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The Second East Asian Miracle?:
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Yasunobu Okabe

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JICA Research Institute
10-5 Ichigaya Honmura-cho
Shinjuku-ku
Tokyo 162-8433, JAPAN
TEL: +81-3-3269-3374
FAX: +81-3-3269-2054

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Financial Restructuring after the 1997 Crisis and Impact of the Lehman Shock: Path Dependence of Financial Systems in Korea and Thailand

Yasunobu Okabe*

Abstract

After the 1997 Asian financial crisis, South Korea (Korea) and Thailand implemented financial restructuring in a similarly successful manner and regained the healthiness of their banking sectors. However, when the Lehman shock hit their financial markets in 2008, its impact on the two countries was quite different. Korea, which had performed better in the financial restructuring than Thailand, was driven to the brink of a second financial crisis in 2008 while Thailand weathered the shock easily. This paper addresses this paradoxical contrast from the path dependence perspective, focusing on different historical paths of formation and change of the respective financial systems. It concludes that the successful state-led financial restructuring in Korea fostered banks' propensity of active lending while the private sector-led reform in Thailand only reinforced banks' conservative lending behavior. Furthermore, betraying the critical juncture theory, the severe economic crises helped reinforce the institutional legacies in the two countries, resulting in aggressive foreign borrowing by Korean banks and timid borrowing by Thai banks. These differences explain their contrasting vulnerability to the Lehman shock.

Keywords: financial crisis, path dependence, institutional legacy, financial system, Korea, Thailand

*Research Fellow, JICA Research Institute (Okabe.Yasunobu@jica.go.jp)

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1. Introduction

After the 1997 Asian financial crisis (AFC), South Korea (hereafter Korea) and Thailand, which had suffered great losses, were able to manage financial restructuring. They tackled the internationally standardized menu of restructuring measures such as the disposition of non-performing loans, the increase of capital base, and the realignment of the banking sector. Their restructuring improved the healthiness of the banking sectors, and the impact of the 2008 subprime loan crisis, or the Lehman shock on their financial markets, was seemingly negligible.

The two countries were quite different in their respective vulnerability to the global financial crisis (GFC) triggered by the Lehman Brothers shock. Korea, which had performed better than Thailand in the financial restructuring and therefore expected to weather the GFC better, was actually more severely affected and driven to the brink of a second financial crisis in 2008. What is the reason for this paradoxical contrast? This paper will address this question from the path dependence perspective, focusing on different paths of formation and restructuring of the financial systems in the two countries.

Korea and Thailand have been selected for this study, because while they differed greatly in the post-AFC restructuring and impacts of the GFC, they share many common external conditions. First, the two countries fell into a similarly serious crisis in 1997-98 and were required to undergo liberal financial reforms in exchange for the IMF rescue package. Second, although their export and GDP growth were adversely affected by the economic downturn in industrial countries during the GFC, the exposure to toxic assets was low in the two countries because local banks had not invested heavily in the US subprime loans. By comparing the Korean and Thai experiences, we will be able to clarify the importance of domestic factors, especially in different institutional configurations of the respective financial systems.

While the progress of their financial reforms and the impact of the Lehman shock drew broad scholarly attention, the differences between the two countries have been largely ignored.

Hamilton-Hart (2008) surveys the post-crisis financial reforms and the subsequent trajectories of the banking systems in Indonesia, Korea, Malaysia, and Thailand. However, her main focus is on how much their banking systems changed in a decade after the AFC. It is not clear how such changes affected each country's vulnerability to the GFC or the response. Ghosh (2006, 63-72) also only discusses the improvement of bank soundness and efficiency, and the general trend of financial intermediation in East Asia after 1997.

On the other hand, several economists examining the impact of the Lehman shock crisis give attention to East Asian resilience during the financial storm and policy measures responding to the crisis (Dowling and Rana 2010; Bhaskaran and Ghosh 2010; Saw and Wong 2010). However, few paid due attention to the different degrees of external vulnerability among the East Asian countries. None have shed light on the differences between Korea and Thailand.

As mentioned above, this study will rely on the path-dependence approach and attempt to explain how external vulnerability of the two countries was affected by the post-1997 financial restructuring. It will also discuss how their ways of restructuring were historically shaped by their pre-1997 financial systems.

This study will be structured as follows. Section 2 will examine the process in which existing financial systems in Korea and Thailand faced mounting pressures for change in the pre-AFC period leading to consequential deregulation and liberalization. As a result, the financial sectors in the two countries accumulated a huge amount of short-term debts and heightened external vulnerability, eventually causing the AFC. Section 3 will clarify how the crisis helped the resurgence of traditional institutional configurations and shaped the basis for restructuring the banking sector. Section 4 then argues how the revived institutional legacies contributed to the emergence of different external vulnerability in the two countries on the eve of the GFC. Finally, some theoretical implications of our study are offered in conclusion.

2. Liberalization and the onset of the 1997 crisis

2.1 Institutional persistence and change

On the eve of financial liberalization, the financial systems in Korea and Thailand were in a sharp contrast. Korea had formed a system characterized as “rent-for-enterprises” while Thailand had a “rent-for-banks” system.

In Korea, the powerful state controlled the banking sector and intervened to mobilize financial resources, both domestic and external, to promote manufacturing industries. For this purpose, the state supplied financial rent to chaebol enterprises through various measures including the maintenance of low real interest rates, credit allocation, debt guarantee, allocation of externally borrowed money, the subordination of the central bank to the pro-industry government, and moderately expansionary fiscal and monetary policies (Choi 1993; Woo 1991).

In Thailand, the private banking sector was powerful while the state was less intervening. The government protected the existing banks by restricting new entries. Beyond that, however, the state avoided interventionist policies and succumbed to private banks’ desires for fiscal balance, money supply control, and central bank independence, all of which were regarded as important to avoid inflation and lowering real interest rate (Doner and Unger 1993; Suehiro 2005).

These characteristics of the financial systems in the two countries were reflections of the power and interest of stakeholders – namely state, banks, and industrial enterprises – during the formative period. Once firmly established, institutions have a strong tendency to persist (Krasner 1984; Pierson 2004). Even when a certain institution has disappeared as a formal organization, actors sometimes accept the existing patterns of behavior as guidance for future behavior (Goldstein and Keohane 1993, 13-17). This is because, facing uncertainty, they have incentive to maintain former institutions or behavioral patterns from which they once enjoyed benefit.[1]

The path-dependence tendency notwithstanding, institutions do change because success and/or failure of the existing institutions transform interest and power of the concerned actors. First, under new domestic and external circumstances, the existing system may not be able to continuously function properly and satisfy everybody. Disenchanted or dissatisfied actors will demand transformation of the system. Second, changes in power balance among stakeholders may lead to actors' efforts to readjust the system to the new balance of power or to recover the former balance of power. Third, formerly absent players may appear and make new demands for change. These new players cover both domestic and external actors.

In short, institutions create both continuing and transforming tendencies. The balance between persistence and change is deeply affected by political processes developed among stakeholders.

2.2 The Korean case

In Korea, a serious move to systemic transformation began during the 1980s in the form of liberalization of the domestic financial market.

Serious concern regarding inflation and corporate debts spread among political and bureaucratic leaders. Technocrats in economic ministries especially feared that the mounting non-performing loans of the big corporations would cause a debt crisis. It was also worrisome that inflation caused by financial repression was destabilizing the economy (Cho and Kim 1997, 42).

