


# Financial Restructuring in East Asia: Halfway There?

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## Summary

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**R**esolving systemic banking and corporate distress is no easy task. This paper reviews bank and corporate restructuring efforts in the four East Asian crisis countries—Indonesia, Republic of Korea, Malaysia, Thailand—and identifies remaining priorities for reform. The analysis indicates that two years into the process, much has been done—but much remains to be accomplished. Although governments have spent substantial resources to clean up the balance sheets of financial intermediaries, restructuring is incomplete, much new capital is still needed, and for most intervened financial institutions new private owners have yet to be found. Progress on corporate restructuring is less advanced, and many corporations remain overindebted. Durable economic recovery depends on further progress in both areas. In particular, decisive improvements in the allocation of investible funds will require better-capitalized banking systems and deeper institutional reforms in financial regulation and supervision, corporate governance, and bankruptcy procedures. ■




## ***Acknowledgment***

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## Introduction

### ***The East Asian financial crisis is no different from other crises in origin, but it is much larger in scale and more complex***

The causes of the East Asian financial crisis were not very different from those underlying banking crises elsewhere. But the East Asian crisis is unusual given the depth of the region's financial systems and the large distress arising from corporations with high leverage, rather than the more typical weak real estate markets. Private claims exceed GDP in most East Asian countries, and corporate distress—as measured by nonperforming loans relative to GDP—is significantly higher than in other crises. International experience indicates that dealing with bank and corporate debt overhang is always a long process: after a banking crisis it takes an average of three years for an emerging market economy to return to pre-crisis economic growth. But given the magnitude of financial claims to be restructured and the scale of corporate distress, the recovery in East Asia could take even longer. Moreover, restructuring corporations is much more difficult than restructuring real estate projects, and often has important social implications.

### ***Not surprisingly, bank and corporate restructuring is still a work in progress***

*Banks remain inadequately capitalized in all countries.* Government responses and progress on financial restructuring have varied considerably. Authorities in Korea and Malaysia have moved relatively aggressively to strengthen their banking systems through injections of public funds (with little conditions attached), nationalizations, removal of bad debts, and mergers. Thailand has given banks a transition period to raise capital and offered public funds with tight conditionality attached. Indonesia has a public recapitalization program in place, but bank restructuring has only just begun. While banks appear most financially solid in Korea and Malaysia (thanks to government injections of capital), more adequate provisioning for nonperforming loans may reveal further capital shortfalls. The situation is worse in Thailand and Indonesia (Table 4, page 15). Foreign investment in banks is unlikely to cover these capital needs. In Korea and Malaysia banks may be able to cover their capital shortfalls from retained earnings in a reasonable period. But this is not the case in Indonesia and Thailand: already distressed borrowing firms would not be able to afford the required spreads (twice those at present) on interest rates.

*Allowing banks to grow out of the crisis is risky.* While governments could decide to let banks fend for themselves, this approach would entail risks. Self-recapitalization makes banks less willing to absorb losses and so hinders corporate restructuring. It also limits corporate lending because capital-constrained banks shift assets into government securities, impeding economic recovery. Moreover, the lower deposit and higher lending rates needed to widen banks' net interest rate spread taxes borrowers and depositors. And as international experience has shown, an undercapitalized financial sector can inspire banks to finance risky but

potentially high-return projects in attempts to restore capital. In Indonesia the only options for the remaining private banks might be to hold government bonds or pursue risky lending in desperate attempts to survive. Neither approach will lead to sustainable corporate growth.

*Progress with corporate restructuring is gathering speed.* In most of the crisis countries corporate distress peaked in 1998. Since then stronger operational cash flows, lower interest rates, and more favorable exchange rates have eased financial distress (except in Indonesia)—though it remains high. Data for the first half of 1999 indicate that 27 percent of Korean, 26 percent of Malaysian, and 28 percent of Thai publicly-listed firms cannot fully cover interest payments from operational cash flows. Indonesian public corporations are much worse off: 64 percent cannot cover their interest payments.

*Many corporations are unlikely to grow out of their problems, especially in Indonesia.* Although higher economic growth has reduced corporate distress, more restructuring is needed. With current growth projections and current low interest rates, a quarter of Thai corporations and more than half of Indonesian corporations would still not be able to cover their interest expenses by the end of 2002. And if interest rates return to their historic, higher levels, the share of distressed firms will be even higher, unless real economic growth increases significantly. Korean and Malaysian companies have a more favorable outlook, because Korean companies have experienced large improvements in cash flows and Malaysian companies entered the crisis with lower financial leverage.

*Growth in public debt may constrain recovery.* Combined with the balance sheet pressures in the private sector, higher public debt burdens could constrain economic recovery (the W-shaped recovery scenario). Financial sector restructuring costs are high, with market sources estimating adding 15–50 percentage points of GDP to public debt. If all financial restructuring costs fall on the public sector, public debt levels will rise sharply—and could reach close to 100 percent of GDP in Indonesia. While interest payments on debt range (at present interest rates) between 6 and 14 percent of fiscal revenues in Korea, Malaysia, and Thailand, they are above 90 percent in Indonesia. Fiscal pressures are a new experience for East Asian countries, and raise the question of whether a debt overhang will make potential investors (foreign and domestic) less willing to commit resources, thereby hindering growth prospects.

### ***Institutional reforms need to go deeper***

*Institutional reforms in the financial sector have not gone far enough.* While many weaknesses in financial sector regulation have been addressed, specific areas—such as loan classification and provisioning guidelines—still trail international best practice (Table 11, page 26). More needs to be done to tighten the rules for dealing with weak financial institutions (a factor contributing to the crisis). And further improvements are needed in the governance structure of banks to assure that public resources are used most productively.

*Corporate governance rules have improved but are not fully enforced.* Much debated as a major cause of the crisis, the rights of minority shareholders have been formally improved in all countries. But enforcement of these rights is weak. Although Indonesia, Korea, and Thailand have passed new bankruptcy and collateral laws, creditor rights have improved only marginally. And while judicial efficiency has improved, it remains weak in Indonesia.


### ***The state needs to divest quickly the many assets it has acquired***

*Restructuring has meant a bigger role for the state.* Countries now have fewer financial institutions and more concentrated financial sectors. They also have higher state ownership as a result of government interventions in weak financial institutions. Increased state ownership extends to corporate sectors as well. Altogether, the state controls an average of 50 percent of financial system assets, and in Indonesia the state controls more than 70 percent of corporate assets. Governments have had limited success in selling off such assets: only four intervened banks have been sold, and on average only 2 percent of corporate assets have been sold. While foreigners now play a larger role in corporations, most notably in Korea, entry in the financial sector has been limited—with just four foreign banks so far—and many family-controlled banks and conglomerates seem set to survive. Moreover, links between nonbank financial institutions and the corporate sector have not been severed in Korea. The continued concentration of corporate control in the hands of a few families, and the strong political connections of these families, may continue to hinder deep institutional reforms.

*Governments will need to accelerate divestitures.* While a large role of the state was beneficial at the early stages of the crisis, a continued large role of government in the real sector would be inconsistent with the crisis countries' goals of market-based resource allocation. Governments could signal their desire for greater private involvement by sharing losses on the nonperforming loans of banks and letting the private sector acquire defunct assets to work out. Retrenchment of the state should proceed carefully, however. Overly rapid privatization of intervened banks may lead to larger ownership by a few families and increased (indirect) links between banks and corporations. Moreover, countries would want to divest with the aim of changing the governance of the financial and corporate sectors so that resources will be more efficiently allocated in the future. Divestiture through private, strategic investors will likely remain limited, however, and governments need to consider alternatives. In some countries this may mean moving to a more fully funded pension scheme to create institutional investors that can provide independent oversight to the corporate and financial sectors. In other countries corporate restructuring funds could be created to acquire ownership stakes now held by banks or the state, allowing companies to remain publicly owned but become privately managed. Such strategies would make short-term restructuring efforts work toward a desirable paradigm change.

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*Accelerating restructuring may require more public funds and deeper institutional reforms.* Governments could enhance the sticks and carrots for bank and corporate restructuring by, for example, requiring financial institutions to be more realistic in their restructuring and make proper provisioning for restructured loans. Making more public funds available for bank recapitalization can speed up corporate restructuring and hasten the recovery. It requires, however, adequate burden-sharing and adopting deep institutional reforms to prevent a recurrence of the crisis.



## Was the East Asian Crisis Unique?

The East Asian crisis began in Thailand in mid-1997, when an ailing financial sector, an export slowdown, and large increases in central bank credit to weak financial institutions triggered a run on the baht. The crisis then spread to other countries in the region as common vulnerabilities and changes in international sentiment triggered large capital outflows.

