

ORIGINS OF FINANCIAL REFORMS IN DEVELOPING COUNTRIES

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This dissertation aims to explore political determinants of the *magnitude* and the *pace* of six dimensions of financial reforms in developing countries. The *magnitude* of financial reforms refers to the degree a country engages in a larger scale of financial reforms at one time, while the *pace* of financial reforms refers to the degree to which a country speeds up financial reforms. I argue that the IMF conditionality programs play a role in facilitating a larger magnitude of financial reforms and in speeding up the pace of each of the six dimensions of financial reforms. However, these IMF effects are conditioned by the number of veto players; namely, as the number of veto players increases, these IMF effects tend to decrease. Further, I predict that the stronger the influence of the manufacturing sector in a country, the larger the magnitude of financial reforms and also the quicker the pace of financial reforms for most dimensions, with the dimension of the enhancement of banking supervision as an exception. Also, countries with a stronger influence of the banking sector tend to choose a smaller scale of financial reforms at one time and tend to delay financial reforms.

These arguments were examined both quantitatively and qualitatively. Quantitatively, using the *Financial Reform Database* developed by the IMF, I examined thirty developing countries' data from 1973 to 2002. Qualitatively, I employed case study analysis in three countries: Indonesia, Thailand, and Korea. Results demonstrated that the IMF's impact on financial reforms is contingent upon the number of veto players in both the pace and magnitude of financial reforms as hypothesized. In addition, the effects of the manufacturing sector were confirmed in both quantitative and qualitative analyses, while the effects of the banking sector were confirmed in qualitative analysis.

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PREFACE

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1.0 INTRODUCTION

1.1. THE LACK OF EXISTING LITERATURE ON FINANCIAL REFORMS

Financial reforms are one of the most important economic reforms in developing countries. Economists tend to assume that financial reforms have a welfare-enhancing effect (McKinnon 1991; Shaw 1973). Then, why do not developing countries all follow the same path of financial reforms? In fact, the *magnitude* and the *pace* of financial reforms varied greatly from country to country when a surge of neoliberal economic reforms occurred during the 1980s and the 1990s in developing countries and they continue to be very diverse. For instance, some Latin American countries such as Argentina and Uruguay initiated financial liberalization such as interest rate liberalization and elimination of entry barriers on banks during the 1970s. On the other hand, East Asian countries such as Indonesia started to take these reform measures only after the 1980s. South Asian countries did not much commit to financial reforms until now. However, even within the same South Asian region, Bangladesh has already fully liberalized foreign direct investment (FDI) whereas India has maintained many restrictions on capital account transactions.

What accounts for these variations of financial reforms? What makes the *magnitude* and the *pace* of financial reforms vary in developing countries? The *magnitude* of financial reforms refers to the degree to which a country conducts financial reforms on a large scale, all at one time. On the other hand, the *pace* of financial reforms refers to the degree to which a country speeds up or delays financial reforms. The aim of this dissertation is to explore how the International

Monetary Fund (IMF) as an international factor and veto players and interest groups as domestic factors shape the *magnitude* and the *pace* of financial reforms in developing countries.

Concerning conventional studies of financial reforms, vast amount of studies of financial reforms have been conducted by economists.¹ However, these studies tend to focus only on policy outcomes of financial reforms and/or the impact of financial reforms on macroeconomic outcomes. Therefore, these studies tend to ignore the question of *why* these reforms occurred.

Scholars of international political economy (IPE), on the other hand, have paid most attention to capital account liberalization. Much of the IPE literature is based on quantitative studies using large numbers of countries as cases or on studies in developed countries (Quinn 2000; Quinn and Toyoda 2007). Regime type difference such as democracy versus autocracy is one of the central political explanations for explaining the level of capital account liberalization in conventional quantitative studies using a large number of countries as cases. For example, a more democratic regime is argued to be associated with a higher degree of financial liberalization because a more democratic government is more likely than an autocracy to protect its citizens' right to conduct international financial transactions (Quinn 2000).

Studies of developed countries, on the other hand, have contributed to theoretical accounts examining causes of capital account liberalization. Scholars have attributed the political causes of capital account liberalization to regimes (Quinn 2000; Garret et al. 2000), partisanship (Kastner and Rector 2005, 2003; Li and Smith 2002; Quinn and Inclan 1997), and veto players (Kastner and Rector 2003). In addition to these studies, Ahlquist (2006) has conducted a study on portfolio flows and FDI flows to developing countries and shows that FDI

¹ For example, see Hall (2003), Caprio et al. (2001), Williamson and Mahar (1998).

flows are sensitive to a receiving country's political institutions while portfolio flows are more sensitive to fiscal policy outcomes.

Concerning previous studies on other than capital account liberalization, Rothenbluth and Schaap (2003) did conduct a study in which they examined banking regulations. Also, some case studies on banking regulations have been done focusing on the role of banks as interest groups. These case studies revealed that uncompetitive banks oppose banking deregulation (Perez 1997) and strong banks support banking deregulation (Economides et al. 1996; Krosner and Strahan 1999). In addition, Satyanath (2006)'s work is an important previous study that looked at the cause of lax banking supervision using Asian countries as cases. In examining the causes of the Asian financial crisis, he argues that under democracies with open capital accounts, lax banking regulations could occur even if an executive leader does not have crony ties with banks due to miscommunication between an executive leader and the economic technocrats.

In the reform literature done by political economists, the causal determinants of neoliberal economic reforms are examined. In this literature, developing countries have been examined using case studies. In existing prior research, financial crisis (Weyland 1996; Rodrik 1994; Haggard and Kaufman 1992), external pressures by the IMF (Haggard and Kaufman 1992; Stallings 1992), and political leadership changes (Haggard 2000; Haggard and Webb 1994; Kaufman 1985; Heller et al. 1998) are often identified as the most prominent causes of neoliberal economic reforms.

Also, some recent quantitative studies have revealed that political institutions are significant predictors in explaining neoliberal economic reforms in developing countries. However, empirical results concerning how political institutions matter in predicting neoliberal

economic reforms remain indeterminate (Neilson 2003; Johnson and Crisp 2003; Frye and Mansfield 2004; Biglaiser and DeRouen Jr. 2004).²

As existing studies on financial reform have been concentrated on capital account liberalization, various forms of domestic financial reforms have tended to be neglected. Notable exceptions are those studies conducted by economists Abiad and Mody (2005) and Lora (1998), where comprehensive indices of financial reforms are developed and the political impact on these reforms is examined; but their works barely show a significant impact of political variables on financial reforms. Therefore, empirical findings in the existing literature concerning political determinants of financial reforms remain far from conclusive. In this vein, this dissertation aims to contribute to the reform literature and the IPE literature by examining not only capital account liberalization but also other domestic dimensions of financial reforms or various banking reforms in developing countries.

1.2. WHY ARE FINANCIAL REFORMS IMPORTANT?

The reason why most prior research has been concentrated on capital account liberalization as discussed above is that the consequences of capital account liberalization can be profound. We have experienced a significant increase in financial globalization since the late 1980s (Claessens and Schmukler 2007; Lane and Milesi-Ferretti 2005).³ This phenomenon, financial globalization,

² In terms of trade liberalization, an electoral system (Neilson 2003) and democracy and electoral timing (Frye and Mansfield 2004) are associated with trade liberalization. Concerning neoliberal economic reforms in Latin America, while party ideologies in congressional elections are argued to be the best predictor by Johnson and Crisp (2003), Biglaiser and DeRouen Jr. (2004) contend that inflation is the only significant predictor of neoliberal economic reforms and that political institutions have a very minor impact.

³ Financial globalization reached unprecedented levels as measured by gross capital flows and

is a policy outcome of capital account liberalization. Some scholars argue that the integration of the international capital market can be regarded as a structural condition of perfect capital mobility (Simmons 1999; Andrews 1994). Hence, for example, highly mobile capital may put pressures on countries for policy convergence by constraining a country's policy options (see Clark and Hallerberg 2000, for example). Thus, capital account liberalization is one of the most important dimensions of financial reforms. Nevertheless, financial reforms do not only mean capital account liberalization. It is worth examining other dimensions of financial reforms, especially banking reforms including privatization of banks, banking supervision, and interest rate liberalization, given the imperative roles that banks play in developing countries.

These imperative roles can be listed as follows. First, given the lack of development of other financial intermediaries such as mutual funds and pension funds, banks tend to play a dominant role in a country's financial system in developing countries. Second, banks have been regarded as "special" because of the key roles that banks play in the economy. Banks provide fundamental services such as deposit taking, credit extensions, and payment processing. In addition, banks perform the liquidity transformation function from savings to investments. Due to these key "special" roles that banks play, banking reforms are critical in order to achieve economic development for developing countries. According to neoliberal economists such as Shaw (1973) and McKinnon (1973), financial reforms in such areas as interest rate liberalization, elimination of controls over banks' reserve requirements, and credit allocations, for example, are key factors in economic development, creating a more liquid financial system and allowing financial deepening, which in turn, leads to economic development. Third, banks play a

stocks of foreign assets and liabilities (Claessens and Schmukler 2007, 3). Stallings (2007) reports that FDI flows to developing countries once decreased after the Asian financial crisis but again increased after 2004.

“special” role in implementing monetary policy. A central bank aims to control money supply by directly controlling banks’ quantity of money or by intermediating banks through policy tools such as market operations and discount rates. Lastly, banks are extremely vulnerable if a bank run once occurs.⁴ If a bank run occurs, a bank run may trigger a crisis in the sector as a whole, and this banking crisis may have a devastating impact on the economy as a whole. Hence, how to manage banks and how to reform banks can be critical to a country’s economic system as a whole.

Despite these important economic roles of banks play in a developing world, political reasons that cause banking reforms in developing countries have been understudied in prior research by both international political economists and comparative political economists. This is surprising given the profound impacts of banks on a country’s economy as discussed above. To fill this gap, this dissertation focuses on not only capital account liberalization, but also other dimensions of financial reforms by mainly focusing on banking reforms. In this light, I look at political determinants of the following six dimensions of financial reforms:

- 1) Privatization of banks
- 2) Enhancement of banking supervision over the banking sector
- 3) Capital account liberalization
- 4) Interest rate liberalization of banks’ deposits and credits
- 5) Elimination of credit controls
- 6) Elimination of entry barriers on banks

⁴ Bank assets are very liquid because they are typically cash while bank liabilities such as real estate are very rigid. This mismatch of maturity makes banks vulnerable to a bank run. For special roles of banks, see (E.A.J. 1997), for instance.

In a developing country, maintenance of a heavily repressed financial system tends to be a pre-condition of financial reforms. In such a repressed financial system, a government owns banks, prohibits the opening of new banks, and restricts capital account transactions. Also, as a central bank directly decides credit allocations, sets interest rates of banks, and determines reserve requirements that banks have to hold, governments can exercise monetary policy by directly controlling banks as discussed above. Therefore, financial reforms often mean that policy makers in developing countries will lose their direct means of controlling the quantity of money as a monetary policy tool. In addition, by privatizing banks governments may lose an important source of money to finance their debts.

Furthermore, by eliminating credit controls over the banking sector, politicians may lose politically important tools such as mandatory credit allocations for cultivating ties with particular groups. On the other hand, financial reforms may open new opportunities for politicians to cultivate ties with particular groups. For example, by opening foreign capital inflows such as big investment projects, politicians can be provided with better access to foreign capital or foreign investments for particular firms.

Thus, exploring the dynamics of banking reforms has significance not only in the economic realm but also in the political realm. Hence, examining various forms of financial reforms is important particularly in the contexts of developing countries. Each of the six dimensions will allow explanation of political dynamics of financial reforms.

Given the lack of prior research on various forms of financial reforms, much work still has to be done concerning why these various forms of financial reforms have occurred. The lack of prior quantitative research may come from the fact that the comprehensive data measuring financial policy reforms has not existed. Therefore, I make use of the *Financial Reform*

Database constructed by the Research Department of the International Monetary Fund (IMF) to comprehensively explore political determinants of each of the six dimensions of financial reforms.

I focus particularly on causal determinants of the *magnitude* and the *pace* of financial reforms. Concerning the *magnitude* of financial reforms, I aim to explore when a country is more likely to engage in a wider range of financial reforms at the same time. On the other hand, in terms of the *pace* of financial reforms, I seek to specify conditions related to political factors which facilitate or hinder the *pace* of financial reforms.

In assessing determinants of both the *magnitude* and the *pace* of financial reforms, I look at the relative importance of the following factors on three levels as determinants of financial reforms: 1) international pressures as an explanation at the international level, 2) the number of veto players as an explanation at the national level, and 3) interest group pressures as an explanation at the societal level in determining financial policies. I examine the impact of the IMF as an international factor and I specifically examine how the IMF's impact on financial reforms is conditioned by the number of veto players. With regards to societal sectors, I explore the influence of two sectors: the manufacturing sector and the banking sector.

In this vein, this project examine when and how banking reforms as well as capital account liberalization in developing countries is conducted. Does a developing country choose financial reforms as a response to the strong international pressures to liberalize its domestic financial system? Or is it that veto players play a role in facilitating financial reforms? Or rather, should financial reforms be understood as the response to societal pressures? What is the relative importance of these factors in determining financial reforms in developing countries? These are the central questions that I ask in this study. I seek to account for political

determinants of the magnitude of financial reforms as well as the pace of the six dimensions of financial reforms in developing countries.

I argue that international pressures by the IMF are the major determinants of financial reforms in developing countries. However, the IMF's effects on financial reforms vary from country to country because the number of veto players conditions the effects of the IMF programs on financial reforms. In this light, this dissertation contributes to a series of the IPE literature looking at how international and domestic factors shape a country's economic policy outcomes by assessing not only capital account liberalization but also other various dimensions of banking reforms in developing countries. How the IMF's impact on the *magnitude* and the *pace* of financial reforms is conditioned by the number of veto players and societal pressures is assessed by both quantitative studies and case studies in the subsequent chapters, in addition to exploring the relative importance of political factors at three levels as discussed above.

1.3. PLAN OF THE DISSERTATION

This dissertation is organized as follows: In Chapter 2, I discuss theoretical arguments concerning political determinants of the *magnitude* and the *pace* of financial reforms. I look at political sources on the following three levels — the IMF as an explanation at the international level, veto players as explanations at the national level, and the manufacturing sector and the banking sector at the societal level— to account for the magnitude of financial reforms or factors determining the degree to which a country is more likely to engage in big-bang type of financial reforms. I also examine the timing or factors facilitating or delaying the six dimensions of

financial reforms in developing countries. I hypothesize how decisions of policy makers in developing countries, corresponding to both the international pressures by the IMF and the societal pressures within the constraints of the number of veto players shape the *magnitude* and the *pace* of financial reforms. In Chapter 3, using the IMF's *Financial Reform Database*, which looks at six dimensions of financial reforms of thirty developing countries from 1973 to 2002, I perform quantitative analyses. I employ ordinal logit regression models to quantitatively explore determinants of the *magnitude* of financial reforms. I employ event history analysis to examine predictors of the *pace* of financial reforms in each of the six dimensions of financial reforms respectively. Results of these quantitative analyses show that the effects of the IMF on the magnitude and the pace of financial reforms are conditioned by the number of veto players. Also, the manufacturing sector is an important predictor of the magnitude and the pace of financial reforms. However, the effects of the banking sector are not well confirmed in the quantitative analyses.

In Chapter 4 and Chapter 5, theoretical arguments are assessed employing case studies. I conduct case studies of the following three countries: Indonesia in Chapter 4 and Thailand and Korea in Chapter 5. Especially, I look at how these countries have engaged in financial reforms by comparing the pre- and post-Asian financial crisis. All three countries were praised as countries that achieved the Asian miracle of growth. Also, all three countries were severely hit by the Asian financial crisis. Indonesia, Thailand, and Korea all asked for IMF rescue packages and all these countries also conducted banking reforms under similar IMF conditionality programs. However, despite these similarities, these outcomes of the banking reforms for these countries have been diverse. Therefore, I find that the number of veto players and their preferences explain the outcomes of financial reforms, holding the IMF pressures as constant.

Also, I look at how interest groups such as the banking sector and the manufacturing sector exert influence by putting pressures on governments and sometimes by colluding with politicians. It is important to examine the roles of the banking sector given that I was not able to obtain expected results in quantitative analyses. Overall, I closely examine how the interactions between the IMF, policy makers, and interest groups shape the outcomes of financial reforms.

In order to do so, in Chapter 4, I illustrate Indonesia as a case of delayed financial reforms due to collusion between politicians and banks. I examine financial reforms from 1965 to 2003 chronologically, starting from the beginning of the Suharto regime to graduation from the IMF programs. Indonesia experienced four presidents from 1997 to 2003, when Indonesia was under the Fund conditionality programs. Despite that Indonesia was under IMF pressures to facilitate financial reforms, commitment to financial reforms varied from a government to a government. By examining temporal variation, I illustrate not only the IMF programs but the number of veto players and societal pressures matter in shaping financial reform outcomes. Also, I illustrate which dimensions of financial reforms were facilitated or hindered was also conditioned upon not only IMF programs but also domestic political factors such as the number of veto players and interest group pressures.

In Chapter 5, I look at the cases of Thailand and Korea, respectively. Thailand is illustrated as a case of delayed financial reforms because of the large number of veto players as well as a strong banking sector presence. Korea, on the other hand, is representative as a case where financial reforms were accelerated, in its case, by the executive initiative despite the long-standing presence of powerful conglomerates or *chaebols*. Lastly, I also make a comparison between three cases: Indonesia, Thailand, and Korea. The differences in financial reforms after the Asian financial crisis in these three countries can be explained by looking at the number of

veto players in each, especially if one looks at the dimensions of enhancement of banking supervision over the banking sector and restructuring of banks, both of which were emphasized by the IMF in their conditionality programs more than ever after the Asian financial crisis. Finally, in Chapter 6, I conclude by summarizing the findings and discussing future policy implications.

2.0 THEORETICAL PERSPECTIVES OF FINANCIAL REFORMS

“How conditionality works depends on country-specific circumstances, in particular the government’s commitment to reform.... If commitment is very weak, neither extensive conditionality nor a more limited approach may do much to improve implementation. In intermediate cases, conditionality may, to some extent, help ensure the implementation of reforms that otherwise would not have been done, but there are clear limits to substituting conditionality for the authorities’ commitment (International Monetary Fund 2001b, 82).”

2.1. INTRODUCTION

This chapter lays out theoretical arguments to account for the *magnitude* and the *pace* of six dimensions of financial reforms in developing countries. In the next section, I explain each of the six dimensions of financial reforms and how politics may matter in each dimension. In the third section, I lay out theoretical arguments concerning factors for shaping the *magnitude* and the *pace* of financial reforms. To do so, I look at the relative importance of the following factors on three levels as determinants of financial reforms: 1) international pressures as an explanation at the international level, 2) veto players as an explanation at the national level, and 3) interest group pressures as an explanation at the societal level. I examine the impact of the IMF as the international factor and the impact of the number of veto players as an explanation at the national level. As societal factors, I explore two sectoral influences: the manufacturing sector and the banking sector. Specifically, I argue that although currency crises and the following IMF

conditionality programs are the most important predictors for determining the magnitude and the timing of financial reforms, veto players also matter in a way to intermediate the effects of the IMF on developing countries. In the fourth section, I recapitulate the hypotheses.

2.2. SIX DIMENSIONS OF FINANCIAL REFORMS

In this section, I explain each of the six dimensions of financial reforms respectively and how politics matters in each dimension. As listed in the previous chapter, the six dimensions of financial reforms are as follows: 1) privatization of banks, 2) enhancement of banking supervision over the banking sector, 3) capital account liberalization, 4) interest rate liberalization, 5) elimination of credit controls, and 6) elimination of entry barriers on banks. Table [2.1](#) below presents prototypical situations of pre- and post-financial reforms with respect to each of the six dimensions of financial reforms.

Table 2.1 Prototypical Conditions of Pre-and Post-Financial Reforms

Dimension of Financial Reforms	Pre-Financial Reforms	Post-Financial Reforms
Privatization of Banks	Most banks are state owned	All banks are privately owned
Enhancement of Banking Supervision	Lack of comprehensive legal framework, and/or lack of enforcement of banking supervision and prudent regulations	Comprehensive legal framework, strict enforcement of banking supervision and prudential regulations
Capital Account Liberalization	Many restrictions on capital account transactions	Free movement of capital without restrictions
Interest Rate Liberalization	Interests rates set by the central bank	Interests rates determined at market rates
Elimination of Credit Controls	Credit allocation determined by the central bank, preferential credit allocation at subsidized interest rates	Credit allocation determined by banks, no preferential credit allocation
Elimination of Entry Barriers on Banks	No entry of new banks allowed, no new branches allowed, restrictions on banks' activities	Free entry of new banks, no branching restrictions, banks' wide range of activities permitted

2.2.1. Privatization of banks

In many developing countries, state-owned banks play a dominant role. Since state-owned banks tend to be heavily protected from competition, privatization of banks is desirable from the viewpoint of efficiency maximization. However, although many states try to privatize banks as a part of financial reform programs, in fact, privatization of banks tend to be delayed compared with other dimensions of reforms. Politicians tend to hesitate to privatize state-owned banks in many circumstances. Since governments can directly control state-owned banks, governments can collect necessary money and allocate for their own purposes. Further, state-owned banks

tend to finance government debts by buying government bonds in developing countries. Therefore, governments do not want to lose this resource to finance their debts. Also, politicians may also utilize state-owned banks as sources for collusion with particular sectors or firms by offering better credit conditions to them than private banks would. In addition, politicians may not want to sell banks to foreign investors or foreign banks, given the special roles that banks play in a country's economic system. Hence, to know when governments privatize banks has the important political implications given the important roles that state-owned banks play in developing countries.

2.2.2. Enhancement of banking supervision over the banking sector

This dimension refers to policies for enhancing supervision and prudential regulations over the banking sector. Information asymmetry is high between banks and investors. Namely, the amount of information possessed by banks is much larger than that by investors. While banks know the real conditions underlying their own balance sheets, investors and depositors do not. Therefore, financial reforms toward financial liberalization without adequate supervision over the banking sector can cause banking crises and currency crises as seen in the cases of the Asian financial crisis in 1997. Possible measures to prevent such crises can be deterring banks' risky lending behavior, increasing the transparency of the available information concerning banks' real balance sheets, and resolving banks' problems as soon as possible. In order to enhance banking supervision over the banking sector, countries can take various measures such as increasing the capital adequacy ratio, monitoring banks' balance sheets, and strengthening the banking

supervisory agency's power to resolve banks' problems by allowing the dissolving of insolvent banks, for example.

However, in reality, it is very difficult for developing countries to enhance banking supervision. For example, although Chile is well-known as being a rare case of a developing country which has an relatively independent central bank, Chilean banking supervision is weak according to the assessment of international financial institutions.⁵

The lack of adequate bureaucratic and technical capacity in developing countries to estimate risks of banks might be one of the reasons in general, but political reasons should also be taken into consideration in accounting for the difficulties in enhancing effective banking supervision.

Politicians do not want to enhance banking supervision because their influential supporters may be bank owners. Even politicians themselves may be a part of financial conglomerates when they have crony ties with banks. In other circumstances, the Ministry of Finance (MOF) may not want to give up their influence over the banks, and conflicts between the MOF and the banking supervisory agency may prevent effective banking supervision over the banking sector. In yet another case, firms that have strong connections with politicians may be provided with credit by banks, and therefore politicians may want to protect firms' interests by delaying bank reforms. As a result of these various conditions, governments may hesitate to enhance effective banking supervision. Hence, a country will attempt to enhance banking supervision under very limited circumstances.

⁵ On this regard, see the report of the Financial Stability Assessment Program for Chile (IMF 2004a).

2.2.3. Capital account liberalization

Contrary to the cases of developed countries, in the cases of developing countries, policy makers may not necessarily choose to open capital accounts even under the current integrated global financial market. However, when they know the fact that capital is highly mobile due to the globalization of financial markets, in which the main capital comes from developed countries, it will become more difficult for policy makers in developing countries to maintain closed capital accounts or to make moves toward closing capital accounts once opened.

If possible, leaders in developing countries would like to open capital accounts for capital inflow while they would like to prevent any form of capital outflow so that they can earn foreign and domestic capital. However, in reality, without maintaining open capital accounts, investors with foreign capital will hesitate to enter into developing countries. Also, domestic capital held by the rich people in developing countries may not stay in the country if they are afraid that their capital accounts may be closed and currency convertibility might become restricted. Then, under what conditions does a country try to open capital accounts?

2.2.4. Interest rate liberalization

The fourth dimension, interest rate liberalization, refers to policy measures that allow banks to set deposit rates and lending rates free from intervention by the central bank. In many developing countries, before reforms, the central bank directly determines deposit rates and lending rates for monetary policy purposes and banks are not allowed to set interest rates on deposits and lending rates at all. Or the central bank imposes restrictions on deposit rates and

lending rates by setting minimum values (floor) or maximum values (ceiling) on banks' interest rates or allowing only a certain range of banks' interest rates (band). Under these circumstances, the banking sector does not face any competition or faces only limited competition as opposed to facing a more competitive environment, where banks would try to offer higher deposit rates and lower lending rates in order to attract depositors and borrowers. In fact, under a repressed financial system, where restrictions on nominal interest rates are maintained, real deposit rates are often negative and loan interest rates are often high, which discourages savings and distorts a country's efficient allocation of credits (Hallwood and MacDonald 2000, 432).⁶ Therefore, banks cannot play an effective role in transmitting money from savings into investments.

Interest liberalization is an important policy tool for achieving financial deepening. By liberalizing deposits and loan interest rates, banks will become more competitive, hence, savings are increased and investment projects can become more competitive, thereby allowing banks to play a more effective role in channeling financial savings to investments.

The monetary base is more observable and controllable for central bankers if they use direct measures such as setting banks' interest rates directly. So, policy makers in developing countries may prefer to take these direct means to control the monetary base. However, to take more indirect means of setting monetary policy by using market operations and discount rates is more desirable for financial deepening by enhancing banks' functions to channel from savings to investments. I will explore when a policy maker agree to let banks free in determining banks' deposit rates and lending rates.

⁶ According to McKinnon (1981, 376), under financial repression, a positive relationship exists between *real* lending rates of interest and nominal inflation rate whereas a negative relationship exists between *real* deposit rate of interest and nominal inflation rate.

2.2.5. Elimination of credit controls

The fifth dimension, elimination of credit controls, captures the elimination of government control over banks' credit allocation, including their giving preferable conditions to particular sectors, and/or the elimination of subsidized interest rates for certain sectors, and the elimination of excessive controls over banks' liquidity management.

In countries under a repressed financial system, the central bank tends to impose high levels of reserve requirements (i.e., the percentage of deposits that banks have to keep with them and not lend). Also, the central bank tends to determine the banks' credit allocation (i.e., set mandatory requirements of credit allocation to certain sectors, and/or the central bank requires banks to set subsidized interest rates for certain sectors). Under these circumstances of strong government control, financial markets remain shallow, and less efficient credit allocation with a bank-dominated financial system becomes an obstacle to diversification of financial markets by impeding the development of other institutional investors (Lopez-Mejia 1999; Arvai and Heenan 2005). Hence, it is important to facilitate diversification of financial markets by eliminating controls over banks' credit allocations and banks' liquidity management.

However, at the same time, policy makers tend to utilize credit controls over the banking sector as means to cultivate ties with particular sectors in exchange for political support. By offering special credit allocations and better interest rates to these sectors, governments are able to create preferable credit conditions for particular groups or sectors, regardless of whether banks are publicly owned or privately owned. Therefore, it may be difficult for policy makers in developing countries to choose reform options that may mean losing policy tools by which they can cultivate ties with supporters.

2.2.6. Elimination of entry barriers on banks

The sixth dimension, elimination of entry barriers on banks, refers to policy reforms that enhance competition among banks; namely, policies such as lowering entry barriers of new domestic and foreign banks into a domestic market, lifting branching restrictions of banks, and allowing a wider range of activities that banks can engage in. Lack of competition among banks and/or with other financial and non-financial institutions such as security firms produces a predominance of inefficient banks. Therefore, it is ideal to encourage various policy measures related to banking competition. However, politicians may hesitate to support such policy measures as elimination of entry barriers of foreign banks because politicians would then lose control over banks. On the other hand, lowering entry barriers of domestic banks and lifting branch restrictions may provide business opportunities for well-connected individuals or groups of firms.

Thus, as discussed above, it is important to explore political determinants of not only capital account liberalization but also other dimensions of financial reforms in developing countries. Exploring the dynamics of banking reforms has not only economic significance but also political significance.

When and why will governments accept loss of control over the banking sector, given the economic and political importance of banks? In the next section, I will lay out theoretical arguments to account for financial reforms in developing countries.

2.3. THEORETICAL PERSPECTIVES OF FINANCIAL REFORMS

2.3.1. The International Monetary Fund: an explanation at the international level

2.3.1.1. Controversy about the effects of the International Monetary Fund

The main predictor to determine the *magnitude* and the *pace* of financial reforms in developing countries is the effects of IMF programs as a factor at the international level. The degree to which the IMF's conditionality programs have an effect on macroeconomic outcomes remains controversial in quantitative examinations. For example, concerning whether the IMF plays a role in helping a country to recover from banking crises, Montinola (2003) concludes that the IMF plays no role in banking crises resolution. In addition, although reducing inflation is one of the primary purposes of the Fund (IMF 2001a), many existing quantitative studies show that IMF programs have no effects on reducing inflation.⁷ Also, the IMF claims that economic growth is one of the prominent purposes of the Fund (IMF 2001a). However, Vreeland (2003) demonstrates that IMF programs deter a country's economic growth and worsen income inequality, though other scholars (Lee and Rhee 2000; Dics-Mireaux et al. 2000) report that the IMF programs have positive effects in increasing economic growth. Thus, existing literature remains inconclusive concerning the effects of the IMF on macroeconomic outcomes.⁸

On the other hand, in past qualitative studies, the influence of the IMF on neoliberal economic reforms is widely acknowledged as a major cause of neoliberal economic reforms

⁷ See Conway (1994), for example. However, Stone (2002)'s work, in which Stone reports that the IMF programs are effective in reducing inflation in cases of the post communist East European countries, is an exception.

⁸ For a summary and review of various studies concerning the IMF impact, see Stone (2002, 41-45), for instance.

(Haggard and Kaufman 1992; Stallings 1992). However, in fact, the implementation rate of the IMF programs in past studies remains only from around forty percent to seventy percent.⁹ For example, the IMF examined the 308 IMF programs, including 4600 structural conditions, from 1987 to 1999, using the expanded IMF monitoring fund arrangement (MONA) database, and reported that while 69% of prior actions have been implemented, only 58% of performance criteria and 56% of structural benchmarks have been fully implemented (IMF 2001b). In addition, by making use of the MONA database, Ivanova et al. (2003) reports that 44% of 170 IMF supported programs approved between 1992 and 1998 experienced irreversible interruption and 70% of IMF programs experienced minor interruption.

In this vein, given the increase in type and policy areas covered as the IMF conditionality programs over time, some scholars express concerns about “ownership problems” (Khan and Sharma 2003; Drazen 2002; Killick, Gunatilaka, and Marr 1998). A country’s ownership of the IMF programs is defined as “the extent to which a country is interested in pursuing reforms independently of any incentives provided by multilateral lenders” (Drazen 2002, 37). If a country lacks ownership of the Fund conditionality programs, governments will not commit to reforms; hence, the IMF programs remain ineffective. Namely, even if a country is under the IMF’s conditionality program, a country may not necessarily implement the IMF programs. Moreover, the IMF may not enforce implementation of conditional programs equally in all recipient countries. For example, it is easier for large and important developing countries to enter the IMF conditionality programs than small countries (Stone 2002). Hence, important and larger developing countries may find it easier to enforce conditionality programs less strictly than smaller countries.

9 Concerning other studies on of implementation of the IMF conditionality programs, see Ivanova et al. (2003), Kahler (1992), IMF (2001b), and Dreher and Vaubel (2004).

As discussed above, given these controversial past studies concerning effects on macroeconomic outcomes and the actual amount of implementation of the IMF's conditionality programs, an unanswered question is the degree to which the IMF plays an important role in setting the magnitude of financial reforms and the pace of financial reforms in developing countries. Does the IMF play the decisive role in determining both the magnitude and the pace of financial reforms? Or does the IMF play a minor role and remain ineffective due to the ownership problems? In Chapter 3, I empirically assess these questions employing quantitative analysis, and in Chapter 4 and Chapter 5 I assess them employing case study methods.

2.3.1.2. Theoretical aspects of the International Monetary Fund

Conditionality programs of the Fund refer to “an explicit link between the approval or continuation of the Fund’s financing and the implementation of certain specified aspects of the government’s policy program” (IMF 2001a, 7). Thus, the key to the IMF’s conditionality programs is a tight link between money disbursement and a country’s commitment to the planning and implementation of reform programs.¹⁰

With respect to the *magnitude* of economic reforms, neoliberal economists’ prescription for ensuring economic reform outcomes is a simple one; “do all reforms immediately and simultaneously” (Sturzenegger and Tommasi 1998, 16). While it is normatively important for the IMF to respect a state’s ownership in designing the IMF conditionality programs, the IMF cannot be certain of the degree to which a state has an independent “political will” to pursue

10 Conditionality programs of the Fund currently consist of six kinds of facilities. Concerning the changes in the nature and the emphasis of the IMF conditionality programs over time, see Polak (1991), Goldstein (2000), and Dreher and Vaubel (2004), for instance.

financial reforms when negotiating whether a state enters conditionality programs. Even if a political leader has a will to commit financial reforms at the time when a state is negotiating with the IMF, a country may not necessarily implement the IMF conditionality programs later because a country may experience an unanticipated change in political conditions such as changes in political leadership or even regime transitions to and from democracy. As the uncertainty of the IMF would be larger if a country engages in financial reforms in a gradual manner, the IMF tries to convince countries to conduct a larger magnitude of financial reforms. Hence, a country under the IMF conditionality program will engage in a larger magnitude of financial reforms.

With respect to the *pace* of financial reforms, the IMF demands a country firmly commit to financial reforms and implement necessary financial reforms as early as possible in exchange for the disbursement of money when negotiating contents and schedules of conditionality programs as the IMF cannot be certain of the degree to which a state will commit to financial reforms after entering programs. Hence, the IMF tries to move economically necessary financial reforms at a fast pace when the IMF and a state are deciding whether a state enters a conditionality program and when negotiating contents and schedules of conditionality programs. In negotiating with the IMF, knowing that the disbursement of the IMF money is dependent upon the agreed conditions, a country will have to set a fast-paced schedule of financial reforms. In addition, when a state tries to enter conditionality programs is not the only time that the IMF can influence a country's financial reform plans. Though whether or not money initially disbursed is critical for a recipient country, the IMF conditionality program is designed as "phased disbursement," that is, money is disbursed gradually rather than once conditioned upon whether

countries meet specified policy criteria.¹¹ Therefore, the IMF continues to check progression of financial reforms using these various criteria.

Furthermore, financial reforms are the key policy arena of IMF expertise; hence, the IMF's role in facilitating a larger magnitude of financial reforms and in accelerating the pace of financial reforms is more observable than with other macroeconomic policy outcomes such as economic growth and stabilization of inflation, where empirical findings remain controversial. Despite the changing nature of the IMF programs and the increasing trend of the number of conditionalities that are covered under the IMF programs, financial sector policies are one of the core competent policy areas in which the IMF has expertise. In addition, in terms of structural measures, financial sector policies have been the core components of the IMF structural conditionality programs, together with macroeconomic stabilization and fiscal and exchange rate policies (Goldstein 2000).¹² In fact, in terms of financial reforms, enhancement of banking supervision, capital account liberalization, and privatization of banks, for instance, are major policy reform targets in the IMF's conditionality programs. Because of the IMF's expertise in financial reforms relative to developing countries, where the lack of enough technical capability

¹¹ Various monitoring measures are taken by the IMF in conditionality programs. Prior actions are measures that have to be taken before approval of a loan by the Executive Board of the Fund. Quantitative performance criteria set specific macroeconomic variables' quantitative targets such as credit aggregates and need to be met for money disbursement. Structural performance criteria are set as the critical structural policy measures that should be met for money disbursement. For example, these structural measures include appropriate financial sector operations. In addition, structural benchmarks are specified as a small step in a critical reform process or criteria that cannot be measured objectively enough as performance criteria. Further, a recipient country is usually subject to a quarterly program review of the Fund and the progress of reforms is checked by the Fund staff (this information is available through the internet: <http://www.imf.org/external/x10/changeccss/changestyle.aspx>, accessed on December 2, 2006).

¹² The IMF reports that the financial sector is the second-most concentrated on policy arena among the structural conditionality programs from 1991–1999 next to the fiscal sector, and the third most concentrated policy arena from 1987–1990 following the fiscal sector and trade regime (see IMF 2001b, 24).

tends to be more common, developing countries have less alternative policy choices, especially in the turmoil of a currency crisis when negotiating the contents of the IMF conditionality programs.

Concerning the preferences of the IMF in each of the six dimensions of financial reforms described in the previous section, the IMF firmly holds to the neoliberal perspective and aims to promote a set of neoliberal economic policies called “Washington consensus (Williamson 1990)”, in which financial reforms are one of the core policy areas. The preferences of the IMF in each of the six dimensions of financial reforms are shown below as Table 2.2.

Table 2.2 Distributional Preferences of the International Monetary Fund

Six Dimensions of Financial Reforms	Preferences of the IMF
Privatization of Banks	Support
Enhancement of Banking Supervision	Support
Capital Account Liberalization	Support
Interest Rate Liberalization	Support
Elimination of Credit Controls	Support
Elimination of Entry Barriers	Support

Since the IMF prefers a minimum of government intervention in the market, the IMF supports financial reforms toward financial liberalization. Namely, the IMF supports financial reforms in such areas as privatization of banks, capital account liberalization, interest rate

liberalization, elimination of credit controls, and elimination of entry barriers. The IMF supports privatization of banks because private banks can work more efficiently than state-owned banks. Also, the IMF prefers capital account liberalization because, by eliminating barriers against foreign direct investment, for instance, foreign firms and domestic firms can compete on equal ground (Williamson 1993, 1333), and capital account convertibility is an important policy goal of the IMF. In addition, the IMF supports interest rate liberalization and elimination of credit controls because these reform measures enhance banks' efficiency in channeling savings to investments and help to develop a country's financial system. In addition, the IMF supports elimination of entry barriers on banks because competition between domestic banks and foreign banks enhances the efficiency of domestic banks.

With respect to enhancement of supervision over the banking sector, the IMF supports this measure though it means more government intervention in the market, because enhancement of banking supervision can be regarded as a necessary regulatory measure to prevent bank's risky lending behavior in that it contributes to prevention of banking crises. Thus, concerning the preferences of the IMF, the IMF supports all of the six dimensions of financial reforms, as shown in Table 2.2.

As discussed above, I argue that the IMF faces uncertainty regarding the degree of a state's commitment to financial reforms when the IMF negotiates the contents and the schedule of conditionality programs. Hence, the IMF will try to facilitate a larger magnitude of financial reforms and will also try to bring forward the timing of financial reforms in all of the six dimensions. Since the IMF supports all of the six dimensions of financial reforms, the IMF conditionality programs not only facilitate a larger *magnitude* but also quicken the *pace* of financial reforms if the country is under the IMF conditionality programs.

Hence, though empirical results concerning the effectiveness of the Fund programs are controversial as discussed earlier, the IMF conditionality programs will result in facilitating a more “big bang” type of financial reforms and also bringing forward the timing of a country’s financial reforms. I hypothesize as follows concerning the effect of the IMF on the *magnitude* of financial reforms as Hypothesis 1a and on the *pace* of financial reforms as Hypothesis 1b respectively:

Hypothesis 1a. *When a government is under the IMF conditionality programs, the country is more likely to engage in a larger magnitude of financial reforms.*

Hypothesis 1b. *When a government is under IMF conditionality programs, a country is more likely to bring forward the timing of financial reforms in all six dimensions of financial reforms.*

However, this effect of the IMF as to facilitating financial reforms will vary, depending on the recipient country’s political conditions. In the next section, this conditioning of the IMF’s effect by veto players will be discussed.

2.3.2. Veto players: an explanation at the national level

2.3.2.1. The effect of veto players in the past literature

The concept of veto players is developed in Tsebelis (1995, 2002). Veto players refer to “individual or collective actors whose agreement is necessary for a change of the status quo” (Tsebelis 2002). Each veto player has its own policy preference as regards each policy. Therefore, the number of veto players and each veto player’s policy preference determine the size of win sets or the set of points that can beat a policy status quo. A larger win set means a higher likelihood of change in policy status quo. The number of veto players, their policy preferences, and the distance of veto players’ preferences from the policy status quo are the factors which determine the size of win sets. In general, as the number of veto players increases, policy stability is more likely to increase.

The past literature on veto players reveals that veto players affect various economic policy outcomes in such areas as exchange rate regime (Hallerberg 2002), tax reforms (Basinger and Hallerberg 2004), regional trade integration (Mansfield, Milner, and Pevehouse 2006), pension privatization (Brooks 2005), trade liberalization (Henisz and Mansfield 2006; O’Reilly 2005), policy responses to currency crises (Macintyre 2001, 2003; Hicken, Satyanath, and Sergenti 2005), and capital account liberalization (Kastner and Rector 2003).

In these prior studies, the relationship between the number of veto players and policy outcomes shows diverse findings. For example, Kastner and Rector (2003), Henisz and Mansfield (2006), O’Reilly (2005), and Henisz and Zalner (2006) confirm Tsebelis’s claim above. Namely, as the number of veto players increases, a change in policy status quo is less

likely to occur in policy arenas such as capital account liberalization (Kastner and Rector 2003), trade liberalization (Henisz and Mansfield 2006; O'Reilly 2005), and electric utilities' infrastructure project (Henisz and Zelner 2006).

On the other hand, Macintyre (2003, 2001) examines four Southeast Asian countries' responses to the Asian crisis and argues that too small a number of veto players causes policy problems which are very volatile, while at the same time the presence of too many veto players causes policy problems which are too rigid. Therefore, although his argument is consistent with Tsebelis's theory of veto players, by reframing the dependent variable as a problem of governance, he argues that a curvilinear relationship exists between the number of veto players and the responses to currency crisis. Satyanath (2006, 8) examines the relationship between the condition of banking regulations in 1997 and the number of veto players in six Asian countries.¹³ He argues that lax banking regulations in a country with a larger number of veto players cannot be explained by the number of veto players but can be explained by signaling problems between chief executives and the central bank governor. Further, Hicken, Satyanath, and Sergenti (2005) report that there is *no* systematic relationship between the number of veto players and the responses to currency crisis.

Concerning the literature that looks at the relationship between the number of veto players and the IMF, by focusing on conditions to enter the IMF programs, Vreeland (2002) shows that as the number of veto players increases, a country is more likely to enter into agreement with the IMF because an executive leader can utilize the IMF programs as a device to push unpopular reforms when a leader cannot convince opposition parties to agree to pay the costs of reforms. Hence, as the number of veto players increases, a country is more likely to

¹³ Satyanath (2006) uses Barth et al (2006)s' data to examine the condition of banking regulations.

enter into the IMF agreement. However, on the other hand, the IMF is less likely to enter into an agreement with a country which has a higher number of veto players, anticipating that it will be difficult for a country to commit to reforms. Thus, recent empirical studies show various possibilities concerning the relationship between the increase in the number of veto players and the changes in policy status quo. Then, what role do veto players play in cases of financial reforms?

2.3.2.2. The role of veto players in financial reforms: conditioning the IMF's impact

In this dissertation, I especially focus on the role of veto players in conditioning the effects of the IMF on the *magnitude* and the *pace* of financial reforms. I argue that the effects of IMF programs on facilitating a larger magnitude of financial reforms and bringing forward the timing of the occurrence of financial reforms varies, depending on the number of veto players. Veto player theory predicts that the increase in the number of veto players will make a radical policy shift less likely to occur (Tsebelis 1995, 2002). I argue that a country with a larger number of veto players tends to find it harder to commit to financial reforms; hence, the IMF effects of facilitating a larger *magnitude* of financial reforms and speeding up the *pace* of financial reforms will decrease as a country has more veto players.

Financial policies such as interest rate liberalization, elimination of credit controls, and capital account liberalization are technically oriented policies. Therefore, important information would be shared among cabinet members within the executive coalitions, these being technocrats such as central bankers, and bureaucrats like the Ministry of Finance. Since financial policies are technically oriented policies, it is difficult for each political party within an executive

coalition to estimate the net effects of financial reforms ex ante. In this light, as shown by Fernandez and Rodrik (1991), even if aggregated outcomes of reforms are beneficial for a majority of the populace, the aggregate uncertainty about reform outcomes tends to produce a status quo bias.

In this vein, I assume that it would be uncertain for each political party participating in an executive coalition to estimate the net outcomes of benefits and costs of financial reforms in negotiating the contents of the IMF conditionality programs. Despite the technical difficulties in estimating these net benefits and costs, they would nonetheless need to take into account how each of the political parties is supported, not only by the manufacturing sector and the banking sector, but also by other sectors and the general populace.¹⁴ Further, even when political parties may agree to conduct financial reforms, they have to agree first on the extent to which financial reforms will be conducted at one time. Due to the uncertainty of costs and benefits of financial reforms for each political party, each political party participating in an executive coalition tends to resist a large scale of financial reforms. Therefore, concerning the *magnitude* of financial reforms, I assume that as the number of political parties within an executive coalition increases, the IMF's effects on the *magnitude* of financial reforms will decrease.

Concerning the *pace* of financial reforms, as well as the *magnitude* of financial reforms, even when political parties may agree to conduct financial reforms such as privatization of banks, for instance, they need to further decide which banks should be privatized first and how and when they will be privatized by anticipating who will be likely to buy banks at which prices.

