banks and assets, willing and qualified buyers have been scarce. Consequently, the restructuring process will likely require a further infusion of public money (see table 1.3).

The strength of the crisis countries' public commitment to structural, financial, and corporate reform may have contributed to their economic recovery. Market confidence—and hence the return of foreign direct and portfolio investment—has been boosted by the expectation that Asia will emerge from the crisis with more stable and efficient financial sectors than before (see box 1.6).

Unfortunately, it is too early to be certain of such success. Despite continuing pressure from international financial institutions, corporate and financial reform has slowed, and backtracking is evident in some cases. Moreover, it is an open question whether some crisis countries had sufficient political leadership and institutional capacity to implement such massive and complex structural reforms within a short time. Institutional weaknesses have been the main obstacle to rapid and efficient implementation of reform programs in Indonesia and Thailand.

Though much remains to be done, it is not too early for a critical appraisal of the region's reform efforts. With hindsight, the crisis countries obviously did not have a well-designed road map to guide their financial and corporate restructuring. The reason is clear: with the crisis deepening daily, these countries did not have the luxury of spending months designing an optimal reform program. Nonetheless, there are several lessons to be learned.

Synchronizing Restructuring Efforts. In every crisis country, the restructuring process began with banks. Balance sheets were cleaned up and capital bases strengthened so these banks could take charge of restructuring ailing firms. Unfortunately, this strategy did not work, as banks were ill-prepared to lead the corporate restructuring efforts. Their main priority was to avoid a further deterioration of their assets by becoming more conservative in lending and asset management and sharply scaling back normal inter-

Table 1.3 Fiscal Costs of Recapitalization, Selected Crisis Countries, Mid-October 1999
(percent of 1998 GDP)

Cost	Indonesia	Korea	Malaysia	Thailand
Estimated recapitalization cost	58.3	16.0	10.0	31.9
Funds disbursed	10.6	12.5	4.2	23.9
Expected additional costs	47.7	3.6	5.8	8.0

Source: World Bank (1999a).

Box 1.6 Trend of Foreign Direct Investment in Crisis Countries

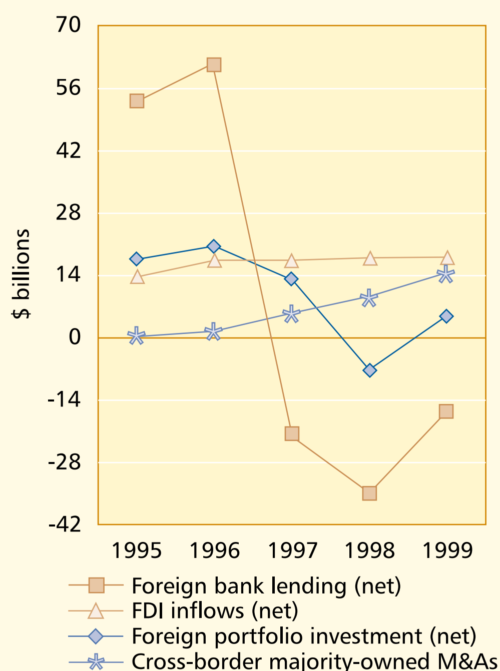
Foreign direct investment (FDI) has long been an important source of external finance in developing Asia. It also proved to be much more stable than other forms of capital flows during the crisis. In 1998 and 1999, net FDI flows into the five worst-hit countries—Indonesia, Korea, Malaysia, Philippines, and Thailand—slightly increased from the 1997 level of $17.5 billion. However, individual countries fared differently. FDI inflows into Korea were $2.8 billion in 1997, $5.5 billion in 1998, and $8.5 billion in 1999. FDI inflows into Malaysia for the same years were $5.1 billion, $3.7 billion, and $3.8 billion. This difference, in large part, reflected different attitudes by the crisis-affected countries toward the role that FDI should play in corporate and financial reform.