In addition, observing a mounting criticism among the public opinion against the government favoritism of chaebols, the Chun Doo Hwan government felt the necessity to rectify

1. Weir and Skocpol (1985, 120-21) shows the way past policy was institutionalized, or policy legacy, shapes understanding of politicians and technocrats about future policy and determines the kind of policy that can be developed.

the image of a cozy relationship between the government and the big business (Lim 2003, 48; Zhang 2003, 75).

To these domestic pressures joined the external demand for financial-market liberalization. Pressure from OECD, IMF, and the US government became stronger after the late 1980s. The Kim Young Sam government (1993-98), longing for OECD membership, felt an especially strong pressure to quicken the reform (Haggard 2000, 37).

The process of liberalization began in the domestic market. The national banks were privatized throughout the 1980s. However, to avoid chaebol's dominance over the privatized banking sector, the government imposed a limitation on ownership. The maximum ownership by any single shareholder was limited to 8% in 1982. The limit was tightened to 4% in 1994 (Bank of Korea 2006, 18). In addition, the government continued to supervise the banks by controlling appointment of top executives and interfering in their budget-making (Park and Kim 1994, 192).

Nevertheless, big business-led export expansion and democratic opening in the latter half of the 1980s strengthened chaebol power. Chaebols, though excluded from the banking sector, had enough resources and reputation to establish non-bank financial institutions to raise money domestically and externally. Their influence on public policy was also enhanced as politicians and political parties increasingly relied on financial contributions from big corporations (Kang 2002, 153-54, 158-66).

The financial policy of the government was constrained by the expanding influence of chaebol. The interest rate was liberalized only in a very gradual manner because higher interest rates could raise the already heavy debt burden of the chaebol corporations (Choi 1993, 49-51; Chung 1994, 115).

Chaebol influence also affected the order of the liberalization of international capital transactions. In 1994, the short-term capital transactions were liberalized, preceding the liberalization of long-term capital accounts such as equity investment and FDI. This sequence perfectly fit chaebol preferences for obtaining easy short-term capital to expand export-oriented production while excluding the possibility of foreign intrusion into the lucrative businesses. Public opinion is usually critical of the privileged status of chaebols in Korea, but chaebols could count on the public with regard to common aversion of foreign capital intrusion.[2]

Before the AFC, technocrats in the Kim Young Sam government intended to rectify debt dependence of chaebol enterprises to avoid debt crisis similar to the one experienced in the early 1980s. However, taking advantage of the financial deregulation and liberalization, chaebol enterprises now could finance their businesses with corporate bonds, equity, and/or foreign short-term borrowing instead of bank credits. This made chaebols more independent of the government. They competed vigorously to raise money and invest in heavy and chemical industries. However, given the excessive supply of semiconductors and shipbuilding in the international market, increase in labor costs, and the technology lag behind advanced industrial countries, this competition only led to excessive investment (Haggard 2000, 55) and lower profitability, and aggravated chaebol indebtedness. The average corporate debt ratio (total liabilities/stockholders' equity) in the manufacturing sector reached as high as 317.1% in 1996 and 396.3% in 1997 (Bank of Korea 2000).[3]

The failure of chaebol firms such as Hanbo steel and Kia Motors triggered the crisis. Fingers point at the Kim Young Sam government for lacked consistency and speed, thereby making the rollover ratio of foreign short-term capital decline and bringing about capital flight (Dooley and Shin 2000, 157). The massive capital outflow was precipitated by the well-known double-mismatch of foreign short-term borrowing (Yoshitomi and Ohno 1999; Park 1998, 29).

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2. Lee Kyu-Sung, who served as Minister of Finance (1988-1990) and Minister of Finance and Economy (1998-1999), writes: "(Before the AFC) in Korea, FDI was being impeded by restrictive investment policies and widespread ambivalence and suspicion among the general public" (Lee 2011, 118).
3. There was moral hazard on the chaebol side. Chaebols counted on the government to come to their rescue as it had done during the previous crises because they are too big to fail. Hahn (2000) concluded in his statistical analysis that the bigger chaebols are, the more their investment behavior is risk-taking.

2.3 The Thai case

Financial liberalization was delayed in Thailand, but the factors which precipitated the reform were similar. Government technocrats discerned functional deficiencies in the existing financial system. But different from the Korean case in which inflation and corporate debts were main problems, the primary problem in Thailand was a broadening gap between savings and investment. To meet the expanding demand for business financing, government officials attempted to develop a local bond market and enhance foreign-capital intake (Suehiro 2005, 39; Bank of Thailand 1992, 331-32).

Criticism against oligopolistic business groups dominated by big commercial banks also mounted gradually. As the polity was democratized, the government felt the necessity to tackle this problem.[4] The liberalization was expected to benefit broader segments of society.

Then the Thai government faced increasing international pressures to comply with trade-related obligations under the GATT Uruguay Round agreements and to implement capital-account liberalization demanded by the World Bank, IMF, and the US government (Pasuk and Baker 2002, 164-65; Zhang 2003, 113, 129-30).

Under the circumstances of rapid economic growth and expanding influence of political parties, newly emerging firms and local entrepreneurs sought for financial liberalization to reduce the cost of raising money. Big banks, however, opposed the competition-enhancing liberalization of interest rates. Furthermore, the Thai Bankers' Association, together with the Bank of Thailand (BOT), resisted the deregulation of foreign entry into the banking sector. They feared it would destabilize the banking system and intensify competition (Zhang 2003, 120-24).

As a virtual compromise, foreign capital transaction was freed in 1993 only in the offshore market (Bangkok International Banking Facilities: BIBF). By this measure, foreign

4. Author's interview with Tharin Nimmanhemin, former Minister of Finance (1992-1995) at Bangkok, February 20, 2009.

entry in the financial market was avoided. However, foreign short-term money did not stay in the offshore market. It flew into the domestic market massively.

Different from the Korean experience, domestic banks and finance companies invested the money in real estate and securities. These financial institutions had not developed enough capacity for financial intermediation under the long-term government protections and sought quick profits in the non-productive sectors. This practice led to an asset bubble, the same double-mismatch of foreign borrowing (Ammar 2005, 72, 80), and several conspicuous defaulting of finance companies and banks. However, the government continued to rescue ailing nonbanks and commercial banks (Thitinan 2001, 118-25, 194-95), thus deepening the wound incurably.

3. Financial restructuring

3.1 Post-crisis restructuring measures

Theoretically there are three main areas of restructuring after a serious financial crisis (Claessense et al. 2001; Honohan and Klingebiel 2000). They are (1) to dispose of NPLs (non-performing loans) through setting up public and/or private asset management corporations, (2) to recapitalize ailing or failed banks through injecting public, private, and/or foreign fund, and (3) to realign the banking sector through nationalization, private M&A, and/or the invitation of foreign banks. The third task is connected to the second one, because recapitalization is deeply related to the ownership structure and the government-bank relationship.

While these three tasks are common for crisis-ridden countries including Korea and Thailand, their approaches differ with regard to the role of the government in the process. For instance, a government-led approach was taken in Korea while a market-driven approach was adopted in Thailand. This section will reveal that path-dependent institutional constraints reemerged prominently during the immediately post-crisis period while the influence of change-seeking political forces receded (at least temporarily) due to the crisis.