¹⁴ In this vein, each political party is seen to work as an agent that represents societal interests (Bearce 2003). Though political parties may not necessarily work as partisan agents due to a lack of strong party consolidation in developing countries compared with developed countries, I assume that political parties have policy preferences concerning whether they support neoliberal economic reforms.

Hence, even though they may agree to financial reforms, it would still take time to reach agreement among political parties participating in an executive coalition in negotiating the contents of the IMF programs and in implementing the IMF programs.

Moreover, although political parties within an executive coalition may agree to commit financial reforms in deciding to enter the IMF programs, once the loan is disbursed, each political party has an incentive to minimize the costs of reforms and/or to maximize the benefits of reforms depending on who supports each political party. Also, a country has less incentive to conduct financial reforms in the implementation phase than in the initial entry agreement phase if a country has already survived an initial acute phase of crisis by receiving a certain amount of conditionality loan. Now, in order to commit to financial reforms, each political party may have to reorganize vested interests and may have to pay costs. Therefore, I argue uncertainty for each political party will cause delay in reaching the agreement with respect to the pace of each dimensions of financial reforms.

Hence, this is what leads to the decrease in effects of the IMF programs on facilitating financial reforms as the number of political parties within an executive coalition increases. Conversely, as the number of veto players decreases, the IMF's effect of bringing forward the timing of financial reforms is more likely to increase. Hence, I posit the hypotheses concerning the intermediating effect of the number of veto players on the *magnitude* of financial reforms (Hypotheses 2a) and on the *pace* of financial reforms (Hypothesis 2b), respectively, as follows.

Hypothesis 2a. *The IMF's influence on financial reforms is conditioned by the number of veto players. As the number of veto players increases, the IMF's effects on enhancing a larger magnitude of financial reforms are more likely to decrease.*

Hypothesis 2b. *The IMF's influence on the pace of financial reforms is conditioned by the number of veto players. As the number of veto players increases, the IMF's effects with regards to facilitating financial reforms are more likely to decrease.*

2.3.3. Interest group pressures: an explanation at the societal level

Regarding the explanation at the societal level, I will examine two sectors' impacts: the manufacturing sector and the banking sector.

2.3.3.1. The manufacturing sector

Concerning preferences of the manufacturing sector, the manufacturing sector will support financial reforms if the manufacturing sector can benefit from increased access to credit and/or access to better credit conditions as the results of financial reforms.

In developing countries, in a country where the manufacturing sector is well developed, conglomerates often dominate the manufacturing sector. In these cases, conglomerates tend to cultivate strong ties with political elites and political parties in democracies. Further, in developing countries, conglomerates often possess both firms and banks, and banks tend to serve to provide group firms with credits. In this bank practice, or connected lending, banks tend to provide credit for related firms without enough checking of loan risks. If that is the case, the manufacturing sector's preference will reflect predominantly the large firms' preference, given the large political influence of conglomerates. In addition, under these conditions, distributional

preference of the manufacturing sector will prevail rather than that of the financial sector because banks will be subordinate to conglomerates' firms.

Specifically, I argue that the manufacturing sector will support reform measures in such areas as privatization of banks, capital account liberalization, elimination of interest rate controls, elimination of credit controls, and elimination of entry barriers. The hypothesized distributional preference of the manufacturing sector is shown as Table 2.3.

Table 2.3 Distributional Preferences of the Manufacturing Sector

Six Dimensions of Financial Reforms	Preferences of the Manufacturing Sector
Privatization of Banks	Support
Enhancement of Banking Supervision	Oppose
Capital Account Liberalization	Support
Interest Rate Liberalization	Support
Elimination of Credit Controls	Support
Elimination of Entry Barriers	Support

With respect to privatization of banks, as noticed before, politicians tend to hesitate to privatize banks because it will lead to the loss of their own influence over the banks. However, when a government has to privatize banks, the easiest way to privatize banks is the case for the government to sell national banks to well-connected individuals or groups so that political elites will not lose their political influence over the banks. In this vein, a conglomerate or business elites may buy a national bank. If politicians obtain support from those business elites who aim

to buy banks, politicians would welcome a privatization of banks. Further, competitive firms will be able to obtain more loan opportunities and better loan conditions from privatized banks. Therefore, under these conditions, the manufacturing sector will support privatization of banks.

However, the manufacturing sector will oppose the reform of enhancement of banking supervision. These policy measures include policies such as increasing banks' capital adequacy ratio, enhancing the independence of banking supervisory agencies, and strengthening the supervisory power of a banking supervisory agency, for example. If these measures are taken for enhancing prudential regulations and banking supervision, banks need to refrain from risky lending behaviors and it would become harder for firms to gain access to credit. Therefore, the manufacturing sector will oppose these policy measures.

On the other hand, the manufacturing sector will support capital account liberalization. Export oriented firms will be able to increase their access to FDI as a result of capital account liberalization. Moreover, even uncompetitive firms and domestic oriented firms can benefit from capital account liberalization because capital account liberalization results in an increase in capital inflow not only to firms but also to banks; therefore, small firms will also be able to increase their access to better credit conditions. Hence, the manufacturing sector will support capital account liberalization.

With respect to the dimension of interest rate liberalization, interest rate liberalization or liberalization of banks' deposit rates and lending rates leads to lower lending rates and higher deposit rates. Since firms will be able to take advantage of lowered lending rates, the manufacturing sector will support interest rate liberalization. Hence, the manufacturing sector will support reform measures concerning interest rate liberalization.

Concerning the elimination of credit controls, when firms are competitive enough, they will prefer the elimination for banks' credit controls, since when banks become free from credit controls and restrictive reserve requirements, competitive firms can enjoy more expanded loan opportunities. On the other hand, if the manufacturing sector is not competitive enough, they will oppose the elimination of credit controls because they may lose preferential credit allocation as part of a designated sector or they may lose access to credit at preferential interest rates, the manufacturing sector's preferences with respect to the elimination of credit controls will be mixed. Therefore, if large influential firms such as conglomerates are not beneficiaries from preferential credit allocations and if they want to expand loan opportunities, they will exert their political influence to eliminate credit controls. While politicians may want to utilize credit controls as a policy tool to cultivate ties, when large influential firms such as conglomerates would like to eliminate credit controls, the politicians have to respond these demands. Therefore, a strong manufacturing sector will support the elimination of credit controls, though this will be conditioned by who are benefited by preferential credit allocation.

In terms of the elimination of entry barriers on banks, the manufacturing sector will support these reform measures. The manufacturing sector will be able to expand loan opportunities provided by banks as a result of policy measures to enhance competition among banks such as lowering entry barriers of domestic banks and foreign banks, eliminating branching restrictions of banks, and allowing a wider range of activities that banks can engage in. Consequently, in a country with a strong manufacturing sector, reform measures on elimination of entry barriers of banks will be supported.

Given the distributional preferences of the manufacturing sector as discussed above, with respect to the preferences of the manufacturing sector on the *magnitude* of financial reforms,

financial reforms such as privatization of banks, capital account liberalization, interest rate liberalization, elimination of credit controls, and elimination of entry barriers, for instance, will provide them with a better chance to access credits, so they will not resist radical financial reform measures, even if these reforms are conducted at one time. Therefore, I assume that the manufacturing sector will support a wider range of financial reforms as the manufacturing sector will seek a wider variety of opportunities to access better credit conditions. Thus, as to the effects of societal actors on the *magnitude* of financial reforms, I hypothesize as follows:

Hypothesis 3a. *A country where the manufacturing sector has a strong influence is more likely to engage in a larger magnitude of financial reforms.*

With respect to the influence of the manufacturing sector on the *pace* of financial reforms, I assume that when the manufacturing sector supports certain dimensions of financial reform measures, these dimensions of reforms will be accelerated, while when the manufacturing sector opposes a particular dimension, that dimension of reform will be delayed. Therefore, a country with a strong manufacturing sector's influence will bring forward the timing of reforms in such areas as privatization of banks, capital account liberalization, elimination of interest rate controls, elimination of credit controls, and elimination of entry barriers of banks. On the other hand, a strong manufacturing sector's influence will hinder financial reforms in the dimension of the enhancement of banking supervision. The derivable hypothesis from the above discussion concerning the effects of the manufacturing sector on the *pace* of financial reforms is as follows:

***Hypothesis 3b.** In countries where the manufacturing sector has a strong influence, financial reforms are more likely to be hastened in such dimensions as privatization of banks, capital account liberalization, interest rate liberalization, elimination of credit controls, and elimination of entry barriers. On the other hand, in this same type of situation, financial reform is more likely to be delayed in the dimension of enhancement of banking supervision.*

2.3.3.2. The banking sector

The main theory of economic reform argues that the costs of reforms are concentrated and the benefits of reforms are widely dispersed. Although financial reforms such as interest rate liberalization, elimination of credit controls, and the elimination of entry barriers on banks are technical policies, since the banking sector would be the one to be most likely affected, the banking sector would have the stake concerning these financial policy reforms.

One point of view holds that these previously privileged actors who need to pay the costs of reform will engage in collective actions, which would impede economic reforms. Following this logic, domestic financial banks are expected to oppose financial reforms (Lukauskas 2002). Also, in examining the impact of the banking sector's influence on exchange rate regimes, Hall (2005) argues that the banking sector's influence is particularly strong when banks dominate a financial system, and they will engage in collective action. Another point of view looks at banks as long-term efficiency maximizers, and as such, expects that domestic banks should support financial reforms because they can anticipate future benefits and can bear short-term costs (Haggard and Maxfield 1996).

Although whether the banking sector opposes or supports financial reforms is controversial in prior research, I assume that banks are not necessarily long-term efficiency maximizers. In developing countries, banks dominate a country's financial system, and they tend to be heavily protected without competition. Therefore, they will not want to endure short-term costs for the sake of long-term benefits. Hence, in general, I believe the banking sector is likely to oppose financial reforms. Hypothesized distributional preferences of the banking sector in each of the six dimensions of financial reforms are shown below as Table 2.4.

Table 2.4 Distributional Preferences of the Banking Sector

Six Dimensions of Financial Reforms	Preferences of the Banking Sector
Privatization of Banks	Oppose
Enhancement of Banking Supervision	Oppose
Capital Account Liberalization	Oppose
Interest Rate Liberalization	Oppose
Elimination of Credit Controls	Oppose
Elimination of Entry Barriers	Oppose

With respect to the preferences of the banking sector, the banking sector will oppose all six dimensions of financial reforms. State banks do not want to be privatized since they enjoy a more heavily protected status than private banks. Also, private banks do not want other publicly-

owned banks privatized since then they would need to face heavier competition with other banks. Hence, the banking sector will oppose privatization of banks. With respect to enhancement of banking supervision, since banks prefer that the banking supervisory agency not check their real balance sheets and not intervene in their banking business, they will oppose the enhancement of banking supervision.

In terms of capital account liberalization, by liberalizing capital accounts, banks will be able to borrow money from abroad in capital markets; however, firms also will be able to borrow necessary money from abroad, which may reduce domestic banks' opportunities to lend money. Also, banks will need to set interest rates closer to the world interest rate if capital is mobile, which may lower banks' revenues from loan payments. Therefore, although preferences of the banking sector may be mixed, in general, the banking sector will oppose financial liberalization.

Concerning interest rate liberalization, banks would have to face severe competition among banks if banks' deposit rates and lending rates were liberalized by offering higher deposit rates and lower lending rates to clients. Hence, the banking sector will oppose interest rate liberalization; therefore, in a country with a strong banking sector, interest rate liberalization will be delayed.

With respect to the elimination of credit controls, banks would be allowed to determine credit allocation by themselves as a result of these financial reform measures; however, credit allocations can be an important political tool for banks to make strong ties between politicians. Hence, knowing that credit allocations can be politically important tools, banks would like to preserve their politically special status as providers of preferential credits. Also, banks will not want to face more competitive pressures to earn profits, which is another result of the elimination

of credit controls. Therefore, I assume that the banking sector will oppose the elimination of credit controls.

In regards to the last dimension, the elimination of entry barriers into the domestic market, the banking sector will also oppose these financial reform measures. Elimination of entry barriers or allowing entry of new domestic banks and/or foreign banks into the domestic market, for example, will increase competitive pressures among banks. Therefore, I assume that the banking sector will oppose the dimension of the elimination of entry barriers.

Based on hypothesized distributional preferences of the banking sector discussed above, concerning the banking sector's influence on the *magnitude* of financial reforms, contrary to the manufacturing sector, I assume that the banking sector will oppose a wider range of financial reforms since the banking sector does not prefer all six dimensions of financial reforms. Also, as discussed before, the banking sector is the sector most likely to be affected by various financial policy reforms. The banking sector tends to be heavily protected and sheltered from competition in developing countries. Therefore, the banking sector will resist radical financial reform measures at one time. Hence, a country with a stronger banking sector will be more likely to engage in a smaller magnitude of financial reforms.

Hypothesis 4a. *A country where the banking sector has a stronger influence is more likely to engage in a smaller magnitude of financial reforms.*

In terms of the influence of the banking sector on the *pace* of financial reforms, the banking sector will oppose all six dimensions of financial reforms. Hence, a banking sector with

stronger influence will result in delay in each of the six dimensions of financial reforms. Hence, I posit the following hypothesis concerning the effects of the banking sector on the *pace* of each of the six dimensions of financial reforms.

Hypothesis 4b. In a country where the banking sector has a strong political influence, financial reforms in such dimensions as privatization of banks, enhancement of banking supervision, capital account liberalization, interest rate liberalization, elimination of credit controls, and elimination of entry barriers are more likely to be delayed.

2.4. RECAPITULATION

In this chapter, I have laid out the main hypotheses for predicting both the *magnitude* of and the *pace* of financial reforms in developing countries. As shown below as Figure 2.1, I argue that both the magnitude of and the pace of financial reform outcomes are dependent upon state responses to the IMF at the international level, and veto players plays the role in a way that conditions the IMF effects. Also, financial reform outcomes are state responses to societal pressures, especially from the manufacturing sector and the banking sector.

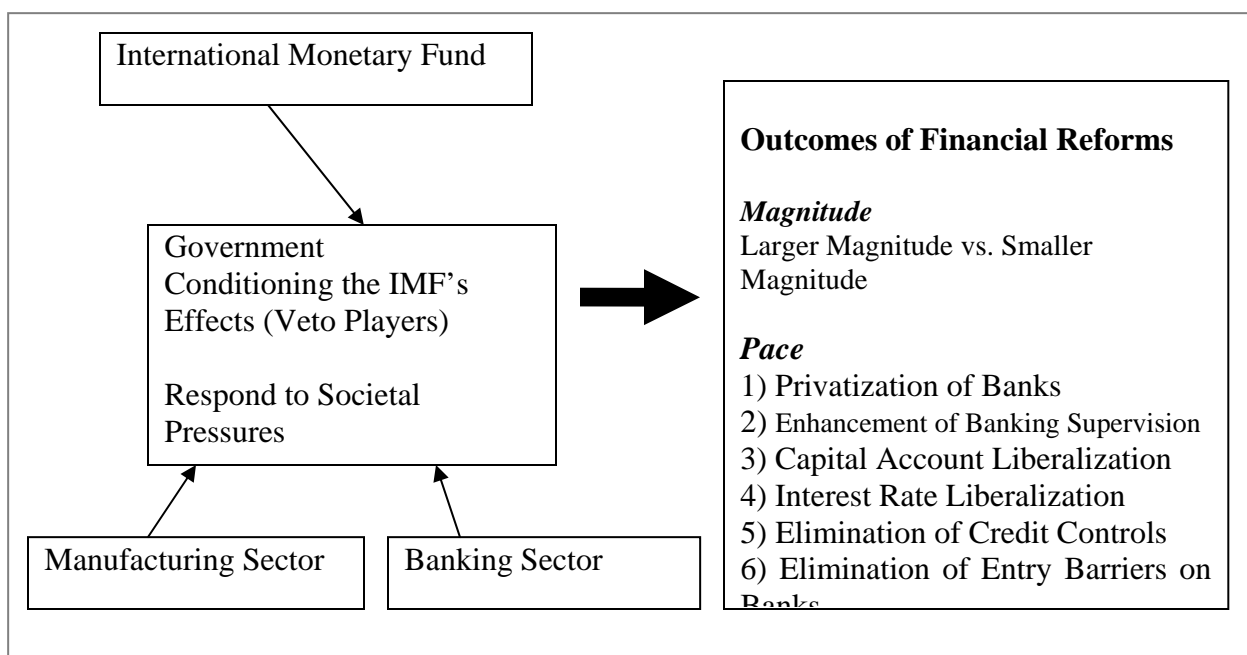


Figure 2.1 Hypothesized Determinants of Financial Reforms

Hypotheses for predicting the magnitude of financial reforms are summarized as Table 2.5 below. A plus sign indicates the expected effects of predictors in facilitating a larger magnitude of facilitating financial reforms and minus sign indicates those effects causing a smaller magnitude of financial reforms.

Table 2.5 Hypotheses Predicting the Magnitude of Financial Reforms in Developing Countries

Predictors	Magnitude of Financial Reforms
IMF	+
Conditioning Effects of Veto Players for the IMF (as the number of veto player increases)	–
Strong Manufacturing Sector’s influence	+
Strong Banking Sector’s influence	–

As shown above, while the IMF conditionality programs will facilitate a larger magnitude of financial reform (Hypothesis 1a), as the number of veto players increases in a country, the effects of these programs decreases (Hypothesis 2a). Also, a stronger influence of the manufacturing sector will support a larger magnitude of financial reforms (Hypothesis 3a), whereas a stronger influence of the banking sector will result in more gradual reforms or a smaller magnitude of financial reforms (Hypothesis 4a).

I also hypothesized determinants of the *pace* of each of the six dimensions of financial reforms and the hypotheses are summarized as Table 2.6 shown below. A plus sign indicates the expected effects of predictors in speeding up the pace of facilitating financial reforms and minus sign indicates those delaying effects of the pace of financial reforms in developing countries.

Table 2.6 Hypotheses Predicting the Pace of Financial Reforms in Developing Countries

	Privatization of Banks	Enhancement of Banking Supervision	Capital Account Liberalization	Interest Rate Liberalization	Elimination of Credit Controls	Elimination of Entry Barriers
IMF	+	+	+	+	+	+
Conditioning Effects of Veto Players for the IMF (as the number of veto player increases)	–	–	–	–	–	–
Strong Manufacturing Sector's influence	+	–	+	+	+	+
Strong Banking Sector's influence	–	–	–	–	–	–

As discussed before, the IMF will have the effect of bringing forward the timing of financial reforms (Hypothesis 1b). However, this IMF's effects on facilitating financial reforms will be intermediated by the number of veto players. Namely, as the number of veto players increases, the IMF's effects on facilitating reforms will be likely to decrease (Hypothesis 2b).

On the other hand, if financial reforms are the state's response to societal pressures by interest groups, the manufacturing sector or the banking sector's preferences as shown below will be reflected as policy outcomes. A country with a strong manufacturing sector will facilitate financial reforms in such areas as privatization of banks, capital account liberalization, interest rate liberalization, elimination of credit controls, and elimination of entry barriers, and will delay

the enhancement of banking supervision (Hypothesis 3b). On the other hand, if the banking sector has stronger influence, it will cause to delay the timing of financial reforms in all six dimensions (Hypothesis 4b).

Concerning the dimension of banking supervision, I assume that both the manufacturing sector and the banking sector oppose it. Then, who will support stricter banking supervision? Economic technocrats such as central bankers and bureaucrats of the banking supervisory authority can be the supporters for neoliberal economic reforms. However, not all staff of central banks or banking supervisory agencies are neoliberal-minded economic technocrats, especially in the cases of developing countries. Also, the central banks and the banking supervisory agency rarely can be regarded as politically independent in many circumstances. Moreover, although independent neoliberal-minded economic ministers can be promoters of the enhancement of banking supervision, these economic ministers need to be backed by political leaders. Therefore, unless political leaders support the enhancement of banking supervision or unless political leaders are pushed toward these reform measures by international financial institutions such as the IMF, it would be difficult for economic technocrats to enhance banking supervision over the banking sector.¹⁵

In terms of the relationship between the *magnitude* and the *pace* of financial reforms, in general, when a state conducts a larger magnitude of financial reform, a state may not conduct

¹⁵ Concerning other societal influence besides the manufacturing sector and the banking sector, the influence of the agricultural sector may be important in shaping the pace of the elimination of credit controls. The agricultural sector will oppose the elimination of credit controls since the agricultural sector is often a primary protected and benefited sector from preferential credit allocations with subsidized interest rates in developing countries. Therefore, I will take the agricultural sector into account in the dimension of the elimination of credit controls and will conduct an additional quantitative examination later. However, for other dimensions of financial reforms, the agricultural sector will not be directly affected and will not organize themselves to influence financial reform outcomes. Therefore, I examine the impact of the agricultural sector only in the dimension of elimination of credit controls.

another round of reforms. Also, a state may conduct reforms gradually but many times over the years at a faster pace. However, in the cases of developing countries, although a state may conduct a larger scale of financial reforms at one time, the state may take a large reversal of policy measures toward financial repression. If that is the case, a state determines when and the extent to which financial reforms should be conducted again and a state may conduct a large scale of reforms again.

When and why do financial reforms occur? Do states choose financial reforms as a response to strong international pressures to liberalize their domestic financial systems? Or do veto players play a role in determining the outcome, facilitating or hindering financial reforms? Or rather, should financial reforms be understood as the states' responses to societal pressures? In the following chapter, Chapter 3, I quantitatively examine predictors of the magnitude of financial reforms employing ordinal logit regressions in order to answer these questions. Also, hypotheses for predicting the pace of each of the six financial reforms are examined employing duration models.

3.0 DETERMINANTS OF FINANCIAL REFORMS: QUANTITATIVE ANALYSIS

3.1. INTRODUCTION

This chapter quantitatively assesses political determinants of the *magnitude* and the *pace* of financial reforms. The *magnitude* of financial reforms refers to the degree to which a country is likely to engage in a wider range of financial reforms at one given time such as with a big-bang type of reform. “What makes a country pursue a larger scale of financial reform at one time?” This is the first central question that I try to answer in this chapter. In prior research, economists have lively debated whether a country should conduct a large scale of economic reforms at one time, a so called “big-bang” approach or “shock therapy,” or whether a country should conduct economic reforms in a gradual manner.¹⁶ While economists tend to discuss whether a country should conduct economic reforms on a larger scale at one time or in a gradual manner from a normative viewpoint, this study takes a different stance. This study aims to empirically specify under which conditions a country is more likely to engage in a larger *magnitude* of financial reforms or a smaller *magnitude* of financial reforms.

In addition, I further analyze political determinants with respect to the *pace* of financial reforms. “What makes a country conduct financial reforms at a faster pace?” This is the second central question that I try to answer in this chapter. Since the *Financial Reform Database*

¹⁶ In addition to these theoretical studies, as another strand of research, economists also report policy outcomes of financial reforms such as big-bang reforms versus gradual reforms in their case studies (for example see De Brouwer with Pupphavesa (1999)). However, in these studies, economists hardly ask the question why some countries take a big-bang type of path of financial reforms while others take a gradual path or of financial reforms.

developed by the Research Department of the IMF has allowed me to examine six dimensions of financial reforms, I have been able to quantitatively explore this issue.

As stated in the previous chapter, I look at the relative importance of the following factors on three levels as determinants of financial reforms: 1) international pressures by the IMF as an explanation at the international level, 2) veto players as an explanation at the national level, and 3) interest group pressures as an explanation at the societal level. In particular, by interacting the IMF impact and the number of veto players, I examine how the IMF's impact on financial reforms is conditioned by the number of veto players.

This chapter is organized as follows. In the next section, I review past relevant literature on the magnitude of financial reforms. Also, I reiterate hypotheses concerning political determinants for predicting both the magnitude and the pace of financial reforms. In the third section, I explain the dataset used to perform quantitative analysis. In the fourth section, I describe the *Financial Reform Database* developed by the Research Department of the IMF, which serves dependent variables in quantitative analyses in this chapter.¹⁷ Using this dataset, I also present a brief outlook of the magnitude and the pace of financial reforms in thirty developing countries. In the fifth and the sixth sections, I describe the operationalization of variables — independent variables and control variables, respectively. In the seventh section, I explain the methodology used: ordinal logit regression for exploring determinants of the magnitude of financial reforms and event history analysis for the pace of financial reforms. In the eighth section, results concerning the predictors of the magnitude of financial reforms are presented. In the ninth section, results on the predictors of the pace of financial reforms are presented. In the last section, the tenth, I discuss findings and conclude.

¹⁷ I obtained the authorization of the access to the database from the Research Department of the IMF. However, this database is not yet publicly available.

3.2. PAST RESEARCH AND HYPOTHESES

In past literature, economists have engaged in lively debates over whether a country should engage in a big-bang type manner of reform or in a more gradual manner in order to overcome resistance to reforms.

As a proponent of “big-bang” reforms, Roland and Verdier (1994) argue that in the cases of the East European countries, a big-bang type reform is desirable, because a big-bang type will create a “critical mass,” which will support economic reforms, thereby ensuring economic reforms by reducing resistance to reforms. As the other rationale for big-bang reform in general, Martinelli and Tommasi (1997) show that in a gradual approach, if one big group who possess a strong veto power can block economic reforms, another group will not agree to initiate a reform knowing that the strong group will not agree economic reforms later. Hence, a big-bang approach is a viable option for a government to propose economic reforms.

As a proponent of gradual economic reform, Ronald (1994) argues that the aggregate uncertainty of a big-bang reform strategy can result in the inhibiting of economic reforms under the existence of political constraints; in these cases, a gradual economic reform is a more feasible strategy because implementing only a subset of economic reforms will reduce aggregate uncertainty and will therefore be more likely to be supported by a majority. Dewatripoint and Roland (1992) also point out that if one has to compensate for a group of losers as a result of reforms, the costs of reforms will be lower in a gradual reform than a big-bang approach. Therefore, they claim a gradual reform will be more likely to be feasible under budget constraints. Wei (1997) also argues that although a big-bang reform is preferable, a gradual reform is more feasible under political constraints because it can divide resistant forces who

oppose economic reforms. Thus, economists argue which approach is optimal by comparing the gradual approach and the big-bang approach.

However, in this chapter, rather than arguing an optimal magnitude of reforms normatively, I aim to contribute to the IPE literature by empirically specifying under which conditions financial reforms are more likely to be implemented in a larger scale at one time. To account for causal determinants of the *magnitude* of financial reforms, I posited four hypotheses in Chapter 2. These four hypotheses posited in the previous chapter are restated as follows:

Four Hypotheses Predicting the Magnitude of Financial Reforms

Hypothesis 1a. *When a government is under the IMF conditionality programs, the country is more likely to engage in a larger magnitude of financial reforms.*

Hypothesis 2a: *The IMF's influence on financial reforms is conditioned by the number of veto players. As the number of veto player increases, the IMF's effects on enhancing a larger magnitude of financial reforms are more likely to decrease.*

Hypothesis 3a. *A country where the manufacturing sector has a strong influence is more likely to engage in a larger magnitude of financial reforms.*

Hypothesis 4a. *A country where the banking sector has a stronger influence is more likely to engage in a smaller magnitude of financial reforms.*

Next, to account for causal determinants of the *pace* of financial reforms, I also posited four hypotheses in Chapter 2. These four hypotheses are reiterated as follows:

Four Hypotheses Predicting the Pace of Financial Reforms

Hypothesis 1b: *When a government is under IMF conditionality programs, a country is more likely to bring forward the timing of financial reforms.*

Hypothesis 2b: *The IMF's influence on the pace of financial reforms is conditioned by the number of veto players. As the number of veto players increases, the IMF's effects on bringing forward the timing of financial reforms are more likely to decrease.*

Hypothesis 3b. *In countries where the manufacturing sector has a strong influence, financial reforms are more likely to be hastened in such dimensions as privatization of banks, capital account liberalization, interest rate liberalization, elimination of credit controls, and elimination of entry barriers. On the other hand, in this same type of situation, financial reform is more likely to be delayed in a dimension of enhancement of banking supervision.*

Hypothesis 4b. *In a country where the banking sector has a strong influence, all six dimensions of financial reforms — privatization of banks, enhancement of banking supervision, capital account liberalization, interest rate liberalization, elimination of credit controls, and elimination of entry barriers — are more likely to be delayed.*

To quantitatively assess these hypotheses, in the next section, I explain the database that I use in this chapter.

3.3. DATASET

In this section, I explain the dataset, which I constructed, covers thirty developing countries from 1973 to 2002. The thirty developing countries covered in this dataset are shown below as Table 3.1.

Table 3.1 Thirty Countries in the Dataset

Caribbean and Latin American countries (13)

Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Jamaica, Mexico, Peru, Uruguay, Venezuela

Asian countries (11)

Bangladesh, India, Indonesia, South Korea, Malaysia, Nepal, Pakistan, Philippines, Singapore, Thailand, Sri Lanka

Middle Eastern and African countries (6)

Egypt, Ghana, Morocco, Turkey, South Africa, Zimbabwe

As shown above, this dataset covers major Latin American and Asian countries, while it does not cover many African and Middle Eastern countries. Also, it does not cover East

European countries, either. The quality and availability of the data before the 1990s tend to be limited in these countries that are not covered in this dataset. Therefore, it can be said that this dataset sacrifices the number of countries for the sake of long year coverage.¹⁸

3.4. DEPENDENT VARIABLES

In this section, I first introduce the *Financial Reform Database*, which served as dependent variables in quantitative examination in this chapter. Second, I describe how the dependent variables were constructed to measure the magnitude of financial reforms and also present an overview of the actual patterns of magnitude of financial reforms in thirty developing countries. Third, I explain how the pace of financial reforms was measured as dependent variables and also present an overview of the pace of financial reforms in each of the six dimensions.

3.4.1. Financial reform database

As discussed above, causal determinants of financial reforms other than capital account liberalization have been neglected in conventional literature. Hence, I look at the following six dimensions of financial reforms: 1) privatization of banks, 2) enhancement of banking supervision over the banking sector, 3) capital account liberalization, 4) interest rate

¹⁸ Many East European countries and China lacked economic data before 1990s. Therefore, this dataset does not include these countries. Also, the African countries in this dataset — Egypt, Ghana, South Africa, and Zimbabwe — tended to be major and economically well developed countries relative to other countries in the region. In this vein, this data may be more biased towards countries where there are more financial reforms. However, this limitation is partially compensated for by the long coverage of years, though it may not be fully remedied.

liberalization of banks' deposits and credits, 5) elimination of credit controls, and 6) elimination of entry barriers on banks.

The data have been taken from the *Financial Reform Database* developed by the Research Department of the IMF, the original data coverage of which I expanded and also assisted to refine and revise.¹⁹ Out of the six dimensions, five of them —privatization of banks, enhancement of banking supervision, interest rate liberalization, eliminations of credit controls over the banking sector, and elimination of entry barriers on banks—focus on banking reforms. Also, out of the six dimensions, five dimensions look at financial reforms toward liberalization, where reforms occur in a way that states are less likely to intervene into markets. Only one dimension —the enhancement of banking supervision over the banking sector— looks at the regulatory dimension of financial reforms, in which reforms are conducted in a way that states are more likely to intervene into markets for regulatory purposes. A list of the coding rules for each dimension is appended as Appendix 3.A.²⁰

Each dimension is coded on a four point scale: 0 = Fully Repressed, 1 = Partially Repressed, 2 = Largely Liberalized, and 3 = Fully Liberalized.²¹ Correlations between each of the six dimensions using raw values and also differences are shown as Appendix 3.B and Appendix 3.C respectively. Correlations of raw values between the dimension of privatization and any of the other dimensions tend to be lower (0.292–0.425) than correlations between any

19 For details of coding rules of the Financial Reform Database, see Omori (2006). For details of the original dataset, see Abiad and Mody (2005).

20 In the Financial Reform Database, the six dimensions used in this dissertation project are labeled respectively as follows: 1) State Ownership of Banks, 2) Entry Barriers, 3) Credit Controls and Reserve Requirements, 4) Interest Rate Controls, 5) Prudential Regulations and Banking Supervision over the Banking Sector, and 6) Capital Account Restrictions. These labels are still tentative as of March 1, 2007.

21 For the banking supervision dimension, 0 is Not Regulated, 1 is Less Regulated, 2 is Largely Regulated, and 3 is Highly Regulated.

two of the other dimensions (0.462–0.672). Overall, however, since correlations between dimensions are not particularly high, it can be said that each dimension captures a different aspect of financial reform.

3.4.2. Overview of the magnitude of financial reforms

In order to measure the *magnitude* of financial reforms, I created a change index for all six dimensions of financial reforms. Since each of the six dimensions is coded zero (Fully Repressed), one (Partially Repressed), two (Largely Liberalized), to three (Fully Liberalized), I took the difference for each dimension and added these change values of the six dimensions, with the result that the additive change values of the six dimensions express the *magnitude* of financial reforms for each country in a given year. These additive change scores serve as dependent variables to examine magnitude of financial reforms. Larger values indicate a larger magnitude of reforms. In this vein, I explore the magnitude of financial reforms to a relative degree, in which “big-bang” type of reforms can be the possible extreme end of policy outcomes. Using these scores, I present actual patterns of the magnitude of financial reforms in these thirty developing countries from 1973-2002, which are presented below as Figure 3.1 and Figure 3.2. A longer positive line indicates a larger magnitude of financial reform, while a shorter positive line indicates a smaller magnitude of financial reform. A negative line indicates a policy reversal to a more repressed financial system.

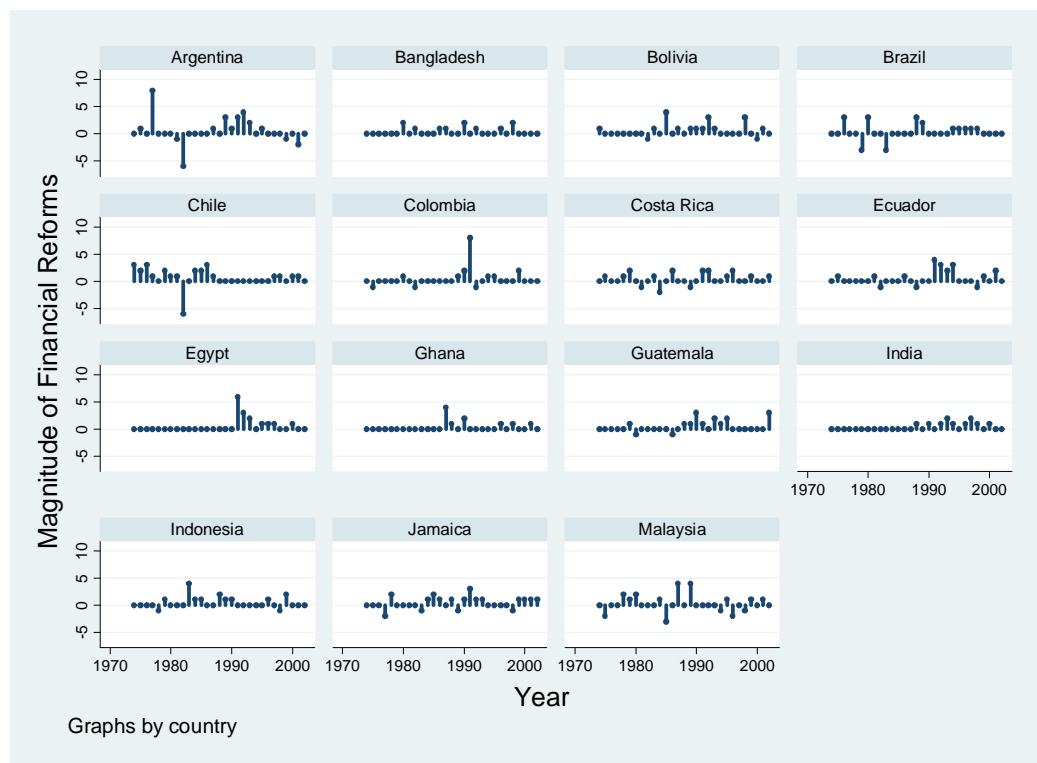


Figure 3.1 Magnitude of Financial Reforms of Thirty Developing Countries I

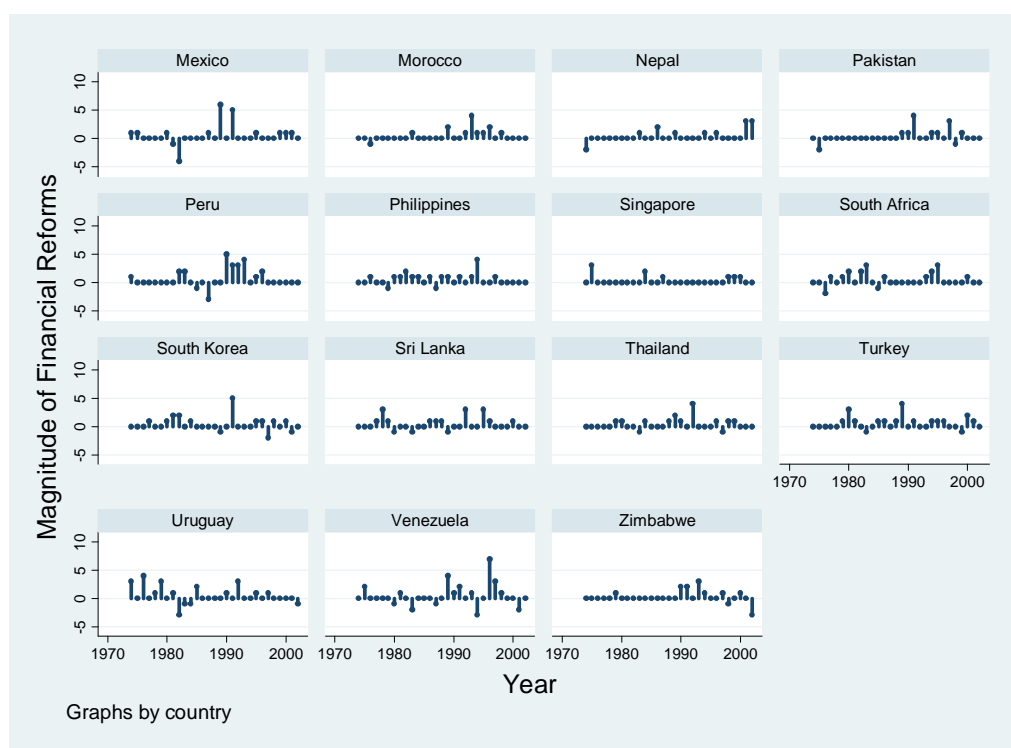


Figure 3.2 Magnitude of Financial Reforms of Thirty Developing Countries II

Although New Zealand is a well-known example of big-bang type of financial reforms in developed countries,²² New Zealand is not the only case of big bang type of financial reforms. As seen above, some developing countries have also conducted a large magnitude or “big-bang” type of financial reform: Argentina in 1977, Colombia in 1991, Egypt in 1991, and Mexico in 1989 as at the extreme end of outcomes of larger magnitude of reforms. On the other hand, other countries have taken more gradual paths of financial reform, especially seen in the cases of Bangladesh, Costa Rica, and India.²³ Thus, as can be observed in Figure 3.1 and Figure 3.2, the extent of the magnitude of financial reforms in developing countries has been very diverse.

3.4.3. Overview of the pace of financial reforms

Second, in order to quantitatively examine the pace of financial reforms I use the methodology of event history analysis, which I explain later in more detail in the methodology section. Here I explain how I construct dependent variables. In order to model what hinders and what facilitates financial reforms, how many years have passed until financial reforms occur is used as a dependent variable. To know when financial reforms occur, I take the differences between year t and year $t-1$, and when values are changed positively, it is counted as an event occurring or financial reforms occurring. Then I count the years until financial reforms occur. If financial reforms never occur in a country, values range from 1 to 29. In order to take into account

22 See Caprio et al. (1994), for example.

23 The value of change in the additive index is eight in Argentina in 1977 and Colombia in 1991, six in Egypt in 1991, and six in Mexico in 1989. The *Financial Reform Database* includes New Zealand, known as a famous case of a “big-bang” type of financial reforms, as one of nine highly developed countries and its change value was six in 1984. On the other hand, in the cases of Bangladesh, Costa Rica, and India, the maximum value of change in additive index is two for thirty years.

repeatability of financial reforms, as discussed later, when a second reform occurs, coding begins at 1 again.²⁴

The average of the years until financial reform occurs and the standard deviation of the time in each dimension is presented as Table 3.2 below. In this table, the average number of times financial reform occurs and the standard deviation of the number of times are also presented.

Table 3.2 Average Time until Financial Reform Occurs and Average Number of Financial Reform Occurring

	Privatization of Banks	Enhancement of Banking Supervision	Capital Account Liberalization	Interest Rate Liberalization	Elimination of Credit Controls	Elimination of Entry Barriers
Mean Time until Financial Reform Occurs	10.100	9.867	6.644	6.734	6.885	7.264
SD of Mean Years	7.168	7.056	5.072	4.766	5.129	5.186
Mean No. of Financial Reform Occurring	0.377	0.318	1.226	1.240	1.108	0.971
SD of Mean No.	0.660	0.587	1.271	1.146	1.139	1.045

24 For details of data construction for conditional time gap model, see Cleves (1999).

It appears that it takes a longer time for financial reforms to occur in such dimensions as privatization of banks and enhancement of banking supervision. It also seems that reforms in dimensions of privatization of banks and enhancement of banking supervision occur less often relative to the other dimensions of financial reforms. Nonetheless, these values look relatively similar across dimensions. However, when I examine the correlations between the average years until financial reform occurs across dimensions (appended as Appendix 3.D), the correlations take values from 0.424 to 0.672. Therefore, it can be said that each dimension measures different timing. Also, the correlations between the average numbers of failures across each dimension vary from 0.133 to 0.466, which is also fairly low (appended as Appendix 3.E). Therefore, even if a country conducts a particular dimension of reforms many times, this does not necessarily mean that the country also conducts other dimensions of financial reforms.

Further, the correlations between the *pace* of financial reforms in each of dimensions and the *magnitude* of financial reforms (additive change scores) and also additive level scores are appended as Appendix 3.F. The correlations vary within a range between 0.003 and 0.164 with the magnitude of reforms. Therefore, the correlations between the two aspects of financial reforms, the magnitude and the pace, are fairly low.²⁵

In order to account for political determinants of the magnitude and the pace of financial reforms in the thirty developing countries, in the next section, I explain operationalization of independent variables to test the hypotheses listed earlier.

²⁵ The correlations between the magnitude and the additive level scores range from -0.042 to 0.228.

3.5. INDEPENDENT VARIABLES

3.5.1. International pressures: the IMF's influence

As stated in Hypotheses 1a and 1b, the IMF's conditionality programs are assumed to have the impact of facilitating a larger magnitude of financial reforms and bring forward the timing of financial reforms. To examine these effects of the Fund's conditionality programs, the ideal indicator would be one which identifies whether financial sector reforms are included in the Fund's conditionality programs; however, this information is compiled as a dataset only after 1993 even by the IMF itself, and furthermore, these data are not publicly available.²⁶ Therefore, given the data availability limitations, I take the "use of IMF credits" as an indicator of the IMF's influence at facilitating a larger magnitude of financial reforms and labeled this as *IMF*. The data were obtained from *World Development Indicators*. I divide these values by total population, adjusting for each country's size, in order to take into account the amount of impact of the *IMF*.²⁷

3.5.2. Political institutions: veto players

Relating to Hypotheses 2a and 2b, in order to examine the conditional effects of veto players or how the effects of the IMF in facilitating a larger magnitude of financial reforms and speeding up financial reforms in each of the six dimensions is intermediated by the number of veto players, I created the variable of *Veto Players*. *Veto Players* are counted as the number of political parties

²⁶ The IMF's MONA database, the database of the IMF's conditionality programs, starts from 1993.

²⁷ The unit is expressed as the use of IMF credits per 10 populations.

within the executive coalition based on the cabinet portfolio allocation. The number of veto players is based on the situation as of January 1 for each year so that causal direction of the occurring of financial reforms during a year is not be reversed. The information on cabinet portfolio was obtained from *Political Handbook of the World* (various years) and *Keesing's Contemporary Archives: Record of World Events* (various years). Values are coded as 0 in cases of non-democratic governments, which represents the conceptual notion that an executive leader is not constrained by other veto players.²⁸

By interacting *IMF* and *Veto Players* and by accurately estimating conditional coefficients, I can explore conditional effects for the IMF given the number of veto players. I assume that as the number of veto players increases, the IMF's effects on facilitating a larger magnitude of financial reforms and speeding up financial reforms decreases. On the other hand, results of the *IMF* represent the IMF impact when the number of veto players is zero.

Ideological preferences of veto players, as well as preferential distances from the status quo policy are difficult to grasp in the case of developing countries since the data on political parties' ideologies are not available. Therefore, in order to capture changes in preferences of the status quo, I created a dichotomous variable of *Alteration of Executives*. *Alteration of Executives* is assigned as one if 1) regime transition such as from a democracy to a non-democracy or a democratic breakdown occurs and/or 2) regime transition from a non-democracy to a democracy

²⁸ I used Przeworski et al. (2000)'s coding rules for classifying regime type based on a dichotomous variable called REG. Because the dataset by the Przeworski et al. (2000) only covers to 1990, I expanded the year coverage to 2002. I slightly modified these dummy variables by taking into account military influence. Even if executives are elected by popular elections, when an elected executive leader is under strong military influence or one of the houses is under strong military influence, the country is coded as a non-democracy; namely, the number of veto players is zero. Coding decisions are also made based on consultation with country experts. This modification does not alter the results. How regime type is classified for the thirty countries from 1973-2002 is appended as Appendix 3.G.

occurs. Also, when changes in executive leaders' political parties took place in cases of democratic governments, values are also coded as one and are coded as zero otherwise. Coding is based on the situation as of January 1 for each year.

Data were compiled based on information from *Political Handbook of the World* (various years) and *Keesing's Contemporary Archives: Record of World Events* (various years).

