The Politics of Moral Hazard;

The Origins of Financial Crisis in Indonesia, Korea and Thailand[1]

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While debate continues over the causes of the Asian economic crisis, there is growing consensus that weaknesses in the financial sector were implicated in its onset, propagation and depth. Inadequate supervision and prudential regulation of bank-dominated financial systems permitted high corporate leveraging and excessive risk taking (Krugman 1998; Caprio 1998).[2] Of the three countries considered here, all underwent bank-financed investment booms during which lending grew rapidly despite low and declining returns on capital. In all countries, these booms followed domestic deregulation that permitted new entrants,

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[2] Among the oft-cited regulatory failures were low capital-adequacy ratios; weak, and weakly enforced, lending limits to related managers and enterprises; permissive asset classification systems and provisioning rules; and in general, poor disclosure and transparency of bank operations (World Bank 1998a, 34-5). These problems compounded the effects of weak institutional development of the banks themselves, which tended to lend on the basis of collateral and personal

particularly weakly regulated nonbank financial institutions (NBFI’s; finance companies in Thailand and Indonesia, merchant banks in Korea). Booms were further fueled by a particular regulatory failure that receives dominant attention in some accounts (Wade and Veneroso 1998): the mismanagement of capital account liberalization. Opening of the capital account left banks and firms with little experience in managing foreign exchange risks highly vulnerable to external shocks, particularly where liberalization favored short-term borrowing.

A final, more controversial issue is the extent to which these problems were the result of sins of omission, in the form of weak regulation, or of commission, in the form of explicit or implicit guarantees against losses that generated moral hazard. Such guarantees might have arisen as a result, inter alia, of industrial policy, cronyism and corruption, government fears about disruption of the payments system given the size of leading banks and companies (“too big to fail”), or deposit insurance (Chang 1999). These problems of moral hazard extended to foreign banks, which channeled lending through the domestic financial system in part because of implicit guarantees of stable exchange rates and even of repayment. Other accounts have made much of the additional moral hazard associated with the prospect of IMF lending in the eventuality of payments crises (Calomiris 1998; Schwartz 1999).

In this paper, we examine the government's management of emerging financial sector problems in order to assess these claims with respect to the role of moral hazard. Did mounting financial problems reveal that banks (both domestic

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relationships rather than cash flow.

and foreign) and their corporate clients expected the government to come to their rescue? If they did, and governments responded accordingly, then there would be merit to the moral hazard story. If governments did in fact have a credible no-bailout rule, then the claims for the significance of moral hazard would be exaggerated.

However, there is a third possibility: that there was *uncertainty* about what the government would do. This uncertainty might spring from a variety of political sources, but we focus on two. First, distressed banks and firms might doubt the credibility of the government's commitment to avoid bailouts, and thus engage in lobbying efforts to secure government support. Even if ultimately unsuccessful, these efforts could lead to a "war of attrition" between the government and firms that delayed reform and rationalization, compounded the costs of adjustment, and reduced investor confidence (Alesina and Drazen 1991). We find evidence of these dynamics in all three countries. Second, broader institutional and political factors can reduce the capacity of the government to respond aggressively to crisis as well. In the two democracies, these factors included institutional arrangements, such as divided government in Korea, and characteristics of the party system, such as fragmentation in Thailand which made coherent decision-making difficult. In authoritarian Indonesia, the problems included more fundamental uncertainty surrounding the viability of the government, and the complex of political property rights that went along with it.

Finally, some disclaimers. We do not present a general political theory of the politics of financial crises, nor do we claim causal sufficiency for the factors we highlight here. Our effort is primarily to underline the significance of political factors in the financial crises of the most seriously-affected countries. We are also aware of the risks of 20-20 hindsight; financial crises are difficult to foresee and manage for even the most politically cohesive and competent governments. However, it does appear that problems of moral hazard may be less important than politically-generated uncertainty in determining both the timing and intensity of the Asian financial crisis.

Thailand

By late 1996 Thailand was coming off a remarkable economic boom, prolonged by the inflow of foreign capital. As real GDP growth slowed in 1996, two issues were of particular policy concern: the widening current account deficit (growing from an already-large 8.1 percent of GDP in 1995 to 8.4 percent in 1996) and unease about the health of the recently liberalized financial sector. In combination, these external and internal factors fueled growing speculation against the baht in the second half of 1996 (Bhanupong 1998; Warr 1998). Despite mounting concern over the apparent inevitability of some sort of currency depreciation, Thai authorities failed to address either of these problems in a credible way. Rather, they clung to a strategy of defending the pegged exchange rate, and ultimately fell victim to massive speculative attacks on July 2 1997.

In the financial sector, the period of the late 1980s and early 1990s was one of dramatic liberalization (Vajragupta and Vichyanond 1998; Alba, Hernandez and Klingebiel, this volume). Beginning in 1989, the government liberalized interest rates and the scope of banks' activities widened considerably. The financial system had been dominated by a small group of fifteen large commercial banks, but beginning in the 1970s, finance companies established a niche in the provision of consumer credit. With entry by new banks tightly limited, finance companies came to play an increasingly prominent role in the financial system. In the 1990s, a combination of legal changes and market pressures pushed them into more risky lines of business, including particularly the financing of real estate and share purchases.

On the external front, the government loosened capital controls in 1990 and initiated the Bangkok International Banking Facility in 1993. The initial objective of the facility was to promote Bangkok as a regional financial center (through offshore or so-called "out-out" operations). Given a fixed exchange rate and substantial differentials between on- and offshore rates, the BIBF functioned in practice as a window through which domestic banks and corporates could borrow directly from abroad ("out-in" transactions). After 1993, international borrowing through the BIBF, particularly short term borrowing, funded a very rapid expansion of domestic credit. Despite some efforts to slow the foreign borrowing boom after 1994 through the imposition of prudential controls, by 1996, foreign funded domestic lending totaled 1.8 times the size of the country's monetary base.

Coupled with this increasingly vulnerable external position was a deterioration in asset quality. Finance companies' exposure to the property sector has received the most attention in subsequent analyses of the crisis, but overinvestment in a variety of other industries ranging from petrochemicals and automobiles to private hospitals created substantial surplus capacity; government incentives were implicated in several of these sectors. Concern about non-performing loans and fear that the country's regulatory authorities (located in the Bank of Thailand) were not exercising adequate prudential oversight mounted in the mid-1990s, and the devaluation of the baht pushed the country into full-fledged financial crisis. By the second half of 1997 Thailand was beset with an estimated Bt1 trillion in bad debts held by banks and finance companies and the government had spent an estimated Bt430 billion in propping up failing financial institutions (roughly, $28.6 billion and $12.3 billion) (*Bangkok Post*, August 14 and September 12 1997).