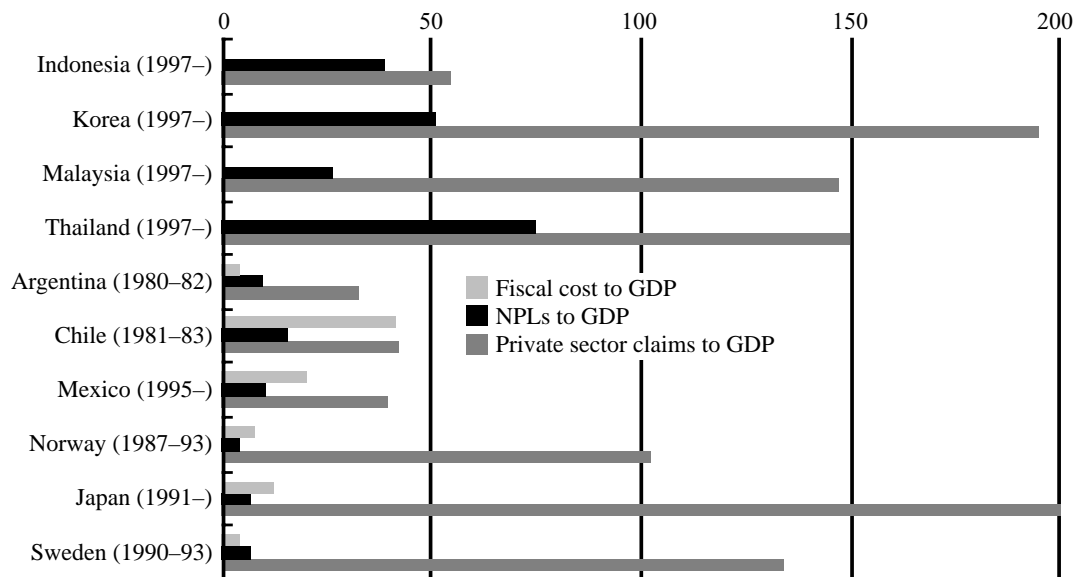
### Views differ on the causes of the crisis

Whether these sudden shifts in market expectations and confidence were the primary source of the financial turmoil has been hotly debated.<sup>1</sup> Proponents of the “sudden shift” view argue that while macroeconomic and other fundamentals had worsened in the mid-1990s, the extent and depth of the crisis cannot be attributed to a deterioration in fundamentals but rather to the panic reaction of domestic and foreign investors (Radelet and Sachs 1998; Stiglitz 1999). Others argue that the crisis reflected structural and policy distortions in the region—including weak macroeconomic policies—and that fundamental imbalances triggered the crisis

Figure 1

### East Asia's crisis is of a larger scale than many other crises

Percent



Source: Caprio and Klingebiel 1999; IMF, *International Financial Statistics*. The years in parenthesis indicate the financial crisis episode depicted here. Private sector claims include claims on nonfinancial entities of deposit money banks and other financial institutions. Note non-performing loans (NPLs) figures are peak NPLs during the crisis.

1 Nouriel Roubini's website, <http://www.stern.nyu.edu/~nroubini/asia/AsiaHomepage.html>, tracks the literature on this debate.

(Corsetti, Pesenti, and Roubini 1998). This group includes those who have pointed to weak corporate governance and the risky investment strategies of corporations as causes of the crisis (Johnson and others 1998; Krugman 1999; Claessens, Djankov, and Ferri 1999). In the final analysis, the causes of the crises most likely lie with foreign panic, interacting with misguided macroeconomic policies and structural weaknesses in the financial and corporate sectors (Alba and others 1999; Caprio and Honohan 1999; Harvey and Roper 1999).

***Though its origins were similar to those of other crises, the East Asian crisis is different in scale***

While the debates on the exact causes of the crisis will continue, it might be more informative to ask whether the East Asian crisis was systematically different from previous financial crises. Cross-country comparisons show that the causes of the East Asian crisis were not too different from those underlying other financial crises (Honohan, Klingebiel, and Molinari 1999). What makes East Asia's crisis unique is the depth of the region's financial systems and the high leverage of its corporations. In Korea, Malaysia, and Thailand private sector claims equal or exceed 140 percent of GDP (Figure 1). And because of the high leverage, corporate distress—as measured by the share of nonperforming loans in GDP—is much higher. Moreover, East Asian economies are dominated by banks, which has made it difficult for corporations to find alternative sources of funding.

## A Steep Decline and Rapid Recovery

GDP growth in East Asia's crisis countries turned sharply negative in 1998 (Table 1). The steep decline in output was driven by a severe drop in private capital investment and to a lesser degree by a reduction in private consumption. The largest drops in investment occurred in Indonesia and Malaysia. In addition, declining inventories played an important role in Korea's GDP reduction.

For most of the crisis countries, exports were stagnant in 1998. Although export volumes increased, prices were depressed through much of the year, and in value terms exports started to increase only in 1999. With imports contracting sharply in all countries, higher net exports contributed the most to mitigating the GDP decline—10 percentage points on average. By mid-1998 most countries had achieved macroeconomic stability, with exchange rates stabilizing and interest rates starting to decline. By the end of 1998 interest rates in all countries except Indonesia were below pre-crisis levels.

### ***The supply of savings may not be constraining growth, but limited intermediation and demand are***

Conditions improved considerably in the second quarter of 1999, with all four crisis countries returning to GDP growth—ranging from 0.2 percent in Indonesia to 3.7 percent in Malaysia and 6.6 percent in Korea (on an annualized basis; see Table 1). While interest rates have declined, lowering the costs of capital for corporations, the recent recovery has not been led by a rebound in capital investment. Exports have picked up, with a substantial part of the increase in export values due to cyclical price effects. Private consumer demand is projected to be the most important determinant of growth, followed by inventory rebuilding and increased public spending.

Table 1  
**Demand factors in changes in real GDP, 1998–99**  
Percent

Variable	Indonesia		Republic of Korea		Malaysia		Thailand		Average	
	1998	1999	1998	1999	1998	1999	1998	1999	1998	1999
Change in GDP	-13.7	0.2	-5.8	6.6	-6.7	3.7	-8.0	2.5	-8.6	3.1
<i>Contribution to change in GDP</i>										
Domestic final sales	-16.1	-0.8	-12.4	3.3	-27.1	3.3	-12.0	0.9	-16.9	1.5
Private consumption	-1.8	0.8	-5.2	3.2	-5.5	1.6	-3.0	1.0	-3.9	1.5
Public consumption	-1.0	0.1	0.0	-0.2	-0.5	1.6	0.4	0.3	-0.3	0.4
Gross fixed capital formation	-13.2	-1.7	-7.3	0.3	-21.2	0.1	-9.4	-0.4	-12.8	-0.4
Change in stock	-2.3	-9.4	-5.6	11.0	0.4	0.3	-0.3	4.1	-2.0	1.5
Net exports	4.7	10.4	12.2	-7.6	20.0	0.1	4.3	-2.5	10.3	0.1

Source: Deutsche Bank data; 1999 Annual Consensus Forecasts (July 1999).

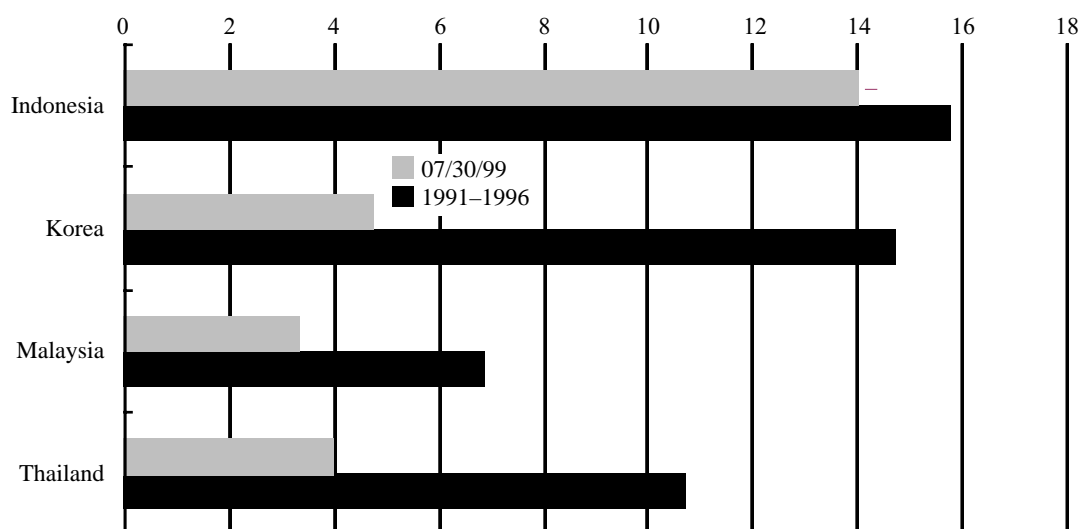
The lack of recovery in capital formation stands in contrast to the region's historical reliance on investment as an important determinant of growth. Investment is expected to remain below historical levels in the near future, partly because of constraints on the supply of financing, the absence of creditworthy borrowers and excess capacity. Real growth rates of bank credit to the private sector are still negative in all countries except Korea, with Indonesia the most adversely affected (because banks have lent to the government instead of corporations, and because high inflation has sharply reduced the real value of credit).