FDI can be important in financial and corporate restructuring. By investing in, or acquiring, distressed companies or banks, foreign investors provide crucial new capital as well as managerial resources. Several countries in the region have made specific efforts to attract FDI, with Korea and Thailand the most prominent. Korea has opened several sectors to foreign investors, including property, securities dealing, and other financial businesses. Restrictions limiting foreign ownership of equity have been abolished, allowing foreign investors to buy as much as 100 percent of a local firm. The Foreign Investment Promotion Act provides comprehensive legal protection for foreign investors in Korea. Thailand also allows foreign investors to hold as much as 100 percent equity in domestic banks and finance companies for as long as ten years, while 39 industrial sectors have been opened to increased foreign participation. Majority foreign-owned companies (with the foreign investor holding more than 50 percent of the voting securities of the business) are now also allowed to distribute their products domestically.

In Malaysia, restrictions on foreign holdings in new export-oriented manufacturing projects have been suspended until 2000 and foreign ownership limits have also been relaxed. Indonesia has just begun implementing new incentives to attract foreign investors, increasing the maximum foreign ownership of banks to 99 percent, while the authorities have provided a clearer legal framework for the conversion of bonds issued locally into equity.

Since the financial crisis, cross-border mergers and acquisitions, as opposed to greenfield investments, have become the most important mode of FDI in the five crisis countries. Cross-border majority-owned mergers and acquisitions reached an annual average value of $12 billion in 1998 and 1999, as compared with $1 billion annually in 1994-1996. Opportunities for cheap acquisitions and a more liberal environment for FDI have attracted foreign investors. In addition to strengthening the rights of foreign investors, the crisis-affected countries have tried to simplify procedures for mergers and acquisitions, revamped their bankruptcy laws, introduced short-term tax measures to facilitate asset transfer, and improved accounting standards to ease asset valuation.

Trend of FDI, Crisis Countries, 1995-1999



Sources: UNCTAD (1999, 2000); IMF (1999c).

mediary operations. This retrenchment created a vicious circle in which heavily indebted but viable firms could not get credit. This, in turn, led to still more NPLs.

In some countries stricter regulatory and supervisory standards made matters even worse. In Thailand, for instance, banks became even more reluctant to lend as regulatory standards were tightened. This exacerbated the credit crunch, creating more business failures and deepening the recession. Regulatory changes in equity markets worsened the problem. Thailand's stock exchange introduced stringent requirements for new entrants, such as a minimum number of shareholders and minimum profits for several consecutive years, which most SMEs were unable to meet. Simultaneously, access to commercial banks and finance companies was drastically reduced.

Not only did the failure to synchronize the restructuring of banks and corporations worsen the region's recession, but it also left banks extremely fragile. The balance sheets of recapitalized banks could easily deteriorate again, depending on the outcome of corporate workouts. Although identifying all troubled firms and accurately forecasting how many will be able to survive the crisis are difficult, a comprehensive restructuring strategy based on a clear assessment of the corporate and financial sectors would avoid the costs of repeated bank restructuring.

Articulating Methods and Goals. While financial sector restructuring efforts benefited from a clear body of international experience, few precedents were available for corporate restructuring of the scale and type necessary. As a result, the process was confused. Policymakers did not understand why the so-called London approach was deemed appropriate for working out corporate debt, why it was so critical to reduce debt-equity ratios in the short term, or why certain corporate structures were considered superior. For instance, the breakup of the chaebols was deemed desirable, but reformers could not recommend what industrial organization should replace Korea's chaebol-dominated system.

Minimizing Damage to Credit System. A properly functioning credit system is the nerve system of an economy. It contains the most important financial and industrial information of the private sector. Once destroyed, this information is difficult to recreate. Similarly, corporations embody organizational and social capital that is also difficult to recreate quickly. Thus, to the extent possible, it is important to avoid damage to the credit system during bank restructuring and to minimize the erosion of social capital during corporate restructuring. Mergers and acquisitions are preferable to outright bank closure, and workouts are better than outright insolvency.

The crisis countries, however, did not adhere to these principles. Many financial institutions were closed in the early months of the crisis without adequate thought about how this would affect the credit system. Similarly, institutional and supervisory improvements, although well intentioned, further endangered the credit system by making it more difficult for banks to function. The countries did not, for instance, follow reform policies that would encourage mergers by liberalizing domestic laws to make foreign takeovers easier. In several cases, reform efforts undermined the rights of secured creditors.