The question for political economy is how the government managed these emerging problems. We argue that political links between members of the government and financial institutions generated severe moral hazard problems by providing opportunities for failing financial institutions to protect themselves and to delay the process of financial restructuring. Where outright corruption was not implicated--and it frequently was--political forbearance towards the interests of the financial sector was.

Broader constitutional weaknesses compounded these problems. With some important differences, all of the democratically-elected governments prior to the crisis--Chaitichai, Chuan, Banharn and Chavalit--rested upon shaky multiparty coalitions, made up of internally weak and fragmented parties that not only provided opportunities for private interests to gain access to the policy process, but made that process extraordinarily contentious. Parliamentary majorities were constructed from a pool of approximately a dozen parties, and cabinet instability was a chronic problem. As leader of the governing coalition, the prime minister was vulnerable to policy blackmail by coalition partners, and in some cases individual ministers, threatening to defect in pursuit of better deals in another alliance configuration. The parties, in turn, were heavily reliant on national or provincial businessmen with strong personal as well as political interests in financial market (and other) economic policies.

These political barriers to coherent policymaking are highly visible in the management of Thailand's ailing financial sector. Early warning signs of the problems facing the country's financial institutions came as far back as 1991 when the Bank of Thailand (the central bank) detected irregularities in a struggling mid-sized bank, the Bangkok Bank of Commerce (BBC). Extending over several years, the BBC scandal was clearly important in denting the reputation of the central bank. More important for our purposes, however, is what the BBC saga reveals about the political constraints on coherent policymaking in Thailand.

A bank examination in 1991 revealed that 27 percent of total assets at BBC were nonperforming (Nukul Commission, para. 283). Subsequent examinations in 1993 and 1994 showed that the problem had only worsened, despite pressure on BBC from regulators to increase its capital. The Financial Institutions Development Fund (FIDF), established in 1985, had a wide range of powers at its disposal to assist and rehabilitate financial institutions whose collapse might have systemic effects, including write down of capital and replacement of management. However, the Fund also enjoyed substantial discretion and could support institutions through low-interest loans, deposits or purchase of convertible debentures and shares. After the 1994 examination, the government agreed to purchase a substantial stake in the bank through the FIDF, but without any writedown of shareholder capital or reduction of management prerogatives. The central bank governor defended this action on the grounds that similar forbearance had been shown toward banks in the past! (Nukul Commission, para. 300 and 306)

As the extent of mismanagement at BBC became public in mid-1996 following disclosure by the opposition, there was a run on the bank. After having indulged BBC for an extraordinary period, the central bank finally took formal control of BBC, forcing the central bank governor to resign. Ultimately, a total of $7 billion was spent to keep BBC afloat. Although the FIDF recovered some of that money, the bailout set a dangerous regulatory precedent and severely damaged the reputation of the BOT, the FIDF and the regulatory process more generally. The Nukul Commission of inquiry sidestepped the issue of outright corruption, stating only that “in a [sic] recent past, top BOT officials were inclined toward political interests.” (para. 317). But several politicians within Prime Minister Banharn’s Chart Thai party were known beneficiaries of large loans from BBC. (*The Nation*, March 13 and April 18 1997; Pasuk and Baker 1998 pp. 105-10, 259). The BBC saga came to life again under the Chavalit when it emerged that criminal charges laid against several BBC executives had lapsed because Bank of Thailand officials had failed to act before the statute of limitations came into play in early 1997. Chavalit ordered the suspension of a deputy governor at the central bank and several other senior officials over the affair, but this did little to conceal the fact that politicians who were now members of his party maintained strong links to BBC.

In September 1996 Banharn's government collapsed after key coalition partners deserted him. After what was widely regarded as the country's dirtiest election, and having benefited from large scale defections from Banharn's Chart Thai party, Chavalit's New Aspiration Party (NAP) narrowly emerged as the largest party in the parliament (*Far Eastern Economic Review*, November 28 1996: 16-22). Chavalit proceeded to construct a six party coalition compromising most of the parties from the previous government. Nonetheless, he also signaled that he would appoint a cabinet built around an "economic dream team" of highly respected technocrats, most notably Amnuay Viruwan as Finance Minister, to address the country's mounting economic difficulties.

The biggest area of concern in the financial sector was not the banks themselves, but the finance companies. By the end of 1996, Thailand's 91 finance companies (25 were pure finance companies and 66 performed both finance and securities functions) accounted for nearly 25 percent of total credit (*EIU* 1998 pp. 31, 50). By the time the Chavalit government entered office, their difficulties were apparent to both domestic regulators and foreign investors: the end of a prolonged property boom in late 1996; mounting nervousness about unhedged foreign liabilities given renewed speculative attacks on the baht; and the consequences of the central bank's misguided effort to help support the currency and dampen inflationary pressures through higher interest rates, an effort which only served to induce more foreign borrowing. By the end of 1996, six companies had requested assistance from the FIDF and the Fund had outstanding loans of about Bt30 billion (Nukul Commission, para. 342)

Despite the effort to insulate economic policymaking from the vagaries of Thai politics, the logic of the country's political structure very quickly reasserted itself. On February 5 1997 the first Thai company (Somprasong) defaulted on a foreign loan repayment. Late in the month, it was announced that the largest of the finance companies, Finance One, was seeking a merger with a bank to stave off collapse. By the end of February, FIDF assistance extended to 14 companies and totalled Bt50 billion (Nukul Commissioin, para. 343). In the face of widespread fears of an impending financial implosion, finance minister Amnuay and central bank governor Rerngchai Marakanond suspended trading of financial sector shares on the stock exchange on March 3 and went on national television to announce a series of emergency measures designed to reassure nervous markets. The two key elements of the policy intervention were a requirement that all banks and finance companies make much stronger provision for bad loans and an announcement that ten of the weakest financial companies would have to raise their capital base within 60 days.