Interest rates are at historic lows—July 1999 interest rates were less than half those of 1991–96 in Malaysia and Thailand and one-third in Korea (Figure 2). Thus the supply of domestic savings has been ample, but the lack of willingness of financial intermediaries to lend has constrained investment. While it is too early in the recovery to expect a sharp increase in investment, also as capacity is often in excess, going forward, sustained growth will depend on whether supply factors have been sufficiently addressed and whether corporate restructuring has been adequate to foster financially viable corporations.

Figure 2

**Liquidity has been ample in most countries**

Nominal Interbank rates, percentage

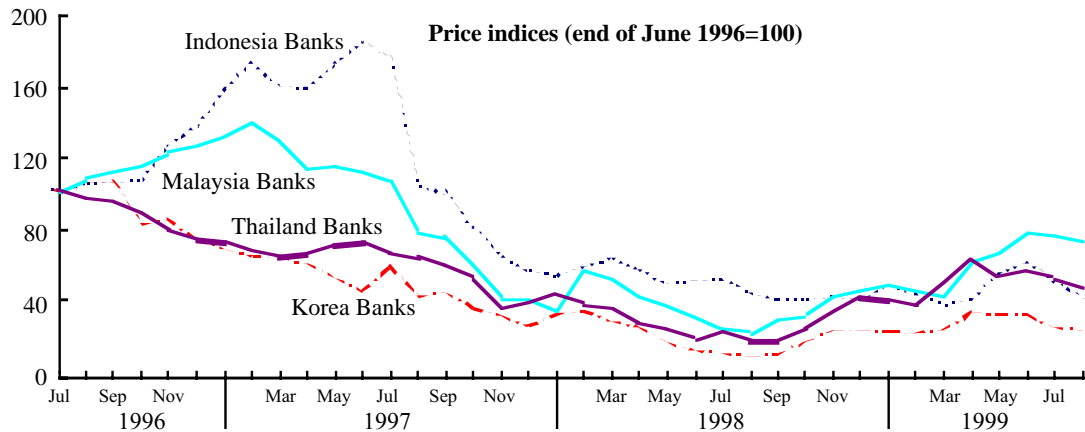


Source: J. P. Morgan, 1999.

Figure 3

**Stock prices of financial institutions have remained low**

Local currency, 1997–99



Source: Datastream data.

***Stocks markets look forward—and they may not like what they see***

Recent stock price movements for financial institutions' stocks appear to reflect concerns about progress in bank restructuring and the durability of the recovery (Figure 3). In the past stock prices appear to have overestimated prospects in the region, and neither the crisis nor the depth of the spring 1998 recession were well anticipated by stock markets. This disparity suggests that there can be a prolonged, systematic mismatch between changes in economic growth and restructuring, on the one hand, and equity price movements, on the other.

After an upswing in the first half of 1999, a correction may again be under way, as average banking stock prices in some countries remain more than 17 percent below their peak in early 1999—and financial institutions' stocks in Thailand are 36 percent below their 1999 highs. Markets may be weighing the risks of a W-shaped recovery.

***There are risks of a bumpy recovery***

The possibility of a bumpier—that is, W-shaped—recovery should not be surprising. As other countries show, recoveries from a banking crisis are often faltering (Caprio and Klingebiel 1997; Kaminsky and Reinhart 1998; BIS 1998). It takes an average of three years for GDP growth to return to trend after a banking crisis in an emerging market economy.

The parallel often drawn between East Asia's financial crisis and Mexico's 1995 banking and currency crisis might be misleading. Mexico experienced a sharp recovery following its balance of payments crisis, but its financial sector was much shallower and corporate distress much less pronounced than in East Asia (see

Figure 1). Moreover, Mexico had the considerable benefit of a solidly growing neighbor—the United States—which meant that the sharp depreciation of its currency could trigger high export growth. The working capital needs of Mexican corporations were often financed outside the country, mitigating the effect of its weak banking system on the corporate sector.

Given the depth of financial systems and the scale of corporate distress, recovery could take longer in some East Asian countries than in other crisis countries. There might be closer parallels between East Asia's crisis and Japan's drawn-out bank and corporate restructuring. Both the scale of the problem and the close links between banks and corporations suggest similarities. Japan's banking problems have continued for almost 10 years. Only recently was a comprehensive framework for dealing with banking problems adopted, including public funds to recapitalize the banking system and address banking sector weaknesses. But the reforms were long overdue, and many actions are still needed.

## Not Surprisingly, Financial Restructuring Remains a Work in Progress

As is typical in most financial crises, at first East Asian governments were slow to address financial distress (Waxman and Hunamalai, 1999). They tried to keep insolvent institutions afloat by injecting liquidity (Table 2)—and in doing so, incurred large fiscal costs. The delayed and sometimes partial response of governments led to financial turbulence and runs on financial institutions. Governments responded to the crisis in public confidence (Indonesia, Malaysia, and Thailand) or foreign currency outflows (Korea) by issuing unlimited guarantees on financial systems' liabilities. These guarantees stemmed the confidence crisis but weakened governments' need to act comprehensively.

### ***Korea and Malaysia have moved relatively aggressively to strengthen their banking systems***

Government responses and progress on financial restructuring have varied considerably. Korea has moved aggressively to strengthen its banking system through recapitalizations, nationalizations, removal of bad debt, and mergers. But the government has been less successful in addressing problems in the nonbanking sector (except for closing merchant banks). Of the 2,069 nonbank financial

Table 2

#### Financial distress resolutions and bank recapitalization strategies

	Indonesia	Republic of Korea	Malaysia	Thailand
<i>Initial government response</i>				
Substantial liquidity support	\$21.7 billion (17.6% of GDP)	\$23.3 billion (5% of GDP)	\$9.2 billion (13% of GDP)	\$24.1 billion (20% of GDP)
<i>Financial distress resolutions</i>				
Bank shutdowns	64 of 237	None	None	1 of 15
Shutdowns of other financial institutions	Not applicable	More than 117	None	57 of 91
Mergers of financial institutions	4 of 7 state banks to merge	11 of 26 absorbed by other banks	58 to be merged into 6 groups	3 banks and 12 finance companies
Nationalizations	12	4	1 and 3 finance companies	4
<i>Bank recapitalization strategies</i>				
Public funds for recapitalizations	Plan in place; some bonds issued	Government injected \$ 8 billion into 9 commercial banks; 5 out of 6 major banks now 90% controlled by state	Danamodal injected \$1.6 billion into 10 institutions	Plan in place; government injected \$8.9 billion into private banks and \$11.7 billion into public banks
Majority foreign ownership of banks	Allowed, 1 potentially	Allowed, 2 completed and 1 near finalization	Not allowed	Allowed, 2 completed and 4 pending
Weak financial institutions still in system	Many weak commercial banks	Many weak nonbank financial institutions	Difficult to assess	Some weak public and private commercial banks

Source: Ramos, 1999; World Bank data; local currency figures converted at mid-September exchange rates.

institutions, many of which are in weak financial condition, only 242 had stopped operations as of August 1999.<sup>2</sup> As a result the top five chaebol-affiliated investment trust companies have been able to continue to extend financing to their loss-making affiliates, mainly in the form of bonds with high interest rates sold to the general public as it moved out of low-yielding deposits. Of the \$34 billion in new funds raised by Korean corporations in 1999, more than half has gone to the top five chaebols. Of that capital, 7 percent was in the form of new equity, 32 percent was bank loans, and 61 percent was corporate bonds. The Malaysian government has also taken forceful actions, including forcing mergers of financial institutions, injecting public capital, and removing loans from banks' balance sheets.

### ***Thailand has taken a market-based approach, allowing banks to raise capital over a longer period***

The Thai authorities have moved aggressively on finance companies, closing two-thirds of them. In contrast, the government has given banks a transition period to raise capital through phased-in requirements for tighter loan provisioning. In addition, the government has offered banks tier 1 capital support—subject to the condition that any bank accepting public money satisfy certain stringent conditions, including meeting strict loan loss provisioning requirements and making management changes. This market-based approach ensures that public funds are provided only when shareholders have most of their capital wiped out. Some banks that need injections of fresh capital may, however, be tempted to delay their application for such assistance, thus prolonging the uncertainty over the health of the banking system. In fact, only two non-intervened private banks have accessed public funds. Instead banks have raised expensive capital on their own. Still, they remain substantially undercapitalized because of high levels of nonperforming loans.