Considering Local Circumstances. All the crisis countries relied heavily on voluntary, out-of-court settlements for corporate restructuring, the hallmark of the London approach. Given the absence of well-functioning bankruptcy courts, this was perhaps inevitable. Within this framework, however, the government was expected to play the role of mediator, facilitating an orderly resolution, while banks, as creditors, managed the workout. Given their undercapitalization and the heavy burden of NPLs, banks did not play their part, particularly in Indonesia and Thailand. The large role played by foreign-based accounting firms, consulting agencies, and investment banks also complicated matters. Naturally, these firms followed international standards for accountancy and due diligence, which were often more stringent than traditional local standards. The new and tougher criteria made it difficult for the lead banks and corporations to reach agreement on debt workouts. As a result, the London approach had only mixed success, and corporate reform has been slow.

Using Intermediary Institutions. The crisis countries had few intermediary institutions, such as investment banks, to facilitate mergers and acquisitions. Instead

commercial banks, which specialized in providing short-term working capital, led the corporate restructuring effort. Not surprisingly, results were disappointing. Instead of evaluating project viability and debt-service capability, commercial banks were more inclined to recover as much of their loans as possible, if necessary by foreclosing on assets clients had pledged as collateral. If they could not recover collateral, the commercial banks kept the NPLs on their books and continued to provide short-term emergency financing to avoid further losses.

Participating in Reform. Beyond these specific lessons for financial and corporate restructuring, broader lessons for reform can be learned. Perhaps the most important is the need for reforms to be "owned" by countries themselves. Only when a country owns a reform program does it act in a cost-effective manner that bears results. Korea stands out as a country whose reform program bore the hallmarks of ownership: committed and strong political leadership, inclusiveness, broad participation, and democratic decisionmaking.

THE NEXT STEPS: SHORT–TERM TASKS

The crisis countries have made significant, if intermittent, progress toward financial and corporate reform. However, there is much more to be done. The biggest risk facing the region is complacency. As markets recover and foreign investors return, the momentum for further reform is weakened. With the growing opposition from vested interests, the risks of backtracking are high.

Slowing or halting the reform process would have serious consequences: it would erode investor confidence, waste the enormous resources already expended, lose an invaluable opportunity to modernize Asia's financial and corporate sectors, and reduce the region's growth potential. The region has much to do, including strengthening the ongoing reforms and improving the governance process.

Strengthen Ongoing Reforms

The focus of the restructuring effort so far has been on resolving NPLs and recapitalizing weak financial institutions. Little attention, however, has been paid to disposing of those bad assets that were bought by or transferred to AMCs. The short-term reform agenda needs to focus on AMCs and disposing of their assets. It also needs to foster further improvements in the related regulatory environment.

All the crisis economies except Thailand established centralized government-supported AMCs, to which NPLs were transferred. By the end of 1999, two thirds of NPLs in Indonesia had been transferred to its Asset Management Unit. In Korea and Malaysia, the share was 50 percent. However, the proportion of NPLs actually resolved or disposed of is far lower (see table 1.4). In Korea less than 5 percent of NPLs held by the Korea Asset Management Corporation have been resolved, and the share is less than 1 percent in Indonesia and Malaysia. The vast majority of the NPLs are still carried on the government's books, at substantial fiscal cost.

Improving the regulatory framework can speed the resolution of the AMCs' portfolios. The purchase, transfer, management, and sale of assets must be easier. In particular, rules surrounding transfer taxes and recognizing losses from the sale need improvement. A second approach is to increase private sector participation in restructuring. This helps reduce the government's fiscal obligation and ensure that the AMCs are as commercial as possible. At the very least, operations need to be market-driven, efficient, and

Table 1.4 Operations of Asset Management Companies, Selected Crisis Countries, January 2000

Country	NPLs to AMCs		% NPLs disposed of
	% total	% GDP	by AMC
Indonesia	66	35	0.7
Korea	50	20	4.7
Malaysia	50	14	0.1

AMC Asset management company.
NPL Nonperforming loan.
Source: Staff estimates.

transparent. Encouraging direct private participation in AMCs would also be useful. All the AMCs increasingly are employing the expertise of private firms to value assets and develop disposal strategies. Malaysia is considering contracting out a proportion of its nonperforming assets to private management. In 1999, the Korean Asset Management Corporation announced plans to establish joint ventures with foreign investors to dispose of nonperforming assets. Each joint venture has about W300 billion in assets, with the foreign share at 65 percent. However, even with this foreign participation, asset disposal has been extremely slow.

