The Political Origins of “Financial Crises of the 21st Century”:
Path Dependence of Financial Systems in Korea, Thailand and Mexico

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Abstract:
Political scientists and economists have discussed the causes of “financial crises of the 21st century” in emerging economies. It has been ignored, however, that there were differences in the process of the crises and the government responses to the crises (the post-crisis economic reforms). This essay examines the cases of Korea, Thailand, and Mexico, which can be characterized as follows: the Korean “big enterprises-manufacturing overinvestment” crisis and relatively successful reform, the Thai “financial institutions-asset bubble” crisis and insufficient reform, and the Mexican “government-portfolio investment” crisis and almost failed reform. This study addresses these differences, historically exploring the government-business relationship in finance with a path dependence approach. It argues that these crises have their origins in the late 1950s and the early 1960s when the governments chose different financial systems before promoting economic growth, and after these periods the financial systems developed on their own path, leading to the different patterns of crises and government responses.

Key words: Financial Crisis, Economic Reform, Financial System, Path Dependence, History.
1. Introduction

Financial crises in the 1990s did enormous damage to Latin American and Asian countries. These crises were composed of two aspects: (i) a currency crisis that occurred when international short term capital suddenly flowed out of the countries and (ii) a banking crisis caused by excessive debt and the lack of liquidity of domestic financial institutions. While economists and political scientists regard them as the same “21st century financial crisis,” it has been ignored that there were differences in the process of the capital flight and the government responses to the crises (the post-crisis economic reforms). This paper examines the cases of South Korea (hereafter Korea), Thailand, and Mexico, crises that occurred because of domestic factors rather than the contagion effect from other countries. These three crises can be characterized as follows.

In Korea, banks and merchant banks borrowed foreign short term capital and lent it to the family-controlled conglomerates (*chaebol*) that excessively invested in heavy and chemical industries. But the uncertainty and moral hazard generated by the government-*chaebol* relations triggered the massive capital flight in 1997. This can be called a “big enterprises-manufacturing overinvestment” crisis. After the crisis, the government accepted IMF conditionality of macro-economic adjustment and struggled with the structural reforms: the disposition of non-performing loans, restructuring of private financial sector and *chaebol*, and the corporate governance reform.

In Thailand, foreign short term capital was loaned by domestic banks and finance companies to the sectors of real estate and securities. This investment resulted in an asset bubble. After the bubble burst, despite widespread fears in the financial market, government actions were indecisive and delayed being influenced by the close relationship with private financial institutions. This contributed to a “financial institutions-asset bubble” crisis. During a critical period, the government undertook macro-economic adjustment. However it delayed disposing non-performing loans and did not set about the full-scale restructuring of financial sector. The corporate governance reform
was left to each company’s decision.

The Mexican market attracted foreign portfolio capital such as government bonds and equity. This capital inflow, however, made the financial market vulnerable to investors’ sentiment, so that economic policy failings and political instability were able to induce capital flight in 1994. At the same time the currency devaluation caused the banking crisis. This can be described as a “government-portfolio investment” crisis. Accepting the IMF support, the government coped with the macro-economic adjustment, but instead the structural adjustment was insufficient. Unlike Korean and Thai officials, Mexican officials did not intervene in bank management when they purchased non-performing loans. Moreover, there was no change in ownership structure of enterprises.

Table 1 summarizes the three crises and the government responses to the crises. The most important factors in the three crises were chaebol in Korea, private financial institutions in Thailand, and the government in Mexico. Moreover, while the macro-economic and structural adjustment after the crises was relatively successful in Korea, it was insufficient in Thailand and almost failed in Mexico. Why do these three cases differ in the process of crisis despite their commonality as a “21st century crisis”? Why were government responses to similar kinds of crises not uniform?

This study addresses these differences, historically exploring the government-business relationship in finance with a path dependence approach. It argues that these crises have their origins in the late 1950s and the early 1960s when governments chose different financial systems before promoting economic growth, and after these periods the financial systems developed on their own path, leading to different patterns of crisis and government response. Here financial system is defined as a set of formal and informal institutions that shape relationships between actors -- government, private enterprises, and private financial institutions -- through the allocation of funds in the domestic market.