### ***Indonesia's bank restructuring has recently begun in earnest***

Indonesia has only recently started putting its banking sector back on a sound footing. Most institutions remain insolvent or undercapitalized (Ramos, 1999; Deutsche Bank, 1999).

### ***Approaches to asset resolution have varied***

The crisis countries have also taken different approaches to asset resolution (Table 3). Authorities in Indonesia, Korea, and Malaysia have actively removed bad loans from banks and transferred them to centralized, government-owned and -managed asset management companies. The Indonesian government has transferred \$28 billion of the assets of closed banks and the worst loans of intervened and state

2 Of these, 44 were merged, 144 were liquidated, and 44 had their licenses suspended. Nonbank financial institutions include merchant banks, securities firms, investment companies, mutual saving and finance companies, credit unions, and leasing companies.

Table 3

**Asset resolution strategies**

Strategy	Indonesia	Republic of Korea	Malaysia	Thailand
Set up centralized asset management company to which banking system's nonperforming loans are transferred	Yes. Asset management unit has accumulated \$28 billion of assets.	Yes. Kamco has accumulated \$37 billion assets.	Yes. Danaharta has purchased \$11 billion of assets.	No. The workout of nonperforming loans is decentralized. One large bank has established a private asset management company, and more private asset management companies are being considered
Centralized asset management companies purchase assets at subsidized prices	Yes	Initially assets were purchased above market-clearing prices with recourse. Since February 1998 purchases have been attempted at market prices	Purchased assets are valued by independent outside auditors	Not applicable
Nature of agency: restructuring or disposition	Unclear	Not clearly defined. Mostly engaged in disposing of assets	Restructuring	Not applicable
Type of assets transferred	Worst assets	No particular strategy	Loans larger than 5 million ringgit and mostly loans secured by property or shares	Not applicable
Assets transferred	66% of nonperforming loans, equal to 35% of GDP	26% of nonperforming loans, equal to 10% of GDP	50% of nonperforming loans, equal to 14% of GDP	Not applicable
Assets disposed of as share of total assets transferred	0.7%	4.7%	0.1%	Not applicable

Source: Barents Group, 1999; World Bank data; authors' calculations.

banks—equivalent to 66 percent of the banking system's nonperforming loans—to the Indonesian Bank Restructuring Agency. The Korea Asset Management Corporation (KAMCO) purchased about 26 percent of nonperforming loans (worth \$37 billion) at an average of 45 cents to the dollar. Malaysia's Danaharta asset management company has bought 50 percent of nonperforming loans (worth \$11 billion) at discounts of 30–50 percent. In all three countries the transfer of assets has substantially reduced nonperforming loans (Figure 4). Thailand's government has left the responsibility for loan workout and asset recovery with banks.

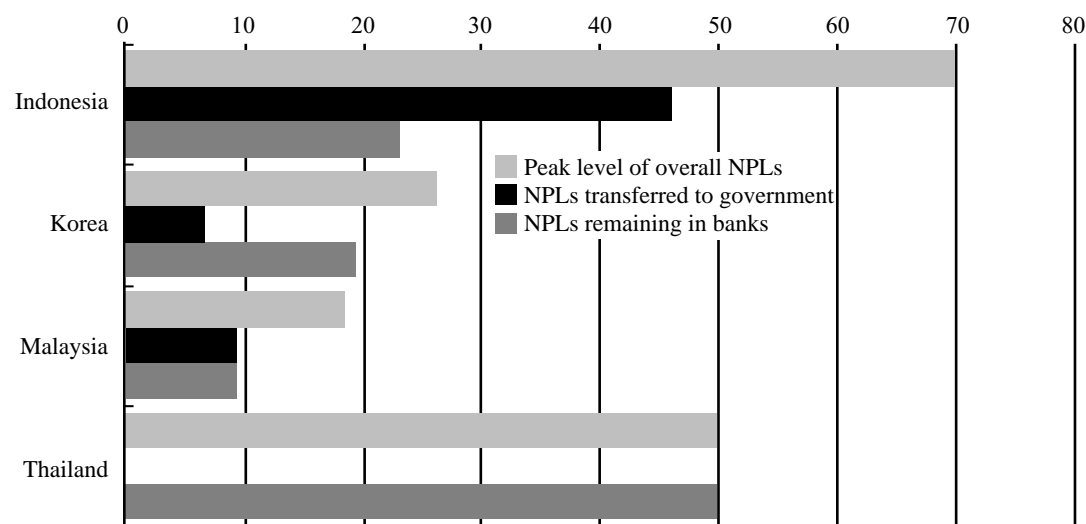
### ***Still, banks remain inadequately capitalized***

Although governments have made significant strides and spent substantial resources to clean up their financial systems, banks remain inadequately capitalized as their main clients, corporations, remain financially distressed. This judgment is based on an assessment that loan-loss provisioning will prove inadequate. Bank capital levels appear most solid in Korea and Malaysia due to

Figure 4

### Transfers to government have lowered NPLs of banks, but not reduced overall NPLs

Percent of total loans



Source: Goldman Sachs, 1999; Barents Group, 1999; authors' estimates.

government injections of capital, but banks in both countries would still be undercapitalized if they were to provision adequately (Table 4). Banks in Indonesia and Thailand are worse off. Thai banks have raised more than \$11 billion in new capital in two rounds—about half of it from the government—yet still have a substantial capital shortfall (Table 4). Whether they will be able to raise more capital in a third round is questionable, also in light of the recent decline in bank stock prices. Indonesia's capital shortfall is the most severe of the four crisis countries, another indication that bank restructuring has just begun.

### ***Could banks grow out of their troubles?***

If banks were to try to recapitalize from earnings, interest rate spreads would have to rise. Because banks cannot raise spreads for all borrowers simultaneously (since not all borrowers can pay), this approach would end up taxing profitable and performing borrowers because they would have to bear the brunt of the higher lending rates.

Given current levels of capital, loan loss provisioning, and nonperforming loans remaining in banks, spreads in Korea and Malaysia would be relatively close to historical levels. Thus these banks may be able to cover their capital shortfalls from earnings (see Table 4). Because their capital shortfalls are so large and solvent borrowers so few, Indonesian and Thai banks are unlikely to be able to recapitalize from earnings. Net interest spreads would have to increase by 2.2 percentage points in Thailand, significantly above historical spreads. And despite the fact that two-thirds of nonperforming loans have been removed from banks'

Table 4

**Assessing banks' ability to grow out of their nonperforming loans**

Percentage of banking system assets unless noted otherwise

Indicator	Indonesia	Republic of Korea	Malaysia	Thailand
Current nonperforming loans	34.1	15.9	17.9	27.9
Current loan loss provisions	6.1	2.7	1.9	3.9
Net impaired assets	28.0	13.2	16.0	24.0
Current capital	-15.1	-1.0	1.8	-4.5
Capital shortfall <sup>a</sup>	18.5	4.0	1.7	8.1
Required net interest spread to reach 8% capital adequacy ratio in three years (percentage points)	8.5	2.1	2.0	5.0
Historical net interest spread (percentage points)	4.0	2.0	2.6	2.8
Required net interest spread as share of historical net interest spread (percent)	212.0	105.0	75.0	178.0
<i>Memorandum items</i>				
Capital shortfall (billions of U.S. dollars) <sup>a</sup>	15.0	41.0	4.0	18.0
Capital shortfall as share of 1998 GDP (percent) <sup>a</sup>	12.7	10.7	5.5	15.4

a. Assumes a 40 percent recovery rate on nonperforming loans, a constant ratio of loans to deposits, and loan growth in line with GDP growth. The capital shortfall is applied to the entire banking system. The calculation on loan loss recovery and growing out of the crisis assumes that the corporate sector will be able to cover the increased interest spread margin.

Source: Ramos, 1999; JP Morgan, 1999; Goldman Sachs, 1999; Deutsche Bank, 1999.

balance sheets, Indonesian banks would have to earn net spreads of 8.5 percentage points—more than twice their historical level—to achieve adequate capital levels within three years.