These measures did little to reassure financial markets, and when trading resumed the following day (March 4), financial shares fell heavily as depositors and creditors moved to withdraw funds. Underlying the market's nervousness were several factors, including doubts about the health of other finance companies and banks as well as about the government's ability to follow through with its restructuring plans. Such fears proved well founded. The original Ministry of Finance report showed that 18 finance companies and three banks faced difficulties, but the list was trimmed following direct intervention from the Prime

Minister (Nukul Commission, para. 368). Several senior members of Chart Pattana, the second largest party in the coalition, had controlling interests in some of the ten targeted institutions. Not only did they succeed in vetoing the plan and ensuring that no action was taken against the ten companies. The very fact that they were permitted to remain open meant that--as with BBC--the central bank had to provide liquidity in order to keep them afloat in the face of runs by creditors and depositors. At the end of March, when 10 finance companies were suspended, FIDF assistance had been extended to 30 firms and totalled Bt130 billion.

The management of the financial market problems in March constituted a critical juncture in the development of the larger crisis in Thailand. Both Thai and foreign analysts expressed concern about the scale of the bad loan problem. Amnuay and Rerngchai were unable to pursue the strict path favored by financial hawks: forcing shareholders to accept losses by allowing ailing institutions to fail. Nor were they prepared to permit foreign investors to take a controlling stake in these institutions. However, even the modest path they opted for--lifting capital adequacy provisions and singling out the weakest institutions for immediate attention--proved politically unattainable. These initiatives were effectively vetoed by other members of the ruling coalition, some with direct stakes in the institutions. Rather than risking the collapse of his new government by alienating Chart Pattana, Chavalit preferred to gamble on compromise and delaying measures.

The finance minister's inability to follow through on the modest plans he had outlined had a corrosive effect on investor confidence. Moreover, there were debilitating costs to delay. An unwelcome side effect of injecting large scale emergency funding into the ten failing finance companies was a substantial surge in the growth of monetary aggregates, which only served to sharpen the fundamental contradiction in the government's overall strategy with respect to the exchange rate. At the same time as it was pumping money into insolvent finance companies to keep them afloat, the central bank was also spending down reserves to prop up the exchange rate and avoid any substantial increase in interest rates. As was increasingly recognized by the markets, this was not a sustainable strategy. In mid-May the baht suffered its heaviest assault to date as both foreign investors and Thai nationals fled to the dollar (Siamwalla 1997, p. 2).

Frustrated by his inability to persuade the coalition's leaders in cabinet to move on more extensive financial sector reforms (as well as on other fronts such as cutting more pork from the budget), Amnuay resigned from the government on June 19. Within two weeks--on July 2--the baht was cut loose, depreciating sharply and signaling the onset of the country's crisis.

However, the onset of the crisis did not, of itself, guarantee effective action. Upon taking office, Amnuay's successor, Thanong Badaya did seek to seize the initiative; on June 27 he announced the suspension of 16 finance companies (including 7 of the original 10), giving them 30 days to implement merger plans. At the same time, however, the Prime Minister announced that no further finance companies would be closed, and that the government would guarantee the closed finance companies loans and deposits; both measures had profound implications for the FIDF, to which the remaining finance companies increasingly turned for support. Moreover, Thanong stumbled on the same obstacle as Amnuay: while he had won approval for the initiative, Chart Pattana leaders were again able to block its implementation. Not only did Chart Pattana succeed in preventing the closure or merger of the 16 finance companies, it also managed to persuade the central bank to continue injecting liquidity into the institutions. In late July, in the context of negotiations with the IMF, it was revealed that loans to the 16 finance companies totaled Bt430 billion, a figure that exceeded the total capital of the finance companies and equaled about 10 percent of GDP.

A week later, on August 5, in an effort to restore confidence and to make a necessary policy prepayment on the IMF agreement,[3] Thanong, announced that a further 42 finance companies would be suspended. A total of 58, or two thirds of the country's finance companies, had now been suspended. Like the earlier 16, this batch was given a short period in which to meet tough new capital adequacy rules, merge with stronger institutions, or go out of business. However, charges of corruption and conflict of interest surfaced with respect to the committee given the responsibility of reviewing the finance companies' rehabilitation efforts. These concerns led to further delays, and were only overcome in late August when Virabhongsa Ramangkura, a respected technocrat newly appointed as deputy prime minister in a hurried cabinet reshuffle in mid-August, installed Amaret Sila-on, the respected head of the Thai Stock Exchange, to oversee the process (*Bangkok Post*, August 26 1997).

But as one section of the government was moving to force an overhaul of the financial sector, another was moving in precisely the opposite direction. With the

[3] The IMF's $17.2 billion package was unveiled in Tokyo on August 11.

deadline for deciding the fate of the suspended finance companies looming, the politics of reform intensified. In early October, the Association of Finance Companies vigorously courted Chart Pattana leader Chatichai as well as prime minister Chavalit seeking a relaxation of the criteria for rehabilitation. The IMF responded by publicly expressing concern that the independence of Amaret's screening committee not be undermined. Nevertheless, a week later he resigned after only a short tenure, declaring that he was being undercut by forces within the government (*Bangkok Post*, October 12 1997). Further concessions were soon made to Chart Pattana and the finance companies. Announcing the creation of two new independent agencies to handle the evaluation and processing of the finance companies, Thanong also revealed that the deadline for their restructuring would now be extended (without a new date being set) and that loans earlier extended to the ailing finance companies by the central bank could be treated as equity. This move increased the probability that the public resources injected into these companies--which had continued to increase (*Bangkok Post*, August 14 1997; Nukul Commission, para. 343-346)--would never be recovered (*Bangkok Post*, October 14 1997). In another successful rearguard move, Chart Pattana succeeded in holding up the approval by cabinet of the plans for the two new agencies announced by Thanong until text was inserted in the decrees specifically reversing their independence from the government (*EIU* 1998, p. 13).

By this stage however, the crisis was forcing broader political realignments. On October 19 finance Minister Thanong resigned over the reversal of a petrol tax a mere three days after it had been announced as part of the government’s IMFbacked program. In the wake of maneuvering in preparation for the formation of an expected new government led by Chart Pattana and impending defections in Chavalit's own party, the crippled prime minister announced his resignation on November 3. Thailand was in very deep disarray.

The crisis in Thailand began to abate in 1998 when a new government under Chuan Leekpai committed forcefully to implement the IMF program and established an independent Financial Restructuring Agency which moved vigorously to close all but two of the 58 finance companies and force a more general process of financial restructuring. The new government was able to make some progress on these issues during an initial honeymoon period when it benefited from a clear sense of national emergency. But as 1998 progressed it too found itself subject to pressures similar to those of its predecessors.