Many aspects of the region's regulatory framework need further improvement. The most crucial is providing mechanisms that give early warning of pending trouble in financial institutions. Laws should require supervisory agencies to provide effective early warning mechanisms and take prompt corrective actions to minimize the risk of financial crisis. For example, when a bank's capital adequacy ratio declines, the bank should automatically fall under greater regulatory scrutiny with tight restrictions on its activities.

More broadly, prudential standards need improvement because they are well below international norms. Bankruptcy and foreclosure laws need to be amended to facilitate seizing debtors' assets and reduce the need to resort to the judicial process. Bank secrecy laws may need loosening to increase financial transparency and discourage the flow of corrupt funds into the region's financial centers. Given that financial and corporate activities are increasingly interrelated, an integrated approach to supervisory functions is needed.

Improve Governance

It is now widely recognized that poor governance was a major weakness in the region's financial and corporate sectors. Symptoms include intricate formal and informal relationships between governments, financial institutions, and corporations; inadequate disclosure requirements; and widespread corruption and favoritism. A major focus of the reform effort has been strengthening governance by improving market discipline and corporate governance, as well as introducing anticorruption and competition policies. Such reforms take time, however, as their goal is an entirely new corporate framework and culture.

With the assistance of multilateral financial institutions, notably the Asian Development Bank, the IMF, and the World Bank, the crisis countries have focused reform actions on increasing the transparency of economic and financial data, strengthening corporate disclosure requirements, increasing accountability to shareholders, strengthening competition laws, privatizing state-owned enterprises, dismantling state-supported monopolies and cartels, and restructuring opaque corporate relations.

The crisis countries have made significant progress toward improving corporate and financial governance. Rights of minority shareholders and broader stakeholders are better protected, and shareholders, including minority ones, are treated more fairly. Active cooperation between stakeholders and corporations is encouraged. Emphasis has been renewed on the responsibility of the board to give strategic guidance, monitor management effectively, and provide accountability to stakeholders. Disclosure of information, for instance, on a firm's financial status, performance, and ownership structure is now quicker and more accurate. In Korea, firms must provide consolidated financial statements. In Malaysia, individuals are restricted to a maximum of ten directorships in publicly listed companies, and firms are required to provide quarterly financial statements.

Despite this progress, more efforts are needed to establish a modern legal and regulatory framework, reduce the risk of bureaucratic and corruption-prone administrative procedures, reform the ownership structure of large business groups, adopt modern financial management techniques, and reduce corruption.

Corruption is a serious systemic problem in some countries. It can involve either monopolistic "crony capitalist" firms or the rent-seeking bureaucracies that extract bribes, called rents, in return for licensing privileges. Crony capitalist firms are best addressed through a well-designed privatization program. The rent-seeking corruption is more entrenched and more difficult to eradicate, and ill-planned efforts to do so could increase inefficiency. To mitigate these risks, governance reforms should be carefully formulated and implemented. Reforms must take into account a country's individual circumstances—its legal, judiciary,

and civil service systems; regulatory standards; corporate governance; and industrial organization—as well as its capacity to implement changes.

SOLVING PROBLEMS: THE LONGER-TERM TASKS

Before the onset of the financial crisis, the region's economies enjoyed strong fiscal positions, and budget surpluses were the norm. When the crisis first hit, fiscal policies were kept tight, but that has changed. All the crisis-affected countries have spent massive fiscal resources on financial restructuring, including buying NPLs, recapitalizing insolvent banks, and protecting depositors and creditors. Public spending also has increased to stimulate economic recovery and provide social safety nets for the poor and vulnerable. Fiscal deficits have risen substantially and public debt has accumulated (see table 1.5 and box 1.7).

Reduce Fiscal Imbalances

Debt accumulation was greater in Indonesia, Korea, and Malaysia, where the financial restructuring was government-led, than in Thailand, which adopted a market-based approach. Indonesia and Thailand, where restructuring is still at a relatively early stage, are likely to suffer large fiscal deficits in 2000 compared with precrisis levels. In Korea, Malaysia, and Philippines, deficits are unlikely to deteriorate further if domestic interest rates remain low and economic recovery continues.