Governments could let banks fend for themselves, but that strategy entails substantial risks, as international experience has shown (for example, the Savings and Loan crisis in the US). While Korean and Malaysian banks may be able to recapitalize themselves, the process could have negative repercussions on lending, with capital-constrained banks shifting their asset base from loans to government securities. Although a shift into government securities would lower interest rates for the public sector, it mean less lending to corporate borrowers. In Indonesia undercapitalized banks could pursue risky lending in desperate attempts to survive. In addition, capital-constrained banks in all four crisis countries could impede corporate restructuring because they have limited abilities to absorb losses and so are reluctant to engage in substantial financial restructuring.

### ***Banks' governance structures may impede their ability to grow out of their problems***

While Korean and Malaysian banks may be able to grow out of their problems (though with associated risks), it is unclear whether today's bank management and governance structures would support that strategy (Laeven, 1999). Korea and Thailand have made some changes in management; Indonesia and Malaysia appear

to have made less. Moreover, few improvements have been made in the governance framework of banks, with only Korea revamping its corporate governance framework (Table 5).

Table 5

### Changes in the corporate governance and management of banks

Country	Corporate governance		Management	
	Independent outside directors	Changes in top management in majority-owned domestic banks	Performance-based pay	Hiring of foreign experts in domestic banks
Indonesia	None	None	None	None
Republic of Korea	Two-thirds of board seats occupied by outside directors	In 6 of the 11 major banks	Being introduced	Frequent
Malaysia	In place	In 1 of 33 bank	Limited	Rare
Thailand	In place	In 3 of 11 banks	Limited	Frequent

Source: Ramos, 1999; World Bank data.

## Corporate Restructuring Is Gathering Speed

The state, represented by asset management companies, is an important holder of corporate assets in Indonesia, Korea, and Malaysia (see Table 3) and could be the agent in restructuring. But asset management companies have not yet disposed of many assets, and in any case, global experience indicates that these companies tend to be weak at corporate restructuring (Klingebiel 1999). Only in one (Sweden) out of nine cases was a publicly-owned asset management company effective in large-scale corporate restructuring. In Korea commercial banks were initially designated to be the agents of change. But since many of the banks became state-owned, and given the size of the problem, the government has effectively provided leadership. In particular, the Financial Supervisory Commission has issued guidelines on restructuring, instructed banks to establish workout units, and directed large chaebols to shed subsidiaries and lower their leverage.

Thailand, by contrast, has adopted a market-based approach, leaving private commercial banks to take the lead on restructuring. In Malaysia corporate restructuring has proceeded with a mix of government (through Danaharta) and private sector involvement. Indonesia has yet to clearly identify agents of change.

### *Out-of-court systems prevail*

All four crisis countries have complemented their frameworks for corporate reorganization and asset resolution for large corporations with out-of-court, extrajudiciary systems. Indonesia established the Jakarta Initiative, Korea the Corporate Debt Restructuring Committee, Malaysia the Corporate Debt Restructuring Committee, and Thailand the Corporate Debt Restructuring Advisory Committee. These committees and associated restructuring processes generally rely on the so-called London rules—principles for corporate reorganization first enunciated in the United Kingdom in the early 1990s. Since the London rules were not designed for systematic corporate distress, countries have tried to tighten them in various ways.

Country approaches to corporate restructuring and asset resolution have three important features. First, whether all (or most) financial institutions have signed on to the accord under regular contract or commercial law. If so, agreements reached among the majority of creditors can be enforced on other creditors without going

Table 6

### Features of out-of-court corporate restructuring, as of mid-1999

Feature	Indonesia	Republic of Korea	Malaysia	Thailand
All or most financial institutions signed on to accord	No	Yes	Yes	Yes
Accord provides for formal arbitration with deadlines	No	No	Yes	Yes
Accord imposes penalties for noncompliance	No	Yes	No	Yes

Source: World Bank.

through formal judicial procedures. Second, the approach is affected by whether formal arbitration with specific deadlines is part of the accord. Without such arbitration, an out-of-court system has to rely on the formal judicial process to resolve disputes—with associated costs and delays. And third, the approach depends on whether the accord specifies penalties that can be imposed for failure to meet deadlines. Based on these criteria, the framework in Thailand, followed by those in Korea and Malaysia, appear to be conducive to out-of-court restructuring. The framework in Indonesia is not (Table 6).

### ***Other incentives for corporate restructuring could be strengthened . . .***

While countries have made bankruptcy procedures more efficient—by, for example, establishing special bankruptcy courts—judicial systems remain weak, especially in Indonesia (Claessens, Djankov, and Klapper, 1999). In all four countries rules for classifying and provisioning troubled debt provide limited incentives for banks to engage in deeper restructuring. Few of the crisis countries require banks to assess repayment capacity in their lending operations, and all four countries allow restructured loans to be upgraded immediately after restructuring. Globally, the more common standard is to upgrade only after several payments have been received and the financial viability of the borrower has been assured. As a result banks in the crisis countries have incentives to engage in cosmetic restructuring, including generous reschedulings.

### ***. . . but progress is encouraging***

The amount of claims registered and actually restructured in formal out-of-court procedures indicates progress on corporate restructuring (Table 7). Indonesia has had the least success, with debtors and creditors having reached standstill agreements or agreements in principle on only 13 percent of debt.<sup>3</sup> Korea and Malaysia have done the most out-of-court restructuring, with about a third of debt restructured. The depth of restructuring in Korea has been limited, however. About 65 percent of workouts have featured interest rate reductions, capitalization of interest, and deferral of principal, with very little conversion of debt into equity, which would have led to more sustainable restructuring. In Malaysia the emphasis has been on subsidized financial support, not on operational or financial restructuring.

Thailand is in the middle. Almost a quarter of debt has been restructured, although 13 percent of the restructured debt has reverted to nonperforming status in just a few months. Formal bankruptcy procedures have not been used much in any of the crisis countries, generally accounting for less than a fifth of restructured debt. Korea and Thailand have done relatively the most, partly because they have created specialized bankruptcy courts.

3 The government has also established the Indonesian Debt Restructuring Agency to enable debtors and creditors to protect against exchange risk, but very little debt has been registered under this program.

Table 7  
**Corporate restructuring, August 1999**

	Indonesia	Republic of Korea	Malaysia	Thailand
<i>Out-of-court restructurings</i>				
Number of registered cases	234	92 <sup>a</sup>	53	825
Number of cases started	157	83	27	430
Number of restructured cases	22	46	10	167
Restructured debt/total debt (percent)	13	40	32	22
<i>In-court restructurings</i>				
Number of registered cases	88	48	52	30
Number of cases started	78	27	34	22
Number of restructured cases	8	19	12	8
Restructured debt/total debt (percent)	4	8	–	7

a. This number does not take into account restructurings outside the 6<sup>th</sup> largest to the 64<sup>th</sup> largest chaebol; many restructurings have taken place among small- and medium-sized enterprises.

Source: World Bank data.

### ***Corporations have benefited from the economic recovery . . .***

Countries can expect corporate distress to abate as the economic recovery progresses. Operational performance of large firms improved in the first half of 1999 (Table 8), for example, partly because of operational restructuring and a

Table 8  
**Operational performance of publicly-traded corporations and share of distressed corporations, 1995–2002**

Percent

Country	1995	1996	1997	1998	1999 (first half)	2000-02 <sup>a</sup>	2000-02 <sup>b</sup>
<i>Net profit margin</i>							
Indonesia	12.4	13.9	-3.6	-13.3	-8.9	3.3	-2.3
Republic of Korea	2.7	0.4	-0.3	-2.6	2.7	3.1	1.1
Malaysia	12.2	12.0	6.9	-2.8	1.3	8.6	6.2
Thailand	7.1	5.1	-3.6	2.2	4.8	6.1	3.7
<i>Firms that cannot cover interest expenses from operational cash flows</i>							
Indonesia	12.6	17.9	40.3	58.2	63.8	52.9	57.4
Republic of Korea	8.5	11.2	24.3	33.8	26.7	17.2	22.6
Malaysia	3.4	5.6	17.1	34.3	26.3	13.8	15.5
Thailand	6.7	10.4	32.6	30.4	28.3	22.3	27.1

Note: Scenarios for 2000–02 are based on GDP growth recovery as projected by the International Monetary Fund as of September 4, 1999. Forecasts have been revised upward since.

a. Projection. Assumes that interest rates stay at current levels throughout the period.

b. Projection. Assumes that interest rates return to historic levels.

Source: Worldscope/Datastream; authors' calculations.

recovery in exports and domestic demand. Small- and medium-sized firms (SMEs) have been hit harder, however. Industrial production by SMEs in Korea was in May 1999 still 25% below its pre-crisis level while overall industrial production had fully recovered. Corporate distress among SMEs may thus be high, also as they often have more limited access to financing.

