Chapter III

The Financial System: Problems and Responses

1. Why is a Financial Crisis a Problem?

1-1. Financial Crisis Extend Negative Effects to the Whole Economy

Banks provide a payment system, which is carried out through interbank transactions. Thus if a bank becomes insolvent, this may cause a chain reaction whereby other banks also become unable to make payments. Banks also provide loans. Thus if banks become insolvent, it may cause a credit crunch where other firms have great difficulty to access funds.

The greater the share of banks in financial markets, and the less developed stock and bond markets are in an economy, the greater the potential negative effects of a crisis. The role of banks definitely loom large in East Asian economies. As Table 1 shows, the overall domestic credit level is relatively small in Indonesia, where it is approximately 60% of GDP, but in Thailand and Malaysia, the level far surpasses GDP. In South Korea too, if we include lending by savings institutions the level is higher than GDP.

Let us now turn to Figure 1, which shows monthly movement of credit to private borrowers by commercial banks in each country. Indonesia shows some unusual movement from December 1997 to January and from April 1998 to June. It is thought that with the sudden drop in the exchange rate, the value of dollar-denominated lending expressed in rupiah expanded. If this effect is factored out, **the amount of credit at Indonesian banks has shrunk dramatically since last November, when a credit crunch began. In the other three countries as well, a severe credit crunch got underway at the beginning of 1998.**

1-2. Government Rescue Can Easily Lead to Moral Hazard

Thus the negative effects of a financial crisis on the economy overall can be very great, and governments cannot simply allow large-scale bank failures to happen. If we consider past financial crises, we see that governments always engineer some sort of response.[1] However, **the fact that governments cannot simply let events run their course is itself a serious problem**. If governments are expected to come to the rescue in the event of a crisis **this gives rise to various forms of moral hazard at financial institutions** including (1) shareholders may not check the actions of management as closely, (2) management may become lax, (3) employees may demand high compensation regardless of their performance, and (4) depositors may place deposits at poorly-managed institutions so long as interest rates are high[2].

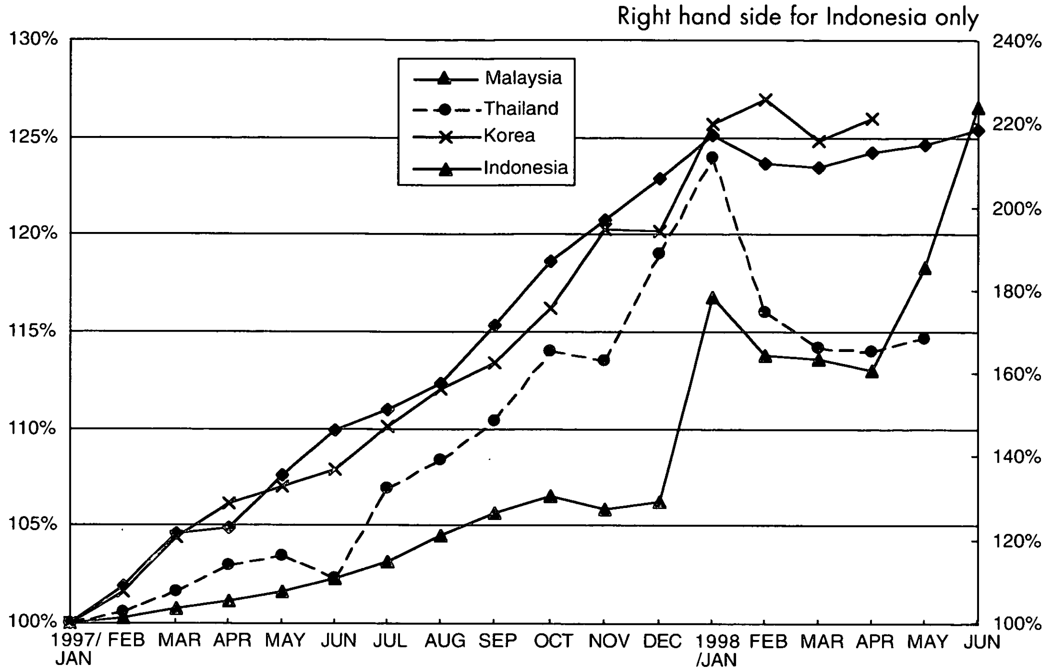
Seen this way, dealing with a financial crisis involves (1) minimizing as much as possible negative effects to the economy overall, and (2) on the other hand to try to avoid moral hazard. However these two aims are in fact mutually incompatible, and reconciling them is an extremely difficult problem[3]. That is why even though financial crises have arisen in countries all over the world on different