3.5.3. Societal factors: the manufacturing sector and the banking sector

To empirically assess the influence of the manufacturing sector on the magnitude and the pace of financial reforms, with the expectation that a larger manufacturing sector's influence facilitates a larger magnitude of financial reform (Hypothesis 3a) and brings forward the timing of financial reforms (Hypothesis 3b), the ideal indicator would be an indicator to measure the amount of political influence. For example, the industrial concentration ratio that measures the degree to which a certain number of firms account for the percentage of industrial output can be a good indicator. However, these data are not available for the thirty countries throughout all thirty years. Therefore, in this study, the influence of the manufacturing sector is operationalized as manufacturing sector output as a percentage of GDP, labeled as *Manufacturing Sector*. Data were obtained from the World Bank's *World Development Indicators*. Though this is not the best indicator to measure the influence of the manufacturing sector, this measurement is widely used in conventional studies in the cases of developing countries.²⁹

Concerning the banking sector's effects on the magnitude and the pace of financial reforms, I hypothesize that as the influence of the banking sector increases, a country is more

29 For example, see Frieden et al. (2001).

likely to conduct a smaller magnitude of financial reforms (Hypothesis 4a) and more likely to delay financial reforms (Hypothesis 4b). To investigate the influence of the *Banking Sector*, the most desirable indicators would be the one to measure political influence. One good indicator can be the bank concentration ratio, which measures the degree to which a certain number of banks accounts for banks' total assets. However, since the data for bank concentration ratios for the thirty developing countries are only available after 1997, I cannot estimate the model for a long enough time-period. Another alternative indicator can be the amount of lobbying contributions by the banking sector to political parties or politicians.³⁰ However, these data are not available for the countries in this dataset.

Therefore, I use claims on the government provided by the depository money banks as an indicator.³¹ Claims on the government measures how much money banks lent to governments, which is used as a proxy for the banking sector's influence on governments. I assume when banks lend more money to governments, the banking sector will have a stronger influence over the government: hence, banks and governments will collude and will resist to radical financial reforms. Data were obtained from the *International Financial Statistics*, line 22a. Values are expressed as a percentage of GDP. To ensure a causal impact of societal sectors on financial reforms, one-year lagged values are used for both the *Manufacturing Sector* and the *Banking Sector*.

30 Broz (2005) uses this measure, campaign contributions from money center bank political action committees (PAC), in examining the influence of U.S. banking sector on the US Congress.

31 Deposit money banks refer to commercial banks and other financial institutions which accept transferable deposits (International Monetary Fund).

3.6. CONTROL VARIABLES

3.6.1. Level of democracy

The first variable to serve as one of the control variables is the effect of the level of democracy on the magnitude of financial reforms: namely, whether a less democratic government is more likely to facilitating a larger magnitude of financial reforms than a more democratic government *ceteris paribus*. Regime impact on economic performance has been a central concern for both comparativists and IPE scholars. In the literature of comparative politics, conventional wisdom in Latin America suggests that authoritarian governments can produce better economic performance such as anti-inflation measures, implying that non-democratic governments are more likely to commit to economic reforms than democratic governments (O'Donnell 1973; Skidmore 1977; Kaufmann and Stalling 1991).³²

On the other hand, quantitative studies in international political economy provide support for the liberal argument, i.e., democratic regimes are more likely to engage in economic liberalization than non-democratic regimes. IPE scholars find that democratic regimes are more likely to engage in economic liberalization than non-democratic counterparts in such areas as trade (Milner 2005; Frye and Mansfield 2004) and capital account liberalization (Quinn 2000).

32 According to O'Donnell (1973)'s well-known arguments concerning bureaucratic-authoritarianism, the populist governments in Brazil and Argentina engaged in redistributive policies in order to respond to popular sectors' demands. However, in the mid-1960s, facing economic, political, and social turmoil due to a financial crisis, populist regimes could not take effective measures. Bureaucratic-authoritarianism was a solution for both the military and technocrats to help restore political order and redress economic deterioration effectively and efficiently. Thus, conventional wisdom in Latin America suggests that non-democratic governments are more likely to commit to neoliberal economic reforms than democratic governments.

Yet, interestingly enough, contrary to these studies of the regime impact on economic reforms conducted by IPE scholars, which use a large number of states as cases, comparative political economists have demonstrated that regime effects on economic policy outcomes is in fact nil with respect to economic growth (Przeworski et al. 2000) and tax extraction capability in quantitative studies (Cheibub 1998), for example.

A non-democratic government may be more likely to adopt a larger scale of reforms at one time than a democratic government because political leaders of non-democratic governments do not necessarily have to obtain majority support to conduct a large magnitude of reforms. If financial reforms are perceived to be indispensable for leaders in a non-democratic country, the absence of a legislative body or the presence of a mere puppet-like legislature will make it easier for leaders of non-democratic governments than democratic governments to conduct a larger magnitude of financial reforms. In a democratic country, on the other hand, constituency support and legislature consent are necessary to conduct a large scale of financial reforms. Therefore, even if a government perceives a necessity to conduct radical financial reforms, it would be more difficult for a democratic government to conduct a large scale of financial reforms at one time than a non-democratic government. Hence, I examine the impact of *Level of Democracy* with the expectation that a less democratic government may engage in a big bang type of financial reform.

Concerning the effect of level of democracy on the pace of financial reforms, I examine whether a less democratic government is more likely to bring forward the timing of financial reforms than a more democratic government *ceteris paribus*. A non-democratic government can affect reform in two ways. It can commit financial reforms at a faster pace by suppressing popular sector demands, or a non-democratic government may delay financial reforms by

maintaining repressive financial policies if political elites continuously collude with particular sectors who oppose financial reform measures. A democratic government, on the other hand, has a system with checks and balances, a democracy will reduce the discretionary power of political elites. In addition, politicians in a democratic country will likely be vulnerable to societal pressures in order to maximize political tenure; hence, financial reforms can be delayed. Therefore, I examine whether level of democracy matters in terms of the pace of financial reforms by holding other conditions constant.

In order to measure regime impact, I use Freedom House's indicator, a continuous variable measuring *Level of Democracy*.³³ I added the scores for political rights and civil rights, and reversed the coding direction, which resulted in continuous scores from two (least democratic) to fourteen (most democratic). A larger value indicates a more democratic country.³⁴ The correlation between *Veto Players* and *Level of Democracy* is 0.405.³⁵

3.6.2. US aid

Another possible international factor that may shape the magnitude and the pace of financial reforms in developing countries is the influence of the United States, namely the effects of *US Aid*. Stone (2002) reports a large impact of US aid on macroeconomic outcomes in East European countries independent from the impact of the IMF. If a country benefits from official

³³ Data is downloadable from the Freedom House website at <http://www.freedomhouse.org>, accessed on March 21, 2007.

³⁴ Originally, scores of the Political Rights and the Civil Liberty are coded from one (most democratic) to seven (least democratic) in each dimension. I reversed the coding direction.

³⁵ Correlation between *Veto Players* and Przeworski et al. (2000)'s extended dichotomous REG variable is 0.689. The use of REG variable instead of *Level of Democracy* does not alter the main results in Chapter 3 and Chapter 4.

development assistance from the US in a targeted policy area, a country may engage in financial reforms. Therefore, I examine the effects of US aid targeted on the financial sector and the business sector on financial reforms since I am interested in both the manufacturing sector and the banking sector. I assume that as a state receives a larger amount of the US aid for the financial sector and the manufacturing sector, a state will encourage a larger scale of financial reforms at one time and will quicken the pace of financial reforms. In this vein, US aid may have an effect as another source of external factors to encourage a larger scale of financial reforms at one time. For coding *US Aid*, data are taken from the *International Development Statistics (IDS) Online Databases* on aid and other resource flows.³⁶ Values are expressed in \$1000 and deflated based on the year 2002.

3.6.3. Macroeconomic factors

To account for other factors which may affect the occurrence of financial reforms, various macroeconomic conditions are also considered as control variables to account for financial reforms. The first variable is *Currency Crisis*. Abiad and Mody (2005) report that currency crises are the main determinants to shape financial reforms. Also, other economists (Rodrik 1994; Krueger 1993) have argued that currency crises are the main facilitator of economic reforms or currency-induced economic reforms. Hence, as a control variable, a dummy variable of currency crises is included. Dummy variables of currency crises were created based on the market pressure index, which is calculated based on the change in exchange rates and the change

36 Available at www.oecd.org/dac/stats/idsonline, access on March 21, 2007.

in foreign reserves. Data are taken from Cerra and Saxena (2005).³⁷ As currency crises may cause reversal of financial reforms in the short run (Abiad and Mody 2005), but in the long run may facilitate financial reforms, current values, one-year lagged values, and two-year lagged values are used to take into account both the short-term and long-term impact of currency crises on financial reforms. Although *Currency Crisis* will be more likely to cause the reversal toward a repressed financial system in the short run (t), in the long run (t-1 and t-2), I expect that currency crises will cause a larger scale and faster pace of financial reforms.

Also, economic growth, a country's level of economic development and a country's market size are considered to be control variables. The role of economic growth on financial reforms is arguable. Regarding *GDP growth*, states may induce a larger scale and a faster pace of financial reforms in good macroeconomic conditions since it will be easier to pay the costs of reforms, but states may also conduct a larger scale and a faster pace of reforms under recession, facing the pressing need to earn domestic and foreign capitals. Economic growth, labeled as *GDP Growth*, is operationalized as real economic growth rate.

With respect to the level of economic development, labeled as *GDP per capita*, a more developed country will induce a larger scale and a faster pace of financial reforms than a less developed country. A country's economic development is operationalized as logged GDP per capita, expressed in the unit of \$1000 US. With respect to a country's market size, labeled as *Country Size*, a state with a smaller domestic market size will be more likely to induce a larger scale and a faster pace of financial reforms than a state with a larger domestic market, since a small state needs to earn capital by liberalizing its domestic market. *Country Size* is captured by using the logged values of GDP expressed in current US million dollars. Data for GDP per

³⁷ I thank Sweta Saxena for providing me with the dataset. For details of coding scheme for dummy variables of currency crises, see Cerra and Saxena (2005).

capita, real economic growth, and GDP were obtained from *World Development Indicators*. One-year lagged variables are used in each case to avoid endogeneity problem.

3.6.4. Other factors

In addition to these macroeconomic factors, the total number of seats in the lower house of the legislative body is taken into account as a control variable. If a country has a larger number of seats, a country tends to have a greater number of parties, whereas if a country has a smaller number of seats, a country tends to have a smaller number of parties. Hence, in order to avoid the inflated estimates of the impact of the number of political parties within cabinets, the total seats of the lower house, labeled as *Total Seats*, is also included as a control variable.

Data are based on the situation as of January 1 for each year, and the information was obtained from Raga and Pérez-Liñán's dataset, *Legislatures in Latin America (1945-2001)*, for Latin American countries and from *Political Handbook of the World* (various years) for other countries.³⁸

Further, lagged level scores of financial reforms are also entered, with the expectation that a country with a higher previous level of financial reforms is less likely to conduct financial reforms.

38 I thank Anibal Pérez-Liñán for providing me with this dataset.

3.7. METHODOLOGY

First, in order to statistically explore determinants of the magnitude of financial reforms, I employ ordinal logit regressions. As dependent variables (the additive change score of six dimensions) are categorical variables that can be ranked, ordinal logit regression is the appropriate method to use. A full statistical model is presented below in equation (1).

$$\begin{aligned} \text{Magnitude of financial reforms} = & \beta_0 + \beta_1 * \text{IMF} + \beta_2 * \text{IMF} \times \text{veto players} + \beta_3 * \text{veto} \\ & \text{players} + \beta_4 * \text{alteration of executives} + \beta_5 * \text{manufacturing sector} + \beta_6 * \text{banking sector} \\ & + \beta_7 * \text{level of democracy} + \beta_8 * \text{US aid} + \beta_9 * \text{currency crises} + \beta_{10} * \text{currency crises (t-1)} \\ & + \beta_{11} * \text{currency crises (t-2)} + \beta_{12} * \text{GDP growth} + \beta_{13} * \text{GDP per capita} + \beta_{14} * \text{country} \\ & \text{size} + \beta_{15} * \text{total seats} \quad (1) \end{aligned}$$

Using time-series-cross-section data with a categorical dependent variable causes a violation against the assumption of time independent observations in logit regression models. Therefore, in order to correct for any time dependence problem, following a recommendation by Beck, Katz, and Tucker (1998, 1271) and Beck (2001, 129), I estimate models with year dummy variables. Also, the lagged level values of dependent variables are included to further correct for any temporal dependent problems. In addition, in order to account for heteroskedasticity problems, statistical estimations are clustered by country, and Huber (robust) standard errors are used to estimate statistical significance. Results are presented in the eighth section.

Second, in order to analyze the political determinants of the *pace* of financial reforms, the methodology that I employ is event history analysis. Event history analysis makes it possible to

examine what factors facilitate or hinder financial reforms by directly modeling the duration of times until financial reforms occur, as opposed to a cross sectional time series analysis, where temporal structures of an event occurring are often ignored (Box-Steffensmeier and Jones 1997). While various ways of modeling event history are possible, in this study I use the Cox model. Since the relationship between covariates and hazard rates (when a country is likely to conduct financial reform while other countries are not) is my interest rather than predicting when a reform is adopted within a legislative session, the discrete time method using Cox models is a suitable methodology to employ rather than a continuous time method (Box-Steffensmeier and Jones 1997, 1424). The hazard rate is defined as the probability of an event occurring given the event has not occurred yet, and the hazard rate for the “i” th country is defined as exponents of coefficients as follows (Box-Steffensmeier and Jones 2004).

$$hi(t) = ho(t) \exp(Xi\beta' X)$$

In the Cox model, $h_0(t)$ is not parameterized. The advantage of using a Cox model over other parametric models of event history analysis and logit estimates is that a Cox model does not have to make any assumptions about any specific forms of baseline hazard function (Box-Steffensmeier and Jones 2004; Cleves, Gould, and Gutierrez 2002).³⁹

³⁹ In a Cox model, the hazard ratio of two the hazards is fixed, expressed as follows:

$$\frac{hi(t)}{ho(t)} = \exp(\beta'(xi - xj)).$$

Hence, if we take the log, we obtain the following expression and as seen, the Cox model does not have an intercept, since the baseline hazard is unspecified.

$$\log\left\{\frac{hi(t)}{ho(t)}\right\} = \beta_1 X_{1i} + \beta_2 X_{2i} + \dots + \beta_k X_{ki}$$

The Cox partial likelihood function is obtained by taking the product of the conditional probability of an event occurring at time t, given the number of cases facing an event risk at time t. We can obtain coefficient estimates by maximizing the log of the partial likelihood function (Box-Steffensmeier and Jones 2004).

I model financial reforms as repeated events using a conditional risk gap time model. Financial reforms are not a single event. For example, in time t_1 , a country may allow foreign banks entry in a limited manner by allowing 49% of bank shares' ownership. Then, in time t_2 , this country may fully liberalize foreign bank entry by allowing 100% bank shares' ownership. Also, privatization of banks may occur many times. Thus, a country may commit to financial reforms many times. In this vein, the usual event history analysis in which the event occurring (failure) is modeled as a single event is not a suitable strategy for modeling financial reforms. Rather, it is reasonable to think that financial reforms may occur many times over years. Thus, the advantage of the use of a conditional risk gap time model is that it can take into account repeatability of financial reforms. Namely, the second financial reform is conditioned upon the first financial reform. Without the first financial reform, the second financial reform will not happen. Specifically, I use a conditional risk gap model in which the "gap" refers to the time interval between successive financial reforms (Box-Steffensmeier and Jones 2004). The hazard rate for "k" th financial reforms clustered in "i" th country and also stratified by the number of financial reforms is expressed as follows:

$$h_k(t) = h_{0k}(t) \exp^{\beta' X_{ki}}$$

In the conditional gap model, the hazard rates are allowed to differ by the number of events occurring (financial reforms). The Cox model is used to estimate the conditional gap time model. Results are presented in the ninth section.

3.8. RESULTS: MAGNITUDE OF FINANCIAL REFORMS

In the first section, the results for determinants of magnitude of financial reforms after employing ordinal logit regressions are presented. In the second section, I discuss findings on the magnitude of financial reforms.

3.8.1. Results

Table 3.3, presented below, reports the results of predictors of the *magnitude* of financial reforms employing ordinal regressions.

Table 3.3 Predictors of Magnitude of Financial Reforms

Variables	Model 1.	Model 2.	Model 3.
IMF	0.071**(0.032)	0.060**(0.030)	0.063**(0.029)
Veto Player x IMF	-0.045**(0.023)	-0.042**(0.021)	-0.043**(0.020)
Veto Player	0.067 (0.064)	0.083 (0.066)	0.065 (0.062)
Alteration of Executive	0.192 (0.231)	0.118 (0.244)	0.118 (0.243)
Manufacturing Sector	0.040**(0.013)	0.041**(0.014)	0.038**(0.013)
Banking Sector	0.010 (0.011)	0.007 (0.013)	0.012 (0.011)
Level of Democracy	-0.081** (0.037)	-0.082** (0.034)	-0.080** (0.035)
US Aid		0.002 (0.001)	
Currency Crisis		-0.328** (0.140)	-0.326** (0.146)
Currency Crisis (t-1)		0.333** (0.162)	0.354** (0.171)
Currency Crisis (t-2)		0.337** (0.155)	0.351** (0.159)
GDP growth		-0.013 (0.020)	
GDP per capita		0.019 (0.019)	
Country Size		-0.041 (0.042)	
Total Seats		0.00006 (0.0005)	
Lagged Level of Reforms	-0.113*** (0.019)	-0.115*** (0.021)	-0.108*** (0.020)
No. of observations	830	830	830
Log Pseudo-Likelihood	-985.839	-978.776	-979.880
Pseudo R Square	0.047	0.0538	0.0528

***p<0.01; **p<0.05; and *p<0.10. Entries are coefficients and robust standard errors are in parentheses. Significance is based on 2-tailed tests. Coefficients of year dummies and cut points are not reported.

Model 1 represents the result for the major variables that I am interested in as well as the level of democracy and the lagged level of reforms. With respect to the impact of the IMF, *IMF* represents the impact of the IMF when the number of veto players is zero. A country under IMF influence with no constraints by veto players is prone to engage in a larger magnitude of financial reforms, which is statistically significant, as can be seen in Model 1.

In addition, concerning the interaction effects between the *IMF* and *Veto Players*, as hypothesized, the IMF's effects on facilitating a larger magnitude of financial reforms are contingent upon the number of veto players. Conditional odds ratios for the IMF given the number of veto players, estimating the interaction effects between *Veto Players* and *IMF* on the magnitude of financial reforms, are displayed below as Figure 3.3.

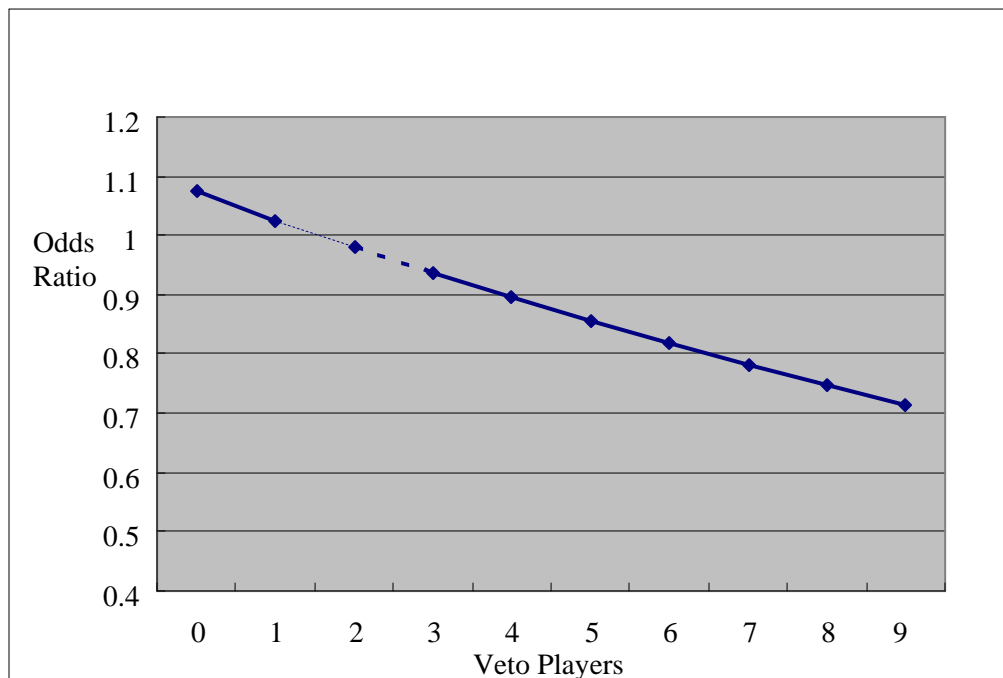


Figure 3.3 Magnitude of Financial Reforms: Conditional Odds Ratio for the IMF Given the Number of Veto Players (Model 1)

These conditional effects for the IMF given the number of veto players show statistical significance when the number of veto players is zero (two tailed significance at a 0.05 level), one (two tailed significance at a 0.1 level), three (one tailed significance), and from four to nine (two tailed significance at a 0.1 level). As the number of veto players increases, the IMF's effect on inducing a wider range of financial reforms decreases. As to societal pressures, an impact of the *Banking Sector* cannot be observed. However, with respect to the impact of the *Manufacturing Sector*, as predicted, a country which has a stronger manufacturing sector tends to undertake a larger magnitude of financial reform.

Model 2 shows the results for the full model with control variables. In model 2, like in Model 1, *IMF*, which represents the IMF's effects in the case when the number of veto players is zero, shows significant impact. With respect to the interaction term between *IMF* and *Veto Players*, Figure 3.4, shown below, displays the conditional odds ratios for the IMF given the number of veto players in Model 2.

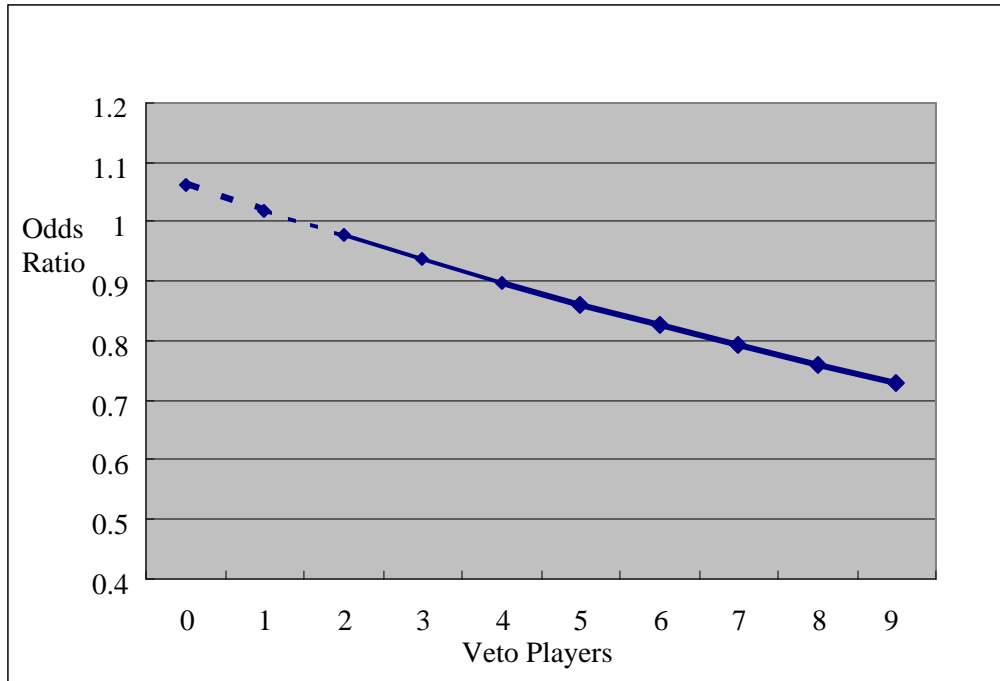


Figure 3.4 Magnitude of Financial Reforms: Conditional Odds Ratio for the IMF Given the Number of Veto Players (Model 2)

After entering control variables, statistical significance improved compared with Model 1. As shown above, the conditional effects for the *IMF* show statistical significance when the number of veto players is one and two (one tailed significance), from three to four (two tailed significance at a 0.1 level), and from five to nine (two tailed significance at a 0.05 level). In terms of the interaction effects between *IMF* and *Veto Players*, as the number of veto players increases, the IMF's influence on facilitating a larger magnitude of reform is more likely to decrease, which provide supports for Hypothesis 2a. Thus, the influence of the IMF in facilitating a larger scale of financial reforms is conditioned by number of veto players. With respect to societal actors' influences, while the *Banking Sector* does not have a significant impact in determining magnitude of financial reforms, the *Manufacturing Sector* has a significant effect

as hypothesized. For a standard deviation increase in the *Manufacturing Sector*, the odds of having a greater magnitude of financial reforms are 1.28 times greater, holding all other variables constant.

With respect to the influence of the control variable, *Level of Democracy*, looking at whether the degree of democracy matters in determining the magnitude of financial reforms holding other conditions constant, the results indicate that a more democratic government is less likely to conduct a larger scale of financial reforms at one time, holding other variables constant. For every standard deviation decrease in the score of *Level of Democracy*, meaning that a country is moving toward a less democratic condition, the odds of having a larger magnitude of financial reforms are 1.25 times greater, holding other variables constant.

Concerning the effects of another control variable, *US Aid*, examining with an expectation that a country which receives a greater amount of US aid in the financial sector and the business sector is more likely to engage in a larger magnitude of financial reforms, is only significant at a one-tailed level. With respect to macroeconomic factors, *Currency Crisis* affects the magnitude of financial reforms. As expected, a *Currency Crisis* in a concurrent year significantly reduces the magnitude of financial reforms, while a *Currency Crisis* in the previous year increases it. A two-year prior *Currency Crisis* is also likely to increase the magnitude of financial reforms, which is statistically significant at a 0.05 level.

In Model 3, insignificant control variables are dropped from the full model, and it shows results that are similar to those in Model 2. The conditional odds ratios, which again shows how the IMF's effects are intermediated by the number of veto players, are statistically significant when the number of veto players is zero (two tailed significance at a 0.05 level), one (one tailed significance), three to five (two tailed significance at a 0.1 level), and from six to nine (two tailed

significance at a 0.05 level) as shown below as Figure 3.5. Thus, the conditional effects show statistical significance and the results remains intact.

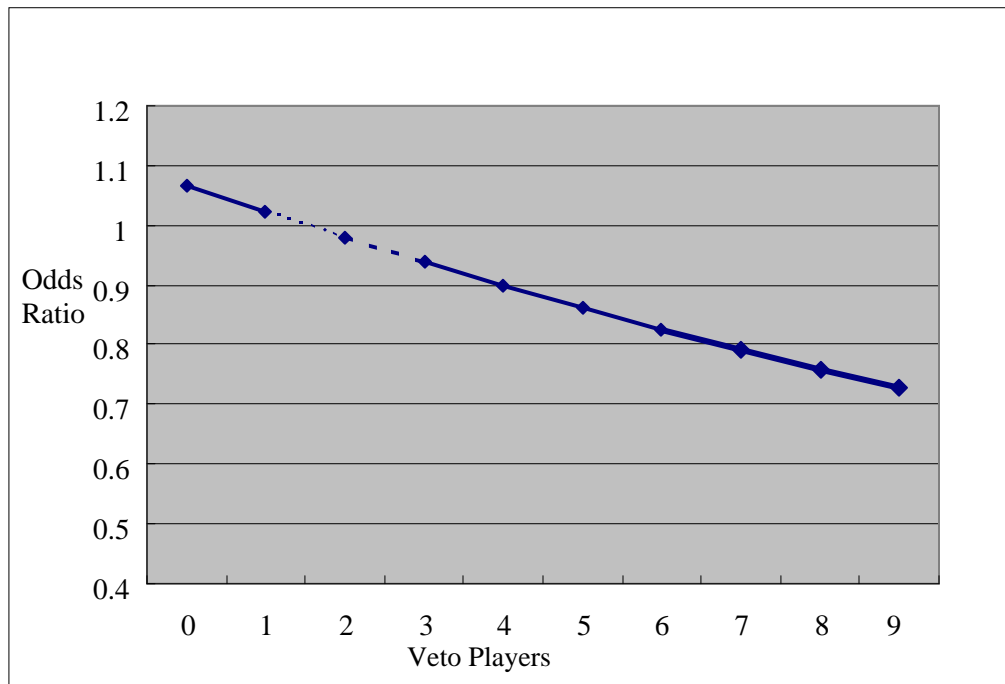


Figure 3.5 Magnitude of Financial Reforms: Conditional Odds Ratio for the IMF Given the Number of Veto Players (Model 3)

Next, using Model 2, I calculate predicted probability of the financial reform where the values of additive change index equal five for interested variables of the *IMF* and the *Manufacturing Sector*, and the other significant control variable, *Level of Democracy*, shown as Table 3.4 below.

Table 3.4 Predicted Probability of Financial Reforms

Variables	Predicted Probability	
	Minimum Value	Maximum Value
IMF	0.003	0.062
Manufacturing Sector	0.002	0.008
Level of Democracy	0.006	0.002

The results for the *IMF* show the effects of the IMF when the number of veto players is zero. When there is no IMF effect, which is shown as the minimum value, predicted probability of financial reform with change score five is 0.003, holding all other variables constant at their means. When the IMF has the maximum value, predicted probability is 0.062, holding all other variables constant at their means. Concerning the impact of the *Manufacturing Sector*, when the manufacturing sector moves from the minimum value to the maximum value, predicted probability changes from 0.002 to 0.008, holding other variables constant at their means. In terms of *Level of Democracy*, when the level of democracy moves from the least democratic to the most democratic, predicted probability decreases from 0.006 to 0.002. Though these predicted probabilities seem small, the effects of these variables are substantive. When I calculate the ratio of change, by moving from the minimum value to the maximum value of each variable, results yield the numbers 19.7, 3, -0.67 respectively.

3.8.2. Discussion

This section presents the results concerning under which conditions a country is more likely to engage in a larger magnitude of financial reforms at one time. As discussed before, previous research on financial reforms remains scarce except in regards to capital account liberalization.

Results demonstrate that as I hypothesized, even rigorously controlling the impact of currency crises, a country is more likely to engage in a larger magnitude of financial reform when a country is under the IMF programs. However, while participation in the Fund conditionality programs increases the likelihood of a government conducting a larger scale of financial reforms, this effect of the IMF is contingent upon the number of veto players. As the number of veto players increases, the IMF's influence on a country to engage in a wider range of reforms tends to decrease. Hence, although the IMF's influence plays the leading role in explaining the magnitude of financial reforms in developing countries, domestic political factors, the number of veto players, also matter in that they intermediate the effects of the IMF.

Concerning societal pressures, while there is no impact of the banking sector, a country which has a stronger manufacturing sector tends to be more prone to engage in a wider range of financial reforms at the same time. Therefore, with respect to societal factors, a country which has a stronger manufacturing sector is likely to engage in a greater magnitude of financial reforms. However, there is no significant effect of the banking sector in shaping the magnitude of financial reforms. Therefore, results concerning the banking sector are disappointing. Thus, the evidence of the impact of societal pressures is mixed.

Although regime type *per se* is not a main interest in this study, a less democratic government is more likely to take a path of larger magnitude of reforms than a more democratic government *ceteris paribus*. While New Zealand is held up as an example of a “big-bang” type of financial reform in highly developed countries, in the case of developing countries, a political leader in a non-democratic country is more likely to take more drastic measures than a democratic government when necessary. However, since this study uses only thirty cases, this finding cannot be called generalizable enough. Further studies will be needed to explore the

relationship between regime type and the magnitude of financial reforms in order to decisively conclude the impact of regime type per se. In the next section, I turn to the results of the pace of financial reforms.

3.9. RESULTS: PACE OF FINANCIAL REFORMS

In this section, I present the results concerning the predictors of the pace of financial reforms in each of the six dimensions of financial reforms, respectively. Before presenting the full results, I present the summary of findings in the next sub-section, [3.9.1](#). Third, I present the detailed results in each of the six dimensions of financial reforms. Fourth, I present the results using an alternative indicator of veto players, POLCONIII (Henisz 2002). This measurement, POLCONIII, takes into accounts both partisan veto players and institutional veto players.⁴⁰

3.9.1. Summary of findings

This section presents the summary of findings before turning to the detailed results in each of the six dimensions in the subsequent section. I especially present findings by focusing on the interaction effects between the IMF programs and the number of veto players. Table [3.5](#), displayed below, exhibits the degree to which the hypothesized conditional effects for the IMF given the number of veto players are upheld by statistical analyses.

⁴⁰ This measure, POLCONIII, takes into account the number of independent branches of government (i.e., executive, lower and upper legislative chambers) as well as the party composition of the executive and legislative branches.

Table 3.5 Summary of Findings: Conditional Effects for the IMF Given the Number of Veto Players in Six Dimensions of Financial Reforms

	Privatization of Banks		Enhancement of Banking Supervision		Capital Account Liberalization	
Measurement of veto players	All cases	Democracy	All cases	Democracy	All cases	Democracy
Number of political parties within an executive coalition	—	—	—	—	—	—
POLCONIII	—	—	—	—	—	—

	Interest Rate Liberalization		Elimination of Credit Controls		Elimination of Entry Barriers	
Measurement of veto players	All cases	Democracy	All cases	Democracy	All cases	Democracy
Number of political parties within an executive coalition	—	—	—	—		
POLCONIII		—				—

Since I test the hypothesis 2b using two measurements for the number of veto players, the number of political parties within an executive coalition and POLCONIII, in both using all cases and democratic cases respectively, results are summarized accordingly. Bold minus signs show statistically significant results for the hypothesis, whereas blank cells show no significance. When the number of political parties within an executive coalition is used as an indicator of veto players, results show that the hypothesis was confirmed in five dimensions (privatization of banks, enhancement of banking supervision, capital account liberalization, interest rate liberalization, and elimination of credit controls) ,excluding only the dimension of elimination of entry barriers on banks.

Also, when POLCONIII is used in estimating models, results support the conditional effects for the IMF intermediated by the number of veto players in three dimensions (privatization of banks, enhancement of banking supervision, and capital account liberalization) when using all cases, and five dimensions (privatization of banks, enhancement of banking supervision, capital account liberalization, interest rate liberalization, and elimination of entry barriers on banks) when using democratic cases, respectively. Hence, the results show that the IMF effects on accelerating the pace of financial reforms decrease as the number of veto players increases, which is well supported by quantitative analysis.

Beside the findings on the interaction effects between the IMF and the number of veto players, concerning the societal impacts on the pace of financial reforms, results with respect to the manufacturing sector are also well supported in four dimensions out of six (privatization of banks, capital account liberalization, interest rate liberalization, and elimination of entry barriers), especially when using all cases. However, concerning the results for the banking sector, I was not able to obtain statistically significant effects in most dimensions. In the subsequent sub-

sections, I present the results of statistical analysis in each of the six dimensions in more detail. To do so, as discussed in the seventh section, the conditional risk gap time model, using a Cox model, is employed for assessing the impact of the IMF, the number of veto players, and interest groups on the pace of financial reforms. Estimates are clustered by country, and Huber (robust) standard errors are used in order to take into account any temporal dependence of time varying covariates. Efron methods are used in order to handle tied events. Estimates are stratified according to the number of financial reforms in order to take into account financial reforms occurring multiple times.

3.9.2. Privatization of banks

Table 3.6, shown below, reports the results of predictors of the pace of privatization of banks estimated by the conditional risk gap time model.

Table 3.6 Conditional Gap Time Model: Predictors of Privatization of Banks, 1974-2002

Variables	Model (1-1) Privatization of Banks (All Cases)	Model (1-2) Privatization of Banks (All Cases)	Model (1-3) Privatization of Banks (Democracy)	Model (1-4) Privatization of Banks (Democracy)
IMF	0.074** (0.054)	0.090** (0.045)	0.137** (0.063)	0.113** (0.047)
Veto Player x IMF	-0.004 (0.003)	-0.016 (0.026)	-0.024 (0.028)	-0.023 (0.023)
Veto Player	-0.062 (0.205)	-0.099 (0.166)	0.009 (0.216)	-0.095 (0.158)
Alteration of Executive	-0.203 (0.491)	-0.225 (0.474)	-0.327 (0.500)	-0.300 (0.511)
Manufacturing Sector	0.147*** (0.041)	0.144*** (0.039)	0.183*** (0.051)	0.130*** (0.040)
Banking Sector	0.024 (0.042)	0.008 (0.041)	0.003 (0.006)	0.055 (0.056)
Level of Democracy	-0.098 (0.108)		-0.279* (0.162)	-0.082 (0.133)
US Aid	-0.007 (0.005)		0.003 (0.006)	
Currency Crisis	0.125 (0.426)		-0.057 (0.415)	
Currency Crisis (t-1)	0.554* (0.323)	0.524* (0.275)	0.344 (0.394)	
Currency Crisis (t-2)	0.781 (0.514)	0.875** (0.370)	1.348** (0.582)	1.238** (0.565)
GDP growth	0.018 (0.050)		0.063 (0.055)	
GDP per capita	-0.339** (0.144)	-0.368** (0.123)	-0.461** (0.189)	-0.399** (0.152)
Country Size	0.091 (0.228)		0.100 (0.268)	
Total Seats	-0.002 (0.002)		-0.005 (0.003)	
Lagged Level of Reforms	-0.633** (0.306)	-0.560** (0.275)	-0.546 (0.630)	-0.601 (0.546)
No. of observations	830	830	433	433
No. of failures	35	35	23	23
Time at Risk	8511	8511	4744	4744
Log Pseudo-Likelihood	-136.09	-138.24	-76.084	-79.406
Wald Chi Square	133.36	53.27	103.25	37.77
Prob.> Chi Square	0.0000	0.0000	0.0000	0.0000

***p<0.01; **p<0.05; and *p<0.10. Entries are coefficients and robust standard errors are in parentheses. Significance is based on 2-tailed tests.

Model 1-1 represents the results of the pace of privatization of banks for all cases, including all cases. Model 1-2 shows the results where insignificant control variables in Model 1-1 are dropped. Model 1-3 exhibits the results using only democratic cases with all main and control variables, and Model 1-4 shows the results for democratic cases where insignificant control variables in Model 1-3 are dropped. In all of the models, the *IMF* represents the impact of the IMF on the pace of privatization of banks when the number of veto players is zero. In all four models, *IMF* is statistically significant at a 0.05 level. Hence, the IMF tends to facilitate the privatization of banks when the number of veto players is zero.

Concerning the interaction term between the *IMF* and *Veto Players*, when the conditional hazard ratio for the IMF given the number of veto players is calculated, significant effects are uncovered. Figure 3.6 and Figure 3.7 display how the effects of the IMF on bringing forward the timing of privatization of banks is conditioned upon the number of veto players in Model 1-1 and in Model 1-3, respectively.

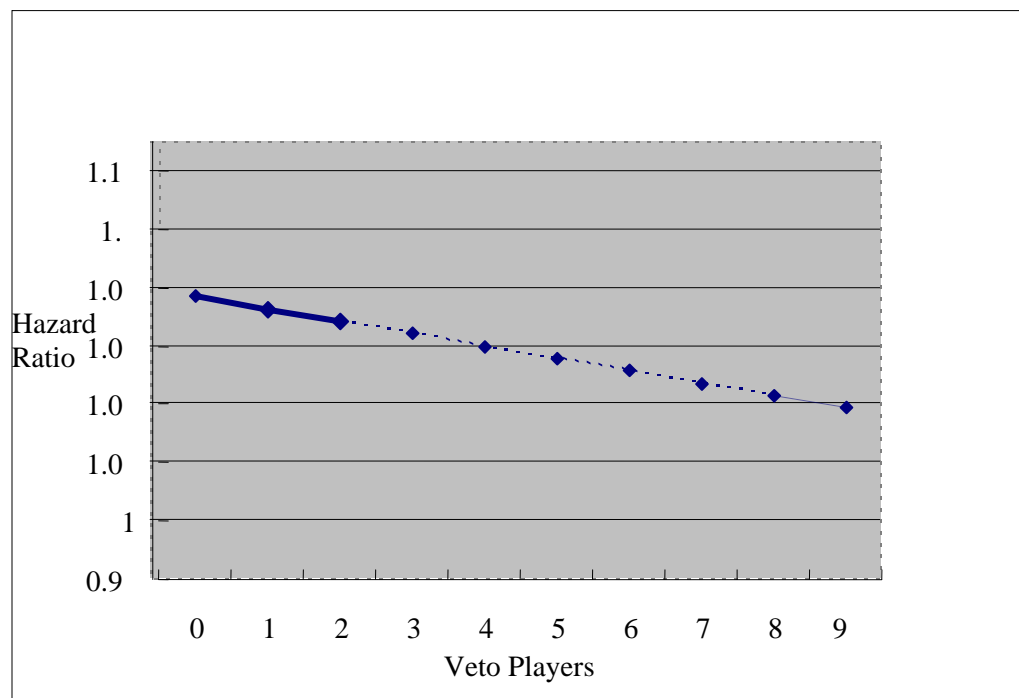


Figure 3.6 Privatization of Banks: Conditional Hazard Ratio for the IMF Given the Number of Veto Players (Model 1-1: All Cases)

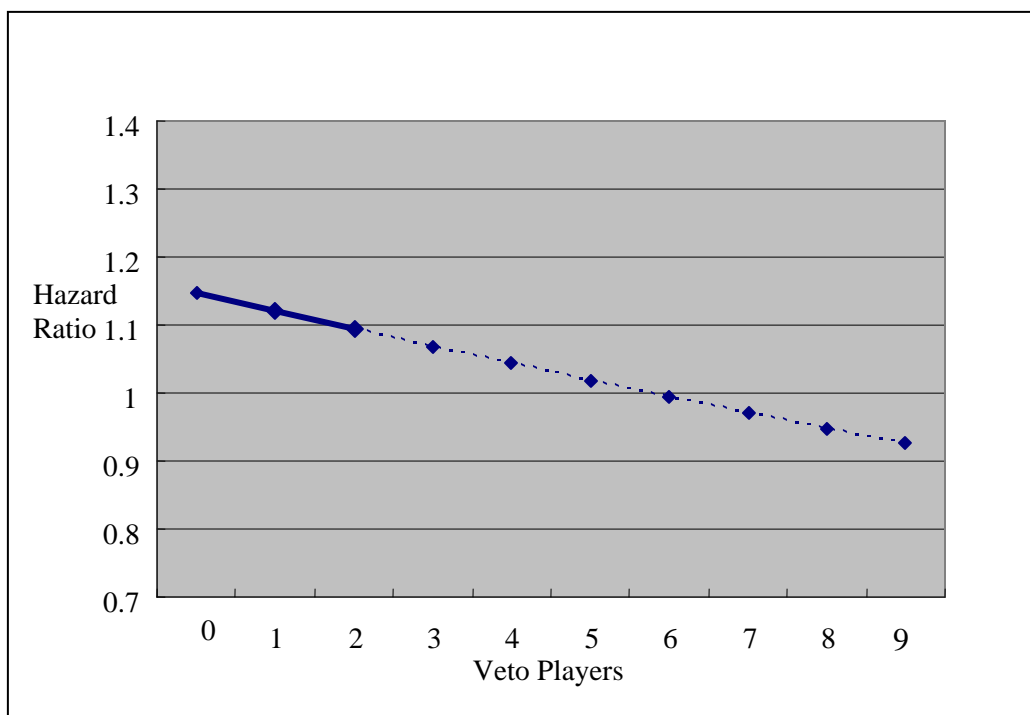


Figure 3.7 Privatization of Banks: Conditional Hazard Ratio for the IMF Given the Number of Veto Players (Model 1-3: Democracy Only)

In both Model 1-1 and Model 1-3, as the number of veto players increases, the IMF's influence in setting the pace of privatization of banks tends to decrease, which is statistically significant when the number of veto players is zero, one, and two in both Model 1-1 and Model 1-3. Though the results of Model 1-2 and Model 1-4 are not reported here, the results remain the same. Thus, the IMF's effect in accelerating the privatization of banks tends to be decreased as the number of veto players increases.

With respect to the influence of interest groups, while there is no significant impact of the *Banking Sector*, the *Manufacturing Sector* tends to have a significant impact on facilitating privatization of banks in all four models as hypothesized. A one percent increase in the manufacturing sector increases the hazard by 15.8 % in Model 1-1 and by 20.1 % in Model 1-3. As expected, a country which has a stronger *Manufacturing Sector* tends to privatize banks at a faster pace because privatization of banks will provide better credit conditions to the manufacturing sector.

Besides these key variables, as expected, *Currency Crisis* also significantly affects the pace of privatization of banks. A previous year *Currency Crisis* facilitates privatization of banks in Model 1-1 and Model 1-2. Also, in Model 1-2, Model 1-3, and Model 1-4, the currency crisis the year before that significantly facilitated privatization of banks, which suggests currency crisis induces reform in the long-run. Also, results of *GDP per capita* suggest that a country tends to delay privatization of banks when the level of economic development is high.

3.9.3. Banking supervision

Table 3.7 presents estimated results of predictors of the pace of the enhancement of banking supervision over the banking sector, employing a conditional gap time model.