To summarize, politics in Thailand exerted a powerful influence over policymaking with respect to the financial sector. There are clear signs of moral hazard related to the way the FIDF interpreted its mandate (Nukul Commission, para. 329-40), but the problems ran deeper. First, politicians with direct interests in regulated financial institutions were able to influence the government's decision-making, delaying an effective response to the problem. Second, and relatedly, both intra-coalitional and intra-party conflict frustrated the efforts of reformers. These political failings contributed to the onset of the crisis directly by weakening confidence in the Thai financial sector, and deepened it once the devaluation occurred by further delaying adjustment until the change of government.

Korea[4]

As in Thailand, the roots of Korea's financial crisis are to be found in an investment boom. Unlike Thailand, investment was heavily concentrated in manufacturing, and within manufacturing in heavy and chemical industries dominated by the largest conglomerates (*chaebol*) (Haggard and Mo 1999). During 1994-96, facility investment grew by 38.5 percent a year, and as in the past, firms relied heavily on bank borrowing to finance it. Because of the size of the Korean groups, the politics of the crisis took a somewhat different form than in Thailand. Rather than attention focusing initially on the insolvency of banks and finance companies, it was the weakness of several large chaebol that triggered concerns about bank solvency.

Also as in Thailand, liberalization of both the domestic financial markets and the capital account constitute an important backdrop to the boom. Korea proceeded in a highly gradual fashion in liberalizing its financial sector; throughout the 1980s, steps in the direction of privatization, deregulation and liberalization were frequently followed by reassertion of government controls. Beginning in 1991, however, the Kim Young Sam government initiated a new financial liberalization package that included deregulation of interest rates. After 1994, the government lifted administrative controls on the important commercial paper market, which led to a rapid expansion of short-term financing. In a heavily politicized process, the government converted 24 relatively weak finance companies into merchant banks in 1994-1996 in order to provide them new business opportunities. Merchant banks

[4] The narrative in this section draws on Haggard and Pinkston 1999.

lent aggressively, engaged in a variety of speculative activities such as investment in Russian bonds, and subsequently proved themselves the Achilles heel of the financial sector.

Liberalization of the financial market was not limited to the domestic front; in the name of globalization and entry into the OECD, the Korean government eliminated a number of barriers to Korean banks and firms borrowing abroad. The result was a sharp increase in foreign indebtedness, which stood at $78.4 billion at the end of 1995, $104.7 billion at the end of 1996, and $161.8 billion in November 1997, when the currency crisis broke. The composition of Korea's debt proved a particularly serious problem. Liberalization of the capital account took a perverse form, initially favoring short-term over longer-term borrowing. At the time the crisis broke, over half of the country's debt (54.9 percent) was short-term, which naturally created tremendous vulnerability to investor panic.[5] Failure to roll over short-term debt on the part of American, European and Japanese banks one of the precipitating cause of the crisis.

The question of the role of moral hazard in Korea's financial crisis has been a hotly contested one. Leipziger (1998, 3), for example, argues that with an average debt-equity ratio on the part of the top 30 chaebol of 363 percent in 1996, "it became clear that domestic lenders were quasi-equity partners in industry." He infers that this high leveraging was itself evidence of moral hazard, since "no respectable banker should have been lending to the chaebol under these circumstances were they not assured that Government would make sure that losses

[5] Capital account liberalization favored short-term debt over long, which substantially increased the country's vulnerability to shocks.

were managed in the event of a downturn." He also notes that banks had access to overdraft facilities at the Bank of Korea. However, Chang (1999) has pointed out that this inference is not so obvious. Industrial policy had peaked in Korea in the late 1970s, and been gradually dismantled over the 1980s; government direction no longer constituted a justification for counting on government support in the case of failure. Moreover, Chang documents that in fact a number of chaebol had been allowed to fail during the 1990s.

With some important modifications, our argument with respect to Korea parallels our discussion of Thailand. First, there is one important case of corruption--the Hanbo Group--which shows that at least some managers believed that they could gain access to credit through bribery. However, Hanbo's expectations proved misguided; unlike in Thailand, vigorous political competition, in the form of an impending election campaign, made it impossible for the government to come to Hanbo's rescue. However, the emergence of additional companies facing difficulty raised uncertainty about the government's true intentions, and whether it could in fact be blackmailed to come to firms' support. A protracted battle over support for Kia proved a seminal event in the unfolding of Korea's crisis, generating substantial uncertainty in the market even before the contagion from Hong Kong's stock market collapse in October that is generally seen as a precipitating factor in the crisis.

As in Thailand, the difficulties associated with the play of interests were compounded by broader institutional and political factors. The impending presidential election scheduled for December fragmented the ruling party and made it difficult to initiate important financial sector reform measures. The poor performance of the Kim Young Sam government, and the potential strength of Kim Dae Jung in capitalizing on that record, created divisions within the ruling party as presidential hopefuls and legislators sought to distance themselves from the government. These political factors blocked the passage of an important set of financial reforms and contributed to a more general uncertainty about the capacity of the government to respond to the crisis.

Any account of the onset of Korea's financial crisis must begin with the Hanbo scandal which broke in January. Although there were several failures of smaller chaebol in the second half of 1996, Hanbo was the country's 14th largest industrial group. The group was emblematic of the deeper problems among Korea's industrial groups. Hanbo had diversified rapidly into a number of capital-intensive activities, and banks finally balked at continuing to support the group's construction of a massive greenfield integrated steel facility. The government denied allegations of impropriety following the announcement of Hanbo's collapse. However a series of subsequent bribery arrests, and above all the arrest, National Assembly testimony, and conviction of the president's son, Kim Hyun Chul, revealed that prominent politicians had used their positions to influence lending to the group.

The disposition of the Hanbo case sent mixed signals about the government's intentions with respect to failing enterprises. The government made no effort to save Hanbo's management; the firm was effectively nationalized through the injection of new money. When two more of the top-30 chaebols folded--Sammi in March and Jinro in April--the government sought to orchestrate a more concerted response to the problem. On April 18, 35 commercial and state banks announced an “anti-bankruptcy” pact, under which they would continue to extend credit to any top-50 chaebol at risk and defer debt payments for 90 days, but only if the company was “basically sound” and came up with a “self-rescue” package of measures including layoffs, sale of assets and organizational consolidation. Since the anti-bankruptcy pact necessarily called the position of the banks into serious question, the government had to supplement the concerted lending and rescheduling effort with a new initiative to inject liquidity into the financial system through the purchase of non-performing assets. However, unlike the operation of the FIDF, this effort appeared to carry some conditionality with it. Market response to the plan was positive, and the stock market rallied sharply. However, beginning in July, Korean financial and foreign exchange markets entered a period of marked turbulence and uncertainty, and the government’s management of the Kia bankruptcy was clearly a major cause. The Kia crisis broke on June 23, when Kim Sun-Hong, chairman of the group, appealed directly to the government for assistance in persuading creditors not to call maturing loans. Kia differed from other chaebol in being both more focused--primarily on automobiles and linked sectors--and having wider ownership; unions were in fact one of the company’s largest shareholders. On July 15, the group’s creditor banks placed it under the anti-bankruptcy pact on the basis of a rescue plan that included a reduction in the number of affiliates, real estate sales and layoffs.