Table 1 Ratio of Domestic Credit to GDP

	1997
Indonesia	58.13%
Korea	74.68%
Korea *	134.85%
Malaysia	123.60%
Malaysia **	165.10%
Thailand	126.96%
Thailand **	157.29%
U.S.	80.00%
Japan	128.00%

Source: *International Financial Statistics*, IMF
Notes: Domestic Credit is the sum of that of Deposit Money Banks and Monetary Authorities
* is the sum of Domestic Credit and claims on private sector by Other Banking Institutions
** includes claims on Other Banking Institutions and Nonbank Financial Institutions

Fig. 1 Claims on Private Sector by Commercial Banks (Stock: 1997/Jan=100%)



Source: IFS, IMF

scales countless times, there is still no definitive, ideal way to deal with them.

In the next section we will further discuss how difficult financial restructuring is, while going over the general way of responding to financial crises.

2. Responses to a Financial Crisis[4]

2-1. Establishing an Independent Specialized Institution to Handle Financial Restructuring

If the central bank is directly in charge of responding to a financial crisis, its original functions of supervising financial institutions and implementing monetary policy to ensure price stability might be impaired. In order to safeguard central bank independence, among other aims, one method is to **establish a separate administrative body** for the purpose of financial restructuring.

In many cases, additional public bodies are established in supporting roles to **collect nonperforming loans** (for example, the Resolution Trust Corporation in the United States, as well as the Resolution and Collection Bank and the Housing Loan Administration Corporation in Japan) and/or to **inject capital into financial institutions.**

2-2. Restoring Solvency

Improving the balance sheets of financial institutions. Simply put, this means **measures to improve the financial situation of institutions where it has already deteriorated**. For example, the government takes such measures as taking over and disposing of nonperforming loans, and injecting funds. However, **these cause moral hazard**, so it is important that they be carried out in conjunction with strict measures such as punishing shareholders by reducing their capital and removing existing management (even so, avoiding moral hazard is difficult).

Naturally, it may be necessary to liquidate financial institutions with no prospect of recovery. However, we would like to **stress the necessity of the final disposal of nonperforming loans, regardless of whether financial institutions are liquidated or not**. What are nonperforming loans to banks are borrowing of general companies, and the matter of what should ultimately be done with these borrowers is very important. Conversely, in the event that a bank is rescued, if the borrowers that account for the nonperforming loans are not dealt with, then the problem cannot be said to have truly been dealt with. Letting companies – not just banks – that have slipped into insolvency just be is a waste of productive resources that imposes a large cost on the economy as a whole. This is also related to maintaining the long-term health of the economy.

2-3. Restoring Profitability

Even if the measures in Paragraph 2 above take care of previous problems, if it seems as though the profitability of the bank's main business cannot be raised, it will mean simply repeating the past. **Efforts at the level of individual banks must be stimulated**, such as restructuring and improving management strategy. However, if measures already taken (for example, measures to improve balance sheets) have given rise to moral hazard at the financial institution in question, chances are that things will not go well.

From the broader perspective of the whole economy, **the government's policy for economic recovery is important.** When the economy as a whole is depressed, it is hard to restore bank profitability. A low interest rate policy is also important as a secondary support to bank profitability. For example, in the early 1990s the American authorities took measures to secure profit margins (the difference between lending rates and deposit rates) for banks. However, it goes without saying that this **may also create moral hazard**.

2-4. Prudential Regulations

Increasing the soundness of the financial systems means taking **measures to avoid moral hazard**. Individual financial institutions must be supervised such that capital adequacy norm is strictly met, that loans are properly classified[5] and loan-loss provisions increased accordingly, and that foreign currency exposure[6] and connected lending[7] are limited, among others. (Together these are called **prudential regulations**). Even if these regulations are established, however, they are **meaningless unless enforced**. Therefore, **information disclosure by financial institutions, improvement of auditing and supervisory systems**, and **securing the independence of supervisory authorities** are also necessary. However, what is difficult is that strengthening capital adequacy norm in the middle of a financial crisis can exacerbate a credit crunch and delay economic recovery.