Little attention has been given to these differences of financial crises in the field of political economy, while various studies have been conducted on the causes of financial crises. However,
one of the topics that have been focuses of much research is the economic policy choice in the face of international economic crises -- the Great Depression, the oil shocks and the debt crises in the 1980s.³ In view of this, it is essential to fill in the gap between the general concerns with economic crises and the lack of empirical studies of financial crises. Even more important is the fact that less concern often has been made with this topic concerning the developing world than the developed one.

A few studies have focused on the issue of financial crises in comparative perspective. Influential studies argue that the most important key factor is the government-business relationship in the pre-crisis period (Haggard 2000; Takayasu 2005; Zhang 2003).⁴ The problem here is that they assume the factor as given and do not examine the historical process in which the relationship has been shaped. For example, it has been assessed that the Korean government dominated the domestic finance for a long time and managed progressive financial deregulation even under international pressure. Why did such a strong government allow chaebol to borrow excessive short term capital and left the financial market so vulnerable? What is the reason why the Thai government was not as successful as the Korean government in financial restructuring despite the fact that Thai officials traditionally managed to control the financial sector? And why did the Mexican government, which also has been historically autonomous, dispose non-performing loans in favor of private banks? These questions can not be answered just by examining patterns of the government-business relationship in the pre-crisis period. The studies mentioned above may argue that the relationships had already changed after the financial liberalization. Then, the question we have to ask is why and how did it change in historical perspective.

By contrast, other analyses suggest that it is not “crony capitalism” (one mode of the government-business relationship) but domestic institutions that are likely to influence government responses to banking crises (Maxfield 2003; Rosas 2006). They argue that domestic institutions -- political regimes⁵ and central bank independence -- can shift the political calculus so that government-business relationships may not determine government responses. However, they examine only banking crises and policy choices between rescuing banks and enforcing bank closures,
without considering currency crises, another aspect of the financial crises in the 1990s, and corporate restructuring. Moreover, they fail to give attention to the differences in the process of crises and therefore overlook possibilities that such differences affect the ways the government responds to the crises. For instance, if a banking crisis has been caused not by excessive bank lending but by currency devaluation after a currency crisis, the government may not have a strong incentive to enforce bank closures, but rather will rescue them. Thus, it is necessary to relate the process of crises to government responses.

This paper proceeds as follows. An analytical framework of path dependent explanation is presented in the following section. The third section analyzes the historical development of the financial system in Korea, Thailand and Mexico, tracing stages of their development. In the last section, the paper concludes and offers some implications.

2. Path Dependence Approach

This study adopts a path dependence approach to explain institutional origin (genesis), persistence, and change. It is an analytical concept of the historical causality that contingent events in one period, critical junctures, create an institutional path and this leads to a particular outcome at a later time. In other words, characteristics of the present are explained with reference to elements of the past (Haydu 1998: 351). It has been pointed out that there are three approaches in the new institutionalism: rational choice, sociological, and historical institutionalism (Hall and Taylor 1996). For comparison with the path dependence approach, we focus on factors that these approaches identify as a basic cause of all stages of an institutional path. Whereas rational choice institutionalists claim institutional function or specific actors’ interest as the basic cause, sociologists view institutions in terms of the construction of social understandings. Historical institutionalists see institutions as the creation of historical structure. The path dependence approach of this study has four advantages
The first is related to the logic of causes that account for institutional genesis, persistence, and change. The contending approaches argue that the same factor -- function, interest, social cognition, or structure -- can explain all stages of an institutional path. They assume logic of “constant causes,” which suggests that the same causality that explains the genesis of an institution will also account for endurance and change over time. By contrast, a path dependence approach emphasizes that each stage has a different cause (Stinchcombe 1968: 101-103; Thelen 2003: 214-222). For one example, an institution that was created for a function can still exist even after having lost the original function. For another, an institution can change even if it maintains the original function. The path dependence approach gives an explanation of these phenomena by logic of “historical causes,” which argues that the persistence and the change of an institution are rooted in a prior stage or its genesis.

Secondly, the path dependence perspective, instead of deducing causes from an outcome as rational choice functionalists do, starts with the starting point of an institutional path, or critical juncture, in order to search for the “forward-looking” causal relationship. By doing so, it is possible to avoid a problem of how far we must trace the history back to find causes (Mahoney 2001: 7). Thus this perspective is an attempt to identify historical origins of an institution. Thirdly, this study assumes that actors are rational and they have a variety of policy preferences. This assumption serves to build a micro-foundation of the path dependence approach that traditional historical institutionalists lacked.