Table 3.7 Conditional Gap Time Model: Predictors of Banking Supervision

Variables	Model (2-1) Banking Supervision (All Cases)	Model (2-2) Banking Supervision (All Cases)	Model (2-3) Banking Supervision (Democracy)	Model (2-4) Banking Supervision (Democracy)
IMF	0.135**(0.061)	0.124**(0.060)	0.180* (0.099)	0.167** (0.067)
Veto Player x IMF	-0.048 (0.036)	-0.046 (0.036)	-0.061 (0.052)	-0.070* (0.036)
Veto Player	0.169 (0.108)	0.144 (0.118)	0.081 (0.204)	0.165 (0.155)
Alteration of Executive	-0.006 (0.376)	-0.120 (0.397)	0.148 (0.393)	0.182 (0.357)
Manufacturing Sector	0.068 (0.048)	0.061* (0.035)	0.138* (0.078)	0.082* (0.047)
Banking Sector	0.032 (0.056)	0.041 (0.046)	0.027 (0.092)	0.022 (0.098)
Level of Democracy	0.029 (0.117)		-0.094 (0.239)	
US Aid	0.003 (0.003)		-0.003 (0.011)	
Currency Crisis	-0.800* (0.422)	-0.806* (0.427)	-0.395 (0.476)	
Currency Crisis (t-1)	0.560* (0.317)	0.600* (0.324)	0.538 (0.434)	
Currency Crisis (t-2)	0.179 (0.304)		0.659** (0.316)	0.433 (0.368)
GDP growth	0.020 (0.042)		0.089 (0.088)	
GDP per capita	-0.077* (0.045)	-0.067** (0.030)	-0.123 (0.180)	
Country Size	0.068 (0.268)		-0.263 (0.394)	
Total Seats	-0.001 (0.002)		0.001 (0.002)	
Lagged Level of Reforms	-4.381*** (0.866)	-4.421*** (0.753)	- 4.546** (1.610)	-4.830*** (1.132)
No. of observations	830	830	433	433
No. of failures	45	45	33	33
Time at Risk	8234	8234	4663	4663
Log Pseudo-Likelihood	-156.222	-157.233	-95.284	-98.872
Wald Chi Square	183.72	109.29	250.25	35.69
Prob.> Chi Square	0.0000	0.0000	0.0000	0.0000

***p<0.01; **p<0.05; and *p<0.10. Entries are coefficients and robust standard errors are in parentheses. Significance is based on 2-tailed tests.

Model 2-1 represents results for all cases, and as with the first set of models, Model 2-2 represents the results of all cases in which insignificant control variables are dropped from Model 2-1. Model 2-3 is the result for only democratic cases and in Model 2-4, insignificant control variables are dropped from Model 2-3.

Concerning the *IMF* variables, the hazard of occurrence of enhancement of the banking supervision over the banking sector is 1.14 times greater in Model 2-1 and 1.13 times greater in Model 2-2, meaning that IMF influence speeds up the enhancement of banking supervision over the banking sector when the number of veto player is zero. This suggests that the IMF's conditionality programs are the major source for facilitating the enhancement of banking supervision.

Figures 3.8 and Figure 3.9 illustrate how the IMF effects on the pace of the enhancement of banking supervision over the banking sector is conditioned upon the number of veto players using all cases (Model 2-1) and only democratic cases (Model 2-3), respectively.

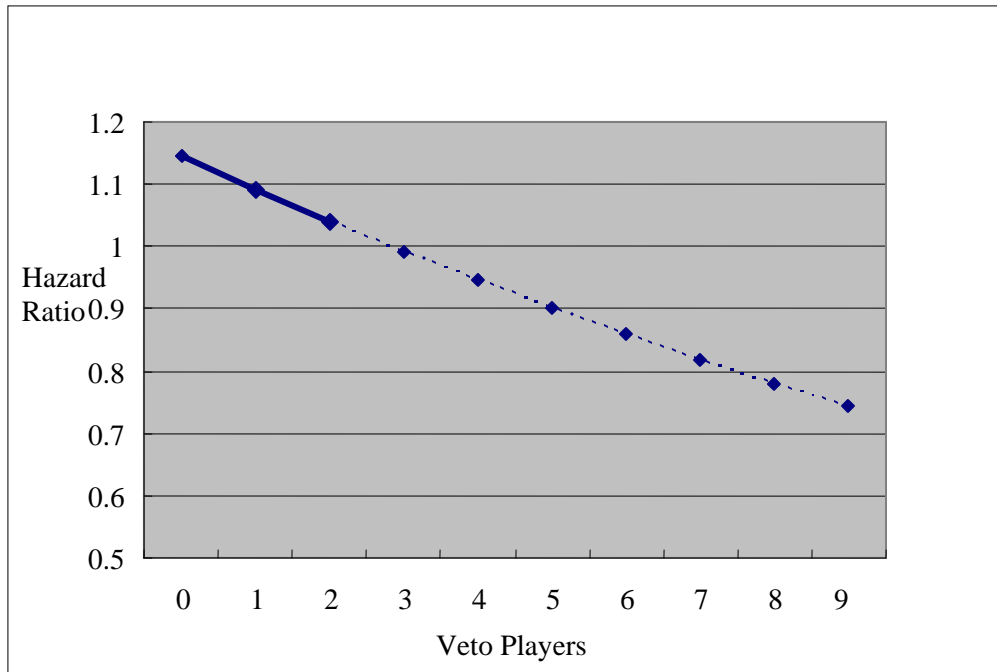


Figure 3.8 Banking Supervision: Conditional Hazard Ratio for the IMF Given the umber of Veto Players (Model 2-1: All Cases)

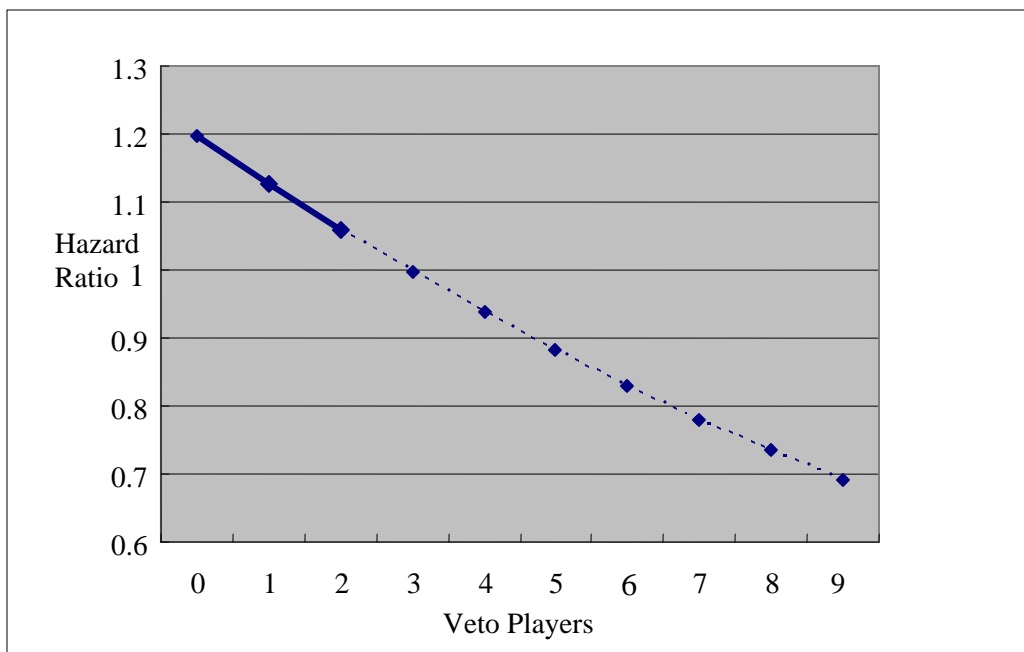


Figure 3.9 Banking Supervision: Conditional Hazard Ratio for the IMF Given the Number of Veto Players (Model 2-3: Democracy Only)

As shown above, the IMF's significant impact on the enhancement of banking supervision is intermediated by the number of veto players as well as by the dimension of privatization of banks. As the number of veto players increases, the IMF's role in facilitating the enhancement of banking supervision tends to decrease, which is significant when the number of veto players is zero, one, and two in both Model 2-1 (Figure 3.8) and Model 2-3 (Figure 3.9). These results also hold for Model 2-2 and Model 2-4.

Concerning the societal impacts of the *Manufacturing Sector* and the *Banking Sector*, I assumed both sectors would oppose the enhancement of banking supervision because both sectors would like to engage in lending and credit activities without intervention by a banking supervisory agency. However, contrary to expectations, results from Models 2-2 to Model 2-4 indicate that an increase in the influence of the manufacturing sector tends to facilitate the enhancement of banking supervision, though it is not significant in Model 2-1. It may be related to the fact that a stronger manufacturing sector may mean a country has enough technological and human capacity for enhancing banking supervision. In regard to the *Banking Sector*, I was not able to obtain expected results as well for the dimension of privatization of banks.

Concerning macroeconomic factors, *Currency Crisis* shapes the pace of the enhancement of banking supervision. A current year currency crisis delays enhancement of banking supervision while a previous year crisis facilitates these reforms, as shown in Model 2-1 and Model 2-2. However, in Model 2-3, using only democratic cases, 2-year lagged currency crisis facilitates the enhancement of banking supervision, though this is not robust when other control variables are dropped from the model, seen as Model 2-4.

3.9.4. Capital account liberalization

Results concerning predictors of the pace of capital account liberalization, which most conventional studies have concentrated on, are presented above as Table [3.8](#). Model 3-1 shows results using all cases and Model 3-2 shows results using all cases without insignificant control variables. Model 3-3 and Model 3-4 display the results using only democratic cases. In Model 3-4, insignificant control variables are dropped from Model 3-3.

Table 3.8 Conditional Gap Time Model: Predictors of Capital Account Liberalization

Variables	(Model 3-1) Capital Account Liberalization (All Cases)	(Model 3-2) Capital Account Liberalization (All Cases)	(Model 3-3) Capital Account Liberalization (Democracy)	(Model 3-4) Capital Account Liberalization (Democracy)
IMF	0.085** (0.040)	0.072* (0.041)	0.090 (0.060)	0.094* (0.053)
Veto Player x IMF	-0.052** (0.026)	-0.057** (0.027)	-0.074*(0.038)	-0.070* (0.037)
Veto Player	0.143 (0.092)	0.070 (0.092)	0.150 (0.126)	0.159 (0.129)
Alteration of Executive	0.921*** (0.290)	0.950** (0.351)	0.873** (0.536)	0.780** (0.342)
Manufacturing Sector	0.074** (0.028)	0.051** (0.027)	-0.002 (0.052)	0.001 (0.034)
Banking Sector	0.030 (0.029)	0.016 (0.030)	0.037 (0.044)	0.023 (0.046)
US Aid	0.001 (0.003)		0.018** (0.005)	0.013** (0.005)
Level of Democracy	0.107 (0.079)		-0.042 (0.196)	
Currency Crisis	-0.373 (0.346)		-0.330 (0.357)	
Currency Crisis (t-1)	-0.693** (0.351)	-0.667** (0.329)	-0.308 (0.416)	
Currency Crisis (t-2)	-0.628 (0.375)	-0.577* (0.341)	-0.919 (0.621)	
GDP growth	-0.024 (0.019)		-0.038 (0.039)	
GDP per capita	-0.085 (0.053)		0.141 (0.125)	
Country Size	0.163* (0.094)	0.082 (0.090)	0.122 (0.107)	
Total Seats	-0.002** (0.001)	-0.001 (0.001)	-0.001 (0.002)	
Lagged Level of Reforms	-0.927*** (0.145)	-1.018*** (0.153)	-1.103*** (0.274)	-0.881** (0.293)
No. of observations	830	830	433	433
No. of failures	79	79	47	47
Time at Risk	5557	5557	2766	2766
Log Pseudo-Likelihood	-281.998	-287.356	-132.619	-138.087
Wald Chi Square	144.70	83.61	87.42	23.65
Prob.> Chi Square	0.0000	0.0000	0.0000	0.0000

***p<0.01; **p<0.05; and *p<0.10. Entries are coefficients and robust standard errors are in parentheses. Significance is based on 2-tailed tests.

As can be seen in Model 3-1, as expected, the IMF accelerates capital account liberalization in cases where the number of veto players is zero and accelerates the enhancement of banking supervision as well. The hazard is 1.09 times greater under the IMF's influence when the number of veto players is zero, as seen in Model 3-1, and 1.07 times greater in Model 3-2. Conditional effects of the IMF on capital account liberalization given the number of veto players are displayed below as Figure 3.10 (Model 3-1) and Figure 3.11 (Model 3-3). In both Model 3-1 and Model 3-3, significant conditional effects for the IMF are obtained when the number of veto players is from two to four (one-tailed significance), and four to nine (two-tailed significance at a 0.1 level) as seen in Figure 3.10, and also when the number of veto players is two (one-tailed significance), and from three to nine (two-tailed significance at a 0.1 level) as seen in Figure 3.11. Thus, as the number of veto players increases, the effects of the IMF on accelerating capital account liberalization decreases.

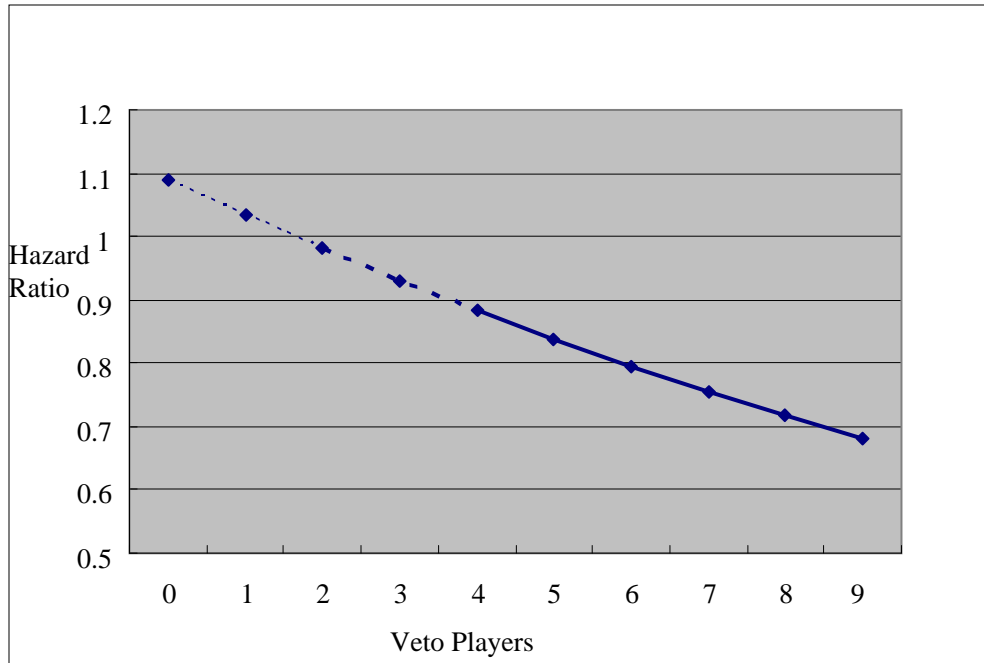


Figure 3.10 Capital Account Liberalization: Conditional Hazard Ratio for the IMF Given the Number of Veto Players (Model 3-1: All Cases)

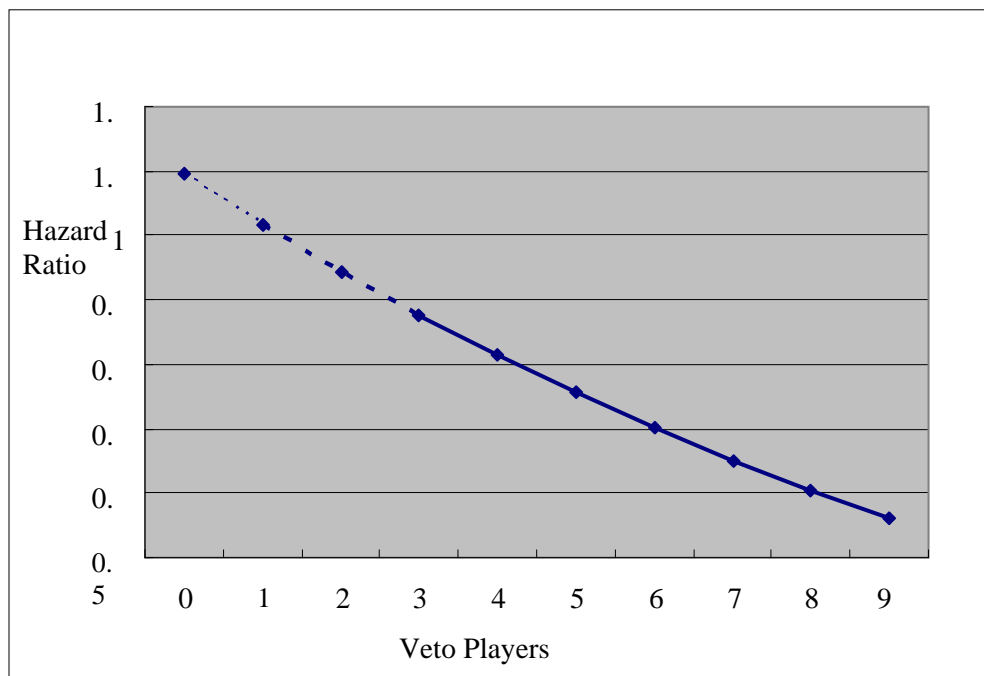


Figure 3.11 Capital Account Liberalization: Conditional Hazard Ratio for the IMF Given the Number of Veto Players (Model 3-3: Democracy Only)

With respect to *Alteration of Executives*, aiming to capture the changes in preferences of policy status quo, it shows significant impact on the liberalization of capital accounts. When there is an alteration of an executive leader's political party and/or a regime transition, the hazard is 2.511 times greater in Model 3-1 and 2.587 times greater in Model 3-3, compared to a case when there is no alteration of executives. The findings for the *Manufacturing Sector* partially confirm my expectation, seen as Model 3-1 and Model 3-2. When the manufacturing sector becomes stronger by one percent, the hazard is increased by 7.7 percent in Model 3-1, suggesting that the manufacturing sector supports an increase to gain access to foreign capital. But in Model 3-3, the *Manufacturing Sector* does not show significant effects.

In terms of the *Banking Sector*, though I hypothesized that the banking sector would prefer not to open capital accounts since banks dislike pressure to lower lending rates by increasing access to foreign capital, contrary to my expectations, it had no significant effects in determining the pace of capital account liberalization.

With respect to control variables, in Model 3-3 and Model 3-4, where only democratic cases are used, *US aid* significantly increases the likelihood of opening capital accounts. As Stiglitz (2002) argues, these results may suggest that the US preference for opening capital accounts is an important political determinant for promoting an integration of the global financial market. In regard to macroeconomic variables, one-year lagged *Currency Crisis* deters capital account liberalization as seen in Model 3-1 and Model 3-2, though these effects of currency crises are not observed when using only democratic cases.

Also, similarly, *Country Size* and *Total Seats* have an effect on shaping the pace of capital account liberalization, though these variables are not significant if we estimate the models using only democratic cases. Last year's level of capital account liberalization significantly

shapes the pace of capital account liberalization. As the previous level of capital account liberalization is lower, a country has more room to induce reforms on capital account liberalization. This is significant in all models.

3.9.5. Interest rate liberalization

Table 3.9, shown below, displays the results for predictors of the pace of liberalization of banks' deposit rates and lending rates. Model 4-1 reports the results of all cases. Model 4-2 drops the insignificant control variables from Model 4-1. Model 4-3 reports the results of only democratic cases and Model 4-4 shows the results in which the insignificant control variables are dropped from Model 4-3.

Table 3.9 Conditional Gap Time Model: Predictors of Interest Rate Liberalization

Variables	Model (4-1) Interest Rate Liberalization (All Cases)	Model (4-2) Interest Rate Liberalization (All Cases)	Model (4-3) Interest Rate Liberalization (Democracy)	Model (4-4) Interest Rate Liberalization (Democracy)
IMF	0.080* (0.048)	0.063 (0.053)	0.325*** (0.096)	0.334*** (0.097)
Veto Player x IMF	-0.032 (0.038)	-0.031 (0.042)	-0.188** (0.075)	-0.197** (0.076)
Veto Player	0.097 (0.135)	0.053 (0.132)	0.376 (0.284)	-0.367 (0.249)
Alteration of Executive	0.203 (0.363)	0.243(0.366)	-0.538 (0.576)	-0.316 (0.591)
Manufacturing Sector	0.088** (0.030)	0.067** (0.029)	0.048 (0.042)	0.041 (0.049)
Banking Sector	-0.019 (0.042)	-0.037 (0.037)	-0.281** (0.127)	-0.306*** (0.086)
Level of Democracy	0.100 (0.083)		0.225 (0.154)	
US Aid	0.002 (0.003)		-0.129 (0.134)	
Currency Crisis	-0.255 (0.322)		-0.256 (0.509)	
Currency Crisis (t-1)	0.123 (0.319)		-1.021 (0.654)	-1.158* (0.589)
Currency Crisis (t-2)	0.174 (0.260)		0.890*(0.471)	0.966** (0.400)
GDP growth	0.040 (0.029)		0.068 (0.042)	0.077** (0.032)
GDP per capita	-0.068 (0.047)		-0.185 (0.217)	
Country Size	0.067 (0.071)		0.043 (0.079)	
Total Seats	-0.003** (0.001)	-0.002** (0.001)	-0.001 (0.003)	
Lagged Level of Reforms	-1.107*** (0.187)	-1.104*** (0.186)	-1.815*** (0.486)	-1.764*** (0.404)
No. of observations	830	830	433	433
No. of failures	67	67	34	34
Time at Risk	5645	5645	3082	3082
Log Pseudo-Likelihood	-250.525	-254.249	-82.441	-85.847
Wald Chi Square	221.93	77.04	232.24	78.01
Prob.> Chi Square	0.000	0.000	0.000	0.000

***p<0.01; **p<0.05; and *p<0.10. Entries are coefficients and robust standard errors are in parentheses. Significance is based on 2-tailed tests.

In Model 4-1, as seen in Figure 3.12 below, the *IMF*'s effects on accelerating the pace of interest rate liberalization is decreased as the number of veto players increases, which is statistically significant when the number of veto players is zero and one (two-tailed significance at a 0.1 level and at a 0.05 level respectively) using all cases.

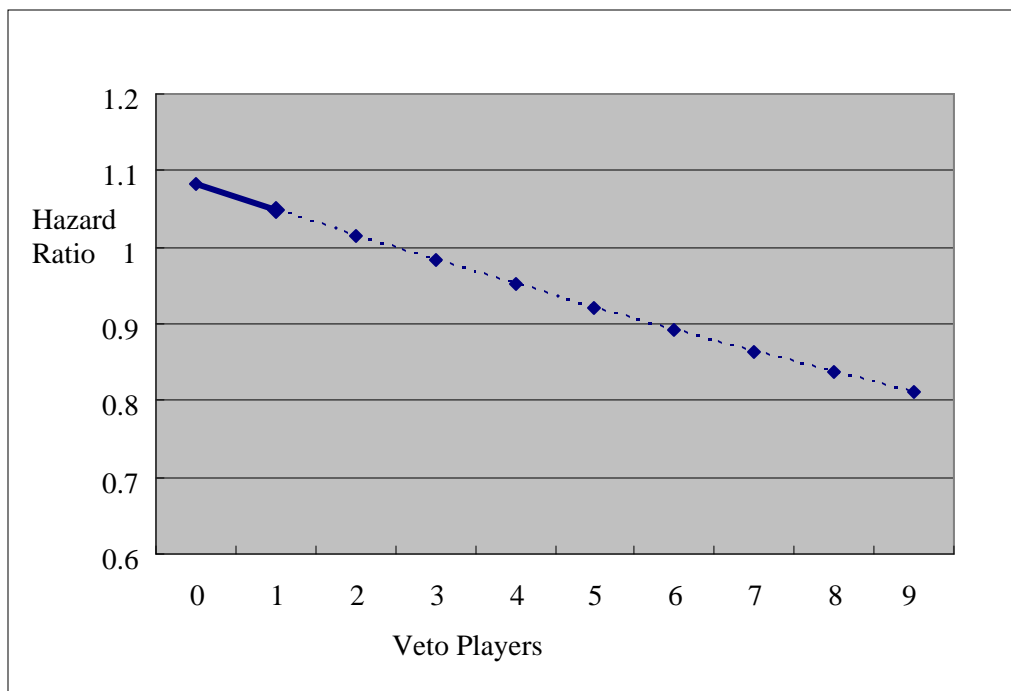


Figure 3.12 Interest Rate Liberalization: Conditional Hazard Ratio for the IMF Given the Number of Veto Players (Model 4-1: All Cases)

When a model is estimated using only democratic cases, as expected, the IMF effects on accelerating the pace of interest rate liberalization also decrease as the number of veto players increases. In Model 4-3, this is statistically significant when the number of veto players is zero and one (two-tailed significance at a 0.001 level), and from three to nine (two-tailed significance at a 0.1 level), presented below as Figure 3.13.

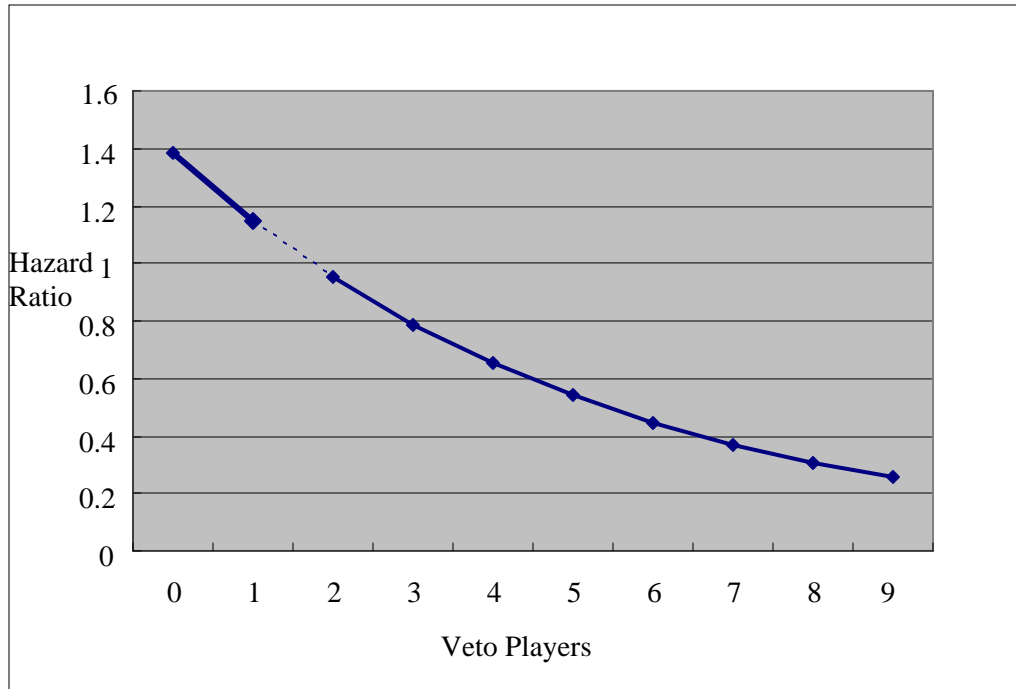


Figure 3.13 Interest Rate Liberalization: Conditional Hazard Ratio for the IMF Given the Number of Veto Players (Model 4-3: Democracy Only)

Concerning the societal impact, the *Manufacturing Sector* significantly affects shaping of the pace of interest rate liberalization. A one percent increase in the influence of the manufacturing sector raises the likelihood of the occurrence of interest rate liberalization by 9.2% in Model 4-1 and 6.9% in Model 4-2, which are both significant at a 0.05 level. However, this significant effect cannot be observed when only democratic cases are used. Hence, though the impacts are only observed when using all cases, as the influence of the *Manufacturing Sector* increases, a country is more likely to facilitate interest rate liberalization because the manufacturing sector is likely to support these reforms in order to enhance access to favorable credit conditions.

Concerning the effects of the *Banking Sector*, as seen in Model 4-3 and Model 4-4, a country which has a stronger connection between banks and the government significantly delays interest rate liberalization. The banking sector opposes interest rate liberalization because they do not prefer the competition among banks which results from liberalized interest rates.

In addition to these main variables, macroeconomic factors also shape the pace of interest rate liberalization. Among macroeconomic variables and other control variables, only the number of *Total Seats* in the lower house shows statistical significance as seen in Model 4-1 and in Model 4-2. In Model 4-4, one-year lagged currency crises deter financial reforms, while two-year lagged currency crises facilitate interest rate liberalization. Also, a country accelerates interest rate liberalization when GDP growth is high. In addition, as with the models presented earlier, if the previous level of interest rate liberalization is lower, a country has more room to conduct reforms, which is significant in all models.

3.9.6. Elimination of credit controls

Table 3.10, shown below, displays the results of predictors of the *pace* of elimination of credit controls. Model 5-1 reports the results using all cases, and Model 5-2 represents the results when insignificant control variables are dropped from Model 5-1. Model 5-3 reports the results using only democratic cases, and Model 5-4 shows the results when insignificant control variables in Model 5-3 are dropped from the model.

Table 3.10 Conditional Gap Time Model: Predictors of Elimination of Credit Controls

Variable	Model (5-1) Elimination of Credit Controls (All Cases)	Model (5-2) Elimination of Credit Controls (All Cases)	Model (5-3) Elimination of Credit Controls (Democracy)	Model (5-4) Elimination of Credit Controls (Democracy)
IMF	0.063 (0.046)	0.057 (0.048)	0.215** (0.083)	0.190** (0.080)
Veto Player x IMF	-0.029 (0.035)	-0.033 (0.044)	-0.152** (0.071)	-0.132** (0.060)
Veto Player	0.029 (0.224)	-0.058 (0.224)	0.200 (0.272)	0.137 (0.270)
Alteration of Executive	-0.163 (0.284)	-0.131 (0.250)	-0.137 (0.340)	-0.182 (0.316)
Manufacturing Sector	0.034 (0.033)	0.022 (0.026)	-0.006 (0.076)	-0.061 (0.050)
Banking Sector	-0.080* (0.044)	-0.067* (0.037)	-0.071 (0.080)	-0.087 (0.056)
Level of Democracy	-0.117 (0.099)		-0.077 (0.221)	
US Aid	0.003 (0.002)		-0.030 (0.022)	
Currency Crisis	0.079 (0.293)		0.242 (0.425)	
Currency Crisis (t-1)	0.353 (0.258)		-0.078 (0.434)	
Currency Crisis (t-2)	-0.060 (0.258)		0.072 (0.321)	
GDP growth	-0.003 (0.026)		-0.046 (0.040)	
GDP per capita	0.027 (0.062)		-0.116 (0.208)	
Country Size	-0.361* (0.209)	-0.264** (0.119)	-0.086 (0.210)	
Total Seats	0.001 (0.001)		-0.002 (0.003)	
Lagged Level of Reforms	-0.433* (0.244)	-0.425* (0.218)	-0.672* (0.342)	-0.893** (0.284)
No. of observations	830	830	433	433
No. of failures	68	68	37	37
Time at Risk	5729	5729	3317	3317
Log Pseudo-Likelihood	-282.285	-285.493	-121.674	-124.950
Wald Chi Square	57.47	33.87	99.2	21.57
Prob.> Chi Square	0.000	0.000	0.000	0.000

Concerning the conditional effects for the IMF, significant conditional effects for the IMF are obtained in Model 5-1 when the number of veto players is zero and one (two-tailed significance), presented as Figure 3.14 below. Also, in Model 5-3 and Model 5-4, significant conditional effects for the IMF are obtained. In the case of Model 5-3, as displayed below in Figure 3.15, the IMF's role in facilitating the pace of elimination of credit controls is intermediated by the number of veto players. Significant effects are obtained when the number of veto players is zero and one (one-tailed significance), from three to five (two-tailed significance at a 0.1 level), and from six to nine (two-tailed significance at a 0.05 level). Similar to with other dimensions presented such as privatization of banks, enhancement of banking supervision, capital account liberalization, and interest rate liberalization, as the number of veto players increases, the IMF effects on speeding up the pace of the elimination of credit controls decrease.

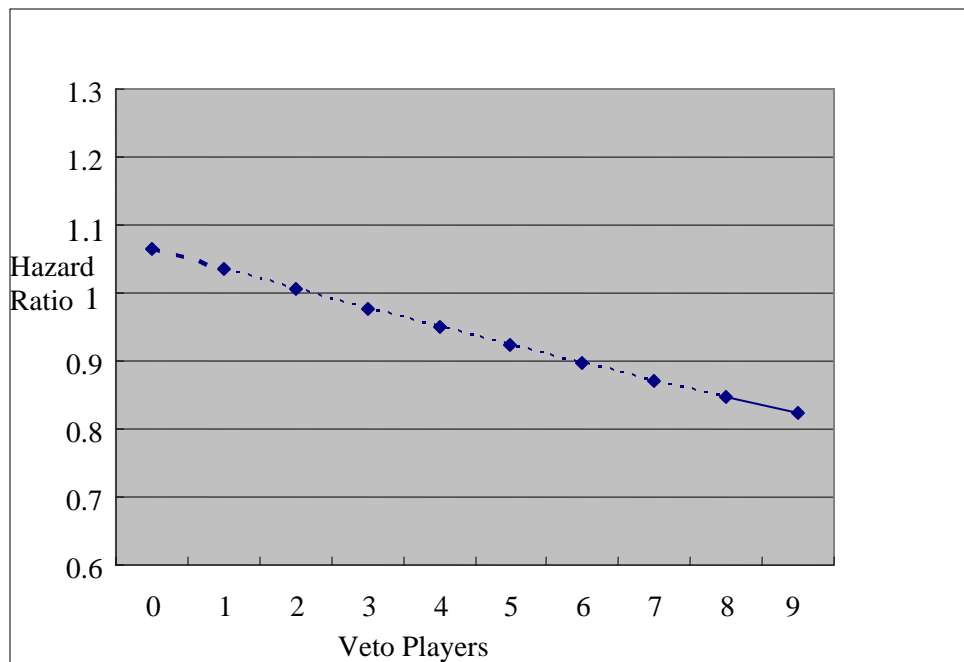


Figure 3.14 Elimination of Credit Controls: Conditional Hazard Ratio for the IMF Given the Number of Veto Players (Model 5-1: All Cases)

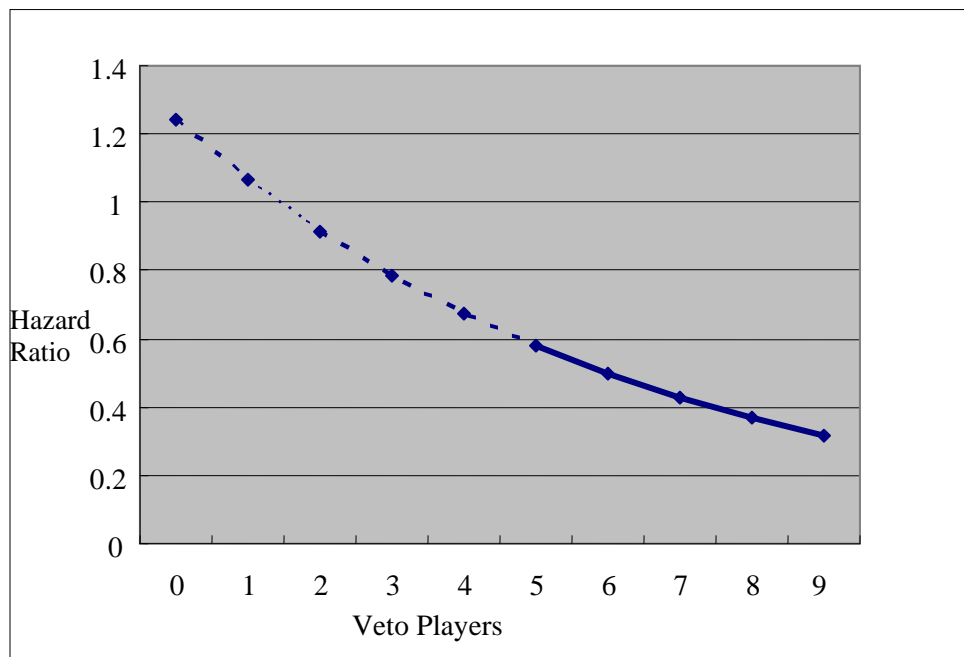


Figure 3.15 Elimination of Credit Controls: Conditional Hazard Ratio for the IMF Given the Number of Veto Players (Model 5-3: Democracy Only)

However, the impact of the manufacturing sector is insignificant when looking at all cases. With respect to the impact of the banking sector, it shows significant effects at a 0.1 level in an expected direction in both Model 5-1 and Model 5-2. Results suggest that as the banking sector and the government collude more, the elimination of credit controls tend to be delayed.

However, in Model 5-3 and Model 5-4, significant results are not obtained for these main variables. Contrary to expectations, the manufacturing sector, which is assumed to support reforms to enhance the access to credit, and the banking sector, which is assumed to oppose the elimination of credit controls to resist competitions among banks, do not affect the pace of elimination of credit controls.

The lagged value affects the pace of the elimination of credit controls. A higher degree of credit controls in the previous year provides room for a country to engage in reforms concerning the elimination of credit controls, as seen in Model 5-2, Model 5-3, and Model 5-4.

Concerning the societal factors' influence in addition to the manufacturing sector and the banking sector, the influence of the agricultural sector may be important in shaping the pace of the elimination of credit controls. The agricultural sector will oppose the elimination of credit controls since the agricultural sector often benefits from preferential credit allocations with subsidized interest rates in developing countries. Therefore, I examined the effects of the agricultural sector measured as a percentage of GDP. Results are appended as Appendix [3.H](#).

A larger influence of the agricultural sector does in fact delay the pace of the elimination of credit controls in a model using all cases, but this influence cannot be observed in a model using only democratic cases. In both models, other variables remain significant.

3.9.7. Elimination of entry barriers

Table 3.11 Conditional Gap Time Model: Predictors of Elimination of Entry Barriers

Variable	Model (6-1) Elimination of Entry Barriers (All Cases)	Model (6-2) Elimination of Entry Barriers (All Cases)	Model (6-3) Elimination of Entry Barriers (Democracy)	Model (6-4) Elimination of Entry Barriers (Democracy)
IMF	0.006 (0.053)	-0.004 (0.055)	-0.037 (0.058)	-0.086** (0.041)
Veto Player x IMF	0.012 (0.034)	0.010 (0.039)	0.052* (0.031)	0.059** (0.026)
Veto Player	0.039 (0.102)	-0.075 (0.088)	-0.023 (0.137)	0.096 (0.128)
Alteration of Executive	0.732** (0.294)	0.703** (0.258)	0.596 (0.470)	0.728 (0.354)
Manufacturing Sector	0.091*** (0.027)	0.076*** (0.022)	0.187** (0.064)	0.108** (0.041)
Banking Sector	0.031 (0.030)	0.021 (0.033)	-0.092 (0.078)	-0.087 (0.054)
Level of Democracy	-0.133 (0.075)		0.002 (0.150)	
US Aid	0.006** (0.003)	0.005** (0.002)	-0.013 (0.016)	
Currency Crisis	0.104 (0.248)		-0.207 (0.329)	
Currency Crisis (t-1)	0.061 (0.257)		0.176 (0.376)	
Currency Crisis (t-2)	-0.131 (0.325)		-0.222 (0.465)	
GDP growth	0.055** (0.026)	0.049** (0.024)	0.072 (0.073)	
GDP per capita (Lagged)	-0.128** (0.046)	-0.123** (0.041)	-0.392 (0.308)	
Country Size	-0.062 (0.147)		-0.206 (0.163)	
Total Seats	-0.001 (0.001)		0.001 (0.002)	
Lagged Level of Reforms	-0.710** (0.351)	-0.817** (0.308)	-0.719** (0.359)	-0.861** (0.867)
No. of observations	829	830	433	433
No. of failures	64	64	30	30
Time at Risk	6093	6097	3436	3436
Log Pseudo-Likelihood	-242.196	-245.953	-79.151	-83.872
Wald Chi Square	109.9	70.49	224.36	70.4
Prob.> Chi Square	0.000	0.000	0.000	0.000

***p<0.01; **p<0.05; and *p<0.10. Entries are coefficients and robust standard errors are in parentheses. Significance is based on 2-tailed tests.

Table 3.11, shown above, reports results for predictors of the *pace* of elimination of entry barriers. Model 6-1 reports the results using all cases and Model 6-2 presents the results when insignificant variables are dropped from the Model 6-1. Model 6-3 exhibits the results for the full model using only democratic cases. Model 6-4 reports the results for when insignificant control variables are dropped from Model 6-3.

Conditional effects of the IMF on the pace of elimination of entry barriers have no significant impact when looking at all cases, as is shown in Model 6-1 and Model 6-2. On the other hand, when only democratic cases are looked at, the relationship between the number of veto players and the *IMF* works in an opposite direction. Contrary to expectations, as the number of veto players increases, the conditional effects of the IMF on the pace of elimination of entry barriers increase, seen below as Figure 3.16.

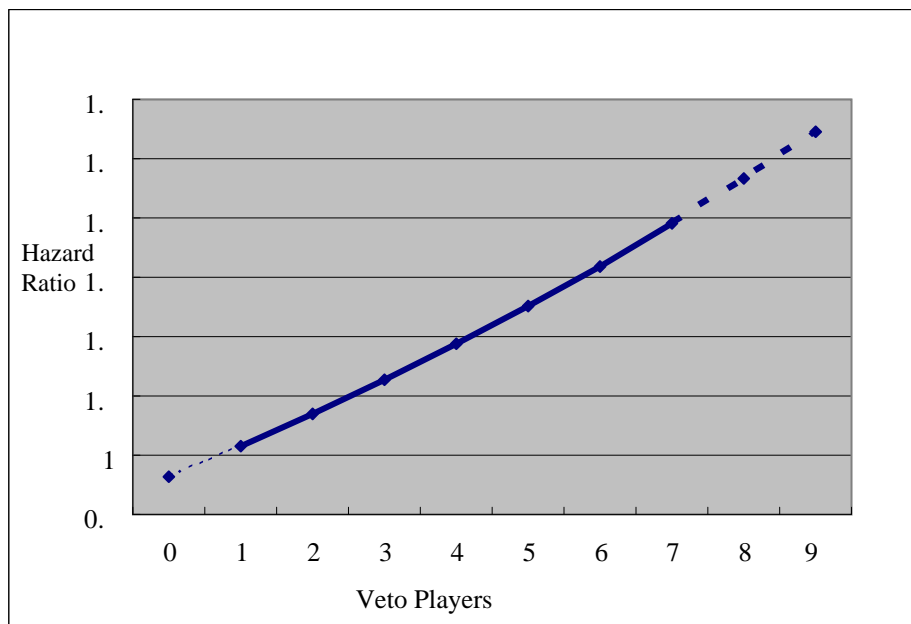


Figure 3.16 Elimination of Entry Barriers: Conditional Hazard Ratio for the IMF Given the Number of Veto Players (Model 6-3: Democracy Only)

This unexpected impact may come from the fact that each political party would like to obtain rents by licensing powers. Or other factors may have an effect on determining the pace of the elimination of entry barriers against banks. For example, an executive leader may have constitutionally defined legislative powers such as constitutional decree authority, which may allow an executive leader to lift entry barriers on new banks, even if a leader faces opposition from coalition partners.⁴¹

Alteration of Executives speeds up the pace of elimination of entry barriers as seen in Model 6-1 and Model 6-2. When there is a change in preferences of the status quo, the likelihood of reform occurring is 2.08 times greater in Model 6-1 and 2.02 times greater in Model 6-2 compared to when there is no alteration of executives. With respect to interest groups, as expected, a stronger influence of the manufacturing sector facilitates the elimination of banks' entry barriers in both models. A one percent increase in the manufacturing sector increases the hazard by 9.5 % in Model 6-1 and by 20.6% in Model 6-3.

Concerning *US Aid*, larger amounts of US aid targeted at both the financial sector and the business sector significantly speed up the elimination of entry barriers, though this effect is only seen when using all cases. As to macroeconomic factors, better economic conditions facilitate the elimination of entry barriers while a more developed country is more likely to delay the elimination of entry barriers of banks. However, these macroeconomic factors are also only significant for the models using all cases.

41 Though I wanted to examine the impact of an executive leader's legislative power, I was not able to obtain the constitutional information for all countries throughout the entire period.

3.9.8. Alternative measurement of veto players

In this section, I also estimate the Cox models using an alternative indicator of veto players, POLCONIII (Henisz 2002).⁴² This measure, POLCONIII, takes into account the number of independent branches of government (i.e., executive, lower and upper legislative chambers) as well as the party composition of the executive and legislative branches. Therefore, this measure counts not only the partisan veto players but also the institutional veto players whereas the number of political parties within the executive coalition counts only partisan veto players. This measurement is used in conventional studies to measure the number of veto players (Henisz and Zalner 2006; Henisz and Mansfield 2006). The correlation between the number of political parties within an executive coalition and POLCONIII is 0.506.

The results of the full models for each of the six dimensions using all cases are shown below as Table 3.12, and the results of the full models for each dimension using only democratic cases are shown below as Table 3.13.⁴³

⁴² Data are taken from the POLCON 2005, available at the website (<http://www-management.wharton.upenn.edu/henisz/>), accessed on November 22, 2006.

⁴³ In previous models, using the number of political parties within an executive coalition as the *Veto Players* indicator, the number of veto players is coded as zero when a case is classified as dictatorship. Hence, the variable *IMF* shows the IMF's effects in cases of non-democratic governments. However, in Table 3.13, the results of the *IMF* represent the impact of the IMF conditionality programs when POLCONIII is zero, which does not exactly match the cases of non-democratic governments in previous models.