As has become clear, **although the way of financial restructuring may appear straightforward, it is actually difficult. There is a contradiction between preventing moral hazard and other measures that can never be completely resolved.** Experience teaches us that even if the balance sheets of financial institutions are improved, the recovery of profitability and soundness of the financial system takes time, and will not be successful in all cases. In fact, in some cases financial crises have recurred. The soundness of the financial system overall is not flawless even in advanced economies, and complete implementation of prudential regulations seems to be an extremely difficult problem.

In many cases financial reconstruction tends to be started in the midst of a financial crisis and a worsening economy. Thus, there often is a strong temptation for policy makers to postpone painstaking actions. However, **the more time passes, the more money (taxes) will ultimately be necessary** to consolidate and restructure failed financial institutions and replenish their capital. **A speedy response once the crisis has been identified is extremely important.**

In the following section we will look at the state of implementation of measures taken in each country. However, to avoid duplication with the country-specific analysis in Chapter 6 and 7, we will just touch briefly on Thailand and South Korea.

3. Responses by Individual Countries[8]

3-1. Indonesia

(1) The Beginning

On November 1, 1997, in accordance to the IMF program, 16 banks were suddenly closed, and as we shall see later, these "violent" measures were much criticized. Whether these criticisms are warranted or not, it is probably safe to say that Indonesia's financial crisis started then. That deposits then were only protected up to a fixed amount (20 million rupiah) was one reason for a general run on banks. (The government only announced protection for all deposits in January 1998)[9]. Increase in special lending to troubled commercial banks and infusion of liquidity to the money markets by the central bank also date from this time.

(2) The Establishment of Specialized Institutions

In January 1998, the government announced the deregulations on foreign ownership of domestic banks, and at the same time established the Indonesian Bank Restructuring Agency (IBRA). The claims to commercial banks resulted by special lending was then shifted to IBRA. A specialized institution for disposing of nonperforming loans was not established as a separate body. Instead it was organized as one section of IBRA, the Asset Management Unit (AMU). In July the AMU was given its legal authority by presidential decree, and the nonperforming loans of closed banks were transferred to AMU. No specialized institution was established to inject capital into banks.

(3) Dealing with Financial Institutions

In February 1998, 54 banks received substantial special loans from the central bank, and in April 14 banks were put under IBRA's control, of which seven were closed. The remaining seven banks were stripped of their powers of management and ownership. In August it was announced that the operations of three of these banks had been suspended, and four had been nationalized. The other banks under IBRA and the remaining banks were undergoing financial audits by internationally recognized auditing firms.

In September the government ordered 14 banks which had received approximately 140 trillion rupiah of special loan from central bank since the beginning of the year to repay. In cases where part could not be repaid through bank assets, IBRA carried out direct negotiations with the owners of corporate groups to which the banks belonged, pressuring them to repay by threatening to seize group assets, among other methods. Borrowers were indeed concentrated among group-affiliated firms, and there were also threats to investigate legal responsibility in terms of potential violations of financial regulations. As a result it appears that basic repayment agreements were reached with a number of groups.

(4) Strengthening Bank Capital by Public Funds

Moreover, in order to increase capital adequacy ratios to 4% by the end of the year, the government announced an injection of public funds into domestic banks. Banks covered would be those with capital adequacy ratios of between -25% and less than 4%, with the government shouldering up to 80% of the necessary cost. In exchange for the injection of public funds the government would obtain shares (convertible preferred shares) and appoint new directors. The government also mandated that capital adequacy ratios for all banks reach 4% by the end of 1998, 8% by the end of 1999, and 10% by the end of 2000.