Labor reductions and wage compressions are, however, the driving force behind the improvements in operational cash flows. Korea's largest corporations have shed more than a quarter of their workers. Among publicly listed companies, labor shedding is even higher—payrolls were 34 percent lower in mid-1999 than in mid-1997. Labor shedding is less important for publicly traded firms in Malaysia (7 percent) and Thailand (12 percent). Productivity gains are still limited, and in any case should not be expected in such a short time.

### ***. . . but not all will grow out of their problems***

Corporate distress—as measured by the share of firms that cannot cover interest expenses from operational cash flows—peaked in most of the crisis countries in 1998. Since then stronger operational cash flows, lower interest rates, and more favorable exchange rates have eased financial distress (except in Indonesia), especially in Korea and Malaysia.

Data for the first half of 1999 indicate that 64 percent of Indonesian firms, 27 percent of Korean firms, 26 percent of Malaysian firms, and 28 percent of Thai firms were not able to cover interest payments from operational cash flows (see Table 8). Moreover, the scope for less corporate distress due to higher economic growth is limited. If interest rates remain at current levels, about a sixth of Korean corporations, a quarter of Thai corporations, and more than half of Indonesian corporations might still not be able to cover interest expenses by the end of 2002 (see Table 8). The share of distressed firms could be even higher if interest rates return to historic levels. Korean companies have a relatively favorable outlook because of the country's strong economic rebound. Yet many will only survive without deeper financial restructuring if economic growth returns to pre-crisis levels. Malaysian companies appear to have the strongest balance sheets among the four crisis economies and could be able to muddle through without deeper restructuring.

### ***New equity capital—especially foreign capital—has increased***

East Asia's crisis countries have seen a large increase in foreign direct investment, but it is unlikely to be sufficient to address corporations' needs (Table 9). Foreign direct investment in Korean companies is estimated to reach \$15 billion in 1999, up from \$2.6 billion in 1996. Foreign direct investment has also risen in Indonesia, from \$4.7 billion in 1997 to \$13.4 billion in 1998, and is estimated to reach \$12 billion in 1999. Foreign direct investment in Thailand almost tripled between 1996 and 1998. Only in Malaysia has foreign investment been minimal.

Table 9  
**Foreign direct investment, 1995–99**  
 Billions of U.S. dollars

Country	1995	1996	1997	1998	1999 (est.)
Indonesia	3.9	8.0	4.7	13.4	12.0
Republic of Korea	2.1	2.6	6.4	8.9	15.0 <sup>a</sup>
Malaysia	4.2	4.5	3.7	1.6	–
Thailand	1.8	2.4	3.8	7.0	8.0

a. \$7.8 billion had been invested as of August 30, 1999. Korea started from a low base—the stock of foreign direct investment in 1996 was 6.7 percent of GDP, compared with 11.6 percent in Thailand, and 48.6 percent in Malaysia.

Source: World Bank data.

### ***However, risks remain large . . .***

Although lower interest rates have considerably eased the burden of short-term corporate debt service, the operational cash flows of many corporations have seen less improvement. Financial restructuring has often been limited to rescheduling or interest reductions—which does not bode well for sustainable financial positions. Given the high leverage of corporations in East Asia, risks are high if interest rates rise without a further increase in real economic growth. If corporate sectors remain fragile, they will undermine the capital adequacy of financial sectors. As international experience has shown, undercapitalized financial sectors may start lending to financially risky but potentially high-return projects. Undercapitalized financial sectors also may roll over loans to loss-making corporations, making it more difficult for performing borrowers to access credit.

### ***. . . and resolution costs have increased public debt considerably***

Financial sector restructuring costs are high in the four East Asian crisis countries—ranging from 15 to 50 percent of GDP—and are swelling public debt (Table 10). Because Indonesia's public debt was largely in foreign currency prior to the crisis, the sharp depreciation of its currency caused its debt to jump to 48 percent of GDP by the end of 1997. If all financial restructuring costs are absorbed by the government, the ratio of public debt to GDP will rise sharply in all the crisis countries: in Indonesia to more than 90 percent and in Korea, Malaysia, and Thailand to 37–48 percent.

Fiscal stimulus programs have already led to large deficits—more than 5 percent of GDP—and rising public debt in all four countries. The additional large financial restructuring costs have caused observers to question the sustainability of public debt burdens. If interest rates remain at current levels, interest payments are expected to account for 6–14 percent of fiscal revenues in Korea, Malaysia, and Thailand. And in Indonesia almost all fiscal revenues would have to be devoted to interest payments to prevent a larger public debt burden.

Table 10

**Public debt, restructuring costs, and the fiscal impact**

Percentage of 1998 GDP unless noted otherwise

Indicator	Indonesia	Republic of Korea	Malaysia	Thailand
Public debt stock, 1997	48.3	10.5	31.6	6.5
Fiscal recapitalization cost to date	37.3	15.8	10.9	17.4
Expected additional fiscal cost	12.7	10.7	5.5	15.4
Total expected public debt burden	98.3	37.0	48.0	39.3
Annual interest payment on this burden	15.4	2.9	1.5	1.2
Interest payment as percentage of 1998 revenue	91.8	14.0	6.5	6.5
<i>Memorandum items</i>				
Fiscal deficit (percentage of GDP), 1999	6.5	5.0	5.5	5.0
Interest rate used (percent)	15.7	7.9	3.1	3.0
Revenue/GDP (percent), 1998	16.8	21.0	23.1	18.4

Source: IMF, 1999; JP Morgan, 1999; Deutsche Bank, 1999; authors' calculations.

In the short run domestic liquidity and foreign investment (and in Indonesia, large official external financing) have eased funding pressure. East Asian countries have a long history of prudent fiscal management, with several countries in the region reducing their public debt ratios sharply in the mid-1980s following (smaller) financial crises. Still, future fiscal stability is not assured.

***Fiscal adjustment is needed***

As private investment recovers, public funding will become more difficult because the supply of savings will be more limited. And if interest rates rise, the costs of public funding will be higher. The rising debt burden will soon require sharp fiscal adjustments to reverse the buildup. The risk is that fiscal adjustments may come at a time when economies are still frail, bank and corporate restructuring are not yet complete, and structural reforms have not fully taken hold.

Containing the rise in public debt will require high receipts from the sale of government assets acquired during the restructuring. Early experiences in the region and from other crisis countries, however, suggest that proceeds from such sales are generally low, especially when management is largely left to public agencies. A further risk is that high interest payments will reduce fiscal flexibility in dealing with adverse shocks, triggering reduced confidence in the solvency of the public sector and leading to higher interest rates.

***Further financial and corporate restructuring is important for a return to sustainable growth***

While East Asian countries have made significant progress over the past two years, the restructuring of financial and corporate sectors is incomplete. Governments need to adjust their approach to bank and corporate restructuring, reduce financial systems' capital shortfalls, and enhance the sticks and carrots for corporate

restructuring—by, for example, requiring financial institutions to be more realistic in their restructuring and to make proper provisions for restructured loans. In Korea this could also mean closer links between bank and corporate restructuring, which can take the form of linking additional fiscal resources for banks to corporate restructuring under a loss-sharing agreement. Thailand needs to move more aggressively in resolving the capital shortfall of large private institutions, as the banks' current approach prolongs the uncertainty about the health of the financial system. This could mean that the government provides for longer buyback periods of government shares for existing shareholders while closely monitoring bank performance and demonstrating the ability (and willingness) to take over institutions in noncompliance. In Indonesia, given the limited capacity in domestic banks and the asset management company, more foreign creditors could be invited to engage in corporate restructuring.

International experience shows that meeting the restructuring costs early on will strengthen financial sectors' incentives for loan recovery and proper restructuring and ultimately yield significantly lower costs. In the end the fiscal costs of financial restructuring can best be reduced by moving the economy to a more sustainable growth path.



## ***The Risk of an Unsustainable Recovery***

**M**arket analysts predict medium-term growth rates in the four crisis countries to be 2 percentage points below those achieved during 1993–96. Underlying these growth projections are lower investment rates, because private external capital will be less forthcoming and fiscal deficits will be higher. Achieving even these lower growth rates will require more efficient investment. This, in turn, requires in-depth structural reforms to correct underlying weaknesses and to ensure that current restructuring efforts support medium-term growth.

An assessment of the changes in structural frameworks for financial and corporate sectors suggests that the crisis countries have only partly addressed current weaknesses. Deeper reforms are needed—and early recovery must not inhibit further structural reforms. Ownership changes will also be necessary to avoid a recurrence of past problems. In particular, since governments have played large roles in restructuring real and financial sectors, it will be imperative to divest these assets quickly but fairly.