Nonetheless, existing fiscal imbalance must be remedied over the medium term. Otherwise, economic recovery will be stymied as private investment is crowded out and debt-servicing requirements impede the public sector's infrastructure development. Thus, the countries should place high priority on reducing fiscal imbalances as soon as possible. They could generate additional revenues by privatizing nationalized banks and state-owned enterprises, and selling financial assets in the publicly owned AMCs. Attracting more domestic and foreign private investment into the ailing financial and corporate sectors also will help alleviate the fiscal burden. So, too, will more consistent efforts to recover defaulted bank loans through systematic investigations into corporations' uses of such loans.

To ensure equitable distribution of the restructuring burden, costs should be allocated to reflect the division of responsibility for the problem. If a financial institution's problems are due largely to government intervention in directing credit to particular borrowers, then the government should bear a larger part of the costs. If, however, banks' losses are largely due to their own commercial mistakes, bank shareholders and managers should absorb most of the costs.

Table 1.5 Fiscal Balance Before and After the Crisis: Crisis Countries, 1994-2000
(percentage of GDP)

Country	1994	1995	1996	1997	1998	1999	2000
Indonesia	0.4	0.6	0.2	0.0	-3.7	-2.3	-5.0
Korea	0.4	0.3	0.3	-1.5	-4.2	-2.9	-2.8
Malaysia	2.3	0.8	0.7	2.6	-1.5	-3.8	-2.0
Philippines	1.0	0.6	0.3	0.1	-1.8	-3.6	-1.8
Thailand	1.9	3.0	2.4	-0.9	-3.4	-3.0	-3.0

Note: Figures for 1999 and 2000 are staff estimates.

Source: Statistical Appendix.

Box 1.7 Fiscal Deficits, Public Debt, and Development Policies

A history of prudent fiscal policy meant that Asia's developing countries entered the financial crisis with extremely low public debt. The ratios of public debt to GDP in the crisis countries were around 20-30 percent at the end of 1997, compared with an average of 70 percent for Organisation for Economic Co-operation and Development member countries. Since then, however, the size of public debt has surged. Korea's public debt almost tripled from W37 trillion to W94 trillion between 1997 and 1999, even though it remained at a relatively modest 19 percent of GDP. In Thailand, the public debt-to-GDP ratio jumped from 6.3 percent in 1997 to 21 percent at the end of September 1999. Public debt was relatively stable in Malaysia, although at a somewhat higher level of 38 percent at the end of September 1999. By contrast, in Indonesia and Philippines, the debt-to-GDP ratio is expected to reach 95 and 58 percent, respectively, by the end of 2000 and 1999.

Excessive accumulation of public debt can affect financial markets and government's development effort adversely in three ways. First, if the central bank monetizes fiscal deficits, inflationary expectations and market interest rates will increase. Based on a study of 88 developing countries, the International Monetary Fund concluded that countries with higher fiscal deficits and public debt experienced higher monetary expansion and inflation (1990). Borio and McCauley (1996) also confirmed the existence of higher interest rates and a crowding-out effect in the bond market.

Second, if the government bond market is not developed (as in Asia's crisis countries), high level of public debt can impair the development of the financial markets. Because Asian bond markets are at their early stages, governments might be tempted to try to force financial institutions to purchase government bonds at higher prices. Such financial repression can restrict the portfolios of financial institutions and distort the market interest rate structure.

Third, government's development effort could be crippled. Interest payments on a large stock of public debt could constrain fiscal expenditure, and prevent governments from focusing on the improvement of public services and investments in physical and social infrastructure. Moreover, a rising interest burden can easily allow public debt to spiral out of control. It was this realization that led the major industrial countries to make fiscal consolidation a priority when their ratios of fiscal deficit to GDP reached 5-10 percent and ratios of public debt to GDP reached 50-60 percent.

Compared with developed countries, the ratios of public debt to GDP in Asian crisis countries are, on average, still low. However, this should not be a reason for complacency. Instead, each government should plan to initiate a fiscal consolidation exercise as quickly as possible.