(5) Making the Institutional Framework

In place of the outdated bankruptcy law which had been put into place in the colonial era (1905), a new bankruptcy law was approved by parliament in July and took effect in August. At the same time approximately 50 judges were trained, and a special commercial courts were established within the regional courts. One of its features was the inclusion of a provision making possible the revival of companies under the recognition of an appointed receiver for borrowers applying to the court for a moratorium on debt repayments, provided they meet the requirement to produce a restructuring plan within the nine-month grace period (similar to Chapter 11 of American Bankruptcy Law). However, as a practical problem, in more detailed matters it is uncertain what kind of legal judgements will actually be handed down by the courts. It will surely be some time before precedent accumulates. It appears that a lot of lenders have already decided on a wait-and-see approach.

(6) Nonperforming Loans Ratio and Fiscal Costs

The NPLs ratio is expected to reach 60% (S&P's projection is 55% and Moody's is 30-75%). We are not at the stage where it is possible to determine what the final fiscal cost will be, but to raise funds for IBRA the government is issuing 150 trillion rupiah of government bonds in 1998. Paying the interest on these bonds and IBRA's operating costs for 1998 and 1999 alone is said to require approximately 15 trillion rupiah (approximately 1.6% of GDP).

(7) The Private External Debt Problem

Based on the Frankfurt agreement reached in June 1998 on external debt held by non-bank private companies, in August the Indonesia Debt Reconstruction Agency (INDRA) was established, and the broad framework for a corporate external debt repayment scheme was announced. Based on this borrowers will repay INDRA in rupiah (for up to eight years), and INDRA will repay lenders in foreign currency. If borrowers fail to make interest and principal repayments for three months, they lose eligibility for the scheme. The main point of the exercise is the assumption by the government (INDRA) of the risk of exchange rate fluctuations. However, the government does not assume any business risk whatsoever (the government does not offer any guarantee in the event that borrowers cannot repay). A problem is that the exchange rate that determines borrower repayments to INDRA (in rupiah) is not fixed yet. At present the only things that are fixed is to compare the rate of $1=13,233 rupiah and the any of 20-day moving average rate until next June, and to use the one that is most favorable to borrowers. In addition, no provisions have been made for borrowers who become unable to repay. The upshot is that at present it is said that almost no firms have applied for the scheme. If we were to evaluate it harshly, we might say that the scheme merely puts off the problem.

3-2. Malaysia

(1) The Beginning

Malaysia experienced a financial crisis between 1985 and 1988. Afterward fast growth was accompanied by rising asset prices and increased funds in the financial sector, and Malaysia already had a bubble-like appearance before the crisis this time. Before the start of the currency crisis in Thailand, the Malaysian government in March 1997 strengthened the limit on banks' exposure to real estate and stock market trading (i.e. margin finance) and were actively working to deflate the bubble. With hindsight it may be said that its timing was terrible. In addition since the end of 1997 it adapted high interest rates policy a la IMF (see Chapter 4, Section 2 to see the propriety of the high interest rate policy). As a result the scale and speed of the collapse of the Malaysian stock market bubble was breathtaking. The total value of listed shares-which had reached four times GDP-imploded, shrinking to approximately 1.5 times GDP in only one to two years[10]. In other words, wealth of more than twice GDP vanished in the stock market alone.

(2) The Establishment of Specialized Institutions

In May 1998 a plan was announced to establish a specialized agency called the Asset Management Company (AMC or Pengurusan Danaharta Nasional) to buy up and dispose of bad loans, and another specialized agency called a Special Purpose Vehicle (SPV or Danamodal Nasional) to inject funds into banks and other institutions. They were launched by September. A noteworthy point was that in taking over a bank's shares and injecting capital, the SPV's purpose also included taking advantage of its position as shareholder to actively reform the bank's management. For example, it was expected to exert leverage to stimulate consolidation and restructuring. On the other hand, no specialized department has been established to be in charge of financial restructuring (akin to Indonesia's IBRA).

The government emphasized that nonperforming loan acquisitions and capital injections would be done at fair prices. Acquiring loans or injecting capital at higher than fair rates amounts to providing hidden assistance, and so this is a very important point. How can fair prices be determined, however? A satisfactory answer has not been provided to this question.

(3) Dealing with Financial Institutions

The plan is to restructure 39 nonbank financial companies into seven or eight companies, and using the SPV and other leverage, to stimulate bank consolidation and restructuring. The government has already merged RHB Bank and Sime Bank, and injected capital at the time of the merger of Commerce Asset Holdings and Bank Bumiputra.