What ensued was a highly politicized battle over the future of Kia, in which Kia's management sought to blackmail the weakened government into providing support. Refusing to resign, the group’s chairman quickly denounced the loan package as inadequate and mobilized support for the company from suppliers, employees, competitors and the public at large through a "Save Kia" campaign (*Korea Newsreview*, July 26, 1997, p. 16.) On August 4, the banks postponed their final decision on the bailout package until September 29 and withheld further lines of credit in the interim.

Because of the high concentration of both the financial and corporate sectors, and the extraordinarily leveraging of the latter, the difficulties of three or four major groups were enough to push the entire commercial banking sector into technical insolvency. On August 25, the government announced measures to shore up the financial system, with a target of providing at least $8 billion of liquidity for the banking system (*Korea Newsreview* August 30, 1997, pp. 24-25). At the same time, the government began to signal its impatience with the open campaign for intervention and support that Kia was waging, and with the entire anti-bankruptcy pact on the grounds that the uncertainty and delay over the future of the firm was itself becoming a major source of financial market uncertainty. The government began to send stronger signals that it wanted Kia's creditors to let the firm go bankrupt when the September 29 deadline passed.

The Kia management was unwilling to submit to court receivership (*pasan*), however, under which existing management would be replaced, and exploited an important loophole in Korean bankruptcy law, to avoid it.[6] After having moved four subsidiaries toward court protection, Kia management filed for court protection for

[6] Under Korean law, firms may file for court "protection" or "mediation" (*hwa ui pob)* . Under this procedure, management maintains its rights and if three-fourths of creditors agree, debt payments can be postponed and new credits extended. Banks may have an incentive to go along with this option since court receivership implies liquidation and certain losses.

nine more on September 22. One powerful weapon the government maintained in trying to force the creditors toward the receivership option was the threat that the government would not guarantee the foreign obligations--$687 million--of the firm if it sought court protection. Meeting on September 25, Kang Kyung Shik and representatives of Kia’s creditors announced their intention to seek receivership for the firm. At the final meeting of the creditors on September 29, the creditors delivered an ultimatum that no further credit would not be extended. Nonetheless, it took a full month, until October 22, before the government intervened to definitively settle the Kia issue by ousting management and effectively nationalizing it.

Thus by late October, the Korean banking system had been severely damaged not simply by the string of corporate bankruptcies themselves, but by a highly politicized and uncertain process which left the ultimate disposition of Kia and its creditors in limbo for months. Korea's tottering financial system was thus already on the verge of collapse when the shock from Hong Kong hit on October 23. On November 1, the Haitai Group announced it was unable to stave off bankruptcy, and Moody's and Standard & Poor's downgraded the credit rating of Korean banks on the 3rd. Foreign banks began to refuse to roll over the short-term foreign debt of Korean financial institutions, the foreign press began to issue reports that the Bank of Korea's foreign exchange reserves were evaporating, and pressure on the exchange rate mounted, culminating in the effective devaluation of November 21.

While the Hanbo scandal, anti-bankruptcy pact, and conflict over Kia were taking place, the government faced an additional set of problems in trying to initiate a broader package of measures to strengthen financial regulation. In the wake of the

Hanbo scandal, the president initiated a Financial Reform Commission. Recognizing that any institutional restructuring would prove highly contentious within the bureaucracy, the Commission decided to proceed in two steps; first, to propose a serious of regulatory measures that could be implemented immediately, and only then address the more difficult questions of institutional reform. The fate of this reform effort also had some influence on foreign perceptions of the government's capacity to act; to understand its fate requires further explication of the government's political weaknesses in 1997.

Following the Hanbo scandal, Kim Young Sam began to distance himself from the party and the party's nomination process. Lee Hoi Chang captured the nomination on July 21, but he was unable to win a majority on the first ballot and only garnered 60 percent on the second. Following his nomination, Lee showed a substantial lead in the polls and appeared on his way to victory in December. However, his popularity plummeted when it was revealed that his two sons had avoided military service for being underweight, quickly opening a debate within the party on whether he should be replaced. Another presidential hopeful, Rhee In Je, left the ruling party and launched his own campaign on September 13, taking many of Kim Young Sam's supporters in the NKP with him and ironically strengthening Lee Hoi Chang's control of the party. Lee's chances were improved by the formation of an alliance with another candidate, Cho Soon, but Kim Dae Jung's position was also strengthened by an unlikely alliance with conservative candidate Kim Jong Pil; the combination of the ruling party's blunders and the alliance of the two Kims opened the possibility in the early fall that Kim Dae Jung might actually win the presidency.

In sum, the political background to policymaking in this period includes a severely weakened president and a divided ruling party headed by a candidate desperately trying to differentiate himself from the incumbent. Although National Assembly elections are not concurrent with the presidential elections in Korea, ruling party legislators naturally had concerns about the party's fate as well, and were disinclined to take actions that would damage the party in the run-up to the presidential elections.

In the meantime, the Financial Reform Commission had moved ahead with its more contentious institutional reform proposals, which involved three key features: increasing the independence of the Bank of Korea (BOK) from the Ministry of Finance and Economy (MOFE), but also stripping regulatory powers out of both the BOK and MOFE and locating them in an independent regulatory agency.[7] As the Financial Reform Commission itself did not have the power to draft legislation, the initiative had to pass through the MOFE, which has a strong interest in limiting the diminution of its powers; a first version of the bill effectively scuttled much of the Commission's reforms. A second version more in line with the Commission's intentions was ultimately submitted, but with few politicians seeing any gain from it, the ruling party and opposition agreed to postpone the legislation until after the elections.

[7] The following is based on interviews with staff of the Financial Reform Commission and the Ministry of Finance and Economy.

However, with the crisis looming in late October and early November, the question of financial reform again received attention, in part at the insistence of the IMF; in secret discussions with the Korean economic team, IMF managing director Camdessus expressed explicit concern about the importance for the markets of passing the financial reform legislation and of guaranteeing that all presidential candidates would back the package.