Table 3.12 Alternative Measurement: POLCONIII (All Cases)

Variables	Privatization of Banks	Banking Supervision	Capital Account Liberalization	Interest Rate Liberalization	Elimination of Credit Controls	Elimination of Entry Barriers
IMF	0.145 (0.088)	0.131 (0.094)	0.108** (0.037)	-0.029 (0.048)	-0.023 (0.077)	0.072 (0.089)
Veto Player x IMF	-0.151 (0.217)	-0.165 (0.196)	-0.299** (0.144)	0.205 (0.121)	0.138 (0.183)	-0.147 (0.208)
Veto Player	2.178 (1.760)	3.253** (1.142)	0.778 (0.952)	-3.069** (1.140)	-1.904* (1.088)	-1.000 (0.957)
Alteration of Executive	-0.192 (0.503)	-0.027 (0.325)	0.965*** (0.285)	0.267 (0.275)	-0.236 (0.311)	0.784** (0.326)
Manufacturing Sector	0.157*** (0.047)	0.071* (0.043)	0.072** (0.029)	0.110*** (0.029)	0.047 (0.031)	0.089*** (0.027)
Banking Sector	0.021 (0.051)	0.030 (0.052)	0.019 (0.027)	0.008 (0.031)	-0.076* (0.041)	0.033 (0.031)
Level of Democracy	-1.186 (0.212)	-0.082 (0.094)	-0.104 (0.086)	-0.006 (0.087)	-0.074 (0.094)	-0.074 (0.081)
US Aid	-0.007 (0.005)	0.003 (0.002)	0.0003 (0.003)	-0.0005 (0.002)	0.002 (0.003)	0.006** (0.003)
Currency Crisis	0.078 (0.436)	-0.847** (0.420)	-0.326 (0.367)	-0.350 (0.325)	0.031 (0.305)	0.091 (0.245)
Currency Crisis (t-1)	0.499* (0.292)	0.564* (0.321)	-0.671* (0.362)	0.017 (0.315)	0.332 (0.264)	-0.024 (0.275)
Currency Crisis (t-2)	0.727 (0.520)	0.134 (0.309)	-0.581 (0.372)	0.133 (0.265)	-0.083 (0.257)	-0.194 (0.325)
GDP growth	0.019 (0.049)	0.039 (0.039)	-0.029 (0.021)	0.043 (0.032)	-0.003 (0.029)	0.063** (0.028)
GDP per capita	-0.369** (0.159)	-0.038 (0.044)	-0.071 (0.053)	-0.131** (0.050)	-0.004 (0.062)	-0.134** (0.049)
Country Size	0.125 (0.235)	-0.116 (0.277)	0.139 (0.095)	0.040 (0.075)	-0.340** (0.168)	-0.034 (0.123)
Total Seats	-0.003 (0.003)	-0.0002 (0.002)	-0.001 (0.001)	-0.002** (0.001)	0.001 (0.001)	-0.001 (0.001)
Lagged Level of Reforms	-0.623** (0.305)	-4.408*** (0.861)	-0.915*** (0.142)	-1.067*** (0.161)	-0.457* (0.261)	-0.733** (0.349)
No. of observations	828	828	828	828	828	828
No. of failures	35	45	79	67	68	64
Time at Risk	8502	8225	5548	5636	5720	6088
Log Pseudo-Likelihood	-135.132	-154.146	-282.658	-246.077	-280.26	-240.964
Wald Chi Square	102.77	277.99	165.44	223.16	106.14	90.35
Prob.> Chi Square	0.0000	0.0000	0.0000	0.000	0.000	0.000

***p<0.01; **p<0.05; and *p<0.10. Entries are coefficients and robust standard errors are in parentheses. Significance is based on 2-tailed tests.

Table 3.13 Alternative Measurement: POLCONIII (Democracy Only)

Variables	Privatization of Banks	Banking Supervision	Capital Account Liberalization	Interest Rate Liberalization	Elimination of Credit Controls	Elimination of Entry Barriers
IMF	0.206* (0.110)	0.220 (0.171)	0.138* (0.081)	0.138 (0.115)	0.044 (0.067)	0.128 (0.163)
Veto Player x IMF Credit	-0.248 (0.247)	-0.316 (0.354)	-0.502*(0.297)	-0.155 (0.255)	-0.028 (0.193)	-0.189 (0.411)
Veto Player	0.778 (2.870)	2.024 (1.740)	0.143 (1.671)	-1.997 (3.378)	-2.445 (1.682)	-1.500 (2.419)
Alteration of Executive	-0.307 (0.515)	0.096 (0.401)	0.848** (0.325)	-0.422 (0.373)	-0.232 (0.409)	0.746 (0.508)
Manufacturing Sector	0.177*** (0.054)	0.134*(0.074)	-0.0004 (0.054)	0.042 (0.046)	0.018 (0.080)	0.198** (0.065)
Banking Sector	0.078 (0.069)	0.024 (0.081)	0.026 (0.044)	-0.237 (0.152)	-0.096 (0.086)	-0.108 (0.082)
Level of Democracy	-0.294* (0.170)	-0.098 (0.226)	-0.051 (0.192)	0.268** (0.129)	-0.065 (0.200)	0.045 (0.144)
US Aid	0.002 (0.006)	-0.002 (0.009)	0.016** (0.006)	-0.166 (0.140)	-0.040 (0.027)	-0.015 (0.019)
Currency Crisis	-0.053 (0.398)	-0.480 (0.502)	-0.242 (0.389)	-0.300 (0.514)	0.119 (0.422)	-0.185 (0.408)
Currency Crisis (t-1)	0.373 (0.383)	0.612 (0.426)	-0.348 (0.409)	-1.026 (0.634)	-0.175 (0.443)	-0.001 (0.375)
Currency Crisis (t-2)	1.283** (0.592)	0.600** (0.298)	-0.830 (0.594)	0.810* (0.457)	0.033 (0.350)	-0.316 (0.428)
GDP growth	0.066 (0.053)	0.112 (0.094)	-0.037 (0.037)	0.080** (0.030)	-0.019 (0.052)	0.068 (0.070)
GDP per capita	-0.424 ** (0.182)	-0.076 (0.159)	0.176 (0.134)	-0.075 (0.195)	-0.076 (0.202)	-0.414 (0.283)
Country Size	0.111 (0.259)	-0.374 (0.451)	0.090 (0.103)	-0.108 (0.103)	-0.181 (0.179)	-0.187 (0.132)
Total Seats	-0.005 (0.003)	0.001 (0.002)	0.0001 (0.002)	0.0003 (0.003)	-0.0004 (0.003)	0.002 (0.002)
Lagged Level of Reforms	- 0.463 (0.636)	-	-1.057*** (0.266)	-1.456*** (0.454)	-0.714** (0.304)	-0.763* (0.412)
No. of observations	432	432	432	432	432	432
No. of failures	23	33	47	34	37	30
Time at Risk	4743	4662	2765	3081	3316	3435
Log Pseudo-Likelihood	-75.935	-95.590	-132.403	-84.412	-122.808	-79.063
Wald Chi Square	64.92	372.28	132.83	918.34	44.55	301.28
Prob.> Chi Square	0.0000	0.0000	0.0000	0.000	0.000	0.000

***p<0.01; **p<0.05; and *p<0.10. Entries are coefficients and robust standard errors are in parentheses. Significance is based on 2-tailed tests.

As demonstrated above, even when I use the alternative measurement for the number of veto players, POLCONIII, the results largely confirm the findings of the previous results. Concerning the societal impacts, an increase in the *Manufacturing Sector's* influence significantly raises the likelihood of reform occurrences in such areas as privatization of banks, capital account liberalization, interest rate liberalization, and elimination of entry barriers in models using all cases. However, effects of the banking sector are not observed except for credit controls, similar to previous models.

Regarding the interaction terms between the *IMF* and the number of *Veto Players* (*POLCONIII*), point estimates of conditional effects for the IMF given the values of POLCONIII are displayed below as Table 3.14 for models using all cases and Table 3.15 models for using only democratic cases. The point estimates are presented at the values of the sample mean of POLCONIII, at the values of plus and minus of standard deviation from the sample mean, and at the minimum and the maximum values of POLCONIII.⁴⁴

⁴⁴ The sample mean is 0.278 and standard deviation is 0.209 for models using all cases (Table 3.14). The sample mean is 0.402 and standard deviation is 0.144 for models using democratic cases (Table 3.15).

Table 3.14 Point Estimates of Conditional Effects for the IMF Given the Values of POLCONIII (All Cases)

Value of POLCONIII	Privatization of Banks	Banking Supervision	Capital Account Liberalization
Minimum	1.156	<i>1.140</i>	1.114**
Mean - 1SD	1.144*	<i>1.127</i>	1.091**
Mean	1.109**	1.088**	1.025
Mean +1SD	1.074**	1.051***	0.963
Maximum	1.042	1.017	<i>0.907</i>

***p<0.001(2-tailed tests); **p<0.05 (2-tailed tests); *p<0.10 (2-tailed tests); and italics is based on one-tailed tests. SD is standard deviation.

Table 3.15 Point Estimates of Conditional Effects for the IMF Given the Values of POLCONIII (Democracy Only)

Value of POLCONIII	Privatization of Banks	Banking Supervision	Capital Account Liberalization	Interest Rate Liberalization	Elimination of Entry Barriers
Minimum	1.229*	<i>1.246</i>	1.148*	1.148	1.137
Mean - 1SD	1.153**	1.149*	1.009	<i>1.136</i>	1.122
Mean	1.112*	1.097**	0.938	1.100*	<i>1.078</i>
Mean +1SD	<i>1.073</i>	<i>1.049</i>	<i>0.873</i>	<i>1.065</i>	1.036
Maximum	1.035	1.002	<i>0.812</i>	1.032	0.997

**p<0.05 (2-tailed tests); *p<0.10 (2-tailed tests); and italics is based on one-tailed tests. SD is standard deviation.

As shown above in Table 3.14, in three dimensions out of six significant conditional effects for the IMF given the values of POLCONIII are observed, similar to previous results. As the number of veto players increases, the IMF's effects on bringing forward the timing of financial reforms tends to decrease in such dimensions as privatization of banks, enhancement of banking supervision, and capital account liberalization when all cases are used to estimate models. In models using only democratic cases, shown as Table 3.15, conditional effects are significant in such dimensions as privatization of banks, enhancement of banking supervision, capital account liberalization, interest rate liberalization, and elimination of entry barriers.

In the previous section, as observed in Figure 3.16, for the dimension of the elimination of entry barriers, the conditioning effects of veto players for the IMF were in an opposite direction. However, when using POLCONIII as an alternative veto player's measurement, here seen as Table 3.15, results confirm the expected direction, contrary to previous findings. However, I cannot observe significant conditional effects for the IMF in the dimension of elimination of credit controls when I use POLCONIII, though I previously observed the expected finding.

In addition, concerning the effects under the label of *Veto Players*, which indicates the effects of the number of veto players per se when there is no impact of the IMF, while I do not observe any significant effects in previous models for any of the six dimensions, when I use POLCONIII, I observe significant effects in the dimensions of the enhancement of banking supervision, interest rate liberalization, and elimination of credit controls. For the dimensions of interest rate liberalization and the elimination of credit controls, Tsebelis's theory of veto players is confirmed: an increase in the number of veto players delays interest rate liberalization and elimination of credit controls when there is no effect of the IMF conditionality programs. On the

other hand, for the dimension of enhancement of banking supervision, the opposite finding is observed, i.e., as the number of veto player increases, banking supervision tends to be facilitated under the lack of the IMF's pressures.⁴⁵

However, despite the differences described immediately above, by looking at the interaction effects between the *IMF* and *Veto Players*, the same results are obtained in three dimensions for all cases, shown as Table 3.14, and in five dimensions for democratic cases, shown as Table 3.15 using alternative veto player measurements. Hence, findings of this chapter concerning the relationship between the IMF programs and the number of veto players as well as the societal impacts can be said to be largely robust.

3.10. DISCUSSION

By explicitly modeling the impact of the IMF, veto players, and interest groups as determinants of financial reforms, this chapter aims to quantitatively explore political determinants to account for the pace of not only capital account liberalization, but also other various dimensions of banking reforms in developing countries, where conventional studies are lacking.

Since the IMF's impact may be overlapped with effects of currency crises, it would be difficult to obtain separate significant results. Further, as discussed before, previous empirical

⁴⁵ This may come from the fact that since enhancement of banking supervision means strengthened government intervention into the market, contrary to with the other five dimensions of financial reforms, the increase in the number of veto players and the resulted rigid policy outcomes may lead governments to choose a more independent banking supervisory agency and other measures of strengthened banking supervisory power as literature on central bank independence assumes (for example, see Bernhard (2002)). However, since this effect is not observed in models including the number of political parties within an executive coalition, further analysis is necessary.

research shows that the Fund's conditionality programs suffer from low implementation rates. Once a country has successfully borrowed money from the IMF, a country may not commit to reforms expecting that the IMF will bail out. In this vein, the IMF's conditionality programs tend to be criticized because of this moral hazard problem.⁴⁶ However, despite these critiques against the Fund conditionality programs, even rigorously controlling for the effects of currency crises, significant effects of the IMF in facilitating the pace of financial reforms can be observed in the issue areas of financial reforms where the IMF's core competence lies. Therefore, IMF programs not only facilitate a larger magnitude of financial reforms but also accelerate the pace of financial reforms. The IMF demands a country facilitate financial reforms not only because of the necessity of reforms given deteriorated economic conditions due to currency crises, but also because of the uncertainty over whether a country has the will to commit to financial reforms given its low implementation rates of conditionality programs.

Especially concerning the interaction effects between the *IMF* and the number of *Veto Players*, results demonstrate that the conditional effects for the IMF on the pace of financial reforms is contingent upon the number of veto players, similar to the results observed for the effects on the magnitude of financial reforms. Measuring the number of veto players as the number of political parties within an executive coalition, significant conditional effects on the pace of financial reforms are obtained in the following five out of the six dimensions in both models using all cases and only democratic cases: privatization of banks, the enhancement of banking supervision over the banking sector, capital account liberalization, interest rate liberalization, and elimination of credit controls. That is to say, the IMF's effect in accelerating

46 Concerning the literature on the IMF's moral hazard problems, see International Financial Institution Advisory Commission (2000) which is known as the Meltzer Commission Report, for example.

the *pace* of financial reforms decreases as the number of veto players increases. In the first three dimensions — privatization of banks, the enhancement of the banking supervision over the banking sector, and capital account liberalization — statistical significance is also obtained in both models using all cases and only democratic cases by using POLICONIII as an alternative indicator, which takes into account not only partisan veto players but also institutional veto players. In other two dimensions, interest rate liberalization and elimination of entry barriers on banks, statistical significance is obtained only in only democratic cases by using POLICONIII. Thus, in democratic cases, the hypotheses concerning interaction effects between the IMF and the number of veto players (hypotheses 4b) are upheld in five out of the six dimensions in both measurements of the number of veto players.

In this vein, although existing findings in quantitative studies show diverse findings in terms of the relationship between the increase in the number of veto players and the change in policy status quo as discussed before — negative relationship (Tsebelis 2002; Basinger and Hallerberg 2004; Kastner and Rector 2003; Henisz and Mansfield 2006), positive relationship (Frye and Mansfield 2004), curvilinear relationship (Macintyre 2003, 2001), and no relationship at all (Hicken, Styanath, and Sergenti 2005) — as far as financial reforms are concerned, empirical findings of this study confirm Tsebelis's claims: When a country has a large number of veto players, the IMF's effects in facilitating financial reforms tend to be weakened, as hypothesized. However, the number of veto players works in such a way that intermediates the effects of the Fund conditionality programs in setting the pace of financial reforms rather than

the number of veto players per se working independently as well as cases of the magnitude of financial reforms.⁴⁷

Alteration of Executives shows a significant impact with respect to bringing forward the timing of financial reforms in the dimensions of capital account liberalization and the elimination of entry barriers of banks. In both dimensions, when there is alteration of executives, the hazards becomes significantly greater compared to a case when there is no alteration of executives. Since *Alteration of Executives* captures regime changes or changes in the executive leader's political party in an attempt to capture the changes in preferences of the status quo, conventional qualitative studies are right; when there is a change in political leadership, a new government is more likely to accelerate financial reforms, though this is only observed in the areas of capital account liberalization (Models 3-1–3-4) and in the elimination of entry barriers (Models 6-1 and 6-2).

With respect to the *Manufacturing Sector*, when the influence of the manufacturing sector increases, a country tends to commit to privatization of banks (Models 1-1–1-4), capital account liberalization (Model 3-1 and 3-2), interest rate liberalization (Models 4-1 and 4-2), and elimination of entry barriers of banks (Models 6-1–6-4). The manufacturing sector seeks an increase in access to better credit conditions. Privatization of banks, liberalized capital flows, liberalized banks' deposit rates and lending rates, and a more competitive environment for banks by eliminating entry barriers increase opportunities for access to credit for the manufacturing

47 In the dimension of the elimination of entry barriers, conditional impact of the IMF works in an opposite direction by using the number of political parties within an executive coalition: as the number of veto player increases, the IMF's impact on eliminating entry barriers increases, though this opposite impact is not observed when I use an alternative measurement of the number of veto players, POLCONIII. This opposite impact may come from the fact that each political party would like to obtain rents by obtaining licensing powers as discussed before.

sector. Hence, the strong influence of the manufacturing sector contributes to facilitate financial reforms in these dimensions. The findings for the *Manufacturing Sector* largely confirm my hypotheses. However, there is no significant effect of the manufacturing sector in the dimension of the elimination of credit controls. Also, in terms of the enhancement of banking supervision over the banking sector, contrary to my expectations, there is a weak significance in increasing the hazard of enhancement of the banking sector (Models 2-2–2-4). Since it is necessary for a country to have the technological capacity to enhance banking supervision, this result may suggest that a country with a strong manufacturing sector has the technological capacity to enhance banking supervision.

Concerning the *Banking Sector*'s influence, the dimensions that meet my expectations are interest rate liberalization (Model 4-3 and Model 4-4) and elimination of credit controls (Model 5-1 and model 5-2). A strong connection between the banking sector and the government significantly hinders interest rate liberalization and elimination of credit controls. However, for other dimensions, contrary to my expectations, there are no significant effects on the pace of financial reforms and these results are disappointing. These results may be a result of data limitations with respect to available indicators as discussed before. Given the limitation of data availability, the influence of the banking sector may not be able to be observed.

In this chapter, political determinants of the *magnitude* and the *pace* of financial reforms are examined. The most important predictor is the external pressures by the IMF, despite controversies surrounding the Fund conditionality programs. However, these IMF effects are conditioned by political institution or veto players. Thus, veto players work in a way that intermediate the effects of the Fund conditionality programs. With respect to the societal actors,

while I confirm the effects of the manufacturing sector, significant effects of the banking sector cannot be obtained except two dimensions.

It is disappointing that the banking sector has a significant impact in only two dimensions quantitatively. However, it may come from the fact that quantitative examination has certain limits in measuring the influence of the banking sector given the limits of the data discussed before. It may also come from the fact that in the cases of developing countries, when conglomerates own both firms and banks, firms' interests may dominate and banks may become subordinate to the firms' interests as a part of the conglomerate. Therefore, I further explore the impact of societal factors in the following case study chapters.

In Chapters 4 and Chapter 5, I further examine how the IMF and a country's interaction shape financial reform outcomes in more detailed case studies of three countries: Indonesia, Korea, and Thailand. In the next chapter, I focus on the case of Indonesia by examining financial reforms from 1965 to 2003, which allows me to examine the financial reform outcomes in Indonesia with a temporal variation concerning the effects of the IMF, veto players, and societal actors in Indonesia.

Appendix 3.A. Coding Rules of the Financial Reform Database

1) Privatization of Banks

FL: Fully Liberalized if no state banks exist or state-owned banks do not constitute any significant portion of banks and/or the percentage of public bank assets is less than 10 %.

LL: Largely Liberalized if most banks are privately owned and/or the percentage of public bank assets is from 10% to 25%.

PR: Partially Repressed if many banks are privately owned but major banks are still state-owned and/or the percentage of public bank assets is 25%- 50%.

FR: Fully Repressed if major banks are all state-owned banks and/or the percentage of public bank assets is from 50% to 100%.

2) Enhancement of Banking Supervision over the Banking Sector

1) *Does a country adopt a capital adequacy ratio based on the Basle standard? (0/1)*

2) *Does a banking supervisory agency become independent from the executives' influence? (0/1/2)*

0 = when the banking supervisory agency does not have an adequate legal framework to promptly intervene in banks' activities and/or when there is lack of a legal framework for the independence of the supervisory agency such as the appointment and removal of the head of the banking supervisory agency; or the ultimate jurisdiction of the banking supervision is under the MOF; or when a frequent turnover of the head of the supervisory agency is experienced.

1 = an objective supervisory agency is clearly defined and an adequate legal framework to resolve banking problems is provided (the revocation and the suspension of authorization of banks, liquidation of banks, and the removal of banks' executives etc.), but potential problems remain concerning the independence of the banking supervisory agency (for example, the board of the banking supervisory agency board is chaired by the MOF, although the fixed term of the board is ensured by law); or although clear legal objectives and legal independence are observed, an adequate legal framework for resolving problems is not well articulated.

2 = if a legal framework for the objectives and the resolution of troubled banks is set up and if the banking supervisory agency is legally independent from the executive branch and actually not interfered with by the executive branch.

3) *Does a banking supervisory agency conduct effective supervisions through on-site and off-site examinations (0/1/2)?⁴⁸*

48 When information concerning on-site and off-site information is not available, I substitute this factor for whether banks are required to report their balance sheets on a consolidated basis,

0 = when a country has no legal framework and practices of on-site and off-site examinations are not provided or when no on-site and off-site examinations are conducted.

1 = a legal framework for on-site and off-site examinations is set up and the banking supervision agency has conducted examinations but in an ineffective or insufficient manner.

2 = the banking supervisory agency conducts effective and sophisticated examinations.

4) *Does a country's banking supervisory agency expand the coverage all financial institutions without exception from supervisory oversight? (0/1)*

0 = if some kinds of financial institutions are not exclusively supervised by the banking supervisory agency or are excluded from banking supervisory agency's oversights.

1 = if all banks are under supervision by supervisory agencies without exception.

After summing up these four dimensions, scores are assigned as follows:

Highly Regulated = [6], Largely Regulated = [4-5], Less Regulated = [2-3], Not Regulated = [0-1]

3) Capital Account Liberalization

1) *Is the exchange rate system unified? (0/1)*

0 = if a special exchange rate regime for either capital or current account transactions exists.

1 = if the exchange rate system is unified.

2) *Does a country remove restrictions on capital inflow controls? (0/1)*

0 = banks are not allowed to borrow from abroad freely.

1 = banks are allowed to borrow from abroad freely without restrictions.

3) *Does a country remove restrictions on capital outflow control? (0/1)*

0 = restrictions on the repatriation of capital, dividends, and interests exist.

1 = the repatriation of capital, dividends, and interests is allowed without any restrictions.

After adding these three items, the countries are categorized as follows:

Fully Liberalized = [3], Largely Liberalized = [2], Partially Repressed = [1], Fully Repressed = [0]

4) Interest Rate Liberalization

Deposit rates and lending rates are coded respectively as follows:

<Deposit rates> <Lending rates>

0 = ceilings/floors of interest rates are set, or interest rates are determined by the central bank.

meaning whether banks are obliged to report accountings based on a bank group as a whole, including subsidiaries and related companies, to avoid a loophole, or on an individual bank.

1 = interest rates are allowed to float within a band or are partially liberalized.

Partial liberalization means that only some kinds of deposit rates (loan rates) are determined by market rates, while other deposit rates (loan rates) are still subject to controls.⁴⁹

2 = interest rates are at market rates.

The dimension of interest rate liberalization is coded by adding these scores for deposit rates and lending rates.

FL= 4 [2, 2]

Fully Liberalized if both deposit interest rates and lending interest rates are determined at market rates.

LL= 3 [2, 1]

Largely Liberalized if either deposit rates or lending rates are freed but the other rates are subject to band or only a part of interest rates are determined at market rates.

PR= 2/1 [2, 0] [1, 1] [1, 0]

Partially Repressed if either deposit rates or lending rates are freed but the other interest rates are set by the government or subject to ceiling/floor; or both deposit rates and lending rates are subject to band or partially liberalized; or either deposit rates or lending rates are subject to band or partially liberalized.

FR= 0 [0, 0]

Fully Repressed if both deposit rates and lending rates are set by the government or subject to ceiling/floor.

5) Elimination of Credit Controls

1) *Does the government reduce reserve requirements?*

<Reserve requirements>

0 = reserve requirement is more than 20%.

1 = reserve requirements reduced to less than 20% or complicated rules to set reserve requirements are simplified as a step toward reducing reserve requirements.

2) *Does the government eliminate preferential credit allocation to certain sectors?*

<Elimination of credit controls to allocated credit to certain sectors>

0 = credit allocations are determined by a central bank or mandatory credit allocations to certain sectors exist.

⁴⁹ For example, in the Philippines in 1981, short-term deposits were subject to controls while long-term deposits were freed. On other occasions, interest rate liberalization may be adopted formally, while in fact, reference rates implicitly work to set interest rates. For example, in Sri Lanka, two dominant national banks functioned as pacemakers until 1997 in setting interest rates, despite the fact that interest rate liberalization had been formally announced in 1991.

1 = mandatory credit allocations to certain sectors are eliminated or do not exist.

3) *Does the government eliminate preferential credit allocation at subsidized rates?*

<Credit supply at subsidized interest rates>

0 = banks have to supply credits at subsidized rates to certain sectors.

1 = the mandatory requirement of credit allocation at subsidized rates is eliminated or banks do not have to supply credits at subsidized rates.

These three questions' scores are summed and coded as follows:

Fully Liberalized = [3], Largely Liberalized = [2], Partially Repressed = [1], Fully Repressed= [0]

6) Elimination of Entry Barriers on Banks

1) *Does the government eliminate restrictions against foreign banks to enter into a domestic market?*

0 = no entry of foreign banks is allowed, or restrictions on the opening of new foreign banks are strictly regulated.

1 = foreign bank entry is allowed, and/or less than 50% equity share by nonresidents allowed.

2 = the majority of share of equity ownership of domestic banks by nonresidents is allowed; or equal treatment is ensured for both foreign banks and domestic banks; or an unlimited number of branching is allowed for foreign banks.

2) *Does the government eliminate restrictions on the entry of new domestic banks or ease branching restrictions?*

0 = the entry of new domestic banks is not allowed or strictly regulated.

1 = the entry of new domestic banks or other financial institutions is allowed into the domestic market, and/or branching restrictions of domestic banks are eased.

3) *Does the government allow banks to engage in a wider range of activities? (0/1)*

0 = the range of activities that banks can participate in consists of only banking activities.

1 = banks are allowed to become universal banks, or specialization among banks is simplified.

The elimination of entry barriers is coded by adding the scores for these three questions.

Fully Liberalized= 4, Largely Liberalized= 3, Partially Repressed= 1 or 2, Fully Repressed = 0

Appendix 3.B. Correlations of Each of the Six Dimensions (Original Values)

	Privatization of Banks	Enhancement of Banking Supervision	Capital Account Liberalization	Interest Rate Liberalization	Elimination of Credit Controls	Elimination of Entry Barriers
Privatization of Banks	1.000					
Enhancement of Banking Supervision	0.334	1.000				
Capital Account Liberalization	0.425	0.462	1.000			
Interest Rate Liberalization	0.384	0.526	0.579	1.000		
Elimination of Credit Controls	0.400	0.558	0.506	0.639	1.000	
Elimination of Entry Barriers	0.292	0.602	0.555	0.672	0.599	1.000

Note: Each dimension is coded from zero to three. Unit is country-year. (900 observations)

Appendix 3.C. Correlations of Each of the Six Dimensions (Differences)

	Privatization of Banks	Enhancement of Banking Supervision	Capital Account Liberalization	Interest Rate Liberalization	Elimination of Credit Controls	Elimination of Entry Barriers
Privatization of Banks	1.000					
Enhancement of Banking Supervision	0.027	1.000				
Capital Account Liberalization	0.132	0.024	1.000			
Interest Rate Liberalization	0.126	-0.021	0.162	1.000		
Elimination of Credit Controls	-0.026	0.092	0.075	0.154	1.000	
Elimination of Entry Barriers	-0.005	0.121	0.112	0.008	0.066	1.000

Note: Differences are taken between year t and year t-1 for each country-year observation. (870 observations)

Appendix 3.D Correlations between Years Until First Financial Reforms Occur

	Privatization of Banks	Enhancement of Banking Supervision	Capital Account Liberalization	Interest Rate Liberalization	Elimination of Credit Controls	Elimination of Entry Barriers
Privatization of Banks	1.000					
Enhancement of Banking Supervision	0.523	1.000				
Capital Account Liberalization	0.495	0.426	1.000			
Interest Rate Liberalization	0.532	0.424	0.649	1.000		
Elimination of Credit Controls	0.525	0.473	0.629	0.578	1.000	
Elimination of Entry Barriers	0.583	0.480	0.602	0.672	0.665	1.000

Appendix 3.E Correlations between the Number of Reforms

	Privatization of Banks	Enhancement of Banking Supervision	Capital Account Liberalization	Interest Rate Liberalization	Elimination of Credit Controls	Elimination of Entry Barriers
Privatization of Banks	1.000					
Enhancement of Banking Supervision	0.319	1.000				
Capital Account Liberalization	0.344	0.180	1.000			
Interest Rate Liberalization	0.275	0.133	0.421	1.000		
Elimination of Credit Controls	0.299	0.150	0.305	0.274	1.000	
Elimination of Entry Barriers	0.373	0.297	0.466	0.287	0.288	1.000

Appendix 3.F Correlations between Magnitude and Pace of Financial Reforms

	Privatization of Banks	Enhancement of Banking Supervision	Capital Account Liberalization	Interest Rate Liberalization	Elimination of Credit Controls	Elimination of Entry Barriers
Magnitude of Reforms (additive change values)	0.092	0.164	0.058	0.003	0.072	0.104
Level of Reforms (additive level values)	0.110	-0.042	0.033	0.228	0.024	-0.041

Appendix 3.G Regime Type

Country	Democracy (450 obs)	Non-democracy (420 obs)
Argentina	1974-1976: 1984-2002	1977-1983
Bangladesh	1974: 1980-1982: 1992-2002	1975-1979: 1983-1991
Bolivia	1980: 1983-2002	1974-1979: 1981-1982:
Brazil	1986-2002	1974-1985
Chile	1991-2002	1974-1990
Colombia	1974-2002	
Costa Rica	1974-2002	
Ecuador	1980-2002	1974-1979
Egypt		1974-2002
Ghana	1980-1981: 1998-2002	1974-1979: 1982-1997
Guatemala	1974-1982: 1986-2002	1983- 1985
India	1974-2002	
Indonesia	2000-2002	1974-1999
Jamaica	1974-2002	
Korea (South Korea)	1989-2002	1974-1988
Malaysia		1974-2002
Mexico	1995-2002	1974-1994
Morocco		1974-2002
Nepal	1992-2002	1974-1991
Pakistan	1974-1977: 1989-1999	1978-1988: 2000-2002
Peru	1981-1992: 2002	1974-1980: 1993-2001
Philippines	1987-2002	1974- 1986
Singapore		1974-2002
South Africa	1995-2002	1974-1994
Sri Lanka	1974-1982: 1988-2002	1983-1987
Thailand	1976: 1989-1991: 1993-2002	1974-1975: 1977-1988: 1992
Turkey	1974-1980: 1992-2002	1981-1991
Uruguay	1986-2002	1974-1985
Venezuela	1974-2002	
Zimbabwe		1974-2002

**Appendix 3.H Conditional Gap Time Model: Predictors of Elimination of Credit Controls
(with the Agricultural Sector Variable)**

Variable	Model Elimination of Credit Controls (All Cases)	Model Elimination of Credit Controls (Democracy)
IMF	0.050 (0.046)	0.185* (0.107)
Veto Player x IMF	-0.030 (0.038)	-0.143** (0.083)
Veto Player	0.027 (0.230)	0.145 (0.364)
Alteration of Executive	-0.088 (0.296)	-0.118 (0.352)
Manufacturing Sector	-0.017 (0.034)	-0.026 (0.077)
Financial Sector	-0.095* (0.057)	-0.080 (0.096)
Agriculture Sector	-0.054** (0.023)	-0.043 (0.051)
Level of Democracy	-0.132 (0.105)	-0.096 (0.228)
US Aid	0.003 (0.003)	-0.031 (0.034)
Currency Crisis	0.104 (0.293)	0.228 (0.411)
Currency Crisis (t-1)	0.359 (0.249)	-0.046 (0.433)
Currency Crisis (t-2)	-0.033 (0.257)	0.065 (0.313)
GDP growth	0.011 (0.026)	-0.028 (0.038)
GDP per capita	0.008 (0.064)	-0.153 (0.229)
Country Size	-0.445** (0.195)	-0.190 (0.264)
Total Seats	0.001 (0.002)	-0.001 (0.003)
Lagged Level of Reforms	-0.434** (0.213)	-0.624* (0.365)
No. of observations	830	433
No. of failures	68	37
Time at Risk	5729	3317
Log Pseudo- Likelihood	-277.945	-120.729
Wald Chi Square	71.8	103.05
Prob.> Chi Square	0.000	0.000

***p<0.01; **p<0.05; and *p<0.10. Entries are coefficients and robust standard errors are in parentheses. Significance is based on 2-tailed tests.

4.0 FINANCIAL REFORMS IN INDONESIA

4.1. INTRODUCTION

Based on the findings of the preceding chapters, theoretical arguments are assessed in Chapter 4 and Chapter 5 employing case studies. I conduct case studies of the following three countries: Indonesia in this chapter and Thailand and Korea in Chapter 5. Indonesia, Thailand, and Korea were all hit by the Asian financial crisis. All three countries asked for IMF rescue packages and all these countries aimed at conducting banking reforms under the IMF conditionality programs after the Asian financial crisis. However, despite these similarities, the outcomes of the banking reforms for these countries showed differences. Hence, I assume that not only IMF influence as an international pressure but also the number of veto players and their preferences would explain the difference in outcomes of the financial reforms. In addition, I look at how interest groups such as the banking sector and the manufacturing sector exert influence by putting pressures on governments and sometimes by colluding with politicians. I hypothesized that the manufacturing sector supports financial reforms in such dimensions as privatization of banks, capital account liberalization, interest rate liberalization, elimination of credit controls, and elimination of entry barriers while the manufacturing sector opposes financial reforms in the dimension of enhancement of banking supervision. Concerning the banking sector, I hypothesize that the banking sector is likely to oppose financial reforms in all six dimensions. Therefore, I closely examine how the interactions between the IMF, policy makers, and interest groups shape the outcomes of financial reforms.

Quantitative studies cannot reveal the dynamics concerning how key players such as the IMF, economic policy makers, politicians, and interest groups interact. Therefore, by conducting case studies, I could closely examine how these key actors' preferences and interactions shape financial reform outcomes. Further, in quantitative analysis, expected results were not obtained concerning the impact of the banking sector. Therefore, by conducting case studies in this chapter and subsequent chapter, I could more thoroughly examine the effects of the banking sector in case studies.

In the case of Indonesia, I examine financial reforms from 1965 to 2003 chronologically, starting from the beginning of the Suharto regime to graduation from the IMF programs. I especially focus on how the six dimensions of financial reforms were facilitated or hindered as a result of interactions between politicians, banks, and conglomerates representing the interests of the manufacturing sector. In the following section, Indonesia is illustrated as a case in which the collusion between politicians and conglomerates and banks shapes the outcomes of financial reforms. In the third section, I conclude.

4.2. FINANCIAL REFORMS IN INDONESIA

Indonesia, once praised as one of the countries that achieved the Asian miracle of economic growth (World Bank 1993), was the hardest hit by the Asian financial crisis. The currency crisis together with the banking crisis had a devastating impact on Indonesia's whole economy. Also, Indonesia is the only country that had experienced democratization during the turmoil of the Asian financial crisis. During the years from 1965 to 1998, Indonesia was a centralized, one

party dominant authoritarian country led by Suharto. Suharto, the military, and the one dominant political party, Golkar, were the central political players. Only two other political parties were allowed to exist and due to the penetration of the military and Golkar through the state apparatus of bureaucracy, although there were elections in order to elect members of the House of Representatives, the *Dewan Perwakilan Rakyat* (DPR), in fact, Golkar's unbeatable winning had not given any room for the other two existing political parties to alter the tenure of President Suharto. Thus, Suharto maintained a highly centralized political system during his presidency over thirty years. It is argued that the Suharto regime transformed from a hierarchical military regime (1965-74), to bureaucratic authoritarianism (1975-88), and finally to a sultanistic regime (1989-98) (Chandra and Kammen 2002).

After the installation of his own government, Suharto maintained Indonesia's repressed financial system in which state banks had played a dominant role. This repressed financial system during the 1960s and the 1970s was successfully reformed into a more liberalized financial system, and private banks became more important during the 1980s. However, as a result of the Asian financial crisis in 1997, state banks became dominant again. After the Asian financial crisis, moral hazard problems and the collusion between politicians and the banking sector in Indonesia were argued as one of the causes of the Asian financial crisis (Haggard 2000). After democratization, new fragile democratic governments had to implement financial reforms as a part of the IMF conditionality programs.

How have Indonesia's financial reforms evolved and why? How does politics relate to financial reform outcomes? Are macroeconomic conditions and the IMF programs the only factors which can explain financial reform outcomes in Indonesia? Have the banking sector and the manufacturing sector played important roles in explaining financial reforms in Indonesia?

How has the newly democratized government committed to financial reforms? In the following sub-sections, I examine financial reforms in Indonesia from 1965 to 2003, from the beginning of the Suharto regime to its graduation from the IMF programs. The years are divided into the five periods: 1) 1965–1982, 2) 1982–1996, 3) 1997–1998, 4) 1998–1999, and 5) 1999–2003.

Indonesia experienced four presidents from 1997 to 2003, when Indonesia was under the Fund conditionality programs. Despite that Indonesia was under IMF pressures to facilitate financial reforms, commitment to financial reforms varied from a government to a government. By examining temporal variation, I illustrate not only the IMF programs but the number of veto players and societal pressures matter in shaping financial reform outcomes. Also, I illustrate which dimensions of financial reforms were facilitated or hindered was also conditioned upon not only IMF programs but also domestic political factors such as the number of veto players and interest group pressures.

4.2.1. State controls over the banking sector via state banks: 1965–1982

At the time when General Suharto took office following a failed coup attempt in 1965, inflation reached 600% because of the former President Sukarno's populist stance. During the Sukarno era, foreign banks were nationalized, state banks financed government debts, and the state banks were amalgamated into one huge state bank, Bank Negara Indonesia (Rosser 2002, 53). The Suharto government had to ask for the IMF's assistance in 1966. Contrary to the pro-communist stance of Sukarno, the anti-communist stance of the Suharto government enhanced their credibility to commit to conditionality programs. Under the IMF's influence, the government adopted stabilization policies and also financial reforms. In 1967, a foreign investment code was adopted to attract foreign capital and controls on foreign exchange were removed (MacIntyre

1993). Further, a series of new banking laws in 1967 and 1968 dismantled Bank Nagata Indonesia into six separated state banks. Then, in 1969, foreign banks were permitted to enter the Indonesian financial market and allowed to operate banks in Jakarta. The IMF was influential in facilitating stabilization programs, opening foreign capital account, and facilitating banking reforms to some extent.

However, with regard to banking reforms, the impact of international financial institutions was limited. Indeed, Indonesia maintained a repressed financial system where state banks dominated its financial system from the 1960s on (Sato 2005; Hamada 2003). Figure 4.1, shown below, displays the lending ratio according to type of commercial banks: state owned banks, private banks, and foreign banks.

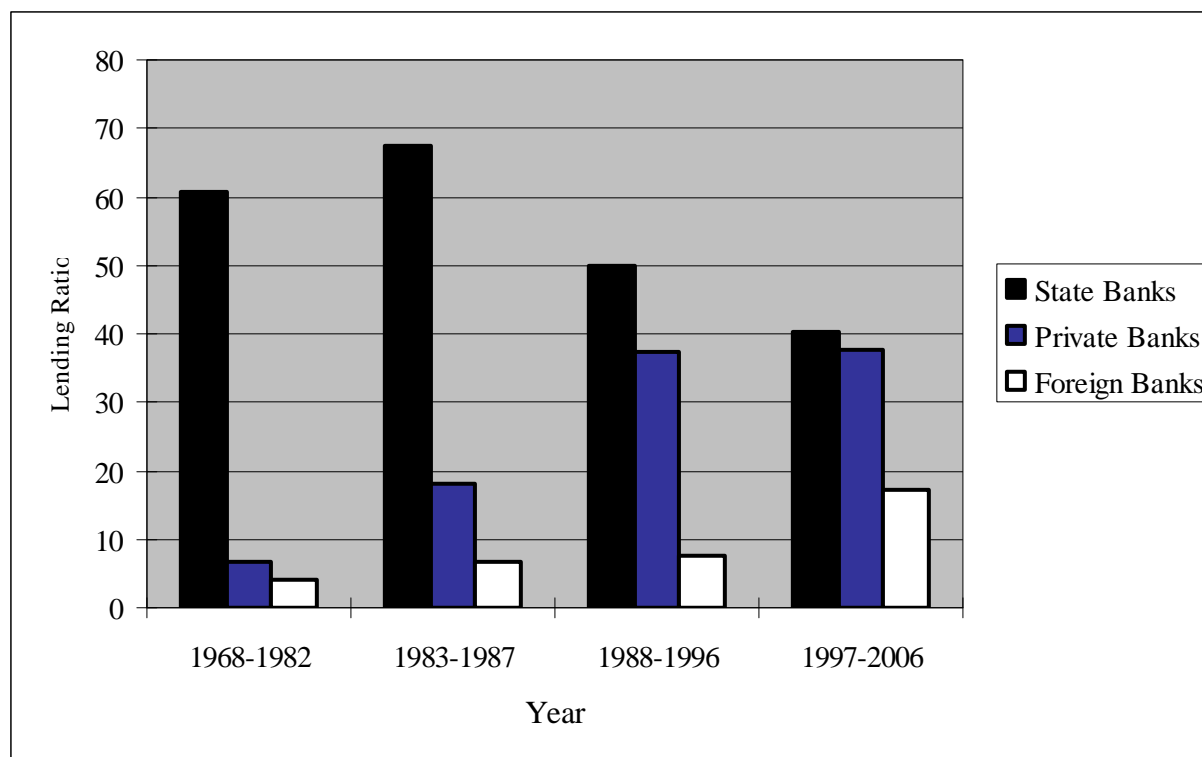


Figure 4.1 Lending Ratio by Type of Commercial Banks in Indonesia

Sources: Hamada (2003), *Indonesian Financial Statistics* (Bank Indonesia, various years), and the central bank's website, <http://www.bi.go.id/web/en/Data+Statistik/>, accessed on January 10, 2007.

As shown above, state banks were dominant from 1965 to 1982 and the lending ratio of state banks increased during the late 1960s and the 1970s. President Suharto increased control over state banks during this period. Direct and indirect credits were allocated through the central bank and state banks to farmers, indigenous firms, the manufacturing sector, and mid-term investment credits, for instance (MacIntyre 1993, 149). Moreover, facing opposition from domestic banks concerning the allowance of the new entry of foreign banks into the Indonesian financial market, new entry of foreign banks was not in fact permitted (Rosser 2002, 55).

During the 1970s Indonesia enjoyed an economic boom as an oil producing country. Backed by the increase in oil revenues, the government increased credit allocation with

subsidized interest rates to specific sectors (Sato 2005). Especially in 1974, after the Malari incident in which an anti-Japanese prime minister student demonstration triggered massive anti-foreign and anti-Chinese street riots, the government introduced preferential credits for *pribumi*, or the Malay people. Also in 1974 investment guidelines which favored *pribumi* business were issued.⁵⁰ Further, in 1979, President Suharto issued a decree that stated preferential credit allocation would be given to *pribumi* in government projects.

The Chinese businessmen lobbied the government not to apply the above investment guidelines (Sato 2003). As a result, even though it looked like the government favored *pribumi* business and not Chinese business using preferential credit allocation, in fact, these guidelines against Chinese business were never strictly enforced (Sato 2003, MacIntyre 1993, 152). On the contrary, during the 1970s, Chinese businesses grew as conglomerates based on their close connection with Suharto. Therefore, by expanding these preferential credit allocations via state banks, state bank officials, politicians, and bureaucrats nurtured ties not only with state corporations but also with business associates, mainly with Chinese businessmen (Rosser 2002, 58).⁵¹ Thus, the government strengthened its control over state banks during this period. Preferential credit allocation created political opportunities for the president and politico

⁵⁰ Investment guideline stated as follows; 1) foreign companies were able to set up joint ventures only with *pribumi* companies, 2) Existing foreign companies that had Chinese business as partners had to give majority ownership of shares to *pribumi*, or sell their shares on the stock market and 3) Companies owned by non-*pribumi* owned companies had to transfer majority shares to *pribumi* or sell their shares on the stock market (Sato 2003).

⁵¹ According to MacIntyre (1993), they were Liem Sioe Liong, Bob Hassan, and William Soeryadjaya, for example (152). Liem Soie Liong was the owner of the largest conglomerates in Southeast Asia, the Salim Group, and also owned the Bank Central Asia. Mohamad Hassan was the owner of the Bob Hasan Group, and William Soeryadjaya was the owner of Astra Group (Sato 1993, 409). For details of the Salim Group, see Sato (1993). Suharto's daughter, Tutut, and a son of Suharto had already become 30% shareholders in Liem Soie Liong's Bank Central Asia in the 1970s (Robinson and Hadiz 2004, 58).

bureaucrats, allowing them to allocate subsidized credits and business opportunities to connected individuals and growing Chinese conglomerates.

4.2.2. The first and the second financial liberalization: 1983–1996

The first wave of financial reform started in 1983. The collapse of oil prices in 1982 caused balance of payment problems. The government had to ask for IMF assistance and the Indonesian government implemented a reform package that included full interest rate liberalization for both deposit and lending rates in June, 1983 (Sato 2005, 98). Conglomerates supported these reform measures. Elimination of interest rate controls would make state banks less competitive so that conglomerates' private banks would be able to expand their business opportunities in the banking sector. However, with respect to the dimension of the elimination of credit controls, although the reform package included the scaling down of preferential credit allocation, these reforms did not progress much. The major reason for delaying reforms was opposition from state bank officials and indigenous business firms (Rosser 2002, 61-62). The President himself also opposed the elimination of credit controls because it meant that the government would lose important policy tools to favor close individuals (MacIntyre 1993, 159).