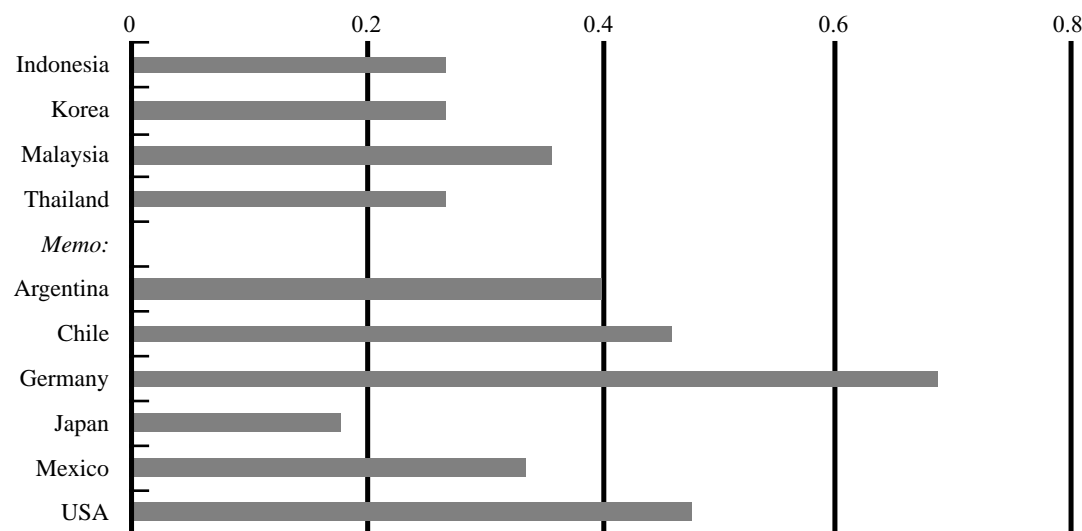
### ***Institutional reforms in the financial sector have not gone far enough***

Financial regulation and supervision frameworks have improved since the crisis began. Still, reforms have not gone far enough to increase the sectors' overall robustness. A key prerequisite for good supervision is arguably an independent agency. Korea transferred most—but not all—regulatory and supervisory responsibilities from the Bank of Korea and the Ministry of Finance and Economy to the new Financial Supervisory Service. In Indonesia and Thailand the central bank remains the banking system's regulatory and supervisory body. But because neither central bank is particularly independent relative to central banks in other countries (Figure 5), the strength of enforcement and the ability to insulate the restructuring from short-term political pressures is in doubt. Thailand has yet to pass a new central bank law, and political consensus for a more independent central bank seems tenuous. Indonesia's new central bank law establishes the central bank as an independent state institution, but its institutional powers are limited.

### ***Financial sector regulation trails international best practice***

Although a number of weaknesses in financial sector regulation have been addressed, several remain. Loan classification and provisioning guidelines often fall short of international best practice and imply substantial forbearance (Table 11). Regulatory arbitrage between banks and nonbanks, an important cause of the East Asian crisis, has not been entirely eliminated. While finance companies in Thailand are now largely subject to the same regulatory framework as commercial banks, state-owned development banks are still treated differently. And in Korea nonbanks continue to be less regulated and supervised than banks, and regulatory authority over development banks remains with the Ministry of Finance.

Figure 5  
**East Asia's central banks were not particularly independent**  
 Index 0 to 1



Note: The figure shows an index measuring central bank independence in a number of dimensions, with the index ranging on a scale from 0 (least independent) to 1 (most independent).

Source: Cukierman, Webb, and Neyapti, 1992.

Table 11  
**Regulatory and loan restructuring frameworks, as of mid-1999**

Country	Loan classification	Loan loss provisioning	Interest accrual	Overall index
Indonesia	2 (2)	2 (1)	2 (1)	2.0 (1.3)
Republic of Korea	3 (2)	3 (3)	3 (3)	3.0 (2.7)
Malaysia	2 (2)	1 (1)	3 (3)	2.0 (2.0)
Thailand	3 (1)	3 (1)	2 (1)	2.7 (1.0)
<i>Memo:</i>				
Chile	3	2	2	2.3
Japan	4	4	4	4.0
Mexico	2	2	1	1.7
USA	4	4	4	4.0

Note: Countries are scored on a scale from 1 to 4 for each variable, with 4 indicating best practice and 1 indicating furthest away from best practice. Numbers in parentheses are scores before the crises, that is early 1997. The definitions for each item are as follows:

Loan classification:	Loan loss provisioning:	Interest accrual:
1 = loans considered past due at more than 360 days	1 = 0% substandard, 50% doubtful, 100% loss	1 = up to 6 months, no clawback
2 = loans past due at more than 180 days	2 = 10–15% substandard, 50% doubtful, 100% loss	2 = up to 3 months, no clawback
3 = loans past due at more than 90 days	3 = 20% substandard, 75% doubtful, 100% loss	3 = up to 6 months, with clawback
4 = repayment capacity of borrower taken into account	4 = present value of future cash flow or fair value of collateral	4 = up to 3 months, with clawback

Source: World Bank data.

### ***Korea has improved its exit framework***

The crisis revealed substantial weaknesses in the exit framework for financial institutions, and many of those weaknesses still have to be corrected. Only Korea has improved its exit framework—putting in place an independent supervisory agency, performing supervision on a consistent and consolidated basis across different types of deposit-taking institutions, phasing out guarantees on banking system liabilities, and adopting a deposit insurance scheme with elements of prompt corrective action. The other crisis countries have yet to establish similar formal frameworks. Weak exit frameworks limit supervisors' ability to quickly address financial distress and undermine the threat of exit. This is a particular concern given the guarantees on banking system liabilities that all four countries have provided. Such guarantees reduce incentives for market oversight and place an even larger burden on supervisors.

### ***The corporate sector has liberalized entry***

All four crisis countries have moved to liberalize foreign direct investment (Table 12). Malaysia is the most open to such investment (except in financial services). Korea has made the most progress in eliminating barriers to foreign entry, though a number of restrictions remain.

Thailand has not amended its Alien Business Law, however, and a proposal now in Parliament to increase the number of sectors in which foreigners are able to have majority ownership is unlikely to be adopted soon. While ownership restrictions on foreigners can be overcome by setting up indirect holding structures, few foreign investors have considered it worthwhile to do so in Thailand. And all four crisis countries maintain ownership restrictions and other limits on foreign investment in utilities.

Table 12

#### **Changes in foreign direct investment restrictions, by sector**

<b>Country</b>	<b>Finance</b>	<b>Manufacturing</b>	<b>Retail</b>	<b>Utilities</b>
Indonesia	From 49% to 100%; limit on number of branches removed	From 51% to 100% (from 0% to 51% for palm oil plantations)	From 49% to 100%	Still restricted; requires special approval
Republic of Korea	From 15% to 100%	From 20% to 100%	From 20% to 100%	From 0% to 49%
Malaysia	Remains at 30% (from 30% to 51% for insurance)	No restrictions	No restrictions	From 30% to 49%
Thailand	Still restricted; requires approval from the Board of Investment	Most sectors do not have restrictions but must comply with the Alien Business Law	Still restricted; requires approval from the Board of Investments	Still restricted; requires approval from the Board of Investments

Source: World Bank data.

## ***There have been plenty of changes in corporate governance, but enforcement lags***

While much debated as one of the main causes of the East Asian crisis, shareholder rights in most countries were not far behind those in other developing countries—and sometimes were even ahead. For example, East Asian countries had an average score of 1.0 (out of a maximum score of 4) on equity protection, compared with 0.8 for Latin American countries (La Porta and others 1998). But equity protection was behind that in OECD countries, which averaged a score of 2.1. Creditor rights were not as strong in East Asia as in Latin American and OECD countries, but they trailed by only a small margin. What was missing was enforcement of these rights, as reflected in measures of the efficiency of the judicial systems (La Porta and others 1998). Minority rights were often violated, and valuations of firms controlled by inside shareholders were far below

Table 13

### **Equity rights, creditor rights, and judicial efficiency, mid-1999**

<b>Indicator</b>	<b>Indonesia</b>	<b>Republic of Korea</b>	<b>Malaysia</b>	<b>Thailand</b>
<i>Equity rights</i>				
One-share, one-vote	0	1	1	0
Proxy by mail	0	0	0	0
Shares not blocked	0	+1	0	+1
Cumulative voting	0	0	0	1
Equity rights score (sum)	0	2	1	2
Improvement over 1996	None	+1	None	+1
<i>Creditor rights</i>				
Restrictions on reorganizations	1	1	1	1
No automatic stay on assets	+1	0	0	1
Secured creditors first paid	0	1	1	0
Management does not stay on in reorganizations	+1	1	1	1
Creditor rights score (sum)	3	3	3	3
Improvement over 1996	+2	None	None	None
<i>Judicial efficiency</i>				
Timetable to render judgment	+1	+1	0	+1
Existence of a specialized bankruptcy code	+1	1	0	0
Judicial efficiency score (sum)	2	1	0	0
Improvement over 1996	+2	+1	None	+1

Note: A 1 denotes that equity and creditor rights are in the law, that there are time limits to render judgement, and that specialized bankruptcy courts exist.