At the end of the second week of November, it appeared that the package of financial reform bills was headed for passage. A subcommittee under the National Assembly's Finance and Economy Committee passed the package by a vote of 6-2 and passed it to the full committee for a vote on the 14th. However, one of the contentious issues in the reform package was the Financial Supervisory Board (FSB), which would consolidate a number of existing regulatory agencies, and whether it would be under the direct control of the Prime Minister or the Minister of Finance and Economy, where the National Assembly believed it would have more oversight powers. The labor unions representing the Bank of Korea and the four agencies targeted for elimination were particularly opposed to the potential impact on agency employees. Bank of Korea workers demonstrated in front of New Korea Party headquarters on the 13th, and employees of the Securities Supervisory Board and the Insurance Supervisory Board protested in front of the National Assembly and Bank of Korea on the 14th (*Korea Herald*, Nov. 15, 1997). The employees all threatened to strike immediately after the National Assembly passed the reform legislation, and a group of former central bank governors held a press conference to voice their opposition the bills.

In principle, the ruling party could have passed the bills on its own, but Lee Hoi Chang's supporters were rightly concerned about the political cost of doing so. Kim Dae Jung did not want to alienate labor right before the election and could easily make an issue of the legislation; the ruling party thus preferred to consult with the opposition to secure their support. However, the opposition had few incentives to cooperate. If they signed on, they would be associated with potentially costly reforms, while if they postponed their assent, any negative economic effects of postponing the reform package would most likely rest at the feet of the president and the ruling party candidate, Lee Hoi Chang. Kang Kyung Shik and his staff tried in vain to persuade the National Assembly to pass the financial reform legislation on the last day of the session, but the Finance and Economy Committee didn't bother to send the bills to the floor for debate. As a result, Kang had failed to deliver the reforms as promised.; for markets already increasingly unsettled by a number of other developments this was but one additional piece of bad news.[8]

We do not mean to dismiss the underlying sources of Korea's financial crisis in the overleveraged chaebol, a precipitous opening of the capital account, and shocks emanating from abroad, particularly in late October. Yet how the markets responded to these problems depended on investors' views of the government, and over the first three quarters of 1997, government behavior generated substantial uncertainty. First, and contrary to a pure moral hazard story, the Korean government did not rush to firms' and banks' rescue and in fact let a number of major firms fail. But there was initially substantial uncertainty about how the government would

[8] On the initial failure of the IMF program, see Graham 1999.

respond, which itself invited tests such as that posed by Kia. Even though the government ultimately stared Kia down, the prolonged period of uncertainty surrounding that case generated increasing doubts about the government's intentions.

These were compounded by larger political milieu which made it difficult for the government to initiate reform. By November, it is doubtful that passage of the reform legislation would have been able to reverse Korea's fortunes. However, the failure reflected a more fundamental stalemate in Korean politics of which investors and analysts were aware; that intra- and inter-party conflict in anticipation of the election was making it difficult for the government to respond effectively to the crisis. Only with the election of Kim Dae Jung was the government able to initiate the far-reaching financial and corporate reforms the country required.

Indonesia

Of all the countries swept up in the Asian financial crisis, Indonesia's case is the most dramatic. This is particularly true given the fact that prior to the crisis, the country's key macroeconomic indicators provided few early warnings of impending crisis (Hill 1998; Radelet & Sachs 1998; World Bank 1998). The current account deficit was substantial, with evidence of overvaluation, but the deficit was less than half of Thailand's and with no tell-tale signs of capital flight or speculation against the currency prior to the fall of the baht. Nor were there the signs of an asset bubble or overinvestment visible in Korea and Thailand. And although there were clearly weaknesses in Indonesia's financial sector, through the third quarter of 1997, they were not seen as urgent or pressing problems. Nor is there a case to be made that the external crisis emanated from the financial sector, as was at least in part the case in Thailand and Korea. It is more plausible to argue that contagion from Thailand contributed to triggering the banking collapse not vice versa. Indeed, as late as the third quarter of 1997, financial reform was not seen as a pivotal issue for investor confidence. And yet by the fourth quarter of 1997 the situation had changed dramatically and the Indonesian banking system was in very deep distress.

In looking at the rapid collapse of the Indonesian financial sector, we focus on two factors. First, we follow a number of other commentators in noting a series of misguided (if well-intentioned) government policy actions that served to dramatically increase the banking sector's problems. However, these policy problems were compounded by the same type of uncertainty we have seen in the foregoing cases. Conflicting signals about the strength of the Suharto guarantee, compounded by broader institutional weaknesses, generated deep uncertainty among both crony and non-crony banks and firms, and paved the way for the rapid collapse of confidence within the banking sector.

The background to Indonesia's financial difficulties includes the combination of domestic financial liberalization and weak prudential regulation visible in Korea and Thailand. From having a very heavily regulated, small, and state-dominated financial sector, banking in Indonesia grew extremely rapidly in the decade prior the regional financial crisis (Cole and Slade 1996; Chant and Pangestu 1996; MacIntyre 1993). Key to this rapid change were two major rounds of financial deregulation in 1983 and 1988 which dramatically lowered the barriers for both local and foreign entrants to the banking sector. One result of this deregulation not evident to the same extent in Thailand and Korea was that industrial groups were able to acquire banking operations, with corresponding problems of intra-group lending. Recognizing these problems, Bank Indonesia (the central bank) introduced a series of additional reform packages from 1989 onwards to strengthen the prudential framework.

Yet quite apart from issues of straightforward corruption and cronyism, to which we return below, the central bank and Finance Ministry had limited capacity to monitor and enforce the new regulations. As former central bank governor Soedrajad Djiwandono (himself fired during the crisis for resisting Suharto) lamented, while the number of banks had doubled in the 1990s the size of the commercial bank supervisory staff at Bank Indonesia remained unchanged (author interview, January 14 1999). Weak monitoring and enforcement capabilities meant that intra-group lending ceilings, capital-adequacy ratios, and limits on lending to the real estate sector were all susceptible to violation, with the attendant growth of non-performing assets.

Two contrasts with the other cases are also notable. Because commercial bank licenses were relatively easy to obtain (between 1988 and 1993 the number doubled, to 240) finance companies or merchant banks played a much less prominent role in the financial system than in Thailand or Korea. The fact that it was commercial banks rather than just NBFIs that were afflicted in Indonesia meant that the crisis had a much more profound effect on the payments system. A second difference is the extent to which foreign borrowing was intermediated through the financial sector. Because Indonesia had long had a fairly open capital account, corporations were able to borrow offshore directly. When the rupiah fell, the corporate sector was directly exposed, which fed back into the domestic banking sector.