In October, 1988, after the second collapse of oil prices in 1986, the second financial reform package, PACT 88, was announced. PACT 88 included financial reform measures concerning the elimination of entry barriers on banks: 1) elimination of entry barriers against domestic banks, 2) elimination of entry barriers against foreign banks, 3) easing of branching restrictions, and 4) abolishment of functional specialization of banks (Sato 2005, 99; Sharma 2001, 86; Hamada 2003, 12–13). Furthermore, in November 1989, the ceiling of offshore

borrowing for banks was abolished and replaced by a net open position system and the limits on FDI inflow were abolished (United Nations 1999, 43).

As to more concrete policy measures, as a result of these reforms, new domestic banks could be set up by holding paid-up capital of 10 billion rupiah. Also, domestic banks could open branches all over Indonesia and foreign banks could open branches outside Jakarta. However, entry of foreign banks was only allowed through either the establishment of a joint venture with local banks or the acquisition of shares of domestic banks via capital markets (United Nations 1999, 40). With respect to the abolishment of functional specialization of banks, now private banks can establish development banks and also existing savings banks can become commercial banks (Hamada 2003, 12).

Table 4.1 shown below displays the number of commercial banks and the number of branches of commercial banks.

Table 4.1 The Number of Commercial Banks and Commercial Bank Offices

	State Banks		Regional Government Banks		Private Banks	National	Foreign and	Joint
	Number of Banks	Number of Offices	Number of Banks	Number of Offices	Number of Banks	Number of Offices	Number of Banks	Number of Offices
1985	7	783	27	201	69	390	11	21
1986	7	798	27	215	68	431	11	21
1987	7	817	27	228	65	464	11	21
1988	7	835	27	238	64	512	11	21
1989	7	860	27	269	63	644	11	21
1990	7	940	27	326	91	1460	23	40
1991	7	1044	27	408	129	2742	29	53
1992	7	1066	27	425	144	2855	30	56
1993	7	1076	27	426	161	3036	39	75
1994	7	1171	27	431	166	3203	40	83
1995	7	1301	27	446	165	3458	41	83
1996	7	1379	27	490	164	3964	41	86
1997	7	1527	27	541	144	4150	44	90
1998	7	1602	27	555	130	3976	44	121
1999	5	1579	27	554	92	3581	40	93
2000	5	1506	26	550	81	3228	39	95
2001	5	1522	26	574	80	3332	34	92
2002	5	1574	26	562	77	3336	34	90
2003	5	1669	26	613	76	3555	31	107

Sources: *Statistical Yearbook of Indonesia* for years from 1985 to 1992 (Badan Pusat Statistik various issues). Entries are as of March in each year. *Indonesian Financial Statistics* from 1993 to 2003 (Bank Indonesia various issues).

As shown above, a rapid increase in the number of banks and the number of offices can be observed, especially in private national banks, as a result of the reforms in 1989. In 1989, the number of private national banks was 63 and the number of offices of private national banks was 644, which increased to 144 and 4150, respectively in March, 1997, soon before the onset of the Asian financial crisis. Also, as can be seen in Figure 4.1 in the previous sub-section, the lending ratio of private banks rapidly increased after 1988. The average lending ratio of private banks rapidly increased from 18.1% during the period 1983 to 1987 to 37.5% from the period 1988 to 1996. In fact, in 1994, the lending ratio of private national banks (38%) surpassed that of state banks (35.3%). Thus, the elimination of entry barriers in 1988 resulted in the development of private banks. Conglomerates hurried to establish their own banks to finance their own projects (Sato 2003, 23).⁵² Each of the large conglomerates came to possess at least one bank (United Nations 1999, 40) and these business affiliated banks became the major players in the banking sector (Sato 2005, 100).

The reason why these financial reforms concerning the elimination of the entry barriers on new banks and the easing branching restrictions were possible was precisely because these reforms were supported by conglomerates (Rosser 2002, 61). The elimination of entry barriers and erasing of branching restrictions as well as the access to global financial market by liberalizing capital inflow provided new business opportunities for conglomerates to expand their business not only to telecommunications, public utilities, and transportation but also into the banking industry. Thus, conglomerates came into the banking sector, which provided them with lucrative opportunities to finance mega projects in the area of infrastructure as well as the

52 For example, the Sampoerna cigarette manufacturing group established Bank Sampoerna, a medium size bank, in August 1989 to finance other within-group firms. After the Asian financial crisis, Bank Sampoerna was taken over by Bank Danamon (Rosser 2002, 73).

manufacturing sector (Robinson and Hadiz 2004, 73). In fact, the Suharto family linked with Chinese conglomerates in running mega projects. Under these circumstances, concerning mandatory preferential credit allocation to specific sectors, except subsidized credits to the agricultural sector, mandatory preferential credit allocation was eliminated in 1990 and strict state controls over the banking sector in terms of credit allocation ended (Sato 2005).⁵³

In 1992, the Banking Law was amended with the aim of enhancing banking supervision over the banking sector. The amended 1992 Banking Law included the following reform measures: 1) the restriction of the aggregate amount of group lending to 20% of bank capital, 2) a tripled minimum capital for giving licenses to banks in order to engage in foreign exchanges, 3) an increase in capital adequacy ratio from 8% to 12%, and 4) the introduction of the CAMEL system for monitoring banks' risks including on-site examination (Sharma 2001, 89).⁵⁴

However, despite these legal amendments, which met with international standards concerning banking supervision, the inter-connected lending within the group firms did not halt. Given the high stakes for the Suharto family, state bank officials, and conglomerates, they strongly opposed these regulatory reform measures and so reforms on the enhancement of banking supervision were not effectively enforced (Robinson and Hadiz 2006, 121). The central bank was also institutionally dependent on the government, which made supervision

⁵³ Nonetheless, it is worth noting that state banks also continuously played a role in providing credits, even with the development of private banks. Especially state banks funded a series of mega projects related to the Suharto family including automobiles and petrochemicals (Robinson and Hadiz 2004, 80).

⁵⁴ CAMEL was developed to objectively evaluate banks' risks when supervisors conduct on-site examinations. CAMEL refers to Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity. CAMEL was originated from the methods of US banking supervision and is now regarded as the international standard to objectively monitor banks' risks. For a detailed explanation of the CAMEL rating system, see Yokoi-Arai (2002, 30–43).

implementation harder, despite its neoliberal economic orientation.⁵⁵ As a result, the implementation of these measures was quite lax.

Before the Asian financial crisis, it was already recognized that the bank problems caused by inter-connected lending behavior had reached an unacceptable level. Private banks owned by major business figures such as Tutut, Bob Hasan, Ibnu Sutowo, Prajogo Pangestu, and Liem Sioe Liong, and Sudwikatmono held an excess amount of inter-connected loans beyond the 1995 legal targets (Rosser 2002, 75). However, while Bank Summa, owned by Soeryadjaya, the eldest son of the largest automaker Astra Group, was closed due to bad loans accumulated because of inter-connected lending, Bank Duta was rescued because Bank Duta was owned by foundations that were well-connected with Suharto (Sato 2005, 101-102).

In the cases of state banks, the problems were the lack of repayment by borrowers. State banks also had problems of non-performing loans caused by risky lending behavior. Because of the collusion between state bank officials and borrowers, well-connected borrowers did not pay back their debts. For example, a leading textile manufacturing firm, Dritex, failed to pay back its debts to state banks (Rosser 2002, 80).⁵⁶ The risky lending behavior of Indonesian state banks and private banks in addition to inconsistent the bailing out practices by the Indonesian government mentioned above made up the Indonesia's moral hazard problem, which were blamed as one of the major causes of the Asian financial crisis.

Thus, under the highly centralized Suharto authoritarian regime, the *pace* of financial reforms or which dimension of financial reforms had been facilitated or delayed, was determined

55 In fact, although lower ranking central bank officials were promoted based on merits, high ranking central bank officials were dependent on Suharto's order in deciding economic policy in a critical moment (interview with the Bank Indonesia's central banker, Wimboh Santoso, on March 2005).

56 Concerning other examples of bank problems before the crisis, see Pangestu and Habir (2002).

depending upon whether financial reforms fit the vested interests centered on Suharto, which included state bank officials and Chinese conglomerates as well as *pribumi* (indigenous) conglomerates.

Overall, the dimensions of capital account liberalization, interest rate liberalization, elimination of credit controls, and elimination of entry barriers were accelerated dimensions supported by conglomerates, in which the manufacturing sector's interests were represented as major conglomerates' activities. Conglomerates wanted to expand their access to credits by liberalizing interest rates, eliminating credit controls, and capital accounts. Also, they welcomed the move toward the elimination of entry barriers that provided them with a chance to set up new banks to enhance access to credits for related groups. On the other hand, the dimension of the enhancement of banking supervision was the delayed dimension facing opposition. The enhancement of banking supervision was opposed by the conglomerates as well as both private banks and state banks. Despite the mounting problems of banks, the Suharto government, backed by colluding banks and firms, did not undertake effective measures on banking supervision to handle these problems but rather postponed taking necessary measures.

4.2.3. The Asian financial crisis and the demise of the Suharto regime: 1997–1998

The Asian financial crisis started in Thailand in July, 1997 had spread into neighboring countries including Korea and Indonesia. Following Thailand's move that allowed the Thai baht to float on July 2, 1997, Indonesian rupiah faced foreign currency pressures. The early move of the Indonesian government to abandon the pegged exchange rate regime on August 14, 1997 was initially welcomed by the IMF in an issued statement (IMF 1997a). However, the crisis did not

stop. Banks were not able to fully repay their unhedged liabilities in foreign currency due to the rupiah depreciation. High interest rates worsened banks' liabilities and corporate distress worsened banks' asset values (Pangestu and Habir 2002, 16). These banking problems soon resulted in a systemic banking crisis.

The Indonesian government contacted the IMF on October 8 on Suharto's instruction. After short negotiations between the IMF and Suharto's economic team from October 13–31, they reached agreement on the first IMF stabilization package as the first Letter of Intent (LOI), on October 31, 1997. This first IMF November package was a three-year standby agreement for 10.14 billion US dollars, with immediate disbursement of 3.04 billion US dollars. The first LOI included macroeconomic stabilization measures such as setting the budget surplus target as 1 % during 1998/1999 as well as structural reform measures, including financial sector reforms (IMF 1997b).⁵⁷ Especially, the following financial reform measures were included as performance criteria: 1) closure of banks that did not submit rehabilitation plans by the end of December or whose plans were disapproved by the central bank, and 2) a quantitative target for state banks based on the agreement between the MOF, the central bank, and state banks by the end of December (IMF 1997c). The list of the LOI by the Indonesian government after the onset of the Asian financial crisis was appended as Appendix 4.A.

On November 1, 1997, as a part of the conditionality programs, 16 insolvent banks (2.5 % of the market share) were closed. However, the lack of public announcement of the contents of the first LOI, the unclear standards for the closure of banks, and the lack of full

57 Included financial reform measures were: the immediate closure of 16 insolvent banks, the merger of state banks as preparation for privatization, auditing of state banks by an internationally recognized auditing firm, submission of a rehabilitation plan for banks to the Central Bank, elimination of credit allocation to specific sectors, and legal amendments to set up exit rules of banks, etc. (IMF 1997b).

deposit guarantee raised the public's concerns, with the public correctly suspecting that other major banks might also be insolvent (Enoch 2000, 6–7). Further, the collusion between the Suharto family and banks continued and these Suharto-related bank owners resisted the IMF conditionality programs being implemented. The owner of one closed bank, a son of Suharto, challenged the bank closure and was ensured he could continue his business under a different name (Robinson and Rosser 2000, 179). This caused further the loss of public confidence. As a result, bank run occurred in two-thirds of the 222 banks by the end of November 1997 (IMF 2003a, 75).

Initially, the IMF felt that the structural conditionality was a good opportunity to assist with structural reforms in Indonesia, where the IMF recognized rent-seeking problems in its surveillance (IMF 2003a, 76). However, Suharto lacked commitment to the conditionality programs, and the IMF evaluated that no performance criteria had been implemented fully in its first assessment in December, 1997. Though the plan of the merger of four state banks and the allowance of the merger by foreign banks were announced on December 31, 1997, these announcements were not effective at restoring public confidence (Kenward 2002, 56–57).

The January IMF package was announced on January 15, 1998 in the midst of a further loss of market confidence as a result of the proposed government's fiscal budget, which did not meet the IMF target. At that time, bank runs continued and the “financial sector meltdown became increasingly real” (Enoch et al. 2001, 32).⁵⁸ Though, the second LOI did not include financial reforms, the IMF stated that a plan for banking sector restructuring had been formulated and would be announced shortly (IMF 1998d). Following this promise, the government took

58 Rupiah depreciated continuously from 4,600 rupiah per US dollar in December, 1997 to 14,000 rupiah per US dollar by the end of January, 1998. Depositors withdrew their deposits in dollars and the central bank continued to provide liquidity support, which reached 6% of GDP.

measures upon approval from the IMF and announced an emergency plan to stabilize the banking sector on January 27, 1998 which included: 1) a blanket guarantee of deposits (Presidential Decree No.26 of 1998), 2) the establishment of the Indonesian Banking Restructuring Agency (IBRA) (Presidential Decree No.27 of 1998), and 3) corporate restructuring. The IBRA was established for the purpose of supervision and bank restructuring (Kenward 2002, 68–69). The roles of the IBRA were to close, merger or take over, and recapitalize banks. Banks who failed to submit rehabilitation plans would be taken over by the IBRA. Also, the IBRA aimed to recover banks' bad loans by selling corporate assets transferred by bank owners as collateral for emergency central bank liquidity credits (Pangestu and Habir 2002, 19).

The first round of bank restructuring was conducted on February 14, 1998. The IBRA consulted with bank owners of 50 private and regional development banks and 4 state banks that had received 200% of liquidity support of their capital. These bank owners agreed to transfer these banks' assets to the IBRA. However, these IBRA operations were treated as confidential, so the public was unaware of them and the impact of these operations was very limited. Further, despite the IMF's suggestion that the IBRA should be an autonomous body, the IBRA was placed under the MOF's authority (Enoch et al. 2001, 75–76), and so was dependent on the MOF.

Suharto's idea concerning the adaptation of the currency board system, the lack of enough implementation of the second IMF package, and re-election of President Suharto further aggravated crisis situation. On March 10, 1998, Suharto was re-elected as President for a seventh term. Suharto announced cabinet members who were business partners close to him such as Bob Hasan, who was the owner of conglomerates and Tutut, his daughter (Robinson and Rosser 2000, 182).

The negotiations between the IMF and the government for the third IMF package started on March 16. At this time, the Fund sent a strengthened staff team for negotiation.⁵⁹ Moreover, the Fund changed its method of money disbursement. Instead of releasing three billion US dollars at one time, the Fund decided to disburse one billion US dollars three times, dependent upon the degree of implementation of the conditionality programs based on the assessment of monthly reviews (Kenward 2002, 83–84). Further, the Fund asked for a prior action by the IBRA, before the third package into effect, to demonstrate the IBRA's independence in bank restructuring operation. Therefore, on April 4, 1998, the second round of bank restructuring was conducted by the IBRA. The IBRA took over seven large banks: one state bank (Bank EXIM) and six major private banks. In addition, seven other small banks that borrowed more than 500% of their capital were closed (Pangestu and Habir 2002, 20). Contrary to the first round of bank restructuring, this time, the criteria to close banks were publicly announced and the operation went smoothly. However, while the IBRA was able to transfer the banks' liabilities, the IBRA was unable to control the banks' assets due to the delay in amending bank laws (Enoch 2000, 13–14).

The third IMF package announced on April 10, 1998 included the banking sector restructuring by the IBRA as a prior action as mentioned above. In addition, other financial restructuring measures such as the complete transfer of problem loans to the IBRA's asset management unit, the merger of Bank Bumi Daya and BAPINDO, and the elimination of restrictions on foreign ownership of banks, for instance, were included (IMF 1998c). However, despite the IMF intention to strengthen the role of the IBRA, on April 22, eight banks were

⁵⁹ The team head was led by the Director of the Asia and Pacific Department, for example, and Stanley Fisher continued to play an active role. "The Fund seemed to be throwing all possible resources at this round of negotiation" (Kenward 2002, 83–84).

released from the control of the IBRA without consultation with the IMF. This caught the Fund's attention, and they asked for clarification of the exit policy of the IBRA (Kenward 2002, 91). In the end, the exceptional treatment was reversed for only four banks out of the eight (Enoch et al. 2001, 36). Further, the restructuring of 54 troubled banks in which bad debts had been transferred to the IBRA in February 1997 had been slipped out of the government's main reform agenda because of lobbying by some bank owners (Enoch 2000, 16). Finally, on May 21, 1998, the incidence of riots due to cuts in basic commodities and students' deaths in the midst of the anti-Suharto demonstration, all led to the demise of the Suharto regime that had lasted for the past thirty two years.

During this period, despite the fact that Indonesia was under the IMF conditionality programs, financial reforms addressed in the IMF conditionality programs tended to be delayed due to collusion between the Suharto family and well-connected business associates. Banking restructuring measures to resolve banking problems were repeatedly delayed and/or had a loophole in order to protect vested interests of banks and conglomerates. However, despite these problems, the establishment of the IBRA was a major achievement for the enhancement of banking supervision under the IMF conditionality program.

4.2.4. Financial reform under Habibie presidency: 1998–1999

After Suharto was ousted from the power on May 21, 1998, Vice President Habibie succeeded him as president. The Habibie government committed to financial reforms than the Suharto government. Under a deepening economic crisis and rising social demands for political liberalization soon after the demise of the Suharto government, he had little choices but to abide

by the reform agenda set in the IMF conditionality programs. The new cabinet immediately committed to notable changes in banking reforms.⁶⁰ The first change was to take over Bank Central Asia (BCA). The May riot, which had led to the demise of Suharto's New Order regime, had triggered a massive bank run on BCA, the largest private bank in Indonesia, owned by the Salim Group, the largest conglomerate in Southeast Asia. BCA was taken over by the IBRA on May 29, 1998. Shareholders' rights were suspended and the management was changed (Pangestu and Habir 2002, 21).

The government announced the IMF package on June 24, 1998 and policies were listed as the second supplementary memorandum of economic and financial policies. In this round of negotiation, it was decided that monthly reviews would continue and the amount of money to be disbursed was increased from 10 billion US dollars to 11 billion US dollars (Kenward 2002, 101). This IMF package included the following financial reform measures: 1) submission of a draft for the amendment of banking laws by August 31, 1998 and 2) submission of a bill to eliminate restrictions on foreign investments in listed banks by June 30, 1998 (IMF 1998b). The new government had changed the role of the IBRA from both supervision and restructuring of banks to bank restructuring exclusively while the supervisory function of banks had been returned to the central bank. Also, the Asset Management Unit was established within the IBRA (Enoch et al. 2001, 77).

During the spring and summer of 1998, international audit firms had conducted portfolio reviews of banks that had been taken over by the IBRA in April 1998. The results of these

60 Unlike the final cabinet of the Suharto government, where cronies occupied the important posts, Habibie allocated major posts to economic technocrats. Habibie ensured the continuation of the post of Coordinating Minister of the Economy, Ginandjar Kartasasmita, who was the most trusted by the IMF in the Suharto cabinet. Also, a highly respected economist, Professor Widjojo Nitisastro at the University of Indonesia, was appointed as an economic advisor (Sharma 2001, 105). For further information, see Johnson (1998, 10).

portfolio reviews were leaked to the press in June 1998. They revealed that the banking sector as a whole was seriously insolvent and immediate actions were necessary to restore the banking sector (Sharma 2001, 105–106),⁶¹ which shocked the public as there was no excuse for the banks under investigation to be insolvent. In these circumstances, the IBRA conducted the third round of banking restructuring on August 21, 1998. Three banks (Bank Umum Nasional, BDNI, and Bank Modern) were closed and their deposits were transferred to the state bank. Further, anticipating the merger of four state banks in preparation for privatization, Bank Mandiri was established (Enoch et al. 2001, 127). In July 1998, the IMF programs were changed from a stand-by agreement to an extended fund facility (EFF). The repayment period was extended accordingly from 3.25–5 to 4.5–10 years (Kenward 2002, 106).

As a big step forward for the enhancement of banking supervision over the banking sector, the new Banking Law replaced the Banking Law of 1992 on November 10, 1998. The amendment allowed 100% foreign ownership of shares of banks in line with the IMF program. Also, the power to give bank licenses was transferred from the MOF to the central bank. The central bank was empowered to set regulations concerning bank branches (Yokoi-Arai 2002, 149–150). Also this amendment gave the necessary legal power to the IBRA to do its job. With this amendment, the IBRA was empowered to transfer assets against a debtor. Furthermore, new regulations were issued concerning loan classification, provisioning, and debt restructuring (Sharma 2001, 106).

Also, a legal amendment to ensure central bank independence, which was listed as performance criteria in the LOT dated on July 29, 1998 (IMF 1998a), was achieved under the Habibie presidency. Upon consultation with the IMF and with the former Governor of

61 Non performing loans of six banks which were taken over reached 55% on average and one was 90% (Pangestu and Habir 2002, 22).

Bundesbank, Helmut Schelsinger, the MOF and the central bank prepared the amendment bill by the end of 1998. The bill was brought to the parliament and after five months deliberation by Commission VIII, the bill was passed in the DPR Assembly on April 14 and became effective on May 17, 1999 (Ali et al. 2003, 85). As per this new Central Bank Act (Act No. 23 of 1999), the central bank was free from intervention by the government. Supervision over the banking sector was defined as the purpose of the central bank as well as the ensuring of macroeconomic stability. Also, the legal base for the establishment of the IBRA was articulated (McLeod 1999, 148). Before the democratic election held in June 1999, the parliament had consisted of three main political parties: Golkar, the United Development Party (PPP), and the Indonesian Democratic Party- Struggle (PDI). Golkar de facto dictated parliament with 80 % of the seats, including appointed military and other appointed representatives and was not constrained by any other opposition parties. Thus, with respect to the dimension of the enhancement of banking supervision, the new Habibie government was able to conduct reforms upon close consultation with the IMF that prioritized the central bank independence as was necessary in its conditionality programs.

However, banking restructuring reforms where bank owners' individual interests were more at stakes tended to be delayed. The IBRA developed a comprehensive recapitalization plan for private banks in September 1998, in which banks were categorized based on capital adequacy ratio (CAR), and when bank owners were not able to inject sufficient capital to push up the CAR to a defined level, banks would be taken over by the IBRA. Banks were categorized as "Category A" when banks had a CAR of above 4%, and banks could then resume operations. Banks were categorized as "Category B" when the CAR was between 4% and -25%. Bank owners were subject to the program. They could inject 20 % of new capital to obtain a 4% CAR.

“Category C” banks were banks where the CAR was below –25%. Owners were given time to inject capital to push up the upper categories and if they failed to do so, banks would be taken over by the IBRA (Pangestu and Habir 2002, 23).

Although, the plan itself was finalized by the end of December 1998, the announcement of the results of bank audits and the implementation of take-over were postponed until the end of February, 1999. Moreover, further postponing due to a lack of consensus concerning the treatment of a few banks caused a negative market reaction since it suggested obvious political interference (Pangestu and Habir 2002, 23; Enoch 2000, 20–21).⁶² The IMF was aware of these delayed restructuring processes and demanded the appropriate closure of banks as a condition for the disbursement of the 43 US billion dollars agreed upon (Sydney Morning Herald 1999).⁶³

Finally, the audit information was released on March 13, 1999. Out of the 150 audited banks, 54 banks were ranked as “Category A”, 56 banks as “Category B”, and 40 banks as “Category C”. Although all state banks except one were ranked as Category C, the state banks were not closed but rather restructured by injection of capital. Four state banks (Bank Ekspor Impor Indonesia, Bank Bumi Daya, Bank Dagang Negara, and Bapindo) were merged into Bank Mandiri (Cameron 1999, 21) on July 31, 1999.

On that day, the IBRA conducted the fourth round of bank restructuring. Thirty eight banks were closed and 8 banks were taken over (Enoch et. al 2001, 127). Nonetheless, banking restructuring reforms such as settling on a bank rehabilitation plan between owners’ of banks and the IBRA tended to be delayed. Since the individual stake was high for powerful business figure,

62 Bakrie Group’s Bank Nusa Nasional was not closed despite the fact that its CAR was –230%. Instead of closure, Bank Nusa Nasional was rather taken over by the IBRA. It was believed that the reason for this special treatment was because the bank owner, Mr. Bakrie, had a close relationship with President Habibie and the Economy Minister (Greenlees 1999).

63 “Indonesian Banks Win Another Reprieve.” The Sydney Morning Herald, 5 March 1999.

bank share-holders tended to resist the repayment of their liquidity supports. For example, Bob Hassan, a shareholder of Bank Umum Nasional, repeatedly postponed a meeting with the IBRA regarding the repayment of liquidity support to the IBRA (Tripathi and Murphy 1998, 58). Further, recapitalization programs and the injected money to rescue banks themselves became lucrative opportunities for politicians and bank owners. In August, 1999, the IBRA claimed that 80 million US dollars used to fund a recapitalization program for Bank Bali was missing. Later, it became apparent that the money was paid to a firm owned by a Golkar's deputy treasurer, Satya Novanto, in exchange for the rescue of other banks (Rosser 2002, 188). In this "Baligate" scandal, not only Golkar politicians but also officials of the IBRA, the Bank of Indonesia, and the Ministry of Finance were believed to be involved. As a result, Habibie suspended the Finance Minister, the governor of the central bank, and others. The IMF, World Bank, and the Asian Development Bank expressed that the disbursement of money would be dependent upon the result of investigation of Baligate by outsiders (Landler 1999). Thus, bank restructuring processes were delayed due to collusion between politicians and conglomerates as banking owners.

Nevertheless, despite these delays in hindsight, the Habibie government committed to financial reforms more strongly than the former Suharto government, especially in the dimension of the enhancement of banking supervision over the banking sector such as ensuring the legal independence of the banking supervisory agency, ensuring the power of the banking supervisory agency to issue and revoke licenses of banks, and in the dimension of the elimination of entry barriers on foreign banks. Facing the end of New Order regime and realizing the inter-rim nature of the Habibie government, "Habibie has little alternative but to appropriate the mantle of reformism, pre-empting more radical agendas for a fundamental dismantling of the regime and

its institutions (Robinson and Rosser 2000, 186).” Knowing that the IMF’s disbursement would be conditioned upon the results of monthly reviews and the banking sector as a whole was de facto insolvent, there was little room to oppose the amendment of the Banking Law. Thus, in terms of the dimension of the enhancement of banking supervision, especially in the dimension that related to the institutional reform of the banking supervisory agency, the Habibie government facilitated reforms because they faced IMF pressure in the form of monthly reviews as conditions of money disbursement.

4.2.5. Post crisis financial reforms under fragile new democracies: 1999–2003

The first democratic election was held on June 7, 1999. The People’s Consultative Council or *the Majelis Permusyawaratan Rakyat* (MPR), 462 out of 700 of which consisted of elected congresspersons of the DPR, convened in October, 1999. The MPR was the supreme body to elect the president and amend the constitution. The 700 members of the MPR consisted of 500 members of the DPR (462 elected congresspersons and 38 appointed military members), 135 regional delegates, and 65 appointed social delegates (Crouch 2000, 116). Therefore, at this time, the president was not elected by direct election but rather elected by the MPR. In this vein, although the MPR once served as an organ to “elect” President Suharto, once it mainly consisted of elected DPR members, Indonesia’s political system became closer to a parliamentary system.⁶⁴ The election results of the DPR for the June, 1999 election is shown as Table 4.2 below.

⁶⁴ This constitutional rule was amended in 2002 and a direct presidential election was held in 2004. Also, 38 seats for appointed military officers in the DPR were abolished. For details of constitutional amendments and electoral rules, see (Sherlock 2004).

Table 4.2 Results of the DPR Election in June 1999

Political Party	No. of Seats	Seat Share
Indonesian Democracy Party-Struggle (PDI-P)*	153	30.6%
Golkar*	120	24%
Unity and Development Party (PPP)*	58	11.6%
National Awakening Party (PKB)*	51	10.2%
National Mandate Party (PAN)*	34	6.8%
Crescent and Star Party (PBB)*	13	2.6%
Justice Party (PK)*	7	1.4%
Love the Nation Democratic Party	5	1%
Nahdlatul Ummat Party	5	1%
Justice and Unity Party	4	0.8%
Indonesian Democratic Party	2	0.4%
10 parties (1 each)	10	0.2% each
Military (Appointed)	38	7.6%
Total	500	100

Source: *Political Handbook of the World 2000-2002*, 507. * shows political party which obtained cabinet posts in the first Wahid government.

In the election for president, Habibie made an accountability speech seeking re-election on October 14 and was rejected by a narrow margin. On October 20, 1999, the assembly elected Abdurrahman Wahid as president and Megawati Soekarnoputri as vice president (McIntyre 2005, 129). Though Abdurrahman Wahid was elected as the president, his National Awakening Party (PKB) did not secure a majority of seats. His party, PKB, was not even a leading party and ranked as fourth, as shown in Table 4.2 above. Rather, Vice President Megawati Soekarnoputri's party, PDI-P, was the leading party.⁶⁵ Upon consultation with Megawati

⁶⁵ However, Megawati Soekarnoputri's presidency was not supported by Amien Rais's National Mandate Party (PAN), which had a loose alliance with other Muslim parties. Habibie was not supported by the Golkar itself when Akbar Tanjung, the chairman of the Golkar, was offered the

Soekarnoputri (PDI-P), Amien Rais (National Mandate Party), Akbar Tanjung (Golkar), and General Wiranto (military), Abdurrahman Wahid formed the National Unity cabinet, which included all the main political parties. Cabinet posts were allocated to PKB, PDI-P, Golkar, PAN, PPP, PK, and PBB as well as the military and non-party affiliates (Crouch 2000, 120). Key cabinet posts, such as the Coordinating Minister of Economy, Finance, and Industry, the Minister of Finance, and the Minister of Industry and Trade, were allocated to Kwik Kian Gie (PDI-P), Bambang Soedibyo (PAN), and Jusuf Kalla (Golkar) respectively. The post of Foreign Minister was allocated to the PKB and the post Minister of Investment and State Enterprise to Laksamana Sukardi (PDI-P) (Soesastro 2000, 138).

A critical task for the new Wahid Government was to restructure banks,⁶⁶ which was also the IMF's priority in its conditionality programs. On January 20, 2000, the new Indonesian government canceled the previous EFF and signed a new arrangement for a three-year EFF (IMF 2000A). It was expected that the new Wahid government would commit to financial reforms. However, unfortunately, it turned out that Wahid did not demonstrate strong leadership, and the lack of coordination among cabinet members in economic policy-making became obvious (Soesastro 2000, 138). "Fragmentation of the cabinet was reflected in the fragmentation of economic decision making authority between a number of competing cabinet ministers and their outside advisers (Sharma 2001, 110)." Under these circumstances, the disbursement of the IMF money was postponed in March, 2000.

post of vice president by Megawati Soekarnoputri in the negotiation process in electing the president. For more information on alliance formation in the presidential race, see (Soesastro 1999; Crouch 2000; Vatikiotis and McBeth 1999).

⁶⁶ The cost for the government in issuing government bonds to finance liquidity supports reached 50 billion US dollars, and the total amount for bank restructuring reached 90 billion US dollars or 85% of the GDP as of 2000 (Soesastro 2000, 136). The IBRA had to maximize its revenue by selling the assets of taken over banks.

It turned out that Wahid lacked the necessary administrative skills to be an effective president. His frequent absence due to visits abroad led members of the cabinet to question his competency (Budiman 2001).⁶⁷ In addition, Wahid's frequent dismissals of cabinet ministers led to further questioning about his capability to take the initiative in policy making among coalitions. Wahid dismissed two major political figures such as Hamzad Haz (party leader of the third ranked political party, PPP), and General Wiranto (the most prominent military officer in supporting democratization processes). Furthermore, in April, 2000, Wahid dismissed two economic ministers: Laksamana Sukardi (PDI-P) from the Minister for Investment and State Enterprises, and Jusuf Kalla (Golkar) (Gorjao 2003, 31). In addition, Wahid dismissed the Governor of the Central Bank, Syahril Sabirin, and placed him in detention in June, 2000, which was openly criticized by the Fund.⁶⁸ Facing strong demands from major political parties in an annual session of the MPR in August, 2000, Wahid agreed to transfer his daily duties of preparing the cabinet's working agenda and determining the focus and priorities of the government to the vice president, Megawati. However, Megawati refused the proposal since she rather wanted a formal decree from the MPR. But this was not acceptable to Wahid since if the decree was issued by the MPR, Wahid would become a mere ceremonial president (Gorjao 2003, 35).

Wahid did not give up the presidential power to appoint cabinet members. A new cabinet was announced without consultation with Megawati in August, 2000. The new cabinet members did not include any PDI-P members except vice president herself and Golkar, but rather

⁶⁷ Wahid visited 50 countries within five months after inauguration (Budiman 2001, 146–147)

⁶⁸ Syahril Sabirin was released and resumed his job as the Governor of the Central Bank in December, 2000 (Dick 2001, 12).

appointed persons who were close to Wahid.⁶⁹ Though Megawati did not explicitly criticize Wahid, she was absent when Wahid announced the new cabinet.⁷⁰ After Wahid survived the annual session of the MPR in August, 2000, various proposals were considered to facilitate the coordination between Wahid and Megawati, though they did not work out (Gorjao 2003, 35–36). Further, Wahid reshuffled the cabinet five times between June, 2001 and mid-July, 2001 (Lanti 2002, 116), which was an extraordinary amount.

These dismissals of cabinet members were not because Wahid wanted to facilitate reforms by exclusively handling cabinet posts. Rather Wahid wanted to maximize lucrative opportunities to nurture ties between his party or himself and close business associates. For instance, Laksamana's dismissal was believed to be because Laksamana revealed the fact that Marimutu Sinivasan, the owner of the Texmaco conglomerate, who violated a banking regulation by receiving a loan of 1.2 billion dollars as Suharto's friend in 1997, donated money to an Islamic organization that Wahid represented (McIntyre 2005). In addition, though the official reason for the dismissal of the central bank governor, Sabirin, was that he was a suspect in the Bank Bali case, it was believed that his dismissal was really because the central bank refused Wahid's preferred candidate in replacing the top management of state banks because of the failure of fit and proper test (McLeod 2000, 8). Furthermore, it turned out that President Abdurrahman Wahid himself became the center of a series of corruption scandals, the so called "Buloggate", "Bruneigate", and "Borobudurgate".⁷¹

69 The other political parties in the cabinet were PPP, PKB, PAN, PBB, and PK (Shiraishi 2003, 7).

70 Wahid explained Megawati's absence was because she wanted to take a shower and stated that one could not stop if a woman wanted to take a shower (Budiman 2001, 148).

71 The first scandal "Buloggate" indicated the incident where money (35 billion rupiah or about four million US dollars) was disbursed from the staff pension fund of the Bulog, the state logistic agency, due to the pressure from "president". Bulog's deputy was arrested. Wahid's masseur,

Due to this paralyzation of politics, the implementation of the IMF package was also delayed. The dismissal of Sabirin caused an interruption in the IMF review. The IMF wanted to protect central bank independence while the Wahid government wanted to intervene. The relationship between the IMF and the Wahid government rapidly deteriorated toward the end of 2000 (Djiwandono 2003, 210). Wahid and the Coordinating Minister for Economic Affairs, Rizal Ramli, desperately sought other solutions such as future sales of oil and gas, for instance, to finance government deficits rather than asking for a rescue package from international financial institutions. The government continued to portray the IMF as foreign body imposing unrealistic conditions (Dick 2001, 10–11).

Further, banking restructuring and the sale of assets of banks, namely the dimension of privatization of banks, tended to be hampered. Although the IBRA had sold 22.5% shares of BCA in May, 2000 (McLeod 2000, 24), and a further 10% in July, 2000 (Siregar 2001, 296), additional share sales of Bank Central Asia (BCA) and Bank Niaga was rescheduled to occur in the first half of 2001 rather than late 2000 (Dick 2001, 21). Although the target of the IBRA's sale for the 2001 budget was to obtain 37 trillion rupiah from asset sales and bank restructuring, only one-third of the target, 8.6 trillion rupiah, was achieved (Lanti 2002, 125). The chair of the IBRA also was changed in June, 2001, with this being the sixth head of the IBRA in the three years since its establishment in 1998.⁷² The lack of cooperation from former owners of banks, who were all well known conglomerates, continued and delayed bank restructuring and IBRA's

Suwondo, was argued to be involved in this incident. The second scandal, "Burneigate" was that Wahid received two million US dollars from the Sultan of Brunei and failed to report it to the state treasury. Though it was explained that this money was for charity in Aceh, the money did not go to the government but went to a project run by his political party (McLeod 2000, 7–8). The third scandal, "Borobudurgate" refers to the name of the hotel where Wahid met Suharto's son, Tommy, who was seeking a pardon from the president (Budiman 2001, 149).

⁷² I Puty Ary Sita replaced Edwin Gerungan in June, 2001 (Siregar 2001, 295).

asset recovery processes (Dick 2001, 23). Moreover, the program reviews by the IMF were often postponed and there was no disbursement of loans from September, 2000 to August, 2001. Finally, in a special session of the MPR held on July 21, 2001, President Wahid was impeached due to failure to provide enough evidence to prove he was not involved in scandals. On the same day, Vice President Megawati succeeded to the presidency.⁷³

Megawati's cabinet, announced on August 10, 2001 was called the "Dream Team" because of the allocation of posts to a combination of technocrats and coalition partners (Sadli 2003, 193). Hamzah Haz, a leader of the Muslim United Party (PPP), became the vice president. He was a key figure of the Central Axis, a loose alliance of Muslim parties. The main cabinet posts were given to members of PDI-P, Golkar, PAN, and PBB (Crescent Star Party) (Siregar 2001).⁷⁴

In order to obtain financial aids from international creditors such as international financial institutions and foreign governments, there was little choice for the new Megawati government but to restore their relationship with the IMF. The Megawati government resumed the relationship with the IMF when a new LOT was signed on August 27, 2001, and in September, 400 million US dollars were disbursed and further loan tranche was conditioned upon three month reviews (IMF 2001c).

73 For details of the impeachment of Wahid, see McIntyre (2005, 232–235).

74 The Coordinating Minister for Economic Affairs was Dorpdjatun Kuntjoro-Jakti, former Dean of Faculty of Economics at the University of Indonesia. The Minister of Finance was Boediono, a technocrat who worked in both the Suharto and Habibie cabinets. Both Laksamana Sukardi as the State Minister of State-Owned enterprises and Kwik Kian Gie as the head of Bappenas (the National Development Planning Agency) were from PDI-P and both of them were once dismissed under the Wahid government. Also, an ex-military officer, Suslio Bambang Yudhoyono, became the Coordinating Minister for Political and Security Affairs (Siregar 2001, 278–279). He became the President after Megawati on October 20, 2004. The political parties in the cabinet were PDI-P, Golkar, PPP, PAN, and PBB (Shiraishi 2003, 7).

However, financial reforms in the dimension of privatization of banks, namely, the asset recovery of taken-over banks by the IBRA, tended to be delayed due to the opposition from political parties in the DPR.⁷⁵ For example, asset sales of 30% shares of BCA again failed in the first few months in 2001. In the LOI in August, 2001, the government stated its intention to sell a majority of the shares of BCA and to set up a strategy for the majority sale of Bank Niaga by the end of 2001 in consultation with the DPR (IMF 2001c). However, many DPR members expressed dissatisfaction due to the fear of selling bank assets to foreign investors and of changing the most influential private bank into a foreign owned bank. Rather than selling the majority shares of BCA as stated in the LOR, the DPR only agreed to sell 30% of shares of BCA in 2001, with an additional 21% to be sold in the future (Siregar 2001, 295–297). Finally, privatization of the BCA, which had originally planned for completion in 1998, was completed in April, 2002. BCA was sold to an American firm, the Farallon Capital Management consortium, for 542 billion US dollars (Athukorala 2002, 142). Further, a majority share of Bank Danamon, targeted in the LOI in July, 2000, was finally divested in June, 2003, which marked a three-year delay (McLeod 2004, 106). Thus, fragmented party controls over the cabinet and the congress caused a delay in privatization of banks.

Furthermore, although privatization of the majority stake of state banks had been particularly emphasized by the IMF, privatization of state banks was delayed. Recapitalization of state owned banks should have been taken place together with privatization of state banks. However, though a 20% share in Bank Mandiri was sold to the general public in July, 2003 and a 49% share of Bank Rakyat was sold in November, 2003, the government never gave up its

⁷⁵ The IBRA, established in 1998, only restructured 30% of its non performing loans and sold 8% of its total assets by September 2001. Similar institution of the IBRA in Thailand and Korea had sold about 70% and 45% respectively (Siregar 2001, 295).

control of the majority shares of state banks by the time of graduation from the IMF programs in December, 2003 (McLeod 2004, 114). Thus, not only privatization of taken over banks but also privatization of state banks tended to be delayed.

In addition, any senior persons involved in any financial scandals were not prosecuted, and due to unequal treatment toward former bank owners by the IBRA, debt repayments were rescheduled for a longer term for former bank owners (Deuster 2002, 16). These situations suggest that political influence of conglomerates still resulted in delaying bank restructuring.⁷⁶ Thus, collusion between politicians and conglomerates, namely corporate owners and former bank owners, inhibited the progress of privatization of banks as well as bank restructuring. In fact, conglomerates tended to support major political parties, not only Golkar but also other parties such as PDI-P and PAN after democratization (Robinson and Hadiz 2004, 232, 235). Thus, newly emerged political parties were backed up conglomerates respectively.

Megawati resisted demands to increase cabinet portfolio allocation for her own party in 2002. However, her cabinet was regarded as highly ineffective due to a multiparty coalition cabinet, intra-party conflicts, and ideological disagreement. There was often contradiction within the cabinet itself and the cabinet was in a gridlock in terms of economic policy making in 2002. The Minister for National Development Planning, Kwik Kian Gie, though he was once regarded as reform-oriented, kept insisting that the government should end the IMF programs, and the Coordination Minister for Economic Affairs, Dorodjatun Kuntjoro-Jakti, was not able to

⁷⁶ The Lippo scandal, which erupted from late 2003 and continued into early 2004, highlighted this point. The Lippo Group, the former owner of Lippo Bank, tried to buy back a majority share of Lippo Bank at a lower price. Finally, this attempt failed and the management of Lippo Bank was changed, and a fine was imposed on the management of Lippo Bank. However, the former bank owner was not prosecuted at this time again, which showed the continuation of the political influence of conglomerates (MacIntyre and Resosudarmo 2003, 151). A 52.05% share of Lippo Bank was sold to Swissasia Global consortium in February, 2004.

stop him (Smith 2003, 98). Vice President Hamzah Haz also became a troubling opponent within the cabinet as he emerged as a potential major candidate for the next presidential race scheduled in 2004 (Smith 2003, 99).

On December 19, 2003, the DPR passed an amendment to the Central Bank Law 23/1999. It comprehensively addressed a lender of last resort function to the central bank. In order to enhance the central bank's accountability, an advisory body (five members) was established over the central bank and the president could dismiss the governors only when they engaged in prohibited acts (Sato 2005, 111). However, central bank independence was rather weakened due to the establishment of the advisory body over the central bank and also paved the way for the president to dismiss central bank governors and the IMF opposed the amendment (Kenward 2004, 28). In addition, although the Financial Services Activity was to set up as a consolidated institution for financial supervision, this was not to be established until 2010 (Kenward 2004, 28). Thus, although the government amended the Banking Law, it did not ensure central bank independence and more effective banking supervision. Rather, the central bank independence was weakened by its amendment of the Banking Law.

The MPR recommended Megawati not renew the IMF programs, which would expire on December 31, 2003 (Suryadinata 2004, 100). Following this MPR recommendation, the Megawati government chose not to renew the programs and graduated from the IMF program at the end of December, 2003. The IBRA was dissolved on February 27, 2004 and unsold bank assets were transferred to a newly established state-owned asset management company (IMF 2004b).

After five rounds of bank restructuring, state banks became dominant again in the Indonesian financial system.⁷⁷ Although attempts at restructuring banks and privatization of banks were made beginning in the early phase of the IMF programs, the dimension of privatization of banks tended to be delayed. The Wahid government had not committed to financial reforms. Frequent reshuffling of cabinet members, a lack of majority support from the DPR, favored treatments to close allies and the involvement in scandals all delayed financial reforms. In addition, relations with the IMF deteriorated during the Wahid government. On the other hand, the Megawati government resumed the relationship with the IMF and tried to commit to financial reforms. However, her cabinet consisted of a multi-party executive collation, which prevented facilitating the privatization of banks. Also, the political influence of powerful conglomerates and former bank owners were still strong, so banking restructuring processes were again delayed.

4.3. CONCLUSION

This chapter qualitatively assesses the degree to which, the interactions between the IMF, the number of veto players, and societal factors such as the manufacturing sector and the banking sector shaped financial reforms from 1965 to 2003 in Indonesia. During the 1960s and 1970s, the Suharto government strengthened control over state banks under Suharto's highly centralized one party dominant authoritarian regime. Suharto and politico bureaucrats such as state bank

⁷⁷ It was only in 2003 when private banks' lending ratio again surpassed state banks.

officials extracted rents through preferential credit allocation and nurtured ties with *pribumi* business elites and Chinese conglomerates.