A + indicates an improvement over the law in place before the crisis, that is, in 1996.

Source: Claessens, Djankov, and Klapper 1999; La Porta and others, 1998.

those of comparable firms, suggesting large-scale expropriation (Claessens, Djankov, and Lang 1999).

Since the crisis formal minority shareholder rights have improved in Korea and Thailand (Table 13). Still, there are many questions on the degree to which these rights are being enforced. In Korea large-scale financial transfers continue among firms within groups, the most recent example being the channeling of SK Telecom profits to loss-making affiliates rather than to shareholders. The key factor is the independence of regulators and the strength of judicial systems. In several countries securities market regulators are still not fully independent. And in Indonesia courts have not been considering any cases involving corporate governance.

Although Indonesia, Korea, and Thailand passed new bankruptcy and collateral laws in 1998, creditor rights have not changed much in Korea and Thailand (see Table 13). Indonesia is an exception, but it is not clear whether its stronger framework will be enforced.

### ***Insufficient institutional reforms may be due to concentrated corporate ownership***

One reason for limited institutional reforms may be the continued concentration of corporate control in the hands of a few families, and the strong political connections that these families have. In East Asian countries where control is most concentrated, the judicial system tends to be less efficient, the rule of law is weaker, and corruption seems more pervasive (Table 14). This implies that institutional reform may be more limited in East Asian countries where wealth is highly concentrated.

Table 14

#### **Ownership concentration and legal frameworks**

Country	Concentration of ownership control among top 15 families (percent)	Efficiency of judicial system index	Rule of law index	Corruption index
Japan	2.8	10.00	8.98	8.52
Taiwan	20.1	6.75	8.52	6.85
<b>Malaysia</b>	<b>28.3</b>	<b>9.00</b>	<b>6.78</b>	<b>7.38</b>
Singapore	29.9	10.00	8.57	8.22
Hong Kong	34.4	10.00	8.22	8.52
<b>Korea</b>	<b>38.4</b>	<b>6.00</b>	<b>5.35</b>	<b>5.30</b>
<b>Thailand</b>	<b>53.5</b>	<b>3.25</b>	<b>6.25</b>	<b>5.18</b>
The Philippines	55.1	4.75	2.73	2.92
<b>Indonesia</b>	<b>61.7</b>	<b>2.50</b>	<b>3.98</b>	<b>2.15</b>

*Note:* All three indexes rank from 1 (worst) to 10 (best). Countries are ranked by degree of ownership concentration. The efficiency of judicial system index assesses the efficiency and integrity of the legal environment as it affects businesses, particularly foreign firms.

*Source:* Claessens, Djankov, and Lang 1999; La Porta and others, 1998 and 1999.

## State ownership is extensive

The restructuring since mid-1997 has required active state involvement in the financial and corporate sectors—much greater than in the past and more than is envisioned by governments in the medium term. In the financial sector this has included the state acquiring ownership of many commercial banks and other financial institutions (Table 15). Twenty-one commercial banks have been nationalized, and only four foreign banks have entered (in Korea and Thailand), although new banking technology and increased innovative capacity are badly needed.

In most countries—especially Thailand—family-controlled banks and conglomerates seem set to survive. Similarly, in Korea links between nonbank financial institutions and the corporate sector have not been severed. In fact, since 1997 nonbank financial institutions have become much more important in Korea, with investment trust companies expanding considerably.

In the corporate sector governments have acquired many claims through purchases by asset management companies and government-owned banks have been involved in corporate restructuring and acquired direct ownership stakes in corporations (for example, through debt-equity swaps). Governments have also been involved more generally in corporate restructuring by designing frameworks and overseeing the restructuring of the corporate sector—including, in some countries, by providing direct guidance on corporate restructuring (as with the restructuring of large business units of Korea's top five chaebols). Through asset management companies, state-owned commercial banks, and nationalized financial institutions, governments control an average of 50 percent of financial assets

Table 15  
Market structure changes in the financial sector<sup>a</sup>

	Number of commercial banks taken over/sold to foreigners/nationalized	Number of private domestic banks (market share)	Number of state banks (market share) <sup>b</sup>	Number of nonbank financial institutions (market share)	Market share of three largest banking institutions, December 1998 (end 1997)
Indonesia	4/0/12	122 (21%)	43 <sup>c</sup> (78%)	245 (1%)	34% (35%)
Republic of Korea	5/2/4	18 (37%)	10 (58%)	11 (5%)	24% (16%)
Malaysia	1/0/1	21 (56%)	3 (18%)	37 (26%)	34% (28%)
Thailand	0/2/4	13 (48%)	6 (45%)	22 (7%)	48% (47%)
Total	10/4/21				

a. Includes commercial banks, specialized banks, and development banks, finance companies, and merchant banks and is thus not strictly comparable to numbers for the other countries.

b. Includes assets transferred from state and private banks to AMCs.

c. Includes 27 regional development banks.

Source: Deutsche Bank, 1999; JP Morgan, 1999; World Bank data; and Ramos, 1999.

Table 16

**Government ownership of financial system assets, mid-1999**

Percent

Indicator	Indonesia	Republic of Korea	Malaysia	Thailand	Average
Share of assets carved out <sup>a</sup>	23	3	4	2 <sup>b</sup>	8
Share of assets held by state-owned and nationalized financial institutions	55	55	14	43	42
Total share of banking assets held by the state <sup>c</sup>	78	58	18	45	50
Assets held by the state as a share of GDP	79	124	62	127	98

a. Table 3

b. Finance companies' assets transferred to the Financial Restructuring Agency.

c. Table 15.

*Source:* Authors' calculations.

(Table 16). Korea and Thailand's governments control assets worth more than 100 percent of GDP.

### ***Governments should reduce their role***

The large role of the state was beneficial in the early stages of the crisis because it allowed for quicker restoration of confidence in the financial sector and stimulated corporate restructuring in some countries. But an overly active state complicates the transition to a more efficient economy. In particular, governments need to divest their significant ownership stakes in banks and other financial institutions.

Although there has been interest, governments have made limited progress in selling financial institutions to foreign investors. Korea has attracted foreign investment in two banks, but efforts to sell one large bank have been indefinitely delayed. In Thailand only two banks have been sold, while three banks have been on offer for more than a year. And the sale of a bank in Indonesia has become mired in controversies. Governments have also had limited success with asset sales by asset management companies. On average, only 2 percent of intervened assets have been sold (see Table 3).

### ***Greater private sector involvement is essential***

Governments will need to accelerate efforts to increase the involvement of private strategic investors in their financial and corporate sectors. Possible signals of the desire for private involvement would be for governments to share losses on the nonperforming loans of banks and to show a greater willingness to have the private sector acquire defunct assets to work out. Government will also need to move from government-guided corporate restructuring to more market-based restructuring and enhancement of corporate competitiveness. This will require moving to a situation in which many agents—including financial institutions, new investors, managers and owners of corporations, and other stakeholders (including workers)—provide the impetus for continuing corporate upgrading and renewal, rather than

government, either directly or under its auspices (as through out-of-court frameworks).

### ***Retrenchment must be carefully timed***

The retrenchment of the state will have to be carefully phased. Overly rapid privatization of intervened banks may lead to larger ownership by a few families and increased (indirect) links between banks and corporations. Similarly, growing ownership of corporations by financial institutions could hinder medium-term changes. Close links could reduce incentives for banks to restructure corporations and perpetuate a situation where banks continue to accommodate the credit needs of corporations without independent monitoring and oversight.

### ***The shift from state ownership provides an opportunity for change***

These potential side effects of both bank and corporate restructuring need not impede the longer-term changes envisioned in East Asia's crisis countries. But addressing them will require a deliberate strategy to make policy interventions work in the medium term. Countries that achieve a more rapid disposal of assets and divestiture of institutions will likely see a quicker redirection of capital to more productive firms and, hence, superior and more sustainable growth.

In some countries this may mean that a move to more fully funded pension schemes is used to create institutional investors that can provide independent oversight to the corporate and financial sectors. In other countries corporate restructuring funds could be created immediately to acquire the ownership stakes now held by banks or the state, allowing them to remain publicly owned but become privately managed. Provided that adequate corporate governance is in place, this move could bridge the gap between the need for government involvement in short-term restructuring and the desire for medium-term refocusing of the economy.

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