As in the other cases, it has been argued that moral hazard problems lay at the heart of the financial crisis in Indonesia; indeed, Indonesia is held as the quintessential case of crony capitalism, in which direct political ties between Suharto's government and banks produced an assumed guarantee against failure.[9] As long-term observers of the Indonesian financial sector, David Cole and Betty Slade (1998: 65) put it, "in the 1999s the 'Soeharto connection' became the 'guarantee' or collateral underlying the viability of many enterprises and financial institutions, most obviously in banking and securities markets. Any financial regulator who attempted to apply prudential rules to such connected financial institutions or tansactions…was removed from his position. Politics and connections dominated."

The power and value of a genuine Suharto connection were widely understood. This was starkly illustrated in 1990 when Bank Duta, a private bank housing the substantial deposits of several shadowy political foundations controlled by Suharto himself lost nearly half a billion US dollars in foreign exchange speculation. Bank Duta was promptly rescued by two other large corporate groups

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[9] The literature on Indonesia's modern political economy groans under the weight of accounts of clientelism and preferential treatment of favoured firms (Robison 1986; Muhaimin 1991; MacIntyre 1994; Winters 1996).

with very close financial ties to Suharto, which in turn were quickly rewarded with other forms of state largesse (Schwarz 1994: 112).

It is important to remember, however, that the inner circle of Suharto family principals and core business associates was actually fairly small. Although the overall web of connected firms that fanned out from these people was indeed extensive, in any given sector only a small number of players were close enough to enjoy a bankable guarantee. Indeed, in principle, it cannot be otherwise as it is virtually axiomatic that a client- or crony-firm enjoys a privileged position that is valuable precisely because of its *scarcity.* The banks of Suharto family members or core-business associates do indeed constitute classic illustrations of moral hazard. But, as we shall see, the normally risk-free operating environment of crony financial institutions was called into doubt from late 1997 as Suharto began sending mixed signals about the strength of their 'guarantee'.

That the great majority of banks could not count on the safety net enjoyed by the few strongly Suharto-connected banks is demonstrated clearly by the collapse of Bank Summa, just two years after the Bank Duta episode. Bank Summa was owned by the Astra group, the second largest industrial conglomerate in Indonesia. Despite its early association with Suharto, the Astra group had consciously distanced itself from the Suharto circle. When massive mismanagement caused Bank Summa to collapse, no assistance from the government was forthcoming and the Bank was forced into liquidation at enormous cost to the parent company (Cole and Slade 1996: 136-7). If the Bank Duta experience illustrated the fail-safe guarantee of a Suharto connection, the Bank Summa experience illustrated that in the absence of a Suharto-connection anything could happen, even to a very large company.[10]

Indonesia's initial response to regional contagion was to widen the band within which the rupiah traded, and when this proved inadequate, to cut the rupiah completely free. As McLeod (1998a; 1998b) has argued, from this point the government proceeded to make a series of very damaging policy missteps. When the rupiah continued to fall sharply, not only did the central bank begin intervening sporadically in the currency market (thus undercutting the notion of a clean float), it also adopted an extremely contractionary monetary and fiscal stance in a bid to attract capital back into the country and support the currency. Although these orthodox measures were widely applauded at the time and served briefly to help slow the fall of the rupiah, it soon became apparent that they represented overkill, and effectively served to push the rupiah lower still.

As interest rates spiked sharply higher, lending to the property and construction sectors dried up and firms struggled to meet their dramatically increased repayment obligations. The same, of course, was also so true for the many borrowers with unhedged dollar-denominated loans who were caught by the rupiah's fall. With assets in the property sector sharply devalued and with more borrowers defaulting on their loans, in part precisely because of the tight squeeze on liquidity, the banking sector was soon in serious difficulty.

[10] In late 1996, Bank Indonesia Governor Soedradjad had been given approval by Suharto to close six struggling banks falling below prudential benchmarks. In the face of heightened political protest, Soeharto directed that the action be held over until after the completion of the parliamentary elections in the second quarter of 1997 – after which events were overtaken by the crisis (interview, Soedradjad Djiwandono January 14 1999).

Two months after floating the rupiah, in early October, the government turned to the IMF. The fourth quarter of 1997 – the period after the arrival of the IMF – proved to be pivotal. Up to this point, the government had demonstrated determined and focused policy action, albeit in a direction that had the unintended effect of making the situation worse. The IMF did not bring much that was new to the equation: it injected a small amount of additional capital,[11] but no markedly different ideas. The broad thrust of IMF advice with respect to macroeconomic policy was to maintain austere fiscal and monetary policy settings to support the currency. A number of sectoral adjustment measures cut deeply into core Suharto family and crony business operations. With respect to the banking sector, the diagnosis was to stop the downward spiral by closing insolvent banks so that confidence in the banking system as a whole would be restored and the flow of deposits and interbank lending might resume. These priorities fitted easily with the existing approach of senior economic technocrats within the government, who saw this as a sensible way of tackling the problems at hand and, coincidentally, as a golden opportunity to force difficult new economic reforms on Suharto.

Notwithstanding the logic behind this strategy, it failed in each and every respect, including with respect to the banking sector (see, inter alia, Radelet and Sachs 1998; McLeod and Garnaut 1998; as opposed to IMF 1999). More important for our purposes, however, were the powerfully conflicting signals that soon emerged from the government in its effort to implement the Fund program.

[11] Notwithstanding the talk of an IMF package of up to US$43billion for Indonesia, in practice only $3billion was released to the government during this critical period, and this with no apparent clear purpose other than to support the currency – even though such an amount was so small as to be almost irrelevant for this purpose.

Uncertainty centered on the value of a Suharto connection, and whether crony banks and firms would be saved or not. The uncertainty that resulted had clear consequences for investor confidence, both local and foreign.

Consistent with the desire to demonstrate its commitment to reform, the government moved very speedily to announce a number of policy measures, including the abolition of a number of crony import monopolies. On November 1, 16 small banks (several controlled by relatives or cronies) were closed. On November 3 further major tariff cuts in industries affecting crony firms were announced, and Indonesia agreed to abide by the WTO's dispute settlement procedure with respect to its controversial national car project controlled by a Suharto son. The administration promised a review of "strategic industries" falling under the portfolio of technology minister B.J. Habibie and the wholesale and distribution sectors were opened to foreign investors. These measures were impressive both for their speed and for the apparent willingness of the president to allow the privileges of allied business to be cut back.