(4) Institutional Framework

In contrast to Indonesia and Thailand, there are no plans for major revisions to bankruptcy laws. There are some minor revisions to parts of the legal system relating to bankruptcy. In order to stimulate private initiative on debt negotiations, the Society for Corporate Credit and Debt Restructuring (SCCDR) was launched in August. By some interpretations, debt recovery could in part last as long as 10 years.

(5) NPLs Ratios and Fiscal Costs

NPLs ratios at banks grew quickly, and although they had been 3.6% at the end of June 1997, they were at 9.3% by the end of March 1998. Some private forecasts call for 20% by the end of 1998. It is expected that AMC nonperforming loan purchases will cost 25 billion ringgit, and SPV capital injections 16 billion ringgit. The plan is for most of these funds to be raised by each institution issuing its own bonds. However, Malaysia's own credit rating has been lowered by S&P and others, and it will be difficult for it to raise capital in the markets. It has been reported that due to lack of funds, AMC has not been purchasing nonperforming loans, but rather fulfilling its mission by acting as intermediary for their resale[11] so far.

(6) Other

Another point to add regarding Malaysia is that many of the borrowers debt-laden banks are dealing with are firms run by Malay business families. As such, there are chances that if severe financial restructuring policies are taken, it will ruin the successes of the bumiputra (pro-Malay) policy followed hitherto. There are fears that this could worsen interracial strife, striking at Malaysia's Achilles' heel. Therefore the expectation is deep-rooted that the government will have to rescue some financial institutions which is not worthwhile.

3-3. Thailand

(1) The Beginning

In Thailand's case, some finance companies (nonbanks) were already in a state of bankruptcy before the currency crisis started. Lending to financial institutions from the central bank expanded quickly from the beginning of 1997. **Then in 1998 the heart of the problem shifted to the banking sector.** Numerous banks failed to reach sufficient capital adequacy ratios, and government measures such as suspending operations and nationalizations were taken one after the other (for details see Chapter 7).

(2) The Establishment of Specialized Institutions

Financial Restructuring Agency (FRA) was established to be in charge of restructuring and disposing of (nonbank) finance companies, and an Asset Management Company (AMC) specializing in purchasing and collecting bad debts. However, both FRA and AMC are only in charge of nonbank finance companies, and there are no specialized institutions covering the banking sector[12]. In addition, there are no specialized institutions for injecting capital.

(3) Dealing with Financial Institutions and Measures to Strengthen Capital

Financial sector restructuring package announced in October 1997, loan classification and provisioning obligation were made stricter for banks, and regulations on foreign ownership would be relaxed within 10 years. In measures to strengthen capital, **the goal is for capital adequacy ratios to reach 8.5% by 2000**. However, in the worsening economic environment, there are few, if any, banks able to reach this goal on their own, and ultimately in early 1998 bank closures and government nationalizations got underway. In the end, it seems likely that in most cases capital will be strengthened by government capital injections to financial institutions. In concrete terms this takes the form of the government providing the banks with 10-year government bonds, which is akin to having the banks who will receive the injection of funds put out the money for the injection. These are not new funds, and there are therefore doubts about the effectiveness of this method.

(4) Institutional Framework and Other Matters

In August 1998 a Corporate Debt Restructuring Advisory Committee was established. In order to promote the smooth handling of bad debts, the committee is discussing legal, tax and other systemic reforms. Reform of the bankruptcy law and the legal system relating to clearing procedures and the collection of collateralized loans is moving forward. In September 1998 the central bank announced guidelines with the purpose of stimulating independent private debt negotiations, indicating basic principles such as the necessity of change in management, dealing each creditors equally, and debtors disclosing financial information. However, they were not accompanied by measures with legal force, and thus their effectiveness is doubted.

(5) NPLs Ratio and Fiscal Costs

In October of 1998 the central bank announced that the NPLs ratio (including debt on which payment was 3 months or more overdue) was approximately 40%. To pay for the cost of financial restructuring, the government has announced that it would issue approximately 800 billion baht of 10-year government bonds by 2000.