Fiscal Balance and Money Supply Growth of Developing Countries, Ranked by Inflation Rates, Various Years (percent)

Economy	Average fiscal balance/GDP	Average money supply (M2) growth
Developing countries: 1983-1989		
28 countries with less than 6% inflation (average 3.2%)	-4.8	9.8
31 countries with 6-15% inflation (average 9.3%)	-5.5	15.4
29 countries with more than 15% inflation (average 84.8%)	-6.9	81.9
Selected DMCs: 1980-1998		
5 countries with less than 6% inflation (average 4.3%)	0.3	16.5
11 countries with 6-15% inflation (average 9.6%)	-5.0	20.8
5 countries with more than 15% inflation (average 37.1%)	-5.8	60.3

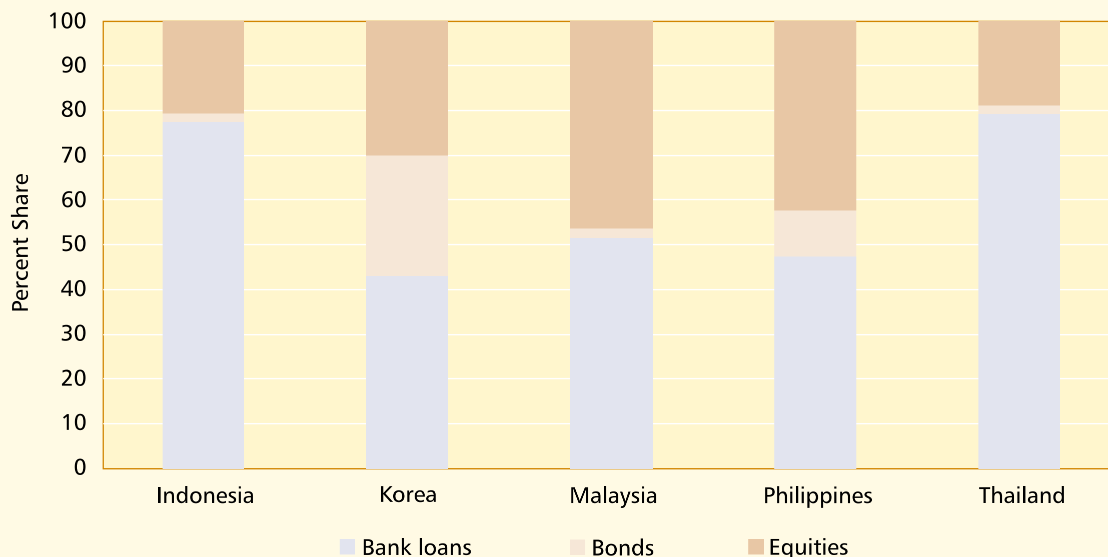
DMCs Developing member countries.
Note: Selected DMCs exclude the Central Asian republics and the Pacific DMCs.
Sources: IMF (1990); ADB data.

Fiscal Balance and Development Performance of Selected Economies, 1981-1999 (percent)

	Fiscal balance/GDP	GDP growth rate	Inflation rate
NIEs	0.7	7.1	5.0
India	-6.7	6.0	9.1
Pakistan	-6.8	5.4	8.5
Sri Lanka	-11.2	4.7	11.6
Argentina	-2.3	2.1	414.1
Brazil	-7.3	2.5	602.2
Mexico	-4.8	2.7	45.2

NIEs Newly industrialized economies.
Note: The three Latin American countries cover 1980-1998; their fiscal balance/GDP covers 1980-1997.
Source: ADB data.

Figure 1.10 Composition of Financial Assets, Crisis Countries, 1998



Sources: Based on data from BLOOMBERG; Monetary authorities' statistics.

Develop Financial Markets

It is generally agreed that one of the major causes of the region's financial crisis was excessive reliance on short-term bank loans from abroad to facilitate long-term investments at home and abroad. Asian finance has traditionally been overwhelmingly bank-based, and that must change (see figure 1.10). An important lesson from the crisis is that it is urgent to develop domestic financial markets that can efficiently allocate domestic savings to long-term projects. Therefore, the crisis countries need to modernize and develop their capital markets, particularly bond markets, and maximize the efficiency with which long-term savings are channeled into profitable industrial and infrastructure projects.