However, facing economic recessions and the collapse of oil prices, the Suharto government was committed to first and second waves of reforms in 1983 and in 1988. Through these two waves of reforms the Suharto government committed to financial reforms toward financial liberalization. However, which dimension of financial reforms were facilitated was depended upon whether particular dimensions of financial reforms fit the vested interests of politico bureaucrats and conglomerates. Capital account liberalization, interest rate liberalization, and elimination of entry barriers were accelerated due to the support from conglomerates, where the manufacturing sector's interests represented as the major industry of conglomerates. Conglomerates wanted to expand their access to credit by liberalizing interest rates and capital accounts. Also, they supported elimination of entry barriers on banks, which provided new opportunities to open new banks to provide credits to related group firms. In addition, although state bank officials strongly opposed elimination of credit controls because of fears to lose opportunities to extract rents and reforms were delayed, during 1990s, credit controls were eliminated along with the development of private banks owned by conglomerates. On the other hand, the dimension of enhancement of banking supervision over the banking sector was delayed and not de facto implemented in both private banks and state banks despite of the legal amendments and rampant inter connected lending did not cease.

However, though the problem of inter connected lending by banks was recognized, because of the country's sound macroeconomic fundamentals, nobody had predicted that the Asian financial crisis would hit Indonesia so hard. In this vein, "the influence of interest groups ... tended to have been underestimated" (Boediono 2002, 386). Suharto asked for an IMF rescue

package, but the banking crisis deepened into a systemic level. Despite the fact that the president's commitment was critical, Boediono, an economic technocrat who worked in both Suharto cabinet and Habibie cabinet, observed that "interest groups stepped up their efforts to gain access to the president" by the end of 1997 (Boediono 2002, 386). Suharto did not committed to financial reforms and instead responded to these interest groups' demands. Thus, "The IMF programs lacked the ownership of those who counted the most in the decision making apparatus of Indonesia" (IMF 2003a, 86).

The Habibie government, on the other hand, committed to financial reforms more than the former Suharto government, especially in the dimension of enhancement of banking supervision over the banking sector. Legal amendments concerning the independence of the banking supervisory agency (i.e., the central bank), the power of issuing and revoking licenses of banks by the banking supervisory agency, and complete elimination of entry barriers on foreign banks were achieved. For Habibie, there was little choice but to follow the IMF's prescription and pursue financial reforms in order to restore market confidence and end bank runs so that he might be able to win a forthcoming election and to become president.

The Wahid government did not commit to financial reforms. Frequent reshuffles of multi-party executive coalitions extending favored treatments to close allies, a lack of majority support from the DPR, and involvement in corruption scandals delayed financial reforms. Also, relations with the IMF deteriorated during his government. On the other hand, the subsequent Megawati government resumed the relationship with the IMF and tried to commit financial reforms. However, despite good relations with the IMF, concerning privatization of banks, a fragmented multi-party executive collation and the necessity of obtaining approval from the DPR tended to result in delaying the privatization of banks. Also, powerful conglomerates and former

bank owners were still politically influential; therefore, banking restructuring processes were delayed. Although privatization of banks and bank restructuring had been emphasized in the IMF programs, these dimensions tended to be delayed. Thus, the number of veto players and the interest of the banking sector resulted in delaying privatization of banks and bank restructuring.

This chapter illustrates the case of Indonesia, examining whether hypotheses listed in Chapter 2 were upheld. Macroeconomic deteriorations and subsequent IMF programs affected financial reform outcomes. However, the IMF programs were not the only factor to affect financial reform outcomes; domestic political factors such as the number of veto players and societal pressures also shaped financial reforms in Indonesia. Suharto facilitated financial reforms in such dimensions as capital account liberalization, interest liberalization, elimination of credit controls, and elimination of entry barriers, in which he was able to provide business opportunities and better credit access to conglomerates. On the other hand, other dimension such as banking supervision tended to be delayed. Thus, with collusion between political elites and business elites was rampant, financial reform outcomes reflected the colluded interests of Suharto and his business associates.

Facing a massive bank run and the risk of collapse of the whole economy in the Asian financial crisis, the government asked for IMF assistance. From 1997 to 2003, Indonesia was under the Fund conditionality programs. Though the IMF approach was assumed to be apolitical, in fact, “The IMF does not only determine the reforms to be undertaken and the target deadlines, but in a number of instances has had to prescribe also how the reforms should be implemented: for example, determining guidelines for debt structuring and selecting individual banks for divestment” (Pangestu and Goeltom 2001, 146). Thus, the government tended to be under strong pressure of the IMF.

However, despite of this pressure, the commitment to financial reforms varied. From 1997 to 2003 when Indonesia was under the IMF programs after the Asian financial crisis, Indonesia experienced four presidents. As mentioned, Suharto did not commit to financial reforms but rather responded to conglomerates' demands. On the other hand, Habibie did commit to financial reforms and relatively free from conglomerate influence, given the political uncertainty after the demise of the Suharto government and the possibility of political liberalization. In addition, Habibie already commanded majority supports in the parliament given the de facto Golkar dominated parliament. Under these circumstances, he could commit to the Fund conditionality programs and he facilitated the enhancement of banking supervision and banking restructuring operations by the IBRA.

After the election of the DPR, President Wahid was a minority president that needed majority support from the DPR, and he appointed a national unity cabinet which consisted of seven political parties. However, frequent reshuffles in cabinet members, his involvement in scandals, the favoring of personal allies and party supporters caused a lack of progress in financial reforms despite the country being under IMF programs. Relations with the IMF deteriorated and disbursement of money was suspended.

The subsequent Megawati government resumed the relationship with the IMF. However, in fact, an executive coalition consisting of fragmented political parties caused prolonged discussion on privatization of banks. In addition, the fragile new democratic government was not free from political interference from conglomerates. These conditions resulted in delays of privatization of banks and restructuring of banks.

Thus, by looking at temporal variation in Indonesian financial reforms, as illustrated in this chapter, not only macroeconomic conditions and the IMF programs but also the number of

veto players and societal pressures also affected financial reforms. Moreover, which dimensions of financial reforms were facilitated or hindered was also conditioned upon political factors such as the number of veto players and societal demands. In the following chapter, Chapter 5, I will illustrate the cases of Thailand and Korea. Thailand is a case of delayed financial reforms due to highly fragmented political parties and multi-party coalition governments. Korea is depicted as a case of facilitated financial reform because of the executives' initiatives.

Appendix 4.A Indonesia and IMF Programs under the Asian Crisis

Title of Documents	Date
Suharto Government	
Indonesia Letter of Intent	31 October 1997
Indonesia—Memorandum of Economic and Financial Policies	15 January 1998
Indonesia—Supplementary Memorandum of Economic and Financial Policies	10 April 1998
Habibie Government	
Indonesia—Second Supplementary Memorandum of Economic and Financial Policies	24 June 1998
Letter of Intent and Memorandum of Economic and Financial Policies	29 July 1998
Indonesia—Supplementary Memorandum of Economic and Financial Policies	11 September 1998
Indonesia—Supplementary Memorandum of Economic and Financial Policies	19 October 1998
Indonesia—Supplementary Memorandum of Economic and Financial Policies	13 November 1998
Indonesia—Supplementary Memorandum of Economic and Financial Policies: Fourth Review under the Extended Arrangement	19 March 1999
Indonesia—Supplementary Memorandum of Economic and Financial Policies: Fifth Review under the Extended Arrangement	14 May 1999
Indonesia—Supplementary Memorandum of Economic and Financial Policies: Sixth Review under the Extended Arrangement	22 July 1999
Wahid Government	
Memorandum of Economic and Financial Policies Medium-Term Strategy and Policies for 1999/2000 and 2000	20 January 2000
Memorandum of Economic and Financial Policies	17 May 2000
Memorandum of Economic and Financial Policies	31 July 2000
Memorandum of Economic and Financial Policies	7 September 2000
Megawati Government	
Memorandum of Economic and Financial Policies	27 August 2001
Indonesia—Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding,	13 December 2001
Indonesia—Letter of Intent	9 April 2002
Indonesia—Letter of Intent	11 June 2002
Indonesia—Letter of Intent	20 November 2002
Indonesia—Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding,	18 March 2003
Indonesia—Letter of Intent	11 June 2003
Indonesia—Letter of Intent	16 September 2003
Indonesia—Letter of Intent	10 Decemebr 2003

Source: <http://www.imf.org/external/country/IDN/index.htm>, accessed on March 21, 2007.

5.0 FINANCIAL REFORMS IN THAILAND AND KOREA

5.1. INTRODUCTION

In this chapter, I further explore two cases, Thailand and Korea, to test my claims qualitatively. I examine the impact of the IMF, the number of veto players, and interest groups on financial reforms in Thailand and Korea by comparing these cases with the Indonesian case. Thailand and Korea, as well as Indonesia, were admired as examples of the East Asian miracle of growth through pursuing export-oriented industrialization. However, in the turmoil of the Asian financial crisis, all three countries experienced not only a currency crisis but also a banking crisis. They all asked the IMF for rescue packages in which financial sector restructuring and banking reforms were the critical policy arenas.

Nevertheless, despite the emphasis on financial reforms by the IMF for all three countries after the Asian financial crisis, the pace of conducting financial reforms varied. Therefore, I assume that the number of veto players and political influence of the banking sector and the manufacturing sector explain the variation of the outcomes of financial reforms, holding the IMF pressures as constant.

Contrary to Indonesia, where state banks dominated the financial system as a precondition to financial reforms, Thailand had maintained a financial system where private banks owned by financial conglomerates dictated its financial system. The banking sector acted as a powerful interest group and resisted financial reforms, which can be especially observed in the dimension of elimination of entry barriers on banks before the Asian financial crisis. Also, the

situation of many veto players because of the multi-party ruling coalition based on highly fragmented political parties caused a delay in financial reforms in Thailand not only before the Asian financial crisis but also after the Asian financial crisis. Therefore, even when Thailand was under the IMF conditionality programs, Thailand's financial reform tended to be delayed.

On the other hand, Korea was more similar to Indonesia, where state banks dictated its financial system. However, in the Korean case, financial policies were part of a state-led industrialization strategy, and the state more systematically imposed restrictions on banks, with conglomerates called *chaebals* systematically benefiting from the government industrialization policy. However, rather than suffering from too many veto players or too fragmented a multiparty ruling coalition as seen in Thailand and in Indonesia after democratization under President Wahid and President Megawati, Korea successfully conducted financial reforms under the IMF conditionality programs. Under the Asian financial crisis, the new president, Kim Dae-jung, wanted to break up the previous government's ties with conglomerates. Therefore, in contrast to the situation in Indonesia and Thailand, where the government delayed reforms, the Kim Dae-jung government accelerated financial reforms.

In the second and third sections of this chapter, I illustrate the Thailand case by chronologically dividing periods into "before the Asian financial crisis" (section 5.2) and "after the Asian financial crisis" (section 5.3). In the fourth section (section 5.4) and fifth section (section 5.5), I similarly illustrate the Korean case. In the last section, I discuss the Thai and Korean cases compared with the Indonesian case.

5.2. THAILAND: BEFORE THE ASIAN FINANCIAL CRISIS

5.2.1. Financial conglomerates and the domination of the banking sector

Financial conglomerates dictated Thailand's financial system vis-à-vis state banks. In fact, in Thailand, after World War II, the five large Sino-Thai banks became the core of Thailand's financial system (Suehiro 2002, 162).⁷⁸ As a result, private banks were dominant rather than state banks, which differed from the initial conditions in Indonesia and Korea where state banks were predominant as prior conditions of financial reforms. In Thailand, these five financial conglomerates nurtured strong ties with military leaders during the 1950s and 1960s. Also, these banking groups diversified into various industrial sectors in the 1960s and 1970s as conglomerates, and they established their own manufacturing firms. Moreover, when Thailand aimed at promoting export-led manufacturing industrialization in the 1980s, commercial banks also developed ties with export-oriented firms in such areas as textiles, electronics, and automobiles. However, despite these connections between banks and export-oriented firms, the relationship between the banking sector and the manufacturing sector was not as close in Thailand as in Indonesia in general. In fact, there were no formal institutionalized ties between the Thai Bankers' Association (TBA) and the Federation of Thai Industries (FTI), which represented the interests of bankers and manufacturers, respectively (Zhang 2003, 54). Thus, in

⁷⁸ Banks owned by the five financial conglomerates were the Bangkok Bank, the Bank of Ayudhya, the Thai Farmers' Bank, the Bangkok Metropolitan Bank, and the Siam Commercial Bank. Concerning the bank concentration ratio of the five largest banks, i.e., the percentage of the total assets held by five financial conglomerates, they were 70.6 % in 1979, 70.5% in 1983, 62.3% in 1990, and 59.5% in 2000 (see Suehiro 2002, 170).

Thailand, the banking sector, concentrated in the form of financial conglomerates, acted separately from the manufacturing sector.

In these circumstances, privatization of banks was not an important dimension of financial reforms in Thailand because banks were already mainly privately owned. Also, credit controls were less rampant as pre-financial reform conditions relative to Indonesia and Korea.⁷⁹ Hence, the elimination of credit controls was a less contentious issue than in Indonesia and Korea as well. On the other hand, these financial conglomerates were heavily protected by high entry barriers against both new domestic and foreign banks. Also, the banks faced less pressure from competition due to the fixed interest rates set by the central bank.

At the end of the 1970s and in the early 1980s, due to the second oil shock, Thailand experienced a balance of payment crisis and implemented the IMF conditionality programs. However, although the government tried to eliminate entry barriers against foreign banks and domestic banks, these financial conglomerates acted as a powerful interest group and strongly opposed these reform measures. The government therefore postponed the decision toward the elimination of entry barriers on banks and dropped it from the reform agenda (Zhang 2003, 112).

5.2.2. Emergence of the new business interests

Politically, Thailand experienced gradual democratization processes. Though legislative elections had been held since the late 1970s, the prime minister, Prem Tinsulanonda, an ex-military independent officer who took office from 1980 to 1988 and led coalition governments, was not elected by the populace. Thailand was democratized as a parliamentary system with a

⁷⁹ See Doner and Unger (1993) in this regard.

constitutional monarchy in August, 1988, when Chatchai Choonhavan became the first elected prime minister. Thailand's democracy was characterized by highly fractionalized political parties under its parliamentary system, with frequent attempts to vote on non-confidence motions. Political party composition in coalition governments from 1988 to 2004 was appended as Appendixes [5.A](#), [5.B](#), and [5.C](#).

When in August, 1988 Chatichai Choonhavan took office as Thailand's first elected prime minister, Chartichai's Chart Thai Party represented newly emerged business interests who supported liberalization measures. Politicians began to fill cabinet posts which had previously been occupied by the military and technocrats (Handley 1997, 98-99). Pramual Sabbavas, the deputy head of the Chart Thai Party, was appointed as finance minister and promised to pursue rapid financial reforms (Zhang 2003, 114). Financial liberalization was considered an important means to reduce the dominant power of the banking sector relative to the manufacturing sector. Therefore, Chartichai's newly installed democratic government pursued some financial reforms backed by the manufacturing sector's interests. For instance, the government abolished the interest rate ceilings on fixed deposits of more than 1 year's maturity in June, 1989 (United Nations 1999, 162). Industrialists welcomed this move to curtail the power of oligopolistic banks. Private bankers and the TBA leaders, on the other hand, opposed this move due to the fear of having to face harsher competition among banks. However, despite the opposition from the banking sector, the government facilitated the reform toward the elimination of interest rate controls by taking advantage of the dominant position of the Chart Thai Party within the coalition government as a leading party (Zhang 2003, 122). With respect to capital account liberalization, in May 1990, the Thai government accepted Article VIII of the IMF agreements and the multiple exchange rate system was abolished (United Nations 1999, 162).

However, concerning the elimination of entry barriers, as in previous years, strong opposition from the banking sector again caused a halt to the move toward reforms. In Thailand, entry barriers against not only foreign banks but also domestic banks had continuously been maintained as mentioned above. When a draft of a bill for eliminating entry barriers was finally announced in 1987, many restrictions still remained in the bill draft. The high capital requirement, the requirement of joint venture, and the requirement for equity participation in existing domestic banks rather than the allowance of opening of foreign bank branches were listed as conditions in order to open new foreign banks in Thailand. Even this bill draft was harshly opposed not only by banks and but also by the TBA leaders. As a result, the plan to eliminate entry barriers on banks was again dropped from the government's agenda in 1990 (Zhang 2003, 124). Thus, the banking sector strongly opposed the move toward elimination of entry barriers against on banks, which resulted in delaying the elimination of entry barriers on banks. In this vein, although the newly emerged manufacturing sector and the benefited middle class supported the Chart Thai Party in its aim to promote the elimination of entry barriers on banks, financial conglomerates were still influential players, and these reform measures were not achieved (Handley 1997, 98).

5.2.3. Financial liberalization in the early 1990s

In February, 1991, the military staged a coup, having felt threatened by their marginalized status under democracy. Ananda Panyarachun accepted the premiership, backed by the military (Samudavanija 1997, 52). Though Ananda's cabinet was backed by the military, the military refrained from intervening in economic policy making. Ananda was a liberal-minded

businessman, and Ananda's cabinet made most of the major decisions toward financial liberalization. They aimed for the establishment of a financial center in the Southeast Asian region (Phongpaichit and Baker 2000, 24). A bill for interest rate liberalization was approved unanimously by the cabinet and full interest rate liberalization was achieved in June, 1992 (United Nations 1999, 162). The Bangkok International Banking Facility (BIBF), an offshore banking center, was established in 1993 and commercial banks were allowed to engage in foreign exchange transactions (United Nations 1999, 162). Banks and firms were now allowed offshore borrowing. As a result, not only financial conglomerates but also newly emerged firms benefited from liberalized capital inflow. Capital inflow massively increased in the form of portfolio investments. Banks started to invest in real estate, service industries (hotels, media etc.), and infrastructure development. Investment in real estate caused an especially serious asset bubble.

5.2.4. Coalition governments and delay in the enhancement of banking supervision

Politically in Thailand, after the political turmoil of another coup and following the King's intervention, democracy was restored in September, 1992, and Chuan Leekpai, the leader of the Democratic Party, became the prime minister.⁸⁰ Chuan's coalition cabinets had to be formed with other political parties which had a wide range of preferences with respect to the banking sector. In particular, coalition partners included the New Aspiration Party and the Chart Pattana Party (the Thai Development Party), both of which had close ties with financial companies

⁸⁰ The military lost its influence due to violence against street protesters and following the King's intervention in May, 1992 (Samudavanija 1997, 53).

(Satyanath 2006, 56).⁸¹ Despite Chuan's clean image, being free from corruption, his cabinet did not seriously tackle corruption (Phongpaichit and Baker 2000, 109) and the Chuan government did not take effective measures to enhance banking supervision over the banking sector.

From mid-1995, the new Banharn Silpa-Archa government started, and it also had to make a fragile coalition with provincial businessmen-politicians of provincial political parties. Banharn allocated cabinet posts, including that of Finance Minister, to new business groups (Phongpaichit and Baker 2000, 112–113), and the governor of the Bank of Thailand was dismissed due to political interference. While the Banharn government and the newly emerged business groups supported capital account liberalization, they opposed any prudential regulatory measures over the financial sector. Furthermore, the Bank of Thailand did not have enough independence to ensure strict banking supervision and prudential regulations over the banking sector. This resulted in lax banking regulations which did not deter banks' risky lending behavior (Charoenseang and Manakit 2002, 601).

In November, 1996, Chavalit Yongchaiyut from the New Aspiration Party became the new prime minister and formed a new coalition government. Again, the central bank governor was changed and the finance minister was replaced with a minor banker. Lax banking supervision was not changed because many political parties within the ruling coalition were the same from the previous government (Phongpaichit and Baker 2000, 114–115). Under these circumstances, coalition partners did not have any interests in enhancing banking supervision over the banking sector. Moreover, the banking sector remained as an influential actor and the Thailand Bankers Association also remained as a powerful lobbying group in Thailand. Overall,

⁸¹ On December 8, 1994, the New Aspiration Party withdrew from coalition. However, on December 12, 1994, the Chart Pattana Party joined coalition.

then, there was no new entry of banks from the entire period of 1966 to 1997 in Thailand (Polsiri and Wiwattabajabtang 2006, 348). Thus, the existence of fragile multi-party ruling coalitions under the influence of the banking sector's vested interests resulted in a lack of competition among banks or no entry of new banks and lax regulations over the financial sector.

Before the Asian financial crisis, Thailand's financial sector was already in trouble. For example, on March 3, 1997, a few months before the crisis began, Finance One, the most developed financial company up to that date, was taken over by the Thai Danu Bank. On May 15, 1997, the government lost US \$10 billion in one day in defending the baht. On June 26, 1997, the government announced that sixteen out of ninety-one finance companies had liquidity problems and their operations were suspended (Jumbala 1998, 278-279).

5.3. THAILAND: AFTER THE ASIAN FINANCIAL CRISIS

5.3.1. Party politics and delayed financial reforms under the IMF programs

The Asian financial crisis was triggered in Thailand when the Bank of Thailand gave up defending the baht and the baht was allowed to float on July 2, 1997. The government asked for IMF assistance on August 5, 1997, and on August 14, 1997, the first LOI was announced, in which macroeconomic stabilization and financial sector restructuring were included as two main targeted policy objectives (IMF 1997d).⁸² In early August, the operations of 42 more financial companies were suspended. In total, 58 financial companies' operations were suspended from

⁸² The list of LOI by Thai governments under the Asian financial crisis is appended as Appendix [5.D](#).

June to August, 1997. However, despite the increase in popular demand for Chavalit's resignation, Chavalit survived a motion of a vote of no-confidence on September 27, 1997.⁸³

As the October deadline to decide on a more detailed plan of financial restructuring approached, the indecisiveness of the multi-party coalition cabinet became apparent. Chatichai, the party leader of the coalition partner of the Chart Pattana, had considerable interest in the financial sector, including in suspended financial companies. The Association of Financial Companies intensely lobbied Chatichai and Chavalit for a relaxation of the criteria of the rehabilitation plan. Moreover, the IMF publicly expressed concerns about the independence of the committees examining financial companies' conditions (MacIntyre 1999, 152).

Facing IMF demands, on October 15, 1997, the following restructuring plan for the financial sector was announced. The remaining 15 banks and 33 financial companies were required to boost capital (Jumbala 1998, 284). The Financial Restructuring Agency (FRA) was established in October, 1997 in order to oversee the restructuring plans which the 58 suspended financial companies had submitted. Also, the Asset Management Company (AMC) was set up in order to sell bad assets under the control of the FSA. Loan classification was tightened and full deposit guarantee was ensured for both depositors and creditors of the remaining 15 local banks and 33 financial companies. In addition, foreign bank entry was allowed by obtaining majority shares in Thai banks for ten years (Lauridsen 1998, 150–151).⁸⁴ However, after obtaining cabinet approval, the Chart Pattana gained political control over the FSA and the AMC and

⁸³ On the same day, the bill of constitutional amendment which envisaged democratic constitution was also approved at the parliament. In the midst of the economic turmoil and continuing demands for Chavalit's resignation, the government had no option but to accept the constitutional amendment (Jumbala 1998, 284).

⁸⁴ However, after ten years, the share of foreign ownership should not be increased though shares in excess of 49% in last ten years can be held beyond these ten years (IMF 2000c). This condition is different from that in Indonesia and Korea where no year restrictions were set in increasing foreign ownership of banks.

successfully undermined these two agencies' independence (MacIntyre 1999, 152; Haggard 2000, 55). Thus, because of the indecisiveness of Chavalit's "shaky multi-party coalitions" (Haggard and MacIntyre 1998, 386), the financial restructuring plan was delayed and undermined.

Demands for Chavalit's resignation continued because of a further crisis situation — baht depreciation did not halt. Finally, Chavalit resigned on November 3, 1997, but the ruling coalition was not able to find a new premier. Consequently, Chuan Leekpai, a leader in the Democratic Party, again became prime minister on November 15, 1997 (Haggard 2000, 94). A new coalition government consisting of six political parties was formed and two highly respected technocrats were appointed to main ministerial posts: Supahcai Panitchpakdi as deputy prime minister, and Tarrin Nimmanahaeminda as finance minister (Jumbala 1998, 287).

The new government announced the second LOI on November 25, 1997, in which the government expressed the intention to promptly implement the restructuring plan announced in October (IMF 1997e). In December, 1997, under intensive pressure from the IMF, the FRA announced that 56 out of 58 financial companies had to be permanently closed (Suehiro 2006, 206). As planned, their bad assets were transferred to the FRA and the AMC and bad assets were sold to the AMC for gradual liquidation (Lauridsen 1998, 152). Also, not only financial companies but six troubled commercial banks out of fourteen existing banks were nationalized.⁸⁵

However, despite this impressive beginning to financial restructuring by the Chuan government, the actual implementation of these plans was significantly delayed. There were issues concerning how to restructure the financial sector: 1) how the assets and liabilities of closed financial institutions would be treated under the lack of an adequate legal framework of bankruptcy laws, 2) how and at what pace the government should introduce new stricter

⁸⁵ They were Bangkok Metropolitan Bank, Siam City Bank, First Bangkok City Bank, Laem Thong Bank, Union Bank of Bangkok, and Nakornthon Bank (Nidhiprabba and Warr 2000, 109).

prudential regulations over the banking sector, and 3) the degree to which the government should assist in restructuring banks' bad loans. The government wanted to take some drastic measures to raise the banks' capital. However, this meant that existing shareholders would have to suffer huge losses. Banks were unwilling to take any further losses. Further, several major shareholders had influential connections to the government. Therefore, it was hard for the government to take any radical measures for restructuring banks (Flatters 2000, 85–87). In fact, in the middle of 1998, it was found that banks' balance sheets had not been cleaned up at all (Charoenseang and Manakit 2002).

Under these circumstances, the forth LOI, announced on May 26, 1998, included a new schedule to hasten the pace of the financial sector restructuring (IMF 1998e). Banks and financial companies were encouraged to sign memoranda of understandings (MOUs), which outlined a plan for improving loan classification and provisioning.⁸⁶ Further measures were announced on August 14, 1998. The August package included the following four major measures: 1) the provisioning requirement was changed and banks were required to meet a refined capital adequacy ratio soon after the capital injection,⁸⁷ 2) the government preserved 300 billion baht for the injection of tier 1 and tier 2 capital schemes in order to facilitate recapitalization of commercial banks and financial companies,⁸⁸ 3) the government encouraged

⁸⁶ This was included as the performance criterion in the LOI dated on November 25, 1997 (IMF 1997e). However, this was again set as the performance criterion that should be met by August 15, 1998, in the LOI dated May 26, 1998 (IMF 1998e).

⁸⁷ The capital adequacy ratio (CAR) was changed. For tier 1 capital, the CAR was decreased from 8.5% to 4.25% and for tier 2 capital, the CAR was increased from 2.5% to 4.25%. Overall, the CAR was unchanged from 8.5% for banks and 8% for financial companies (Charoenseang and Manakit 2002, 603).

⁸⁸ The tier 1 capital scheme was intended in exchange for the adaptation of loan classification and provisioning standard which was to be met by December 2000. The tier 2 capital scheme aimed at restructuring corporate debts. The government provided capital in the form of non-tradable government bonds in exchange for bank debentures of 2% of risk weighted assets

the setting up of private bank-owned AMCs, and 4) central bank intervention became the only resolution when banks and financial companies were not able to recapitalize by themselves (Charoenseang and Manakit 2002, 603–604).

After this banking package was announced, the relationship between banks and Tarrin, the minister of finance who was trying to follow the IMF programs, deteriorated (Phongpaichit and Baker 2000, 142). Tarrin hoped that banks would take part in the August restructuring plan. However, firms did not want tougher treatment with respect to repaying their debts. On the other hand, creditors wanted to have tougher foreclosure and bankruptcy laws and banks wanted government assistance without heavy burdens. International creditors wanted government guarantees to ensure their credit would be repaid. The government was afraid to bear any further fiscal burden to bail out troubled banks and financial companies (Flatters 2000, 86). As a result of this situation, the government was unable to decide whether they should behave moderately or harshly toward banks.

In October, 1998, Chuan asked for the Chart Pattana Party to join the ruling coalition, which meant that Chuan had to allocate cabinet posts to the Chart Pattana Party. The cabinet was reshuffled and the Chart Pattana Party rejoined the government, which gave Chuan's ruling coalition the clear majority (Haggard 2000, 99). However, the increase in coalition partners meant that cooperation among coalition partners became more difficult and the Chart Pattana Party's inclusion itself caused intra-party conflicts (Thabchumpon 1999, 319). In fact, the intra-party conflict between the Democratic Party and the Social Action Party resulted in the withdrawal of the Social Action Party from the ruling coalition in July, 1999 (Haggard 2000, 99).

(Charoenseang and Manakit 2002, 603).

Meanwhile, the restructuring plan of the August package did not improve restructuring of banks as planned. There were only two commercial banks, the Siam Commercial Bank and the Thai Military Bank, which asked for capital injection as assistance from the government. Most banks did not ask the government for a capital injection because the conditions of the MOU were too strict, so banks were afraid to be punished when they were not able to meet them (Higashi 2002, 6–7). Neither banks nor major corporate debtors made adjustments or submitted restructuring plans (Flatters 2000, 93).

In addition, Thailand adopted a “self-help” approach, in which privately owned AMC’s were set up. This is a marked difference from the situation in Indonesia and in Korea (which will be illustrated later), where the government set up its own banking restructuring agency and tried to sell transferred bad loans. In Thailand’s approach, creditors and debtors negotiated with each other directly. The Thai Bankers Association and the central bank acted as coordinators to facilitate debt restructuring (Suehiro 2006, 208). Under this arrangement, debts were merely rescheduled and problem resolutions were postponed. As a result, in May of 1999, non-performing loans reached 47.7% (Charoenseang and Manakit 2002, 604–607). Because of this, the government was increasingly criticized by banks. Despite the fact that banks had to follow stricter provisioning rules and higher capital adequacy ratios, non-performing loans were at the same time left in the hands of banks (Flatters 2000, 99). Moreover, business people, who represented the manufacturing sector more, also criticized the government’s crisis management because banks hesitated to provide new loans to firms as banks had to fulfill stricter prudential regulations without enough government bailout.

Furthermore, the legal amendment necessary for reforms to enhance banking supervision over the banking sector was also delayed because of Thailand’s fragmented party system and

frequent attempts at vote of no confidence. The opposition New Aspiration Party launched a no-confidence debate in the beginning of 1999 (Phongpaichit and Baker 2004, 77). Though the Chuan government survived the vote of no-confidence motion at the beginning, they also had to survive another vote of no-confidence motion at the end of 1999 and the government's clean image was certainly damaged because of the corruption scandals that triggered the vote of non-confidence motions. In the beginning of 2000, the government tried to present a set of new bills to the parliament to enhance the regulatory framework over the banking sector. These laws included the Financial Institution Law that would unify the Commercial Banking and Finance Company Laws, the Deposit Insurance Law, and a new Central Bank Law to enhance central bank independence (IMF 2000c, 38–39), which had already been included on the financial reform agenda in the fifth LOI dated on August 25, 1998. However, again, these laws did not pass.

5.3.2. Graduation of the IMF programs and financial reforms under the Thaksin government

On June 19, 2000, Thailand graduated from the IMF conditionality programs. Though the IMF noted the importance of speeding up corporate debt structuring and financial sector reforms (IMF 2000b), the IMF no longer had influence. On January 6, 2001, Thaksin's Thai Rak Thai Party (TRT) won the near majority at the first general election of the House of Representatives based on the 1997 Constitution. The Thai Rak Thai Party won 248 out of 500 seats whereas Chuan's Democratic Party, which obtained only 128 seats, was defeated. Thaksin Shinawatra, a billionaire who owned telecommunication firms, became prime minister, and the TRT formed a

coalition with the Chart Thai Party, the New Aspiration Party, and the Seritham. Cabinet posts were allocated to Thaksin's close allies, TRT's key business supporters, old politicians within TRT, and coalition partners (Phongpaichit and Baker 2004, 92–93). On July 2001, TRT absorbed 14 Seritham members, and TRT secured majority seats as a single leading party for the first time in Thailand's democratic history.⁸⁹

Backed by the TRT's majority status at the House of Representatives mentioned above, it was the Thaksin government that established the government-led debt restructuring agency, the Thailand Assets Management Corporation (TAMC), despite the lack of the pressure from the IMF. A lot of enforcement power was given to the TAMC in order to collect debts from banks' debtors.⁹⁰ Banks were not enthusiastic about the establishment of the TAMC due to the government's prolonged delay in responding to the banking crisis up to that point. The TAMC could also be regarded as a vehicle that let indebted firms "stay in the game" (cited in Hewison 2005, 322). Nevertheless, the TAMC was still effective in reducing non-performing loans of banks. As a result of transferring assets to the TAMC, banks' non-performing loans drastically decreased from 47% in July, 1999, to 10 % in December, 2001 (Suehiro 2006, 208).

On January 27, 2002, because the TRT merged with another party, the New Aspiration Party, Thaksin commanded a majority not only in the House of Representatives but also in the Senate (Metebi 2003, 102). Backed by the majority in both Houses, the Thaksin government developed a financial master plan from 2002 to 2004 (Menkhoff and Suwanaporn 2007, 8).

⁸⁹ See *Political Handbook of the World 2000–2002* (1088).

⁹⁰ The TAMC was allowed to restructure debts by amending loan terms, mandating debt-equity convention, taking debts or assets in order to settle debts, and buying shares to increase debtors' capital. The TAMC was allowed to take these measures only upon approval by the board of the TAMC (Charoenseang, and Manakit 2002, 611).

However, while a plan toward the development of non-bank financial institutions and security markets was articulated, credit controls were also introduced, even though preferential credit allocations were not traditionally used as policy tools in Thailand. The beneficiaries of preferential credit allocations were small and medium enterprises, and users of export-import credits, as well as rural small farmers (Menkhoff and Suwanaporn 2007, 11). After graduation from the IMF programs, and also after the completion of an early repayment of the IMF credits of the Stand-By Arrangement on July, 31, 2003 (IMF 2003b), IMF influence further diminished. In these circumstances, as seen the introduction of credit controls, the policy direction of the financial master plan was not necessary liberal-oriented.

Also, although regulations for enhancing prudential regulations had been gradually enacted since 2002 (Polsiri and Wiwattabajabtang 2006), a bill to enhance central bank independence was quietly dropped from the agenda due to opposition from businessmen (Phongpaichit and Baker 2004, 122).⁹¹ According to the Bank of Thailand Act of B.E. 1942, the Bank of Thailand is under the supervision of the MOF. The governor of the central bank is nominated, appointed, and dismissed by the King upon the recommendation of the MOF and the approval of the cabinet. Also, the MOF is the superior authority over the Bank of Thailand with regard to banking supervision. Therefore, the Bank of Thailand has to obtain approval from the MOF in order to revise major policy instruments such as setting the capital adequacy ratio (Polsiri and Wiwattabajabtang 2006, 343–344). Hence, the central bank is very much legally

⁹¹ As another example that the government undermined the central bank autonomy, Thakshin dismissed the central bank governor because of a disagreement on interest rate policy (Polsiri and Wiwattabajabtang 2006, 344).

dependent and not free from political interference in Thailand, which is still true as of June, 2007.⁹²

Thus, while TRT's majority position enabled the Thaksin government to act decisively, the policies pursued by the Thaksin government rather aimed at protecting vested interests of business groups as well as rural small farmers, which were primary supporters of TRT. Therefore, without the IMF pressure, the Thaksin government imposed credit controls to protect farmers and did not choose to enhance the independence of the central bank as a banking supervisory agency. This is a marked difference from the Indonesian case, in which legal amendments to ensure central bank independence were enacted under the IMF pressure during the Habibie presidency, as well as a difference from the Korean case discussed below.

5.4. KOREA: BEFORE THE ASIAN FINANCIAL CRISIS

5.4.1. Financial repression and developmental state

As stated, similar to Indonesia, Korea had maintained a state-bank dominant repressed financial system before financial reforms in the 1960's and 70's. Korea at this time is an especially well known "developmental state", where a state aimed to achieve economic development based on

⁹² As mentioned earlier, the Thaksin government was ousted by the successful military coup on September 19, 2006. The interim cabinet was installed and Surayud Chulanont became prime minister. A post-coup constitution will be drafted and a general election will be held on December, 2007 based on this new constitution.

state-led industrialization, in which the allocation of preferential credits to strategic sectors at subsidized rates was the center of policy tools.

After Park Chung-hee took power by the military coup in 1961, the Park Chung-hee government introduced some repressive financial policy measures. In 1962, the new government nationalized banks and the government amended the Banking of Korea Act so that the central bank was clearly redefined as dependent on the government. Both financial policy and monetary policy were set not by the central bank but by the Ministry of Finance, which reflected conglomerates or chaebols' interests (Choi 1993, 26–27; Zhang 2003, 63). When President Park Chung-hee further strengthened his authoritarian rule by declaring martial law in 1972, he clearly set the economic development strategy with heavy and chemical industrialization as the country's goal and established the Heavy and Chemical Industry Promotion Committee as the central organ of industrialization policy planning in 1973. Some industries such as iron and steel, shipbuilding, petrochemical industries, and defense industries, were set as strategic industries. In order to finance industrialization projects in these areas, preferential credit allocation called “policy loans” were utilized as major policy tools.⁹³ As a result, credit allocation in the manufacturing sector was heavily concentrated in heavy and chemical industries. These preferential credit allocations were in favor of the chaebols and big businesses that mainly represented the manufacturing interests (Choi 1993, 35–40).

In Korea, the manufacturing sector, represented by chaebols, was dominant rather than the banking sector. The banking sector was interested in the performance of chaebol firms because they heavily lent to chaebols. On the other hand, however, chaebols were less interested

⁹³ In the “policy loans” credits, nominal loan rates were lower than inflation rates. Therefore, real interest rates were negative. Thus, “policy loans” were allocated with subsidized interest rates by banks (Graham 2003, 40).

in the performance of banking institutions. Almost all banking institutions were members of the Federation of Korean Industries (FKI), an organization representing chaebols' interests. In addition, the FKI and the Korea Federation of Banks (KFB), an organization representing banks' interests, had close contacts between them. However, the FKI was predominant over the KFB in terms of the influence in decision making processes in their meetings (Zhang 2003, 53-54). Thus, the state-led industrialization policies favored chaebols and under the state's control, banks were subordinate to chaebols and served to finance necessary capital under the state's developmental strategy.

By the 1970s, it became clear that heavy industrialization was problematic due to the lack of enough demand in heavy industry in Korea and in export markets. The second oil shock further aggravated economic problems. Furthermore, the assassination of President Park on October 26, 1979, created political uncertainty as well as doubt concerning the government's commitment to industrialization centered on heavy and chemical industries. In fact, Park's assassination marked an end to heavy and chemical industrialization (Graham 2003, 38).

5.4.2. Some liberalization measures in the 1980s and 1990s

Under the political turmoil of the inter-rim governments, the military general Chun Doo-hwan was appointed as the acting head of the KCIA in April 1980, which triggered massive opposition from the populace and demands for democratization. After the bloody Kwangju event on May 18, 1980, in which the military killed protesters who demanded democratization,⁹⁴ Chun Doo-

⁹⁴ Three opposition leaders, Kim Jong-pil, Kim Yong-san, and Kim Dae-jung, called "the three Kims", were put into detention. Kim Dae-jung was sentenced to death and escaped to the US

hwan became the self-appointed president in September, 1980 (1980-1987). Although legislative elections were held in 1981 and 1985, Chun Doo-hwan's ruling Democratic Justice Party (DJP) continually won and obtained majority seats. Due to the stagnation of the economy and inflation, the new government tried to reorient heavy and chemical industrialization. The government asked for an IMF rescue package and the interim government and the subsequent Chun Doo-hwan government reached three Stand-by agreements with the IMF from March 1980 to March 1985. Facing demands for democratization, Chun had a strong incentive to conduct financial reforms and to overcome the economic crisis — to demonstrate the differences of his new regime from the economically failed previous Park regime (Zhang 2003, 75–76).

Under the IMF programs, the government took some financial liberalization measures in such dimensions as privatization of banks and entry barriers on banks. Concerning privatization of banks, in March, 1981, the best performing state bank, the Hanil Bank, was privatized. Two chaebol groups obtained shares in the Hanil Bank. In addition, three commercial banks were privatized: the Korea First Bank in 1982, the Bank of Seoul and Trust Company in 1982, and the Chohung Bank in 1983. As a result, all leading commercial banks were privatized. In these moves, large chaebols obtained shares of banks by acquiring shares through their nonblank financial institutions (Choi 1993, 43–45). Thus, chaebols took advantage of privatization of banks.

Moreover, the FKI and chaebols demanded the elimination of entry barriers on banks. Although chaebols already owned non-bank financial institutions (NBFIs), these NBFIs were not able to engage in deposit-taking activities. Therefore, hoping that chaebols would be able to establish their own new banks, the FKI and leading chaebols lobbied the government to allow

(Graham 2003, 52).

new entry of banks (Zhang 2003, 81). As a result, the Chun Doo-hwan government moved to deregulate entry barriers and to establish more commercial banks.⁹⁵ Further, commercial banks were allowed to set up more overseas subsidiaries and branches in 1986 and the number of foreign bank branches increased (United Nations 1999, 117).

On December 16, 1987, Korea held a democratic presidential election for the first time. The DJP's presidential candidate Roh Tae-woo, an ex-general, won the election (1988–1992) by taking advantage of the split of opposition votes between the two main opposition leaders, Kim Young-sam and Kim Dae-jung. Though the government lacked the majority command after the legislative election in April, 1988,⁹⁶ the DJP merged with the Reunification Party led by Kim Young-sam and the New Democratic Republican Party led by Kim Jong-pil and a new political party, the Democratic Liberal Party, was established. As a result, the Roh government secured majority command on the legislature (Chung-si and Hoon 1999, 149).⁹⁷

Backed by a secure majority, other financial reform measures toward financial liberalization were further taken by the succeeding Roh Tae-woo government, though government's intervention into the market was not eliminated. The government announced its comprehensive plan to reform the financial system in May 1988. Politicians wanted to develop the financial industry and also wanted to meet political needs (Zhang 2003, 84). In order to do so, entry barriers on banks were lowered. Three new commercial banks (Donghwa Bank,

⁹⁵ As a result, the number of commercial banks increased from seven in the mid 1980s to fifteen in the early 1990s (Zhang 2003, 82).

⁹⁶ The DJP obtained 46% of seat shares in the legislative election in February, 1990 (Chung-si and Hoon 1999, 147).

⁹⁷ In Korea, the president's party tends to be dominant over opposition parties. The president's party often seduced a legislator to defect from an opposition party to a president party. In addition, the president's party tended to merge with other parties until a legislative majority was formed (Lim 2002, 2). On the other hand, opposition parties in Korea are typically fragmented, personalistic, not well consolidated, and seldom united on particular issues among opposition parties (Chung-si and Hoon 1999, 149).

Dongnam Bank, and Daedong Bank) were established in 1989. In addition, Korea accepted the IMF's Article VIII in 1988 and started to liberalize foreign exchange controls. Repatriation of capital became fully permitted in 1991, and capital account transactions were made easier for foreign investors (Kaminsky and Schmukler 2003). Also, interest rate controls, which were once attempted in 1988 but did not progress due to unfavorable economic conditions, were partially liberalized in 1991 as the first stage of a four-stage plan. Most short-term lending rates and deposit rates of more than three-year maturity were liberalized in 1991 (United Nations 1999, 116–117). However, chaebols opposed the elimination of credit with preferential rates. Therefore, “policy loans” to chaebols by commercial banks continued (Choi 1993, 52). Thus, under the Roh Tae-woo government, financial reforms gradually progressed in the dimensions of elimination of entry barriers, capital account liberalization, and interest rate liberalization as chaebols were able to take advantage of these reforms. However, in terms of credit controls, credit allocation with subsidized interest rates was not eliminated because chaebols demanded it continue.

In the presidential race in 1992, Kim Yong-sam became the presidential candidate of the Democratic Liberal Party. In February 1993, Kim Yong-sam became the first civilian president in over three decades.⁹⁸ On December 1995, he renamed the DLP the New Korea Party in order to attach his own image to the party name. Democratization strengthened chaebols' relative position vis-à-vis the government. The FKI leaders clearly stated that they would contribute money only to political parties that would protect their business interests and not to politicians who took an anti-business stance (Zhang 2003, 86). Therefore, even though the government wanted to contain chabeols' power, individual politicians wanted to meet these chaebols'

⁹⁸ Kim Yong-sam obtained 44% of votes, followed by Kin Dae-jung's 36% of votes, and Chung Ju-yung's 20% (Graham 2003, 89).

demands, given the need for contributions from them (Kang 2002, 153–154). Chaebols demanded the government not intervene in the market and demanded more liberal policies. In these circumstances, the Kim Yong-sam government ended the government's industrialization planning.

Further, in July, 1993 the government announced the five-year plan called “Blueprint for Financial Liberalization and Internationalization” (Graham 2003, 90). As a result, the government significantly liberalized the financial sector, though it did not reach full liberalization. Capital account liberalization was facilitated in the area of short-term capital borrowing, but long-term capital borrowing was still restricted.⁹⁹ As a result, short-term foreign borrowing by banks increased massively. Short-term offshore borrowing by banks and NBFIs were estimated as 86 billion US dollars as of the end of September 1997, out of which banks owned 69 billion US dollars. The rapid increase in short-term offshore borrowing was argued to be the one of the causes of the currency crisis, due to the maturity mismatch (IMF 2003a, 112).