3-4. South Korea

(1) The Beginning

South Korea's financial problems are **closely entwined with the problems of its financial groups, the *chaebol*** (for more detail see the analysis in Chapter 6). From the beginning of 1997, the operations of banks worsened due to chaebol bankruptcies. By August 1997 the Bank of Korea (the central bank) had already provided special funds to Hanil Bank. In addition, the government accepted stock in exchange for government bonds, thus nationalizing the bank (as such, there is the problem, similar to the Thai one, that no new funds were introduced). Yet **the government only truly started to deal with the banks in 1998**.

(2) The Establishment of Specialized Institutions

In March 1998 a financial supervisory committee was established as a specialized department for financial reconstruction. A specialized institution to purchase and collect bad loans has also been established. However, there is no specialized institution for injecting capital, and such injections to banks (capital increases) are taking place through the deposit insurance corporation, under the jurisdiction of the central bank.

(3) Dealing with Financial Institutions

Please refer to Chapter 6 for details on developments.

(4) NPLs Ratio and Fiscal Costs

The NPLs ratio is projected to be on the order of 33%. The funds required for financial reconstruction will be met by issuing government bonds. The government expects the total amount to come to 64 trillion won, about 14% of GDP. Some estimate that the actual amount required will be greater.

4. The Distress of Asian Economies — Evaluating Responses

As we saw in the preceding section, each country is struggling with the problems of financial restructuring. We would like to split up the various problems and issues and organize them into four sections below.

4-1. Problems with the Initial Response

In early measures, the central bank helped troubled financial institutions by special lending. Amounts were 10% of GDP by the end of January 1998 in Indonesia, 15% of GDP by the end of 1997 in Thailand, and 12.5% of GDP by the end of January 1998 in Malaysia. However, as we saw in Section 1, it appears a credit crunch could not be prevented. In particular the announcement in Indonesia that 16 banks would suddenly be closed caused a run on banks. The strict stance is understandable in order to avoid moral hazard, but the government should have had to provide safety nets such as deposit insurance and well-established scheme for disposing troubled banks. We saw in Section 1 that a process of credit contraction started in Indonesia from November 1997. This coincides perfectly with the time of the above bank run.

4-2. It Takes Time

If we simplify greatly, in each country bankrupt financial institutions were put under public administration, nonperforming loans are scheduled to be written down and sold off, and finally public funds will be used to increase bank capital and consolidate the industry. Decisions varied on whether to create specialized administrative institutions independent from the central bank, as well as whether to create specialized organizations to gather and dispose of nonperforming loans, and ones to inject public funds. In Thailand and Indonesia, bankruptcy laws were reviewed and reformed. In this way, one year after the crisis broke out, it may be said that a framework for financial reconstruction had been put together.

Many questions remain to be answered. For example, the development of domestic human resources have been insufficient. Foreign advisors are attached to Indonesia's IBRA, and foreign investment banks are helping AMU. In Thailand's case as well, for every closed finance company to be wound up, two or three foreign advisors are involved. Moreover, to implement the new bankruptcy laws, the training and retraining of new judges is necessary, and the legal system itself is incomplete. Moreover, as for nonperforming loans problem, only now are we at the stage where the real process of disposal is getting underway.

Considering all the above, we must reiterate the fact that **financial restructuring takes time**. Cleaning up the S&L mess in the Unites States in the late 1980s and early 1990s took three years, and judging from the situation in the Asian economies, it would not be surprising if the cleanup here were to take even longer.

4-3. Funding Problems

The next problem we must touch on is the shortage of funds. The government of each country has plans to raise funds by issuing government bonds, and the IMF has also moved to acceptance of fiscal deficits. However, the amounts required are estimated to be very large. As we saw in Section 1, in every country except Indonesia, total bank lending exceeds GDP. It is said that in these countries the

Table 2 Non-Performing Assets Ratios and Estimate of Costs of Major Financial Crisis after 1980