3.2 The Korean case

Korea's financial restructuring featured strong and prompt government initiative and substantial acceptance of the entry of foreign capital.

The Kim Dae Jung government set up the Financial Supervisory Commission (FSC) to lead the restructuring process. This commission did not hesitate funding for disposing of bank NPLs through the government-established Korean Asset Management Corporation (KAMCO) and recapitalizing the ailing banks. The public funding that was injected from 1997 to 2003 amounted to approximately 30% of GDP in 2002 (Lim and Hahm 2004, 20, 22). In concrete terms, FSC nationalized two banks, injected public funding in 19 banks to support their effort to reduce NPLs and to strengthen their capital bases, and closed down five banks (and also 30 merchant banks).

Under the FSC supervision, several of these ailing banks were merged with or purchased by relatively healthy local banks or by foreign capital. The government approved 100% bank ownership by foreigners and raised the single shareholder ceiling from 4% to 10% in 2002 (Bank of Korea 2006, 18) to enhance incentives for foreign investors. As a result of the bank realignment, the number of banks decreased from 33 in 1997 to 18 in 2006 including 5 governmental banks (Bank of Korea 2006, 19, 22, 32).

The government also launched dauntless corporate reforms by which the largest chaebols were eventually forced to exchange their businesses ("Big Deal") to cut down excess capacities. Smaller chaebols were compelled to liquidate insolvent businesses under the guidance of government-supervised banks ("Workout"). The government further ordered the five largest chaebols to lower their debt-equity ratio to below 200% by the end of 1999 (Mo and Moon 2003, 128-33).

Existing literature mentions several reasons why the Kim Dae Jung government was able to take such a radical approach in the face of powerful chaebol forces and the labor pressure against employment reduction. First, Kim Dae Jung had always been in the opposition and had no chaebol connections (Haggard 2000). Second, there was a general feeling that chaebols were responsible for the crisis. Under such circumstances, it was difficult for chaebols to resist government measures. Third, the national crisis was so profound that the general public as well as political parties buttressed the reforms (Jung 2001, 17-18; Lim and Hahm 2004, 15).

These factors, however, do not explain why the Kim government came up with such interventionist policies to realize neoliberal reforms. It could be understood only if we take into account the institutional legacy of the Korean financial system. The state used to manage the banking sector and credit allocations. The virtual control by the state persisted even after bank privatization.

The institutional persistence of the financial system is reflected in the structure of bank supervising institutions. FSC, the new leading coordinator for restructuring, was integrated into the ministerial hierarchy dominated by the Ministry of Finance and Economy (MOFE) (Lee 2004, 157; Kim and Lee 2006, 415-16). Most of the executive officials of the FSC came from MOFE. For example, Lee Hun Jai, the first chairman of FSC (1998-2000), started his career in the Ministry of Finance (MOF) and experienced financial crises in the 1970s. His successors were also career officials from MOF or MOFE.

Under the pre-crisis Kim Young Sam government, these technocrats considered the possibility of introducing prudential regulations, lower debt financing by the private companies, reduce the risk of short-term borrowing, and to improve international competitiveness of the Korean banks by reducing their number. Their ideas were never put into practice because they could not gather political support to these measures that could damage chaebol and bank interests at least for the short run.

The obstacles were decisively removed by the crisis and an opportunity window was now opened for serious reforms (Kim 2002, 219). Consequently, MOFE and FSC willingly intervened in the financial market not only to promptly solve the NPL problem and implement bank recapitalization but also to scale up the size of the financial institutions.

Once the reforms started, the state dominance of the banking sector was further enhanced as the government raised the stock holding of the banks by injecting public funds (Jung 2001, 16). At the beginning of 2001, the government owned 21.7 trillion won of the commercial bank equities, which represented 48% of the total equities of all financial institutions in Korea (Lee 2002, 163-64). The personnel network connecting MOFE and banks also contributed to the government control of the banks. The network was built upon Amakudari or parachute appointments of MOFE officials to the banks.[5] Such government ownership and networks smoothed the merger of banks and the resolution of NPLs.

Another institutional legacy of the Korean financial system was the continuing limitation of chaebol ownership of banks. The government faced a dilemma of choosing chaebol or foreign investors when it needed money to recapitalize fragile banks and to re-privatize the nationalized banks. The government chose foreign capital (Kim and Lee 2008, 176; Mo 2008, 268), because the public aversion against chaebol was greater than that against foreigners during the early post-crisis years. The government, however, was cautious enough to also limit the foreign ownership of individual financial institutions for fear of nationalist backlash.[6]

5. For instance, in March 2007, a former vice minister of MOFE assumed the presidency of Woori bank, one of the four largest banks. Website of Woori Financial Group (http://www.woorifg.com/) (accessed August 15, 2007). Woori bank was newly founded in 2001 after the merger of four small- and medium-sized banks under the government initiative.

6. Public criticism against foreign investors soon mounted because people believed that foreigners purchased the Korean banks saved by a huge amount of public money at a bargain price (Kim and Lee 2008, 176). This opposition to foreign capital was evident in the news report about the suspicion of illegal acquisition of Korea Exchange Bank by Lone Star Funds, an American equity fund, in 2003 (The Korea Times, March 13, 2007).

3.3 The Thai case

In contrast to the Korean case, the Thai financial restructuring was characterized by gradual and private sector-led reforms and a highly limited acceptance of foreign capital. Different from the Kim Dae Jong government, the Chuan Leekpai government did not play an active role in financial restructuring.

To be sure, the government established the Financial Sector Restructuring Authority (FRA) in 1997 and closed down 56 finance companies and liquidated their assets.[7] The government also nationalized four small and medium-sized banks. However it did not take forceful measures with regard to the big banks. Private banks were left to act on their own initiative to dispose of NPLs and strengthen their capital bases.

Under the Announcement for Comprehensive Financial Restructuring of August 14, 1998, the government planned to inject 300 billion baht for bank recapitalization. In practice, only ten financial institutions participated in the scheme and 70.63 billion baht, or 23.5% of the originally planned amount, was utilized before the deadline (the end of 2000). Large private banks such as Bangkok Bank, Thai Farmers Bank (currently Kasikorn Bank), and Bank of Ayudhya did not join the scheme and opted to recapitalize on their own through the stock market (Veerathai 2003, 26-31).

The market-driven approach was also observed in the NPL disposal. The Chuan government established the Corporate Debt Restructuring Advisory Committee (CDRAC) to foster debt-restructuring negotiation among private companies, but did not form a public entity to force NPL disposal. Instead, it allowed private banks to set up their own asset management companies (AMC). The speed of NPL reduction was naturally slow. To quicken the process, the Thaksin government, which came to power in 2001, shifted to a government-led approach and established a public Thai Asset Management Corporation (TAMC) similar to Korea's KAMCO

7. Those disposed assets amounted to 14.3% of the total assets of all financial institutions including commercial banks, approximately 18% of GDP (FRA 2002, Table 1.2.1; Veerathai 2003, 14).

(Veerathai 2003, 73-76). Nevertheless, it turned out that 80.5% of the NPLs transferred to TAMC came from state-owned banks and their AMCs, not from private ones (author's calculation from TAMC 2002).