Interest rates were also gradually liberalized by following previously determined Roh's four-stage plan. The reduction of “policy loans” was also set as a policy goal. Entry barriers were further lowered and the number of merchant banks increased from 6 before 1994 to 9 in 1994 and to 15 in 1996.¹⁰⁰ Contrary to commercial banks, these merchant banks were not strictly controlled by the government. Moreover, no banking supervision was conducted over these merchant banks (Ha-Joon 1998, 226–228). Chaebols owned these banks and took full advantage of these new banks for expanding their access to credit and financing their debts. Thus, despite the fact that the Kim Yong-sam government accelerated financial reforms in the

⁹⁹ Notification to the government was mandatory for long-term foreign loans, whereas not mandatory for short-term foreign loans (Yanagita 2000, 19).

¹⁰⁰ For instance, the Hyundai group established and acquired more than eight financial institutions including NBFIs, merchant banks, and insurance companies (Graham 2003, 63).

dimensions that chaebols did not strongly oppose, the government did not enhance banking supervision over the banking sector, but rather the government allowed chaebols to take advantage of the opportunity to establish their own banks and also to borrow heavily from banks without enough examination of loan risks.

In this vein, before the Asian financial crisis, chaebols had been already heavily indebted to banks. Banks continued to provide policy loans to some chaebols, fearing that bankruptcy of weak chaebols' affiliates would trigger the collapse of the whole group of chaebols. In some cases, debts were even used to merely pay debt-servicing charges. Thus, banks continued to lend to chaebols despite the fact that their loans were, in fact, non-performing (Graham 2003, 83). Finally, in early 1997, some banks and chaebols collapsed. Hanbo Steel went bankrupt in January 1997 due to a 6 billion US dollars debt. Later, it was revealed that the close relationship between the second son of Kim Yong-sam and Hanbo favored Hanbo's entry into the steel industry and resulted in continuous financing of debts despite its problems (Yanagita 2000, 24). As a result, Kim Yong-sam lost political influence in the nomination race for the next presidential candidate of the NKP (Graham 2003, 102).

Facing the mounting problems of banks' non-performing loans, in January 1997, the government established the Presidential Commission on Financial Reform, which consisted of 31 members from the industrial sector, the financial sector, and academic researchers. The commission recommended further liberalization of interest rates and elimination of entry barriers on foreign banks as well as enhancement of banking supervision over the banking sector (Graham 2003, 101). However, little progress was made in implementing recommended financial reforms. Rather, necessary financial reform measures such as the enhancement of banking supervision were postponed until after the presidential election in December 1997, and a

financial reform bill to establish the independent banking supervisory agency failed to pass the Assembly on November 18, 1997 (IMF 2003a, 108, 118). Moreover, big conglomerates such as Sammi, Jinro, and Kia went into bankruptcy. In these circumstances, it was found that non-performing loans had reached the equivalent to 7% of the GDP by September, 1997. These bankruptcies scared off foreign investors (Yanagita 2000, 24). Thus, facing these mounting problems of banks and chaebols, the Presidential Commission recommended further necessary financial reforms. However, the Kim Yong-sam government was not able to take any effective measures because of its close ties with chaebols.

5.5. KOREA: AFTER THE ASIAN FINANCIAL CRISIS

The Asian financial crisis, which started in Thailand in July, 1997, spread to Korea on October 28, 1997, when the Bank of Korea spent 6.7 billion US dollars in one day to defend the Korean won. On November 18, facing further exchange rate pressures against the Korean won, Korea gave up defending the won and allowed it to float. The Korean government asked the IMF for assistance on November 21, 1997. On December 3, 1997, the Kim Yong-sam government announced the first LOI (IMF 1997f), and three-year stand-by agreement programs were endorsed, with 21 billion US dollar credits approved by the Fund Executive Board.¹⁰¹ In these IMF conditionality programs in Korea, financial sector restructuring was the most prioritized policy arena along with macroeconomic stabilization (IMF 1997f). In negotiating with the IMF, the Kim Yong-sam government resisted the restructuring of banks, i.e., the closure of troubled

¹⁰¹ The list of LOIs by the Korean governments under the Asian financial crisis is appended as Appendix [5.E](#).

commercial and merchant banks, arguing that because Korea had no history of troubled banks being closed. The IMF pushed the Korean government to close insolvent banks, and in the final phase of negotiations, the Kim Yong-sam government agreed to close nine merchant banks and restructure two commercial banks, which were set as prior actions in the first LOI. However, the Kim Yong-sam government did not seriously undertake any further measures and postponed necessary actions until the next presidential election was held on December 18, 1997, in which Kim Dae-jung won the election.

On December 29, 1997, the National Assembly passed 13 financial reform bills, including bills for facilitating financial restructuring, enhancing banking supervision, and accelerating capital market liberalization. This was similar to the failed reform bills recommended by the Presidential Commission on Financial Reform prior to the crisis. The IMF insisted that the new banking supervisory agency should be independent from the Ministry of Finance and Economy (MOFE) (IMF 2003a, 109). In January, 1998, the Banking Act was amended and the Bank of Korea became independent. Thus, the passage of the bill to ensure the central bank independence was only achieved under the IMF influence. In this amendment, the supervision function over banks was transferred from the BOK to the newly established Financial Supervisory Commission (FSC) (Yokoi-Arai 2002, 142).

Also, restructuring of the banking sector progressed, but it did not perfectly meet the IMF's demands in that the IMF originally demanded that two commercial banks, Seoul Bank and Korea First Bank, be sold or closed while these two banks were rather nationalized. Nevertheless, restructuring of the banking sector did progress. Six out of 26 commercial banks and 16 out of 30 merchant banks merged or closed between December, 1997 and March, 1998 (IMF 2003a, 108–109).

Reforms were further accelerated after Kim Dae-jung became the president on February 25, 1998. Kim Dae-jung believed that financial repression and political repression went together. He believed that financial repression was an effective way for the authoritarian state to control and maintain strong ties with chaebols (Woo-Cumings 1999, 131). Therefore, by committing to financial reforms, Kim Dae-jung tried to break up the old ties between chaebols and the previous authoritarian regime and the Kim Yong-sam government. In this way, he would be able to secure his new democratic government by breaking with the past and would be able to reward his supporters. With region being the most important political cleavage in Korea, Kim Dae-jung allocated cabinet posts to several critics of chaebols which came from the southwest region where Kim Dae-jung came from — a disadvantaged region in the authoritarian past. Chon Chol-hwan, a progressive economist, became the governor of the Bank of Korea, and North Cholla Province Governor You Jong-keun, a former economist at Rutgers University, became an economic advisor to the president (Cumings 1999, 39).

Consequently, under the Kim Dae-jung government, reform measures to enhance banking supervision were facilitated. The supervisory function over all types of the financial sector (including banks, non-bank financial institutions, and the security market) was consolidated under the Financial Supervisory Commission (FSC), established in April, 1998 (Graham 2003, 111). In other words, the FSC was established as a “mega-supervisor” and all types of financial institutions were supervised under the FSC. The FSC was placed as accountable to the prime minister and was also responsible for amending and creating supervisory rules. Moreover, the Financial Supervisory Board (FSB) was established in January, 1999, by presidential decree. The FSB was responsible for conducting inspections, audits, and calling for sanctions against troubled banks as per the decision of the FSC (Yokoi-Arai 2002, 152–153). Thus, the Kim Dae-

jung government tried to tackle both bank restructuring and corporate restructuring together by establishing an independent agency, the FSC (Woo-Cumings 1999, 132). In addition, all deposit insurance protection agencies were merged into the Korea Deposit Insurance Corporation (KDIC). Also, all deposits were guaranteed by the government until 2000 (Baliño and Ubide 1999, 31).

Restructuring of the banking sector further progressed under the Kim Dae-jung government, with 12 commercial banks with a Capital Adequacy Ratio (CAR) below 6% being directed to submit rehabilitation plans by April, 1998. The FSC classified banks into “disapproved,” “conditionally approved,” and “approved” upon review of these rehabilitation plans. In June, 1998, the FSC then took an unprecedented move. The FSC revoked the licenses of the five banks categorized as disapproved and merged them with healthy banks. The other seven out of the 12 banks were allowed to operate conditionally, dependent upon restructuring efforts or upon mergers. As a result, a merger of banks took place.¹⁰² The other 13 healthy banks that had met the 8% CAR requirement were also reviewed, and three of these banks were required to follow management recommendations by the FSC (Park 2006, 173–174). In addition, merchant banks were also required to submit rehabilitation plans in order to meet 4% CAR by March, 1998 and 6% CAR by June, 1998. Ten merchant banks were closed in February, 1998 because they did not have a chance of meeting these conditions (Yokoi-Arai 2002, 156).

In terms of capital account liberalization, the Kim Dae-jung government embarked upon reform measures and eliminated the control over foreign ownership of Korean firms in the stock

¹⁰² Commercial Bank and Hanil Bank were merged and Hanvit Bank was established in January, 1999. In February, 1999, Kwangwon Bank and Hyundai Merchant Banks were merged with Chohung Bank. Chungbuk Bank was taken over by Chohung Bank in May 1999. Korea Exchange Bank chose to restructure itself by obtaining capital from the German-based Cimmerz Bank and Korea Exim Bank (Park 2006, 174).

market. 55% of foreign ownership of Korean firms' shares was allowed by the end of 1997 and further, 100% foreign ownership of shares was allowed by the end of 1998 (Yanagita 2000, 33). Thus, the Kim Dae-jung government accelerated financial reforms under the IMF programs more than ever, not only in the dimension of capital account liberalization but also in the regulatory dimensions of financial reforms, i.e., enhancement of banking supervision over the banking sector and restructuring of the banking sector.

Korea graduated from the IMF programs on July 12, 2000. Even after the graduation of the IMF programs, banking restructuring processes continued without policy reversals. In September, 2000, the second round of financial restructuring was launched and five commercial banks were placed as subsidiaries under the bank holding company established in April, 2001, the Woori Financial Holding Company, and public money was injected. Also, other healthy banks were encouraged to create universal banks via consolidation by mergers. As a consequence of mergers, large universal banks were established. In September, 2003, the US-based Lone Star took over Korea Exchange Bank and also in March, 2004, the Citigroup acquired more than 10% shares of KorAm Bank, which exceeded the 10% limit as a single investor. This meant that it actually paved the way for mega foreign banks to acquire 100% shares of Korean banks. In this light, restructuring of the banking sector and consolidation of banks were more facilitated in Korea than in any other Asian countries hit by the Asian financial crisis (Park 2006, 176).

5.6. DISCUSSION

5.6.1. Recapitulation of two cases: Thailand and Korea

This chapter qualitatively examines the effects of the IMF conditionality programs, the number of veto players, and two sectoral interests— the manufacturing sector and the banking sector — on financial reforms by examining two cases: Thailand and Korea. In Thailand, private banks dictated by financial conglomerates were dominant and acted as powerful interest groups. Even when Thailand was under the IMF conditionality programs because of the economic recession during the end of the 1970s and 1980s, the elimination of entry barriers was not achieved because of strong opposition by the banking sector. During the Prem government from 1980 to 1988, which was a semi-democratic government consisting of a multiparty coalition headed by an unelected prime minister, Thai banks were heavily protected by interest rate controls and high entry barriers. Thailand was democratized after 1988 and except for interrupting periods by coups during 1991 and 1992 Thailand was characterized as a country that had many veto players due to multi-party ruling coalitions.

Chatichai and his Chart Thai Party were backed by the newly emerged manufacturing sector based on export-led industrialization. Because of the manufacturing sector's support, the Chatichai government (1988–1990) made progress on financial reforms partially despite opposition from the banking sector. Interest rate controls were partially liberalized and multiple exchange rate regimes were abolished. Thus, due to the manufacturing sector's supports, financial reforms were facilitated in the dimensions of interest rate liberalization and capital

account liberalization. However, even the Chatichai government was not able to eliminate entry barriers on banks because of the strong opposition by the banking sector.

The Ananda government was installed following the coup in 1991 by the military. The Ananda government was not constrained by many veto players. Therefore, the Ananda government took policy decisions toward major financial liberalization in the early 1990s. Financial reforms were achieved in the dimensions of interest rate liberalization and capital account liberalization. As a consequence, firms and banks were allowed to engage in offshore borrowing, which led to the rapid increase of capital inflow.

In 1992, Chuan Leekpai became the premier as a result of the restoration of democracy. However, the Chuan government (1992–1995) as well as the subsequent Banharn government (1995 – 1996) and Chavalit government (1996–1997) were not able to enhance banking supervision over the banking sector despite the surge of capital inflow following capital count liberalization because some political parties within the ruling coalitions tended to maintain close political ties with the banking sector. Therefore, these political parties, such as the New Aspiration Party and the Chart Pattana Party, tended to oppose taking measures to enhance banking supervision. Because the governments did not take any effective measures to deter risky lending behavior of banks, Thailand was unable to avoid being hit by the Asian financial crisis in 1997.

After the Asian financial crisis, Thailand aimed at addressing the issue of restructuring of banks as well as the enhancement of banking supervision under the IMF conditionality programs. However, restructuring of banks was significantly delayed in Thailand even under IMF pressure. Not only the Chavalit government but also the second Chuan government (1997–2000) were not able to advance these necessary reforms due to multi-party coalition governments or too many

veto players until the graduation from the IMF programs in 2000. Although the “self-help” method that Thailand adopted required the commitment to increase banks’ capital, banks were not able to obtain enough capital injection from the government in exchange for increasing banks’ capital by their own efforts. In these circumstances, firms as debtors and banks as creditors together postponed the necessary measures for reducing non-performing loans. Furthermore, despite facing the pressures by the IMF with regards to making banking supervision legally independent, the governments were unable to achieve this as well. Thus, in the case of Thailand, because of many number of veto players, financial reforms tended to be delayed.

Thailand had to wait in order to progress restructuring of banks until Thaksin took power and established the government-led restructuring agency in 2001. However, although the Thaksin government took more decisive actions than the previous governments in terms of restructuring of banks, without IMF pressure, the legal independence of the banking supervisory agency still was not achieved.

In the case of Korea, the Park Chung-hee regime (1961–1979) adopted repressive financial policies. His government nationalized private banks and kept strict controls over banks in terms of credit allocation and interest rates. Banks merely served to provide capital for Korean conglomerates, or chaebols, in order to pursue the state-led heavy and chemical industrialization policies. Chaebols followed these government industrialization plans by taking advantage of “policy loans”, or preferential credit with subsidized interest rates.

In the early 1980s, the succeeding Chun Doo-hwan government (1980–1987) asked the IMF for assistance due to the economic recession at that time and facilitated some financial reform measures in the dimensions of privatization of banks and elimination of entry barriers on

banks. Chaebols demanded the lowering of entry barriers on new banks and NBFIs, since they wanted to establish their own banks to finance their groups. Chaebols also demanded less intervention by the government into the market. Therefore, the Roe Tae-woo (1988–1992) government and the Kim Yong-sam government (1993–1997) further made progress on financial reforms in the dimensions of capital account liberalization, elimination of entry barriers on banks, and interest rate liberalization, but “policy loans” were not completely eliminated since chaebols wanted to maintain the preferential access to credits. In this vein, although I assumed that the manufacturing sector would support the elimination of credit controls, in this case chaebols did not seek liberalization of credit controls but rather took the advantage of better access to preferential credit with subsidized interest rates.

The increase in capital inflow along with the lax banking supervision resulted in an increase in banks’ bad loans, and some chaebols even went into bankrupt. The Kim Yong-sam government was well aware of the banking sector’s problems. The Presidential Commission on Financial Reform had already recommended a comprehensive set of financial reforms. However, without any external pressures, the government did not take any effectual means to implement them before the Asian financial crisis.

After the Asian financial crisis, under the IMF conditionality programs, the Kim Dae-jung government committed to financial reforms. Kim Dae-jung wanted to break up ties which had developed between the previous authoritarian regime and the subsequent democratic governments and chaebols. As a consequence, he accelerated financial reforms and made considerable progress in terms of restructuring of banks and enhancement of banking supervision over banks. The Financial Supervisory Commission, an independent banking supervisory agency, was established in 1998 and acted decisively in expediting restructuring of banks.

Moreover, capital account liberalization further progressed by allowing the full foreign ownership of shares of Korean firms. Thus, in the case of Korea, the executive initiative that tried to break up ties between previous governments and powerful interest groups, chaebols, accelerated financial reforms.

5.6.2. Comparison between three cases: Indonesia, Thailand, and Korea

By comparing Thailand and Korea with Indonesia, financial reform outcomes in Thailand tended to be seriously delayed in terms of restructuring of banks as well as enhancement of banking supervision. Thailand is the only country in which the legal independence of the banking supervisory agency has not been achieved yet. This can be explained by the fact that a large number of veto players caused a delay in enhancing banking supervision even under the IMF pressures.

On the other hand, in the case of Indonesia, legal independence of the banking supervisory agency was achieved during the Habibie presidency, in which the Habibie government did not face constraints by other veto players given political uncertainty after the fall of the Suharto regime and prior to the first democratic election, although this central bank independence in which banking supervision was set as one of the functions of the central bank was rather weakened later during the Megawati presidency.

In the case of Korea, legal independence of the banking supervisory agency was realized under the Kim Dae-jung presidency. The Kim Dae-jung government had a strong incentive to break up old ties between the previous governments and chaebols. Given the dominance of the president's party and the lack of opposition to reforms among opposition parties given the fragile

political party system in Korea, the Kim Dae-jung government was able to commit to reforms in order to enhance the independence of banking supervisory agency. Thus, even though all three countries were under the IMF conditionality programs after the Asian financial crisis, financial reform outcomes differed concerning whether the legal independence of banking supervisory agency was achieved according to the differences in the number of veto players in the three cases. In looking at these three cases, it can be said that as the number of veto players increases, the IMF's influence in accelerating enhancement of banking supervision decreases.

With respect to restructuring of banks, it took a longer time to restructure banks both in Indonesia and in Thailand than in Korea. In Indonesia, due to the lack of cooperation of former bank owners or conglomerates with the IBRA and also due to the collusion between banks and politicians, asset recovery processes of taken-over banks were significantly delayed. In Thailand, the government was not able to formulate effective restructuring plans; hence, banks and firms repeatedly postponed necessary debt restructuring processes. On the other hand, in Korea, the FSC took decisive action and accelerated restructuring of the banking sector. As with the legal independence of the banking supervisory agency, the reason for these different outcomes is attributable to the difference in the number of veto players with all three countries under the IMF programs. In Thailand and Indonesia, multiparty ruling coalitions or too many veto players delayed bank restructuring processes by responding to societal pressures to postpone restructuring. On the contrary, in Korea, the government was able to take the initiative to restructure banks to break up old governments' ties with conglomerates because of having to contend with fewer veto players than Thailand and Indonesia.

In terms of privatization of banks, in Thailand, privatization of banks was not contentious because private banks were already predominant in Thailand's financial system. In Indonesia

and Korea, privatization of banks was an important financial reform dimension. Korea was able to privatize banks faster than in Indonesia because in Indonesia, multi-party ruling coalition governments during the Wahid presidency and the Megawati presidency took time in deciding on privatization of banks and also banks owners or conglomerates remained politically influential, which resulted in the delay in privatization of banks. On the other hand, in Korea, the newly established banking supervisory agency was able to act more decisively.

Concerning the societal interests, the situation in Thailand is distinguished from that in Indonesia and Korea due to the presence of a strong banking sector where banks acted as influential interest groups. Also, the relationship between the banking sector and the manufacturing sector was not so close and acted as separate interest groups. On the other hand in Indonesia and Korea, because of the presence of powerful conglomerates, i.e., Chinese conglomerates in the case of Indonesia and chaebols in Korea, which tended to represent the manufacturing interests, the manufacturing sector's interests tended to dictate policy outcomes rather than the banking sector's interests. This difference was particularly well observed in the reform dimension of elimination of entry barriers on banks. In Thailand, new entry of banks was strictly restricted until the Asian financial crisis whereas in Indonesia and Korea, entry of new banks was accelerated because the governments corresponded to conglomerates' demands in which they wanted to establish banks in order to finance their own projects. As a consequence, in Indonesia and in Korea, elimination of entry barriers on banks was accelerated even before the Asian financial crisis.

In terms of other dimensions of financial reforms such as capital account liberalization and interest rate liberalization, these reforms also tended to be accelerated because of the manufacturing sectors' demands. In these dimensions, conglomerates in Indonesia, newly

emerged firms in Thailand, and chaebols in Korea demanded capital account liberalization as well as interest rate liberalization as illustrated before.

However, in terms of elimination of credit controls, while this dimension was not a contentious one in Thailand, in Korea, this dimension of reform was significantly delayed. Chaebols obtained enormous benefits from preferential credit allocation, and the government also tried to utilize preferential allocation of credit as a means to nurture ties with chaebols; hence, elimination of credit controls in Korea was significantly delayed. On the other hand, in Indonesia, preferential credit allocation mainly benefited *puribumi* firms rather than the Chinese large conglomerates. Therefore, these Chinese conglomerates rather preferred to eliminate preferential credit allocation. In these circumstances, though state bank officials strongly opposed to the elimination of credit controls, this dimension of reform was not as contentious as in Korea. Therefore, although I assumed that the manufacturing sector would support elimination of credit controls, when large firms benefited from preferential credit allocation, these large firms opposed these reform measures. Therefore, conditioning upon whether large firms or medium and small firms were protected by preferential credit allocation, the impact of the manufacturing sector on elimination of credit controls differs. This echoed the results of the quantitative analysis in Chapter 3, in which I was not able to obtain a statistically significant impact of the manufacturing sector in this dimension.

As discussed above, although Indonesia, Thailand, and Korea were all under IMF programs after the Asian financial crisis, the differences in the progress in financial reforms can be observed, especially in the dimensions of enhancement of banking supervision over the banking sector and privatization of banks as well as restructuring of the banking sector. In this light, I qualitatively confirmed my expectations. As illustrated in Chapters 4 and 5, although the

IMF programs were the most important factor in explaining financial reform outcomes, the number of veto players and two societal actors —the manufacturing sector and the banking sector— also played a role in shaping financial reform outcomes by holding the IMF pressures constant.

Appendix 5.A Party Composition in Coalition Governments and Opposition Parties in Thailand I

Chatichai Government (1988.8-1990.12)	No. of Seat Seats Share	Chatichai Government (1990.12-1991.3)	No. of Seat Seats Share	Chuan Government (1992.9-1993.9)	No. of Seat Seats Share	Chuan Government (1993.9-1994.12)	No. of Seat Seats Share	Chuan Government (1994.12-1995.5)	No. of Seat Seats Share
Chart Thai*	87	Chart Thai*	96	Democrat*	79	Democrat*	79	Democrat*	79
Social Action*	54	Thai Citizens*	31	New Aspiration*	51	New Aspiration*	51	Chart Pattana*	60
Democrat*	48	Citizen*	21	Righteous Force*	47	Righteous Force*	47	Righteous Force*	47
Citizen*	21	Solidarity*	10	Social Action*	22	Solidarity*	8	Solidarity*	8
Mass*	5	Community Action Party*	9	Solidarity*	8	Seritham*	8	Seritham*	8
United Democratic*	5	Progressive Party*	8						
		United Democratic*	5						
Ruling Colaition Total	220 62%	Ruling Colaition Total	180 50.4%	Ruling Colaition Total	207 58%	Ruling Colaition Total	193 54%	Ruling Colaition Total	202 56%
United Thai	35	Social Action	54	Chart Thai	77	Chart Thai	77	Chart Thai	77
Thai Citizens	31	Democrat	48	Chart Pattana	60	Chart Pattana	60	New Aspiration	51
People	19	United Thai	35	Seritham	8	Social Action	22	Social Action	22
Thai Mass	17	Thai Mass	17	Mass	4	Mass	4	Mass	4
Righteous Force	14	Righteous Force	14	Thai Citizens	3	Thai Citizens	3	Thai Citizens	3
Community Action	9	Mass	5	Citizen	1	Citizen	1	Citizen	1
Progressive Party	8	Liberal	3						
Liberal	3	Social Democratic Force	1						
Social Democratic Force	1								
Opposition Total	137 38%	Opposition Total	177 49.6%	Opposition Total	153 42%	Opposition Total	167 46%	Opposition Total	158 44%

Source: *Political Handbook of the World (various years)* and *Keesing's Contemporary Archives: Record of World Events (various years)*. * shows political party which obtained cabinet posts.

Appendix 5.B Party Composition in Coalition Governments and Opposition Parties in Thailand II

Chuan Government (1995.5-1995.7)	No. of Seat Seats Share	Banharn Government (1995.7-1996.11)	No. of Seat Seats Share	Chavalit Government (1996.11-1997.11)	No. of Seat Seats Share	Chuan Government (1997.11-1998.10)	No. of Seat Seats Share	Chuan Government (1998.10-1999.7)	No. of Seat Seats Share
Democrat*	79	Chart Thai*	92	New Aspiration*	125	Democrat*	123	Democrat*	123
Chart Pattana*	60	New Aspiration*	57	Chart Pattana*	52	Chart Thai*	39	Chart Pattana*	52
Solidarity*	8	Righteous Force*	23	Chart Thai*	39	Social Action*	20	Chart Thai*	39
Seritham*	8	Social Action*	22	Social Action*	20	Cobra faction	12	Social Action*	20
		Dynamic Thai*	18	Thai Citizens*	18	Solidarity*	8	Cobra faction	12
		Thai Citizens*	18	Mass*	2	Seritham*	4	Solidarity*	8
		Mass*	3					Seritham*	4
Ruling Colaition Total	155 43%	Ruling Colaition Total	233 60%	Ruling Colaition Total	256 65%	Ruling Colaition Total	206 53%	Ruling Colaition Total	258 66%
Chart Thai	77	Democrat	86	Democrat	123	New Aspiration	125	New Aspiration	125
New Aspiration	51	Chart Pattana	53	Solidarity	8	Chart Pattana	52	Thai Citizens	5
Righteous Force	47	Seritham	11	Seritham	4	Thai Citizens	5	Mass	2
Social Action	22	Solidarity	8	Thai	1	Mass	2	Righteous Force	1
Mass	4			Righteous Force	1	Righteous Force	1	Thai	1
Thai Citizens	3					Thai	1		
Citizen	1								
Opposition Total	205 57%	Opposition Total	158 40%	Opposition Total	137 35%	Opposition Total	186 47%	Opposition Total	134 34%

Source: *Political Handbook of the World (various years)*, Haggard (2000, 95-96), and Keesing's *Contemporary Archives: Record of World Events (various years)*. * shows political party which obtained cabinet posts.

Appendix 5.C Party Composition in Coalition Governments and Opposition Parties in Thailand III

Chuan Government (1999.7-2001.2)	No. of Seat Seats Share	Thaksin Government (2001.2-2001.7)	No. of Seat Seats Share	Thaksin Government (2001.7-2002.3)	No. of Seat Seats Share	Thaksin Government (2002.3-2003.11)	No. of Seat Seats Share	Thaksin Government (2003.11-2004.3)	No. of Seat Seats Share
Democrat*	123	Thai Rak Thai *	249	Thai Rak Thai *	263	Thai Rak Thai *	296	Thai Rak Thai *	296
Chart Pattana*	52	Chart Thai*	41	Chart Thai*	41	Chart Thai*	39	Chart Thai*	39
Chart Thai*	39	New Aspiration*	36	New Aspiration*	36	Chart Pattana*	30		
Citizen*	12	Seritham*	14						
Solidarity*	8								
Seritham*	4								
Ruling Colaition Total	238 61%	Ruling Colaition Total	340 68%	Ruling Colaition Total	340 68%	Ruling Colaition Total	369 74%	Ruling Colaition Total	335 67%
New Aspiration	125	Democrat	128	Democrat	128	Democrat	130	Democrat	130
Social Action	20	Chart Pattana	29	Chart Pattana	29	Citizen	2	Chart Pattana	30
Thai Citizens	5	Citizen	2	Citizen	2	Social Action	1	Citizen	2
Mass	2	Social Action	1	Social Action	1	New Aspiration	1	Social Action	1
Righteous Force	1					Mass	1	New Aspiration	1
Thai	1							Mass	1
Opposition Total	154 39%	Opposition Total	160 32%	Opposition Total	160 32%	Opposition Total	131 26%	Opposition Total	165 33%

Source: *Political Handbook of the World (various years)*, *Haggard (2000, 95-96)*, and *Keesing's Contemporary Archives: Record of World Events (various years)*. * shows political party which obtained cabinet posts.

Appendix 5.D Thailand and IMF Programs under the Asian Crisis

Title of Documents	Date
	Chavalit Government
Thailand Letter of Intent	14 August 1997
	Chuan Government
Thailand Letter of Intent	25 November 1997
Thailand Letter of Intent and Memorandum on Economic Policies	24 February 1998
Thailand Letter of Intent	26 May 1998
Thailand Letter of Intent	25 August 1998
Thailand Letter of Intent	1 December 1998
Thailand Letter of Intent and Memorandum of Economic Policies	23 March 1999
Thailand Letter of Intent	21 September 1999

Appendix 5.E Korea and IMF Programs under the Asian Crisis

Title of Documents	Date
Kim Young-Sam Government	
Korea Letter of Intent	3 December 1997
Korea Letter of Intent	24 December 1997
Korea Letter of Intent and Memorandum of Economic Policies	7 February 1998
Kim Dae-Jung Government	
Korea Letter of Intent	2 May 1998
Korea Letter of Intent	24 July 1998
Korea Letter of Intent	13 November 1998
Korea Letter of Intent and Memorandum of Economic Policies	10 March 1999
Korea Letter of Intent and Memorandum of Economic Policies	24 November 1999
Korea Letter of Intent and Memorandum on Economic Policies for 2000	12 July 2000

6.0 CONCLUSIONS

This project aimed to account for political determinants of the *magnitude* and the *pace* of financial reforms in developing countries. In this chapter, I present a summary of findings and discuss them.

6.1. SUMMARY OF FINDINGS

Despite the general presumption during the late 1980s and the 1990s that no differences between countries exist in neoliberal economic reforms in developing countries, as we saw, there indeed does exist a surprising diversity concerning the *magnitude* and the *pace* of financial reforms in these countries. For instance, concerning the *magnitude* of financial reforms, we saw some countries engaged in “big-bang” type of financial reforms at the extreme end of the larger magnitude of financial reforms while other countries engaged in more gradual reforms over three decades. In order to account for determinants of the *magnitude* and the *pace* of financial reforms in developing countries, in the preceding chapters, I examined how the IMF, the number of veto players, and two societal sectors’ interests — the manufacturing sector and the banking sector — shaped financial reform outcomes quantitatively and qualitatively.

Especially in the quantitative examinations, the *Financial Reform Database* developed by the IMF which coded financial reforms as separate six dimensions in thirty developing countries from 1973 to 2002 allowed me to examine not only capital account liberalization, to which

researchers have paid most attention, but also five other dimensions of domestic banking reforms: privatization of banks, enhancement of banking supervision, interest rate liberalization, elimination of credit controls, and elimination of entry barriers against banks.

With respect to the *magnitude* of financial reforms, by creating the additive change index and employing ordinal logit regressions, rather than arguing whether a country should conduct financial reforms in a “big-bang” manner or gradual manner from normative viewpoints as economists had done in prior research, I aimed at specifying the conditions under which a country is more likely to engage in a larger magnitude of financial reforms empirically.

Findings largely confirmed my expectations. While the IMF programs facilitate a larger magnitude of reforms, the results demonstrated that the IMF effects are conditioned by the recipient countries’ domestic political factor: the number of veto players. As the number of veto players increases, the IMF effect of facilitating a larger magnitude of financial reform decreases. In addition, results also confirmed that a country where the manufacturing sector has a stronger influence is more likely to engage in a wider range of financial reforms at one time. In addition, results revealed that a non-democratic government is more likely to take radical financial reform measures *ceteris paribus*. On the other hand, a role of the banking sector with respect to the *magnitude* of financial reformed was not observed, contrary to my expectation.

Concerning the determinants of the *pace* in each of the six dimensions of financial reforms, I employed event history analysis by modeling financial reforms as repeated events. With respect to the interaction effects between the IMF and the number of veto players, findings mostly confirmed my expectations; as the number of veto players increased, the IMF’s impact on bringing forward the timing of financial reforms decreased. When I used the number of political parties within a ruling coalition as the indicator of the number of veto players, these expected

results were obtained in five out of the six dimensions — privatization of banks, enhancement of banking supervision, capital account liberalization, interest rate liberalization, and elimination of credit controls. When I used the widely used other indicator of veto players, POLCONIII, I also obtained significant results in the following five out of six dimensions using only democratic cases — privatization of banks, enhancement of banking supervision, capital account liberalization, interest rate liberalization, and elimination of entry barriers. Thus, these findings provide strong empirical support for a negative relationship between the number of veto players and the occurrence of financial reforms.

In terms of the impact of the manufacturing sector on the *pace* of financial reforms, I obtained the expected effect of accelerating financial reforms in the dimensions of privatization of banks, capital account liberalization, interest rate liberalization, and elimination of entry barriers. However, significant results were not obtained in the dimension of elimination of credit controls. Also, concerning the effects of the banking sector on the *pace* of financial reforms, although I hypothesized that a stronger banking sector influence would delay all dimensions of financial reforms, expected findings were only obtained in the dimensions of elimination of credit controls and interest rate liberalization. Therefore, in terms of the banking sector, I was not able to obtain enough expected results after doing the quantitative analysis.

Hence, in order to further explore the role of the banking sector and to examine whether the quantitatively obtained results could be confirmed, I employed case studies of the following three countries: Indonesia, Thailand, and Korea. These three cases were selected on the grounds that all three countries followed a similar developmental pattern, based on export-led industrialization in Asia. In addition, all three countries suffered from the Asian financial crisis and asked the IMF assistance. As a result, all three countries pursued financial sector reforms

under IMF influence, with financial sector reforms being a key component of the IMF conditionality programs. However, despite these similarities, the outcomes of financial reforms were different in these countries. Hence, I argued that the differences in the number of veto players and in the societal pressures of the manufacturing sector and the banking sector could explain the differences in the financial sector reforms in these countries after the Asian financial crisis, holding the IMF constant.

In Thailand, a large number of veto players and a strong influence of the banking sector caused a delay in the restructuring of banks and enhancement of banking supervision over the banking sector after the Asian financial crisis. Indonesia also experienced a delay in restructuring of banks due to the fragile coalition governments under President Wahid and President Megawati. In Korea, on the other hand, financial restructuring and enhancement of banking supervision tended to be accelerated due to the initiatives of the Kim Dae-jung government, which wanted to break up the old ties between the previous governments and Korean conglomerates, or *chaebols*. Therefore, although Korea and Indonesia share a similarity in terms of societal interests, in which conglomerates which represented the manufacturing interests were dominant vis-à-vis the banking sector, in the case of Indonesia, banking restructuring was delayed. Using these case studies, then, I was able to confirm my expectations qualitatively as well: as the number of veto players increases, the effects of the IMF in accelerating financial reforms tended to decrease. In the case of Korea, there existed fewer veto players than in the cases of Thailand and Indonesia, which caused acceleration in financial sector restructuring under the IMF programs compared with Thailand and Indonesia. With respect to the *magnitude* of financial reforms, a fewer number of veto players tended to cause a larger magnitude of financial reforms, as seen in the cases of the Habibie government in Indonesia, the

Ananda government in Thailand, and the Kim Dae-jung government in Korea, though it meant “a larger magnitude” in relative terms compared with other periods in the same country.

Especially, in the case of Indonesia, by looking at temporal dimensions in terms of the number of veto players across the four governments which were all under the IMF conditionality programs after the Asian financial crisis, the results revealed that the number of veto players and also the collusion between conglomerates and the government shaped financial reform outcomes. While Suharto delayed financial sector reforms due to the collusion between the government and conglomerates, the Habibie government committed to financial reforms than the Suharto government due to no veto player constraints and less close ties with bank owners than those of the Suharto government. However, the Wahid government and the Megawati government delayed financial sector restructuring and privatization of banks. President Wahid, who led a fragile multi-party ruling coalition, lacked commitment to the IMF programs. As a consequence, the Wahid government delayed bank restructuring. In terms of the succeeding Megawati government, on the other hand, even though Megawati had an incentive to commit to financial reforms and Megawati herself did not have close ties with bank owners, fragile multi-party ruling coalition governments or many veto players caused a delay in bank restructuring and privatization of banks.

6.2. DISCUSSION

Given the results for both the quantitative and qualitative analyses discussed above, it is worth reiterating that in spite of empirical controversy surrounding the effects of the IMF conditionality

programs, which tend to suffer from low implementation rates, concerning financial reforms, where the IMF's core competency lies, this study showed that the IMF conditionality programs have a significant impact in both facilitating a larger *magnitude* of financial reforms and also accelerating the *pace* of financial reforms in each of the six dimensions of financial reforms in developing countries.

Moreover, although the IMF conditionality programs are touted as apolitical, this study demonstrated that the effects of the IMF programs are conditioned by the domestic political factor: the number of veto players. In this light, as expected, though the IMF is the most predominant factor in determining the *magnitude* and the *pace* of financial reforms in developing countries, the IMF is not independent from recipient countries' domestic political conditions. Further, though empirical findings on the relationship between the number of veto players and policy outcomes have varied and are controversial in conventional studies, concerning financial reforms, this study suggests that a negative linear relationship exists between the number of veto players and the *magnitude* and the *pace* of financial reforms. However, as stated, the number of veto players works in a way that conditions the effects of the IMF in general rather than working independently of the IMF programs. Therefore, it would be necessary for the IMF to take into consideration a recipient country's political conditions in designing conditionality programs. If a country has a large number of veto players, it would be likely to take more time for a country to conduct financial reforms with the country also more likely to conduct a smaller scale of reforms.

With respect to societal impacts, it can be stated that it is easier for a developing country to conduct financial reforms in dimensions such as privatization of banks, capital account liberalization, and interest rate liberalization when a country has a stronger influence of the manufacturing sector because in these circumstances, firms would demand better access to

credits. However, concerning the elimination of credit controls, as the insignificant impact of the manufacturing sector in quantitative analyses suggests, depending upon whether large firms can profit from preferential credits, large firms may want to preserve preferential credits rather than eliminate those credits, as was observed in the Korean case. Concerning the effects of the banking sector, although I was not able to obtain enough significant results in quantitative analysis, from the Thai case I was able to observe that a strong banking sector had the effect of delaying financial reforms, especially in the dimension of the elimination of entry barriers on banks. A stronger opposition from the banking sector caused postponement of financial reforms for lowering entry barriers on banks, with these reforms being postponed for many years.

With respect to the dimension of the enhancement of banking supervision over the banking sector, a prior study done by Satyanath (2006) showed that a signaling problem between an executive leader and a banking regulator results in lax banking regulation under liberalized capital flows in a democratic government because the executive leader in a democratic country does not know the real state of the banking sector due to the polarization of preferences between executive leaders and bank regulators. Therefore, even if the leader himself/herself is free from corruption, lax banking regulation can still occur.

Because it is difficult to assess the impact of this signaling problem on the likelihood of the enhancement of banking supervision quantitatively, Satyanath also employed case study methods to verify this theory. Although his study is convincing, banking supervision does not only mean policy measures to know the real information of banks' accounts but also should take into account policy measures such as enhancing the independence of the banking supervisory agency and giving a stronger power to the banking supervisory agency to resolve problems of insolvent banks when necessary, for example. In this vein, quantitative assessment in this study

used a more comprehensive indicator of the enhancement of banking supervision in which not only supervisory measures to know banks' real balance sheets but also the independence of banking supervisory agencies and measures to enhance prudential regulations of banks. Further, this study offered more comprehensive empirical assessment, employing quantitative studies using the data of thirty developing countries spanning three decades.

The results of this study do not refute that the signaling problem between chief executive and bank regulators may cause lax banking regulation. However, as the above quantitative findings and case studies show, the number of veto players and societal pressures from the banking sector and the manufacturing sector may matter more than signaling problems in determining the outcomes of the enhancement of banking supervision. In particular, case studies after the Asian financial crises in Thailand and Korea in this study revealed that both the Chuan government in Thailand and the Kim Yong-sam government in Korea were not able to articulate effective measures for enhancing banking supervision after the Asian financial crisis.

Both of them were used in Satyanath's study as the cases supporting his theory of a signaling problem in which executive leaders did not know the real state of the bank problems. Even though they doubtless knew the bad condition of the banking sector after the Asian financial crisis, because of a large number of veto players in the case of the Chuan government in Thailand and because of the close ties of Kim Yong-sam's political party with chaebols in the case of Korea, their governments were not able to take effective measures in responding to banking sector problems after the Asian financial crisis.

Further, even though Chuan, especially was relatively free from corruption scandals and did not have close ties with bank owners, when his coalition partners had close ties with indebted firms and banks, his government was not able to act decisively in enhancing banking supervision.

Therefore, as this shows, the number of veto players and societal pressures may more matter than the signaling problem in determining the enhancement of banking supervision.

In this vein, concerning the relationship between the number of veto players and the likelihood of policy changes in the cases of developing countries, this study's results were contradictory to some previous findings. MacIntyre (2003, 2001)'s studies, which were also cited in Satyanath (2006)'s work, showed a curvilinear relationship between the number of veto players and the degree of governability under the Asian financial crisis. He argues that a middle range of number of veto players works best in terms of the responses to currency crisis after examining four Asian cases (Malaysia, Indonesia, Thailand, and the Philippines). However, his studies focused on a shorter period and his results were based only on case studies. On the other hand, Hicken, Satyanath, and Sergenti (2005) examined 44 countries and compared growth difference between 1990 to 1997 and 1997 to 2002. They found that there is *no* systematic relationship between the number of veto players and economic growth recovery from forced devaluations and rather conflicting results exist depending on the measurement of veto players. In contrast, the present study looked at longer periods in three cases and also quantitatively examined a thirty-year period in thirty developing countries; as a result, this study confirms Tsebelis's claim in terms of financial reforms.¹⁰³ These different results may come from the fact that while these other studies examined responses to currency crisis and growth rate recovery, this study looked at more direct sets of policy changes in financial reforms.

Under the turmoil of the Asian financial crisis, the IMF faced massive criticism from researchers, policy makers, and street protesters alike because it demanded draconian sets of contractionary economic policy measures despite the sound macroeconomic fundamentals of the

¹⁰³ However, I do not imply committing to faster and larger scales of financial reforms means better governability in developing countries.

Asian countries.¹⁰⁴ In this vein, though the IMF's objective is to maintain an objective, apolitical stance, it is difficult to exclude the importance of political conditions of recipient countries taken into account in order to ensure implementation of conditionality programs. This study suggests that it would be worth it for the IMF to consider more country-specific contextual political conditions when designing conditionality programs. Considering not only the interests and the roles of key political players but also the interests and the roles of key societal groups is important for understanding how to enhance the "ownership" of recipient countries in implementing conditionality programs.

It is also noteworthy that since the Asian financial crisis, much emphasis has been given to the quality of banking supervision over the banking sector in order to establish a sound banking sector. In this light, it would be important for the IMF to analyze why some liberalization measures such as the free entry of domestic banks and capital account liberalization tend to be more facilitated than those in the regulatory dimension, i.e., enhancement of banking supervision, even in the same policy area of financial reforms. Since I assumed that both the manufacturing sector and the banking sector oppose this regulatory dimension of financial reforms, which was confirmed in the case studies, this study suggests that it may be difficult for a developing country to enhance banking supervision without external pressures. Though economists suggest that a proper sequential order of economic liberalization is desirable, with economists arguing that enhancement of banking supervision over the banking sector should come prior to external liberalization such as capital account liberalization,¹⁰⁵ this

¹⁰⁴ The IMF was also criticized because the IMF was perceived to have failed in detecting the risks of the currency crisis beforehand and also in estimating the depth of the Asian crisis once it occurred.

¹⁰⁵ For literature review on sequential economic liberalization, see Nsouli, Rached, and Funke (2005), for instance.

study revealed why developing countries may suffer from a failure to implement financial reforms in the suggested sequential manner. Because of opposition from banks and firms, politicians tend to delay enhancement of banking supervision more than other dimensions of financial reforms toward liberalization.

In this regard, one notable implication of this research is the effective roles of the relevant international institutions in enhancing banking supervision over the banking sector. Given the difficulties in achieving this regulatory dimension of reforms, the existence of some forms of external pressure at the international level, such as from the IMF, the World Bank, and the Bank for International Settlements (BIS), can be important. The FSAP, started in 1999 as a joint operation by the IMF and the World Bank, plays an important role in facilitating the enhancement of banking supervision in developing countries by assessing the extent of compliance to the Basle Committees' Core Principles for Effective Banking Supervision as a part of programs. Also, the BIS and the Basel Committee on Banking Supervision, which set the unified international standards for both developed and developing countries, has been quite important in providing the benchmark to establish the effective banking supervision as used in the FSAP.

From a broader perspective, this study implies that states tend to commit more to mandates from international organizations when states are able to obtain critical benefits from the commitments to these mandates. However, even in cases where states can obtain critical benefits from commitments to mandates, states' compliance to mandates is still affected by domestic political factors both at the national level and the societal level. This study suggests that an increase in domestic institutional constraints such as in the number of veto players makes states commitments to mandates harder. In addition, it seems that states' compliance to

mandates is also affected by how influential societal actors can obtain gains from the commitments to mandates from international organizations and how these influential societal actors can exert influence over executives to obtain their desirable outcomes. But even under conditions of more institutional constraints due to many veto players and lack of the support from influential societal actors, international organizations can still effectively promote their agenda only if states critically rely on resources from international organizations. In these limited circumstances, these domestic political constraints would tend to work as intermediate factors rather than independent sources to affect the outcomes of states' commitment to mandates. Therefore, in these circumstances, states would still provide commitments to mandates even though they may repeatedly delay in committing to mandates from international organizations.

As to a future research agenda, since I only examined three Asian cases in this study, I would like to extend case studies to Latin America regions. Given the history of frequent currency crises and the following frequent IMF interventions in this region, this extension would provide other good cases to illustrate how the interaction between the IMF, veto players, and societal actors shape the outcomes of various dimensions of financial reforms. In the meanwhile, I hope that this dissertation contributes to accumulation of knowledge concerning *why* financial reforms occur in developing countries.

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