A financial sector development strategy is a useful way to prepare for this kind of fundamental change. The strategy should aim to ensure greater diversification and market orientation in the financial sector by increasing operational efficiency, developing human resources, maximizing synergy between various subsectors, and facilitating resource mobilization. It should cover the banking sector, nonbank credit institutions, insurance sector, capital markets, and newer financial institutions such as venture capital entities. Thailand has begun working on a long-term blueprint for the structure of the overall financial sector.

All types of long-term financial markets—equity, bond, and insurance—need to be fostered. However, bond markets deserve particular attention because they have long been neglected, while efforts at developing equity markets began long before the crisis. Bond markets were underdeveloped for several reasons: persistent government surpluses meant that the region's countries had little, if any, outstanding government debt. Therefore, there was no benchmark yield curve of returns on safe government debt, mak-

ing it difficult to price other bonds. The investor base for bonds was limited; the market infrastructure was inadequate. Moreover, weak corporate governance and underdeveloped regulatory and supervisory arrangements reduced the attractiveness of corporate bonds. As a result, the markets for corporate bonds and asset-backed securities were particularly stunted. According to a 1999 survey by the Asia-Pacific Economic Cooperation Council, outstanding bonds in member countries, excluding Japan and the United States, on average represented only 34 percent of GDP. Once Japan and the United States were included, the average rose to 105 percent.

Given the rudimentary nature of domestic bond markets, a gradual approach is desirable. First, the market for primary government securities issues must be developed. Then a secondary market for these issues should follow, and corporate bond markets will develop. In 1999, Asia-Pacific Economic Cooperation provided guidelines to facilitate the development of domestic bond markets in member countries (see box 1.8).

CONCLUSION

The financial sector was the weakest link in Asian economies. Excessive government intervention, overreliance on banks, and pervasive crony capitalism hampered innovation and distorted incentives. Sustainability of the region's short-term recovery, as well as its long-term economic future, rests largely on how effectively and comprehensively the financial and corporate sectors can be restructured. This will first entail cleaning up from the crisis. Corporate restruc-

Box 1.8 Recommendations for Developing Bond Markets

In August 1999, Asia-Pacific Economic Cooperation presented policy recommendations for the development of domestic bond markets, which focused on five key areas: government policies, regulatory framework, market infrastructure, liquidity, and risk management. Government policies were to emphasize these elements: (a) striking a balance between sovereign debt management policy and a strategy for domestic bond market development; (b) developing a comprehensive bond market development strategy; (c) creating a sound legal framework; (d) ensuring a level playing field with consistent tax policies for all financial instruments and market participants; (e) maintaining consistency between the bond market development strategy, fiscal and monetary policies, and the financial sector development strategy; and (f) using a phased approach to the bond market development.

On the regulatory framework, the report emphasized several issues: (a) full, timely, and accurate disclosure of information; (b) objective criteria to differentiate between public offering and private placement and to distinguish sophisticated institutional investors from other investors; (c) good governance principles for institutional investors and contractual savings institutions; (d) clarity in the roles, responsibilities, and objectives of the regulatory authorities; (e) transparency in trading and price reporting; and (f) sound criteria for external credit assessment institutions.

The report made important suggestions on market infrastructure, liquidity, and risk management. To develop market infrastructure, it is essential to ensure clear rules and procedures that can be legally enforced, create an effective regulatory regime and risk-management procedures, and provide relevant information to participants on a timely basis. To ensure the liquidity of domestic bonds, it is crucial to have accurate and reliable benchmark yield curves, transparency in the primary and secondary markets, low transaction costs, diverse groups of market participants, and the gradual creation of derivatives markets.

To promote effective risk management, the report proposed identifying risks of the bond program, maintaining a debt profile, risk sharing between government and private issues, ensuring sound investment and risk management policies by bond investors, preventing issuance through unregulated channels, avoiding overreliance on credit rating, keeping credit rating agency assessments, and keeping credit rating agencies credible.

Source: APEC (1999).

turing, especially, must be accelerated, while nonperforming assets must be disposed of. At the same time, the crisis countries must pay more attention to the foundations of their future financial system. A 21st century financial system requires a different role for government. The public sector can and must play an important role in overcoming coordination failures and setting regulatory standards, but it should not become directly involved in allocating capital. A diverse and largely private financial system within a well-constructed regulatory and supervisory framework allocates resources most efficiently and safely. The region's prosperity depends on how quickly and effectively such a financial system can be created.