Neither did happen any large-scale alignment of the banking sector (except the nationalization of some small and medium-sized banks). In contrast to the Korean case, foreign investors were allowed to buy only small and medium-sized banks. The share of foreign banks in the Thai banking sector was as small as 4.3% in 2005, while the corresponding figure for Korea was 55.6% (World Bank 2007).[8] The oligopolistic structure of the banking sector remained the same in the post-crisis period.

The reason why the Thai government adopted the private sector-led approach and limited the entry of foreign capital is the resurgence of institutional constraints of the financial system due to the weakening of change-seeking political forces under the crisis. The emerging firms and small and mid-sized local entrepreneurs, potential supporters of anti-big bank policy, were hard hit and weakened by the crisis. Their loss was deepened when the government implemented the IMF-sponsored austere monetary and fiscal policies and made the fire sale of local assets to foreigners (Hewison 2005, 315-16). As a consequence, as opposed to financial liberalization in the pre-crisis years, they could not exert political pressures on the government to speed up NPL disposal and accept greater participation by foreign banks, policies contradicting big bank preferences.

Relieved from political pressures, officials of the Ministry of Finance (MOF) and BOT simply reinforced their traditional behavior of non-intervention. The Thai officials apparently felt more comfortable in the market-centered approach even in the post-crisis years. In an interview with the author, a BOT director said anonymously that the Thai government adopted the market-led approach, in contrast to the government-led approach of Korea, due to the

8. Here "foreign banks" are defined as banks in which more than 50% of the shares are owned by foreigners.

difference of "culture."[9] A former co-director of the MOF Fiscal Policy Office said that he was not sure that government initiative would be more efficient than private initiative in tackling financial restructuring.[10]

The second institutional legacy of the Thai financial system was the oligopolistic structure of the commercial banking sector and its preference for limited government intervention in the financial market except for the policy of excluding foreign competition. Even after the AFC, assets of the biggest five local banks (out of around fifteen) continued to surpass 70% of the total banking sector assets. Four of the five were private. Such private dominance of the financial market, different from the government-centered Korean experience, contributed to enhancing the influence of private banks over the government policy for recapitalization, NPL disposal, and foreign entry. Consequently, as mentioned above, large private banks owned by founder families and their close friends did not participate in the government scheme for recapitalization. The top bank executives worried that the government might intervene in their lending practices and demand their resignation.[11] Neither did Thai bankers want government involvement in the NPL problem. They preferred to solve it by their own initiative even if the speed of the rectification was slower.

Finally, the banking sector as well as the Thai government coincided in their aversion against foreign dominance of the financial market. Lacking anti-bank sentiment equivalent to the anti-chaebol feeling among the general public, the Thai government did not need to rely on foreign capital for their effort to restructure. Consequently, while allowing foreign investors to participate in the recapitalization of small and medium-sized banks, the government has not approved majority ownership of major banks by foreigners.[12] When foreign shareholders were

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9. February 27, 2007, Bangkok.
10. Author's interview with Veerathai Santiprabhob in January 31, 2007, Bangkok.
11. Author's interviews with Veerathai Santiprabhob (see fn.10) and with Twatchai Yongkittikul, Secretary General of the Thai Bankers Association in February 9, 2007, Bangkok.
12. Financial Institutions Act that was approved by the National Legislative Assembly in 2007 allows BOT to give permission to foreigners for shareholding of banks up to 49%. In addition, over 49% shareholding of a bank by foreigners is permitted only when Ministry of Finance considers it necessary for stabilizing the bank.

allowed to increase their stocks in large banks such as Kasikorn Bank and Bangkok Bank, their stocks were non-voting shares. Many restrictions were also imposed on foreign banks operations. Even if they acquire the status of local banks, they are allowed to open no more than four branches. A Japanese banker in Bangkok complained to the author that the acquisition of the status of a local bank would not be worthwhile since foreign-dominated banks were subject to stricter supervisions by the BOT.[13]

4. Different impacts of the Global Financial Crisis (GFC)

4.1 Financial systems on the eve of the GFC

The financial restructuring contributed to the recovery of the banks' healthiness and stability in both countries. As Table 1 shows, they gradually improved the capital adequacy ratio (CAR) and the NPL ratio through the 2000s, thereby helping the recovery of bank lending after the AFC.

However, the speed of recovery was much greater in Korea than in Thailand. In fact, the Korean bank lending - loans and discounts – constantly increased in the post-crisis years (Figure 1) while the Thai bank lending turned upward only in early 2002 (Figure 2).

The loan/deposit rate was again greater in Korea than in Thailand. The Thai lending behavior was quite conservative probably due to the slow pace of NPL disposal. Their loan/deposit rate was below 100% during 2000-2007, which means that the banks loaned less than what they received as deposits (Figure 3).[14] The ratio exceeded 100% only in 2008. In Korea, the loan/deposit rate exceeded 100% as early as in the fourth quarter of 2003 and reached 140% on the eve of the GFC (Figure 4).

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13. Author's anonymous interview with an executive of a Japanese commercial bank operating in Thailand (February 8, 2007).
14. Possibly the rest of the deposit was invested in safer assets such as government bonds.

The capacity of financial intermediation of the banking sector also differed in the two countries. Although the proportion of direct finance (e.g. stocks and other equities) rose in corporate financing in both Korea and Thailand, the dependence on financial loans was much higher in Korea than in Thailand as shown in the flow-of-funds tables (Table 2 and 3).

Finally, the Korean banking sector showed more stability than its Thai counterpart. The Bank Z-score shown in Table 2 is a proxy for banking stability. It scores higher when the return on asset (ROA) is higher, the capital adequacy rate is greater, and/or when the standard deviation of ROA is smaller (which means less volatility of return). According to Table 4, the annual averages of Bank Z-scores for 2002-2008 were similar in Korea and Thailand: 6.67 for the former and 6.20 for the latter. However, Korean scores were clearly in the upward trend while Thai scores were quite volatile.

In short, whereas the two countries' bank healthiness and stability enhanced, the recovery of bank lending and its contribution to corporate finance were more successful in Korea than in Thailand. This is the result of speedier restructuring through state-led measures in Korea.

Ironically, however, when the GFC hit Asia, Korea received by far more serious impacts than Thailand. Korea actually was driven to the brink of a second financial crisis in 2008 while effects on Thailand were minor.

In many cases, external factors are referred to as crucial in explaining the impact of the crisis on each country. For instance, Chalongphob and Somchai (2009) point out that external debts and exposure to subprime loans were low in Thailand, while Shin (2010) and Takayasu (2010) argue that the unexpected shift of foreign money in the wake of the Lehman shock was critical for the Korean crisis. According to an IMF report (IMF 2010, 62), Korean banks had very little direct exposure to the troubled US credit instruments. The main cause of the new crisis in Korea was the accumulation of short-term foreign debts and their sudden outflow, the same phenomenon as the AFC. To understand why the same failure happened in Korea (but not in Thailand) where the financial restructuring progressed much more deeply and quickly, we again need to refer to the institutional legacies of the financial systems.

4.2 The Korean case

Somewhat ironically, it was the active lending behavior of the refurbished banks, both domestic and foreign, that caused the renewed external vulnerability of the Korean economy.