Country	NPAs Ratios or Scope of Crisis	Estimate of Costs (% of GDP)
Benin (1988-90)	NPAs ratio was 80%.	17
Mauritania (1984-93)	5 major banks had NPAs of 45-70%.	15
Senegal (1988-91)	NPAs ratio was 50% in 1988.	17
Indonesia (1994)	Classified assets equal to over 14% of banking system assets with over 70% in the state banks.	2
Malaysia (1985-89)	NPAs ratio was 32% in 1988.	5
Philippines (1981-87)	NPAs ratio of commercial banks was 19% in 1986.	13
Thailand (1983-87)	NPAs ratio was 15%.	1-2
Mexico (1994-)*	NPAs ratio was 12% in the end of 1995.	12-15
Argentina (1980-82)**	NPAs ratio was 9% in 1980 and 30% in 1985.	55
Chile (1981-83)**	NPAs ratio was 19% in 1983.	41
Venezuela (1994-95)	NPAs ratio was 8.5% at the onset of the crisis in 1993.	18
Uruguay (1981-84)**	NPAs ratio was 11% in 1982 and 59% in 1986.	30
Bulgaria (1990s)	Estimated NPAs ratio was 75% in 1995.	14
Hungary (1991-95)	8 banks (25% of financial system assets) were insolvent in 1993.	10
Spain (1977-85)	110 institutions holding 20% of all deposits were rescued and government nationalized 20 small/medium sized banks.	17
Finland (1991-93)	NPAs ratio was 13% in 1992.	8
Sweden (1990-93)	NPAs ratio was 18%.	6
Norway (1987-93)	NPAs ratio was 6%.	4
The United States (1984-91)	More than 1,400 S&L and 1,300 banks failed.	3

Source: Gerard and Klingebiel [1996], Lindgren, Garcia, and Saal [1996] proportion of nonperforming loans to total lending is 30 or 40%. This suggests that the costs of disposal will be approximately as large as quarter to one third of GDP. Only in Indonesia is the ratio of total lending to GDP relatively low (60%). Instead, its proportion of nonperforming loans to total lending is much higher than the rest (roughly 60%), and the disposal cost is expected to come to 30% of GDP.

Table 2 shows the experience of other countries. Judging from the cleanup cost, Asia's current financial problems are comparable to those faced (by the countries marked by "**" in Table 2) in the financial crisis that accompanied the Latin American debt crisis of the 1980s. The table also shows that the scale of the financial crisis accompanying the 1994 Mexican crisis (marked by a "*") was relatively small.

4-4. Is Financial Reconstruction Possible with High Interest Rates and a Worsening Economy?

Worsening macroeconomic conditions make financial restructuring difficult. The damage done by high interest policies is much more serious than expected. Let us consider the recent situation in Indonesia. Table 3 shows changes in recent Indonesian interest rates as per the central bank's official figures. In July 1998, the 3-month deposit rate – which corresponds to banks' borrowing costs – was 43% , but the lending rate – from which profits derive – for short-term loans (working capital loans) was only 34% and for long-term loans (investment loans) only 23%. Banks actually faced a negative spread of 10 to 20%. The interest rate on central bank bonds, which represents the policy rate, went over 55% (and later to 70%, before falling to 60% in October) so if banks went to the interbank short-term financial markets instead of depositors to obtain funds, their costs would be even higher. Looking back, until July of 1997, short-term and long-term lending rates were both higher than deposit rates, but only with a tiny spread. Then in August, deposit rates surpassed long-term lending rates, but with a tiny or zero spread still existing between deposit rates and short-term lending rates. However, from June of 1998, deposit rates overtook short-term lending rates by a wide margin. According to a local survey carried out by the authors in the second half of August, these conditions had not yet changed. According to a source connected to Indonesia's IBRA, "If the current situation continues for another 6 months, there will not be a single bank left in this country that can survive".

Is this the way to conduct financial restructuring? No matter how wonderful the financial specialists who are drafted in to help, no one can save Indonesia at this time. At present the balance sheets of Indonesian banks are being checked by accountants from advanced economies. However, as long as these negative spreads continue, this exercise is meaningless. While these "financial audits" are being carried out, banks' balance sheets continue to deteriorate. What will be gained if most all banks are driven into insolvency?

5. Conclusion

The original response, especially in Indonesia, of **closing banks and such without a sufficient deposit insurance scheme in place**, triggered a run on banks. **The government should have adopted a more careful approach. Besides, there is no reason to expect success for a policy that attempts financial sector restructuring while hiking interest rates** (see Chapter 4 as well on interest rate policy).