Finally, more importantly, this paper sheds light on the problem of endogenous institutional change that those contending institutionalisms have not sufficiently treated, and attempts to explain it by the logic of “historical causes.” Many studies argue that path dependent processes involve three distinct stages -- critical juncture, reproduction of institutions, and the end of the path. While focusing on institutional reproduction (persistence), they have not been concerned with institutional change or have regarded it as being exogenous as the punctuated equilibrium model does (Collier and Collier 1991; Krasner 1984; Mahoney 2001). We agree that institutions can change exogenously,
but we will also take up the issue of endogenous change. Choices on one period (i.e. critical junctures) not only make institutions endure over time, they may also structure available options and shape the choices at later stages (Haydu 1998: 353). Accordingly they may endogenously influence the patterns of institutional change.

Now this section will discuss five stages that form the path dependent explanation: (i) initial conditions, (ii) critical junctures, (iii) institutional persistence, (iv) institutional change, and (v) social outcome (see Figure 1).

2.1 Initial Conditions

Initial conditions set the options available to actors to choose an institution. Theoretically we can suppose four conditions: function; interest of actor, social legitimacy, and historical structure. They are the factors that the contending institutionalisms identify as a basic cause of institutional origins. None of them determine which institution actors will select, but instead they structure options for the institutional shaping. The choice of institution is made at the stage of critical junctures.

2.2 Critical junctures

This point shapes an institution and puts it onto a path of development that leads to a particular outcome. The selection of institution is made in a contingent political process that initial conditions do not theoretically expect (Mahoney 2000: 513). This study claims that critical junctures are institutional origins because the logical rupture exists between initial conditions and critical junctures.

2.3 Persistence of Institutions

Once critical junctures lock institutions into particular paths, the institutions can persist over time and can not be easily reversed. This analysis focuses on performance of institutions to explain the
mechanism of their reproductions. When performance of institutions meets the policy preferences of actors, they will intend to keep up the institutions by using other ones that can complement them (“institutional complementarity”). At the same time the greater the institutional performance is, the more actors will adapt their behavior to the institutions to gain from it (“strategic complementarity”). How much and which actor’s preference meets the institutional performance depends on the choice made during the critical junctures; patterns of persistence is path dependent.

2.4 Institutional Change

Recently the concern with modes of change has been growing. This paper will discuss the ways of change to shed light on path dependent and endogenous change. Here institutional change is broadly defined as modification, reform, and transformation.

Institutions begin to change when a reactive sequence to them occur. On the one hand, when the gain from the institutional performance is biased in favor of some actors, two problems will emerge: functional disorders and the imbalance of power. Then the institutions can change. First, over time the efficiency and the effect of institutions may progressively decline, and consequently, will easily lead to functional disorders. Then any actors under disadvantages may attempt to change institutions. Second, if only some actors grow and gather force, it can alter the balance of power of actors in the institutions. In this case, those who challenge existing institutions may not be only actors under disadvantages but also grown actors that search for more profitable institutions. On the other hand, we can suppose there are external actors that are excluded from the institutions concerned. If their cost of exclusion is very high, they will have an incentive to reform and to participate in them.

In sum how institutions change depends on patterns of their persistence. In this sense institutional change is path dependent and endogenous.

2.5 Social Outcome

In the debate of path dependence influenced by the concept of punctuated equilibrium, it has
been often discussed that final outcomes of paths entail the breakdown of old institutions and the formation of new ones (Collier and Collier 1991; Krasner 1984; Mahoney 2001). By contrast, this study focusing on endogenous change understands that institutional changes are sequential, and therefore it is concerned with outcomes to which institutional paths lead rather than the genesis of new institutions. Fiscal crisis caused by pension system and the party system changed by election system are good examples of such social outcomes. These outcomes are rooted in previous stages of paths: persistence and change. As mentioned above, institutional endurance can cause problems and actors attempt to change institutions to cope with them. Nevertheless, not all problems are solved. Some may remain unsolved and others may be worsened. The result of this process is social outcomes.

3. Paths of Financial Systems in South Korea, Thailand and Mexico

This section explains the paths of financial systems in Korea, Thailand and Mexico. After presenting an overview of financial systems and actors in the three countries, this paper will chronologically examine each stage of the three paths.