As seen in Figure 1 and Figure 4, Korean banks, freed from the NPL burdens, increased their lending in the 2000s and raised the loan/deposit ratio from 100% (2004) to 140% (2008). In order to supplement the shortage of deposits,[15] banks increasingly depended on foreign borrowings. Table 5 shows that Korea's total external liabilities rose from $225.2 billion in the fourth quarter (Q4) of 2006 to $365.1 billion in the third quarter (Q3) of 2008, just before the Lehman crisis broke out. Half of this, or $189.6 billion, was short-term debts. The largest short-term debtors were domestic banks and domestic branches of foreign banks, which held short-term debts amounting to $65.4 billion and $93.9 billion respectively (the sum total represented 43.6% of the whole external debt in Q3 of 2008).

Domestic banks and domestic branches of foreign banks borrowed the short-term money to finance the investment by residents in foreign funds and also to finance shipbuilders' contracts.

On the one hand, the foreign portfolio investment boomed in the middle of the 2000s reaching $56.44 billion in 2007 (Bank of Korea Website). This boom was precipitated by two factors. First, Korean depositors, unsatisfied with low deposit interest rates, shifted their assets to foreign investment funds as well as the capital market. Second, the scope of the tax exemption on dividend income extended to overseas listed shares during 2007-2009 (Takayasu 2010, 187). Asset management companies that managed foreign funds, fearing won appreciation,

15. In fact, Korean households shifted some of their financial assets from deposits to portfolio investment against a background of an investment boom in 2006-07 to the extent that commercial banks fell short of funds in Won (SMBC Seoul 2009, 15).

hedged exchange risk by making forward contracts with domestic banks and foreign bank branches. These banks subsequently augmented foreign short-term borrowing to adjust their position.

On the other hand, against the backdrop of the world-wide shipbuilding boom between 2003 and 2008, Korean shipbuilders received orders equivalent to $215.1 billion US dollars as of November 2008 (SMBC Seoul 2009, 5).[16] The shipbuilders also hedged exchange risk by making forward contracts with banks, which in turn increased foreign short-term borrowing.[17]

Although these foreign debts of banks were actually guaranteed by foreign currency that those asset management companies and the shipbuilders would be paid in the future, such heavy dependence on foreign short-term debt made both domestic banks and foreign bank branches vulnerable to liquidity risks and changes of external financial conditions, despite little exposure to subprime assets (Shirai 2009, 34).

To make the situation worse, the government's prudential regulation was lenient for foreign bank branches. Domestic banks were strongly pressured to compensate their debts with foreign currency-denominated assets so that their foreign exchange (FX) position was squared. In contrast, foreign bank branches were left without such obligation (Shin 2010, 179). As a result, foreign bank short-term debts piled up rapidly and exceeded those of domestic banks after the second quarter (Q2) of 2006 (Table 5).

When capital inflows into Korea declined under the worldwide subprime loan crisis, the Korean won sharply depreciated (almost 30% in one month). At the same time, the ratio of international reserve to the foreign short-term debt fell rapidly from over 200% in 2006 to 126.4% in Q3 of 2008 (Table 5). The Korean economy was almost in the second financial crisis.

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16. Their order book amounted to 67.02 million cgt (compensated gross tons) at the end of December 2008, representing 36.7%, the biggest share of the world (Clarkson Research Services, excerpt from Nexans, Shipbuilding White Paper, December 2008. http://www.nexans.us/Corporate/2009/wp_shipbuilding2008.pdf. [Accessed May 15, 2011]).
17. As shipbuilding generally takes 2-4 years from contract until delivery, it was necessary for Korean shipbuilders to hedge exchange risk.

Korea could avoid the crisis only thanks to a $30 billion currency swap agreed with the US Federal Reserve Board in October 2008.

A major cause of the renewed upsurge of short-term debts resides in the framework of financial regulation dominated by the Ministry of Strategy and Finance (MOSF). Since the Bank of Korea (BOK) does not have autonomous status in Korea, misjudgment of the MOSF has little chance for self-rectification.

The Lee Myung-bak government, which took power in February 2008, established the Financial Services Commission (FSC) to replace the Financial Supervisory Commission (former FSC) and granted it full authority of financial regulations (Park 2010, 55, 59). Under the new regime, the function of MOSF' Division of Financial Policy was theoretically transferred to the new FSC. In practice, MOSF, as the primary coordinator of all economic policies, continues to hold strong influence on financial matters (Park 2010, 58). Just like the former FSC, the new FSC is associated with the MOSF by parachute appointments. The chairman, the vice chairman, and one of the five commissioners of the new FSC are former high-ranking officials of MOF, MOFE, and MOSF who share similar technocratic career paths.[18]

Under the current regime, the BOK is designated to play important roles in maintaining financial stability – the management of the payment and settlement system and emergency liquidity provision to banks as the lender of last resort. For the same purpose, BOK is responsible for providing information on economy, financial markets, and financial institutions. However, BOK's authorities in financial regulations are not clearly defined. The FSC Act recognizes FSC as a guardian of financial stability while the BOK Act does not explicitly include the maintenance of stability in its missions. The Financial Supervisory Services (FSS),

18. FSC website. http://www.fsc.go.kr/eng/ab/ab0401.jsp. (Accessed June 8, 2011)

the executive hand of the FSC, acknowledges only small roles for BOK and frequently refuses providing BOK with information collected in their supervisory operations (Park 2010, 59).[19]

Without an independent supervisory body, the MOSF overlooked the risk of short-term foreign debts creeping through forward contracts. A high-ranking BOK official informed the author that the central bank unofficially called the government's attention to the increasing debts before the Lehman shock. However, government officials, particularly those of the MOSF, did not listen to the BOK warning.[20] They paid little attention to the short-term debts for mainly two reasons.

First, the government allowed a rapid enhancement of short-term borrowings by the banks in the belief that the banking sector was now on a much stronger foundation after the successful financial restructuring with broad foreign participation. Although big chaebol firms strengthened the self-financing capability during the restructuring period, smaller enterprises and households still heavily depended on bank credits and welcomed the expansion of financial resources in the market.

Second, the government did not ask foreign banks to square their position with foreign currency-denominated assets because it wrongly believed that their assets were mostly held in foreign currencies and their main offices were powerful enough to help their subsidiaries in times of crisis (Shin 2010, 179-81). The government's expectation was betrayed by a large capital flight by the foreign banks.

The government-led financial system was quite effective in the quick and deep financial restructuring after the AFC. However, it turned out to be still vulnerable to external financial turmoil during the GFC because the wrong judgment by the government could not be rectified by any independent supervisory body.

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19. This refusal of providing information was confirmed by an anonymous high rank official of BOK in author's interview. This official also said that FSC and FSS had often rejected BOK requests for joint supervisory operation that is allowed by the BOK Act (February 10, 2010, Seoul).
20. Author's anonymous interview with a high ranking BOK official (March 4, 2011, Seoul).

4.3 The Thai case

In Thailand, as mentioned above, both the government and banks were reluctant to accept state interventionism in the financial market, which made the restructuring process slow. The delay of the restructuring in turn strengthened the conservative and risk-averse behavior of the banks. This behavior is also reinforced by the painful experience of the AFC (Chalongphob and Somchai 2009, 3). As a result, external exposure of Thai banks were kept low and consequently helped Thailand escape from the subprime loan crisis. Thai baht remained relatively stable.[21]

In fact, Thai banks did not hold as much foreign short-term debt as their Korean counterpart prior to the Lehman shock (in 2008 Q3). According to Table 6, the amount was 4.5 billion US dollars, representing only 5.7% of the total external debt (compared with 43.6% for Korean banks). Although half of Thailand's external debts were short-term, they were fully covered by international reserve. The ratio to foreign short-term debts reached as high as 271.7% in Q3 of 2008 (compared with Korea's 126.4%).