However, we are in absolute agreement with the idea that **it is not good to postpone dealing with financial problems**. It is not realistic to think that a problem that has built up will go away without proper treatment. **It is imperative that the disposal of bad loans be pursued to the end, including dealing with borrower firms**[13]. This is clearly a long-term process. Moreover, when it comes to **funding the financial resources to pay for it**, each country faces great difficulty.

In addition, a problem characterizing this crisis is the large web of transnational borrowing that has been built up. In fact, lending has taken place that completely bypasses domestic financial institutions, where foreign banks lent directly to general companies. How to unravel all this complexity is a serious problem. The situation is most serious in Indonesia; as we saw in Section 3, the INDRA scheme has been readied in this area. However, in principle the scheme only applies to financially sound companies which we can hardly find in Indonesia. Indeed, this is exactly the kind of prob-

Table 3 Change in Interest Rates of Indonesia

(percent per annum)

1997 (End of Period)	Bank Indonesia Certificates	Money Market Securities	3 Month Time Deposit	Working Capital	Investments
Jan.	10.94	15.38	16.85	19.05	16.36
Feb.	9.75	15.38	16.66	19.00	16.41
Mar.	8.46	14.29	16.47	18.88	16.37
Apr.	8.42	14.88	16.25	18.82	16.38
May	8.64	15.61	16.06	18.79	16.26
Jun.	8.19	14.85	15.93	18.56	16.19
Jul.	9.05	11.15	15.84	18.59	16.02
Aug.	11.21	-	21.73	25.13	19.68
Sept.	14.58	-	26.22	26.41	20.34
Oct.	18.11	20.00	27.73	26.76	20.14
Nov.	17.38	20.00	26.51	26.42	19.77
Dec.	17.38	-	23.92	25.40	18.94

1998	Bank Indonesia Certificates	Money Market Securities	3 Month Time Deposit	Working Capital	Investments
Jan.	15.70	21.00	22.68	25.57	18.96
Feb.	24.29	23.31	24.00	25.63	19.18
Mar.	26.62	28.63	27.26	27.80	20.16
Apr.	45.16	52.00	29.40	29.47	21.64
May	51.35	58.67	32.95	33.21	22.84
Jun.	56.28	60.00	40.63	33.79	27.70
Jul.	55.87	60.00	43.01	34.12	23.38
Aug. 3Q	70.14	68.00	46.23	-	-
Aug. 4Q	70.43	70.00	47.51	-	-
Sept. 1Q	70.59	70.00	48.61	-	-
Sept. 2Q	69.99	70.00	49.68	-	-

Source: Bank Indonesia

lem that international institutions such as the IMF should mediate in, an area where they can truly prove their worth.

Notes:

1. We referred to Lindgren, Garcia, and Saal (1996).
2. We referred to Watanabe, editor (1998), Chapter 1.
3. In Japan too the confusion surrounding the LTCB question comes down to this contradiction.
4. We referred to Dziobek and Pazarbaşioğlu (1997), Daniel (1997), and Nyberg (1997).
5. The classification of loans into non-performing, irrecoverable, etc. and determining the amounts of each.
6. These are regulations designed so that banks do not assume excessive currency risk that limit net holdings of foreign-denominated assets.
7. Regulations limiting lending to specified companies or corporate groupings.
8. We received a great deal of help in this section from country specialists at the Institute of Developing Economies. In particular we received all manner of statistics and information from Junko Mizuno, Masato Kawamori, Masashi Nakamura, and Koichi Kawamura in the Area Studies Department I. We also received advice from the writing team for this report, Satoru Okuda, Shigeki Higashi, and Miki Takeda. We would like to express our thanks to them here. Naturally responsibility for any errors contained in this section are the responsibility of the authors.
9. On the other hand, it appears that there has been strong criticism of the decision to protect all deposi-

tors. This is based on local interviews by the authors in Indonesia in August 1998.
10. Based on interviews by the authors at the Kuala Lumpur Stock Exchange.
11. *Nikkei Kinyu Shimbun*, October 23, 1998.
12. Incidentally, at first it was planned that the FRA would sell all the assets of the finance companies by the end of 1998, but setting fair prices has proved difficult and the target date has been moved back.
13. These firms should be either closed or revived.

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