Comment on “Are Banking Systems in East Asia Stronger?”

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Turner’s (2007) excellent paper analyzes the causes of financial crisis in four Asian countries in 1997–1998 and policy responses to rebuild the banking systems in Indonesia, South Korea, Malaysia, and Thailand. The financial instability in Asia involved twin crises, namely, a simultaneous occurrence of a banking crisis and a currency crisis.

Turner rightly identifies five interrelated policy measures introduced in this region to solve the problems. First, policies to restore macroeconomic stability, accumulate external reserves, and promote economic growth. Second, policies to reduce the need for foreign exchange intervention by replacing the fixed exchange rate system with a floating regime in 1997. The shift replaced the exchange rate target with an inflation target as the nominal anchor for monetary policy. Having been temporarily pegged to the US dollar during the crisis, the Malaysian ringgit moved to independent floating in April 2005. The third set of policies involved the recapitalization of financially distressed banks. Fourth, there were policies to reduce the banking system’s reliance on short-term financing by developing more stable long-term financing from local and regional securities, and derivative markets. Fifth, there were policies to strengthen the financial infrastructure by upgrading governance, prudential supervision, and establishing safety net for the banking system as well as the more complex institutions that surround bond and capital markets. None of the four crisis-affected countries has resorted to financial suppression in dealing with the financial market failures. Of these countries, only Malaysia temporarily imposed capital controls to help address the currency crisis.

To gain a better understanding of how the countries in this region rebuild external reserves, Turner needs to analyze in more detail the different sources of reserve accumulation in the four crisis-affected countries. South Korea builds its external reserves mainly from exports. In contrast, Indonesia generates its external reserves mainly from volatile short-term capital inflows. There are two programs introduced in this region for resource pooling to supplement the International Monetary Fund facilities. The Bilateral Swap Arrangement was introduced in March 2000 under the Chiang Mai Initiative, and the Asian Bond Fund was created in 2003 by the Executives’ Meeting of East Asia–Pacific Central Banks, a group of 11 regional central banks.

The market share of foreign banks has increased after the crisis. Equipped with strong reputations, wide international networks, advanced technology, and rapid product innovation, foreign banks can attract prime customers. By appointing knowledgeable and experienced personnel in the relevant fields and using local expertise, foreign banks can

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outcompete local competitors in serving small- and medium-size enterprises and in developing new markets such as Islamic banking, which is mainly based on risk sharing.

Turner rightly starts his analysis of bank performances with bank profitability. However, he did not dig more deeply into what are the sources of the bank profit, and there is no analysis of the structure of the banks’ asset portfolios. In the case of Indonesia, nearly half of banks’ portfolio is held in government bonds, central bank certificates, and overnight facilities at the central bank. As a result, Indonesian banks’ profits are mainly generated from interest income on sovereign bonds and central bank paper, and not from interest income.

The impressive risk-adjusted capital ratios need to be carefully interpreted. This is because the recapitalization of the banks during the crisis years was mainly financed by sovereign bonds. The recapitalization bonds in Indonesia amounted to 50% of the gross domestic product in 1999. Unlike Japan and China, these countries do not have enough external reserves to recapitalize their banks. In the case of Indonesia, some of the bonds are illiquid partly because there are non-traded. The bond market in Indonesia is in early stage of development as both institutional investors and market infrastructure need to be developed. The illiquidity of the capital and portfolio of the banks has limited their capability to expand credit.

There have been some improvements in corporate governance, legal arrangements, and the quality of banking supervision in Asia. Information sharing among bankers has been facilitated through the newly established credit bureaus. The regional efforts to promote both domestic and regional bond markets help improve the financial infrastructures in Asia. However, corporate governance of state-owned enterprises, including banks, has not changed much in China and Indonesia. As the state still holds their “golden share,” the management of state-owned enterprises are still appointed by and accountable to the government. PT Bank Shinta in Indonesia is now owned and run by those who did not pass the fit and proper test during the crisis years 1997–1998. Weak legal systems in these countries make enforcement of accounting standards virtually absent and bankruptcy resolutions insufficient.

The economic crisis has encouraged painful structural changes, including radical restructuring of highly leveraged companies. The controlling families of the conglomerates and chaebols are now seeking outside shareholders, including foreign investors, and are forced to sell companies unrelated to their core business and diversify into new high margin businesses. To survive in more competitive markets, they have to cut costs, improve efficiency, upgrade the quality of their products, and improve their marketing abilities as well as their brand images.

Reference