Furthermore, while one small bank, ThaiBank, needed to be recapitalized in 2008 because of high exposure to subprime-related toxic assets such as CDO (collateralized debt obligation), most of the banks were only marginally exposed. The banking sector's exposure to foreign assets was 1.2% of the total assets as of August 2008, and only 0.04% of the total assets were related to CDO investment (Bank of Thailand 2008).

The reasons for Thai commercial banks' low dependence on foreign short-term borrowings and their limited exposure to the toxic assets are found both in the commercial bank side and in the bank regulator side.

Commercial banks' lending behavior, as mentioned above, was very conservative, due to the slow pace of financial restructuring and their experience in the AFC. They hesitated to have a finger in subprime loans.

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21. Between December 2007 and November 2008, the exchange rate of baht against the US dollar depreciated by 8.3% while the Korean won depreciated by 96%. The depreciation rates were 16% in Indonesia, 17% in Malaysia, and 8% in Singapore (Shirai 2009, 35).

The bank regulator also learned lessons from the financial crisis of 1997 and reinforced its conservative policy stance. For instance, the BOT strengthened the regulation and supervision on commercial banks during the 2000s. Both domestic and foreign bankers found that BOT was very conservative and eager to control everything related to banking. In an interview with the author, a Thai banker said that BOT was much more concerned with bank soundness than lending to real sectors.[22] According to a Japanese banker operating in Thailand, BOT does not permit the self-assessment of NPLs by commercial banks, a practice widely accepted in the world today.[23]

The Thaksin government which had a more interventionist tendency than its post-AFC predecessors, tried to weaken the BOT regulations but its attempt was averted by the September 2006 coup. After that event, the BOT regained its authority and even succeeded to consolidate its legal independence in 2008.

5. Conclusion and implications

This study has traced the continuity and change of the financial systems in Korea and Thailand in relation to the two grave crises: AFC and GFC.

As the path-dependence approach argues, institutions, once firmly established, have a powerful tendency of persistence. However, as success and/or failure of the existing institutions transform interest and power of the concerned actors and as a consequence, the existing system may be perceived as ill-functional or unsatisfactory, it may be put under strong pressure for transformation.

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22. An anonymous interview by the author (Sept.2, 2011, Bangkok).
23. Author's anonymous interview (August 30, 2011, Bangkok). In addition, the same Thai banker cited in fn.22 said that BOT usually takes long time for procedures to permit new financial products that commercial banks develop.

In Korea, the "rent-for-enterprises" financial system characterized by strong government intervention and the absorption of rent by chaebol firms dominating the non-banking sectors faced challenges from technocrats, democratic forces, and foreign investors. As a result, deregulation and liberalization of the financial market were realized during the 1980s and 90s. However, due to the strengthened chaebol influence, the reforms sharply expanded foreign debts taken by banks and other financial institutions.

In contrast, Thailand had a "rent-for-banks" financial system in which the state took a hands-off policy except for measures to exclude foreign banks and to maintain macro-economic stability. The biggest beneficiaries were oligopolistic private banks. By the early 1990s, this system faced multiple problems including a saving-investment gap, increasing antipathy against oligopolistic business groups, and foreign demand for liberalization. As the political parties became more influential, government policy became more expansionary and interventionist. As a compromise between conservative banks/technocrats and emerging forces, the liberalization of the financial sector took the form of offshore-market opening, which brought enormous foreign-money inflow and the debt crisis.

Ironically, the serious financial crisis in 1997/98 helped the resurgence of traditional institutional configurations of the financial system: The interventionist state and chaebol firms expanding outside of the banking sector in Korea and the conservative state and oligopolistic banks in Thailand. Thanks to active and decisive government intervention, the restructuring of the banking sector was speedy and deep in Korea while it was slow and shallow in Thailand.

Ironically again, the successful restructuring helped strengthen bank propensity to borrow foreign money in Korea while the slowness of the Thai restructuring only reinforced conservative lending and borrowing behavior. Furthermore, the institutional legacies which resurged during the period of restructuring reinforced positive foreign borrowing by Korean banks and timid borrowing by Thai banks. In Korea, due to the weakness of the regulatory authority of the central bank, the misjudgment of the finance ministry about the behavior of domestic branches of foreign banks could not be rectified in time. As a result, Korea almost came to the brink of another financial crisis in 2008. In contrast, GFC's adverse effect on the Thai financial market was minimal partially because the central bank of Thailand successfully resisted Thaksin's pressures and rigidly regulated the financial market.

This study provides two theoretical implications for the broader literature on globalization and institutional evolution.

First, institutions matter even in the highly globalized world. Global financial forces may increasingly compel smaller countries to deregulate and liberalize their financial markets so that they are congruent with global standards. The smaller economies are especially vulnerable in a severe global crisis. Under such conditions, they are further forced to adapt their domestic system to the global rules. Disagreeing with such expectations, this paper proves that financial systems with different institutional characteristics adapt themselves differently under similarly strong international pressures for liberalization and in similarly severe financial crises. The path dependence approach is correct in its insistence on institutional stickiness.

Second, different from the critical juncture literature,[24] this study demonstrates that severe crises could reinforce traditional institutions instead of catalyzing a new institutional configuration. This phenomenon occurs when a serious crisis weakens change-oriented forces and/or reappraises traditional institutions under high uncertainties as they once functioned well.

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24. For example, see Krasner (1984), Mahoney (2001), and Pierson (2004).

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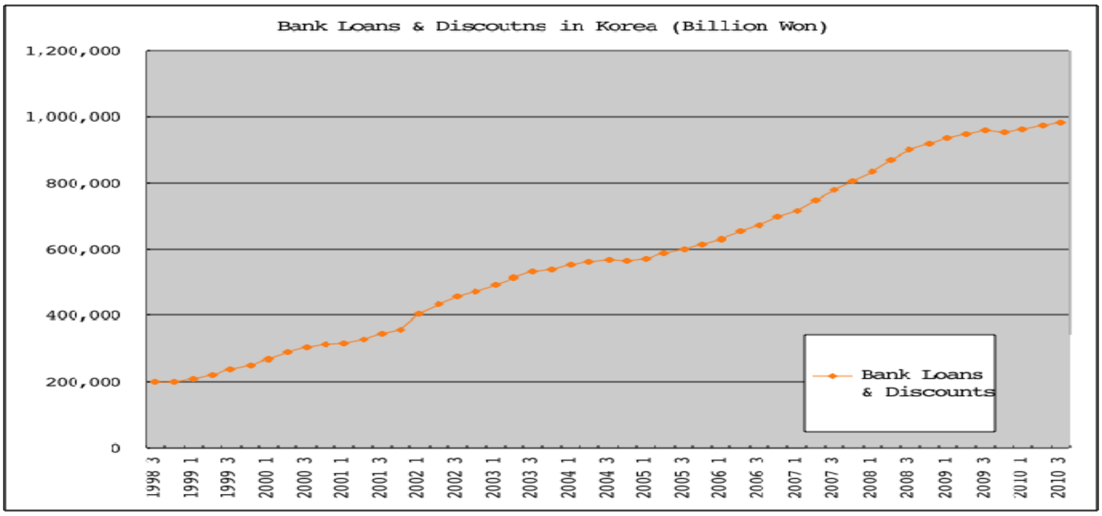
Table 1. Capital Adequacy Ratio (CAR) and NPL ratio of Korean and Thai commercial banks (%)

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009
Korea									
CAR	11.7	11.2	11.1	12.1	13.0	12.8	12.3	12.3	14.2
NPLs	3.4	2.4	2.6	1.9	1.2	0.8	0.7	1.1	1.5
Thailand									
CAR	13.3	13.0	13.4	12.4	13.2	13.6	14.8	13.8	n.a.
NPLs	11.5	16.5	13.5	11.9	9.1	8.4	7.9	5.7	n.a.