However, at the very same time that Suharto was unleashing these reform initiatives, he was also taking rearguard actions which pulled in precisely the opposite direction. On November 1, amidst the flurry of IMF-related initiatives, Suharto quietly signed a decree giving the green light to fifteen big-ticket investment projects that had been postponed in September in the name of fiscal restraint. All of the rescued projects belonged to relatives or close cronies. By the end of the week, the president’s second son and his half brother declared in a public tirade that they would be suing the central bank governor and the finance minister for closing their banks. Although the decision to close these banks was not reversed, within two weeks the president's son announced that he had taken over another small bank and would transfer all the assets of his closed bank into the new one, making public mockery of the decision to close the bank in the first place.

The commitment to tight monetary policy was also called into question when the government allowed banks to borrow from the central bank's special liquidity credit facility to ease their acute operational difficulties. This gave rise to two problems. First, the borrowing resulted in a substantial increase in the money supply and the rapid upward revision of inflationary expectations. Second, as with the backsliding on structural reforms, it called into fundamental doubt the government's commitment to reining in crony privileges. Crony banks consumed the great majority of the emergency liquidity credit operation, with the Salim group's Bank Central Asia (BCA) soaking up Rp 35 trillion (roughly US$ 7 billion in late 1997 prices), support equivalent to more than 500% of its capital (*Jakarta Post*, October 1 1998).[12] As was later publicly confirmed, crony banks immediately misappropriated the credits, siphoning them out of the country and even speculating against the rupiah.

The government's management of the emerging banking crisis was deeply unsatisfactory for Suharto-linked investors and non Suharto-linked alike. For Suharto cronies, the prospect of having their banks closed, monopoly rents jeopardized, and lucrative infrastructure projects shelved was profoundly threatening; their business empires rested on such opportunities and the subsequent flows of credit that followed. Particularly worrying were the reputational costs: the value of these individuals to potential business partners was their ability to deliver a political connection and the value of that connection was now being called into doubt.

For non Suharto-linked investors the situation was, if anything, even worse. The promises and actions which worried the cronies were of course a source of encouragement for non-cronies; they suggested that – as in major economic crises in past decades – Suharto would do whatever was necessary to restore confidence. Notwithstanding subsequent critiques of the macroeconomic elements of the technocrat/IMF agenda, at the time of its announcement the program was seen as promising an improvement of the business environment. However, as cronies fought to maintain their priveleges, the resulting policy backsliding and outright reversals generated deep uncertainty as to Suharto's commitment to reform.

In short, both categories of investors were afflicted by the government's ambiguous policy actions. Crony investors could not be sure that their connection protected them. Non-crony investors could not be sure it had been weakened political property rights to the extent that a fairer business environment might emerge. Faced with this mounting uncertainty, the common reaction was to withhold investment and relocate liquid assets abroad. As indicated by the exchange rate, capital flight grew in momentum through November and December and became a torrent in January in response to a budget which only heightened uncertainty about the government's intentions.

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[12] It is unclear exactly how much money was released through this liquidity credit operation. According to the *official* figures, the total may have reached Rp 92 trillion, in which case BCA would

But by this point, the damage to investor confidence was nearly irreversible, and larger institutional uncertainties came into play. Indonesia's political framework under Suharto was so massively centralized that sudden and strong policy action in almost any direction was possible. But because there were no institutional checks on executive authority by the president, decisive policy action could undertaken – and reversed – with relative ease (see MacIntyre 1999a; 1999b). Thus while this institutional framework could underpin the rapid structural reforms of the 1980s, it could also produce the extreme policy fluctuations that proved so destructive to investor confidence in 1997 and 1998. Although the authoritarian nature of Suharto's regime enabled him to cling to office for several more months, the economic dislocation resulting from the exodus of capital produced sufficient social hardship to trigger a political backlash and the fragmentation of the political elite surrounding Suharto. On May 21 he finally stepped down, ushering in a new political era.

To summarize, three arguments have been advanced in this discussion of the Indonesian case. First, moral hazard is clearly part of the story of Indonesia's financial collapse, but the extent of moral hazard is neither as straightforward nor as widespread as many of the sweeping claims on the subject would suggest. Moral hazard pertained only to a small group of investors; there was ample evidence that others would not, in fact, be protected. Second, the course of economic policy in Indonesia in 1997 and 1998 reflected an underlying struggle over the strength and value of a political connection to Suharto; uncertainty over these political property

have consumed more than a third on its own.

rights generated broader policy and market uncertainty and lack of confidence. Finally, these effects were compounded by the very nature of authoritarian rule, which made highly capricious policy possible.

Conclusion

This paper has as its objective an evaluation of the claim that moral hazard was at the center of the Asian financial crisis. We found evidence of moral hazard in all three cases: in Thailand's FIDF, in Korea's forbearance toward bank excesses, in Indonesia's cronyism. However, we also found that the nature of these guarantees was often highly ambiguous and contested. In Thailand, reformers made efforts to limit government commitments to poorly managed banks and finance companies, but without success. In Korea, both Hanbo and Kia, although for different reasons, thought that they would be supported, but weren't. Similar ambiguities in policy are visible in Indonesia, where Suharto's commitment to protect cronies proved highly uncertain.

We argue that this uncertainty is a crucial element in the onset and depth of the financial crises, as investors come to question the nature of government's policy commitments. In the cases just sited, conflicts among claimants, or between claimants and the government, generated this uncertainty. However, in each case we have isolated broader political factors--although not common ones--that induced uncertainty with respect to the government's stance toward the financial sector, ranging from Thailand’s party system, to the breakdown of party coherence in Korea due to electoral competition, to the authoritarianism of the Suharto regime.

The implications of this review for policy appear straightforward; that credible commitments not to come to the assistance of firms is an important antidote to uncertainty over government intentions. But this policy advice, often given, is nearly circular--credible policy is credible--and begs the deeper political and institutional issues that breed moral hazard and policy uncertainty in the first place. Clearly, one important finding is the importance of increasing transparency and reducing corruption. Exposing the nature of private political commitments in itself is likely to generate opposition to their cost. Yet where corruption and cronyism are rooted in broader institutional structures, such as fragmented party systems or authoritarian rule, addressing financial market policy and corruption may not be enough, and more fundamental constitutional changes may be required to generate more coherent policy.

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