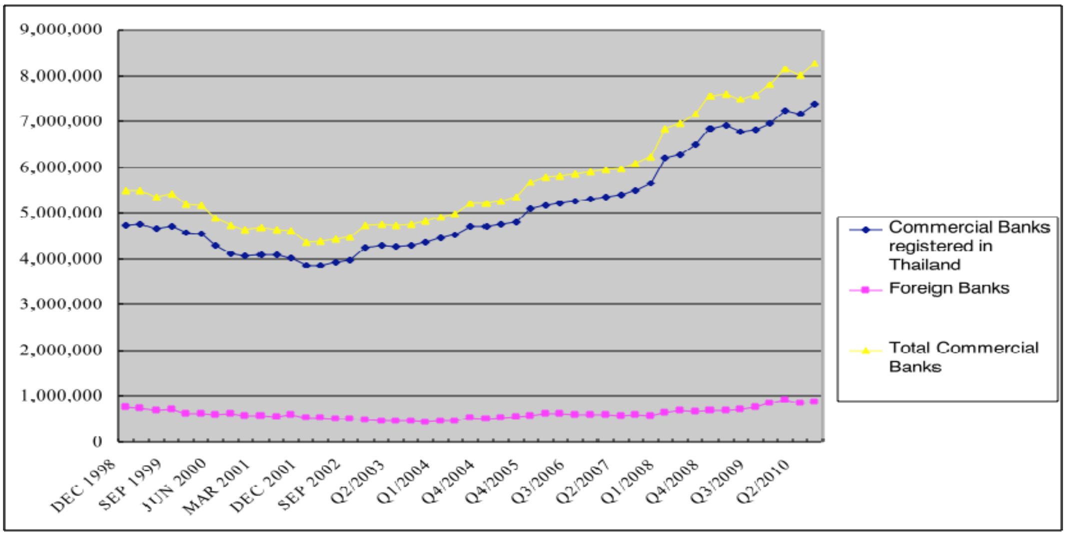
Source: IMF (2007, 2010).

Figure 1. Bank loans and discounts in Korea (Billion Won)



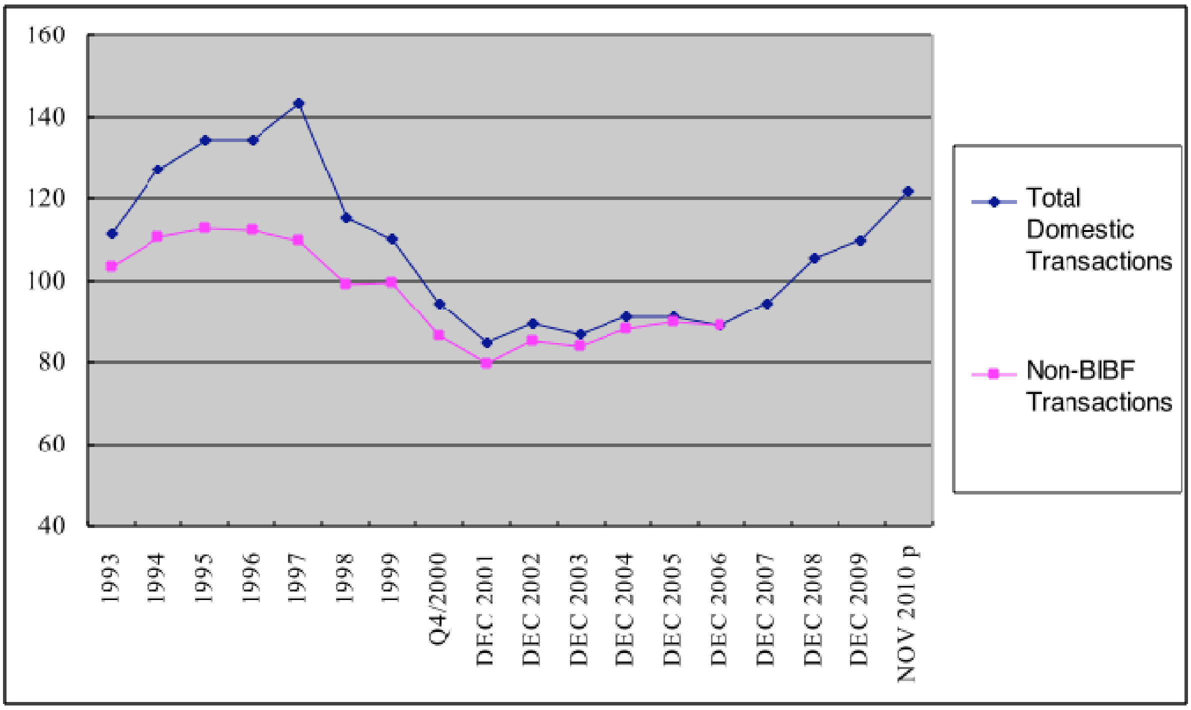
Source: Bank of Korea website.

Figure 2. Loan by commercial banks in Thailand (Millions of Baht)



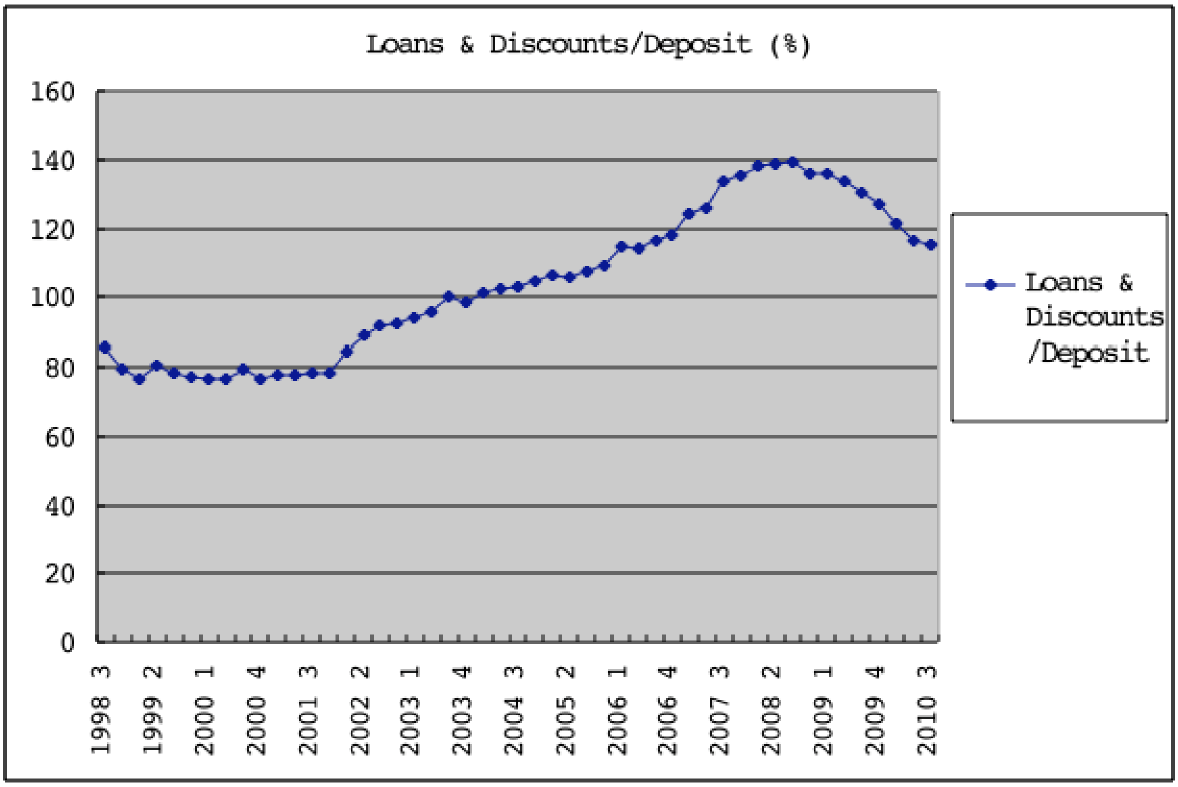
Source: Bank of Thailand website.

Figure 3. Loan/deposit ratio of all commercial banks in Thailand (%)



Source: Bank of Thailand website.

Figure 4. Loan & Discounts/Deposit* Ratio of Commercial Banks in Korea(%)



Source: Bank of Korea website.
Note*: Deposit in domestic currency without certificate deposit (CDs).

Table 2. Corporate finance in Korea: Flow-of-Funds, business sector (Net, %, 2002-2005)

	2002	2003	2004	2005
Bank Loans	49.4	42.5	10.6	17.3
Non-bank loans	10.8	-3.8	6.0	13.2
Stocks	34.5	35.9	33.8	19.8
Commercial Papers	-4.5	-5.7	-6.3	3.2
Corporate Bonds	-9.4	-2.5	0.2	7.8
Foreign Debts and Claims	-3.4	9.5	13.6	5.9
Others	22.7	24.1	42.2	32.8
TOTAL	100	100	100	100

Source: Bank of Korea website (1968 SNA).

Table 3. Corporate finance in Thailand: Flow-of-Funds, business sector (Net, %, 2002-2005)

	2002	2003	2004	2005
Short-term Loans	-1.5	-2.8	-2.4	0.8
Long-term Loans	-23.3	-75.6	68.1	7.2
Share Capital	63.1	104.1	20.3	31.7
Commercial Bills	101.6	114.3	18.3	15.2
Debentures	8.3	79.0	5.9	12.7
Mortgages	2.1	13.4	5.9	4.0
Foreign Debts and Claims	-31.6	-132.6	9.8	26.1
Others	-18.6	0.2	-25.8	2.3
TOTAL	100	100	100	100

Source: National Economic and Social Development Board (NESDB) website.

Table 4. Bank Z-score* of Korea and Thailand (2000-2008)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Korea	2.2	2.8	3.2	4.7	8.0	6.9	6.7	7.7	9.6
Thailand	1.4	1.6	7.0	5.5	4.7	9.0	8.2	4.3	4.7

Source: The dataset including this score is provided by the World Bank website (access on May 7, 2011): http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20696167~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html

Note*: Z-score is estimated as (ROA+equity/assets)/sd(ROA). I am grateful to Jean-Claude Maswana for his suggestion about this score. Here sd(ROA), the standard deviation of ROA, is estimated as a 5-year moving average. A higher z-score indicates that the bank is more stable.

Table 5. External Debt of Korea, 2006-2008 (Billion US dollars)

Gross External Debt	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4
TOTAL	172.9	196.3	212.3	225.2	247.6	271.0	295.9	333.4	358.2	366.6	365.1	317.4
Long-term	97.8	100.8	104.8	111.5	117.6	133.7	150.2	173.2	184.0	189.8	175.5	167.5
Short-term	75.2	95.5	107.4	113.7	130.0	137.3	145.6	160.2	174.2	176.8	189.6	149.9
Total Debt of Domestic Banks	64.5	72.7	80.7	82.1	87.4	93.0	102.3	109.0	118.3	126.5	122.1	97.0
Short-term	33.0	39.7	45.0	44.3	48.1	46.7	53.3	54.6	60.5	66.7	65.4	42.6
Total Debt of Domestic Branches of Foreign Banks	28.4	42.2	49.9	54.4	66.8	75.0	76.4	83.9	92.6	84.2	97.4	72.4
Short-term	26.7	40.1	47.7	51.8	63.9	70.7	71.5	79.3	87.8	80.4	93.9	67.8
International Reserves / Short-term Debt (%)*	289.2	234.9	212.4	210.1	187.6	182.6	176.7	163.6	151.7	146.0	126.4	134.2

Source: Bank of Korea website.
Note*: Author's calculation.

Table 6. External Debt of Thailand, 2006-2008 (Billion US dollars)

Gross External Debt	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4
TOTAL	66.0	67.0	68.6	70.0	69.5	69.9	73.0	74.4	80.3	78.9	78.8	76.1
Long-term	38.7	39.9	39.0	42.7	40.8	39.1	40.0	40.4	41.8	41.2	41.1	42.5
Short-term	27.2	27.1	29.6	27.2	28.6	30.7	33.0	34.0	38.6	37.7	37.7	33.6
Total Debt of Banks	8.4	6.9	8.9	6.7	6.4	6.2	6.3	6.4	6.8	7.7	7.2	7.2
Short-term	5.0	3.1	5.6	3.2	3.8	3.7	3.8	4.0	4.3	5.3	4.5	4.5
International Reserves / Short-term Debt (%)*	203.0	214.2	208.2	245.8	247.5	237.6	244.2	257.1	285.2	280.6	271.7	330.3

Source: Bank of Thailand website.
Note*: Author's calculation.

Abstract (in Japanese)

要約

1997 年のアジア金融危機の後、韓国とタイは金融再建を成功裡に進め、銀行セクターの健全性を回復した。しかし、2008 年にリーマンショックが両国の金融市場を襲ったとき、その衝撃は異なる様相を見せた。韓国では、金融再建の成果がタイよりも優れていたにもかかわらず、2008 年には第二の金融危機の瀬戸際まで追い込まれた。他方、タイは衝撃をたやすく切り抜けた。この逆説的な違いを解明するために、本論文は制度の経路依存性の視点に立ち、二ヶ国の金融システムの形成と変化に関する歴史的経路の違いに焦点を当てる。結論としては、韓国では国家主導の金融再建が成功したことで、銀行の活発な貸出行動が促進されたのに対し、タイにおける民間セクター主導の改革は銀行の保守的な貸出行動を強化しただけであったと論じている。そして、制度の変化には決定的分岐点があるとする従来の理論とは異なって、深刻な経済危機が両国ではかえって制度の遺産を強化することになったと分析する。その結果、韓国の銀行は攻撃的とも言える対外借入をするようになった一方、タイの銀行は対外借入には非常に慎重になった。これらの違いによって、両国のリーマンショックに対する異なる脆弱性は説明できるのである。

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