3.1 Financial Systems and Actors

First, I assume the range of policy preferences that rational actors can theoretically have. The government, pursuing the possibility to remain in office, prefers policies to gain political support. Financial institutions have the preference, from a micro-perspective, to minimize credit risk and deposit mobilization costs, and from a macro-one, to keep real interest rates positive and inflation low. Enterprises prefer minimizing loan rates as well as low and stable real interest rates and prices.

Based on the definition above, financial systems can be classified into different patterns by two perspectives: the first is the degree of government intervention in financial markets, such as financial
repression and the regulation of new entry and ownership of banks, and the second is which actor -- government, enterprises, or financial institutions -- enjoy financial rent generated by the government intervention in markets (See Table 2).

The Korean financial system, established by Park Chung Hee’s authoritarian regime in the 1960s, is characterized as a “rent-for-enterprises” type. In this system, the government strongly intervened in financial markets such as financial repression and bank nationalization, while rent was allocated to large enterprises in form of preferential credit and the permission and guarantee of foreign borrowing. Thus the Korean system was biased in favor of big business. The family-controlled conglomerates (chaebol) diversified businesses and grew rapidly. Another actor of the private sector was financial institutions. While commercial banks were run by the government until the mid-1980s and new entry into the banking sector was not permitted, merchant banks were controlled by chaebol. The government included the powerful president and competent economic technocrats. The independence of the central bank was always low.

In Thailand the “rent-for-banks” financial system was built in the 1960s by the Sarit Thanarat military regime. One important aspect was that the Thai government did not intervene in the economy as much as the Korean and Mexican governments did. They kept inflation low and real interest rates positive, and abstained from financial repression. Another important aspect was that Thai officials prohibited new entry into the banking sector to protect existing banks so that rent was returned to financial institutions rather than enterprises. As for actors of the private sector, Thai conglomerates were as important as Korean and Mexican ones in the national economy. But they differed in ownership of banks. Banks held the dominant power and controlled many finance companies. The government was formed by strong prime ministers and technocrats, and the central bank, Bank of Thailand, was relatively independent of politics.

The Mexican system is described as a “rent-for-government” type, which was born under the López Mateos government in the late 1950s. Its first feature was, like Korea, it showed strong government intervention in the market, such as financial repression and entry limitation into the
banking sector. The most important institution for intervention was reserve requirements, which forced private financial institutions to deposit cash, to buy public bonds or to loan to particular sectors. This had a great effect to control inflation and to finance the government’s fiscal deficit. Thus, different from Korea, the Mexican government absorbed financial rent by itself, and it was the second feature of the Mexican financial system. The main actor of the private sector was family-controlled conglomerates, grupo, which were smaller in size than Korean chaebol, but owned banks just as Thai big business. Banks were dominant financial institutions and formed financial groups including financiera (nonbank financial institution for investment). The government was composed of powerful president and economic technocrats under the long-time authoritarian regime of the Institutional Revolutionary Party (PRI). The central bank independence varied depending on who was the president prior to the 1990s.

3.2 Initial Conditions: Function, Interest, Cognition, and Structure

The range of available options for financial systems was set by initial conditions that each country had been endowed with.

Regarding Korea, some conditions might lead to strong government intervention. There was functional demand for the financial system to promote economic growth. An actor of the private sector, chaebol, needed capital that was scarce in the domestic market. Additionally Korea was a late industrialized country of “the fourth generation” and technocrats inherited the Japanese colonial legacy as a developmental model (Woo 1991). However, it was not certain which actor would receive rent for reasons as follows. First, the Park Chung Hee government, insulated from society and accusing big business owners of illicit wealth accumulation, could not be directly influenced by business’ preferences. Second, before Park took office, financial rent was used for political activities. Moreover, to what extent the government would intervene was not explained, given the fact that the U.S. government recommended conservative financial policy to stabilize the economy.

Thailand also had contrasting conditions. On the one hand, similar to Korea, Thai
industrialization was of the fourth generation, and stimulating the economy was a required function of
the financial system. On the other hand, bankers articulated their interests through patron-client
relationships with political elite, and some technocrats legitimately inherited, from the late 19th
century, conservative financial policies, which the World Bank supported (Doner and Unger 1993:
95). These conditions alone could not determine whether the intervention would be strong or weak.
Bankers might enjoy financial rent, but it should be reminded that public enterprises called for
preferential credit as much as under the former Premier Phibun government in the 1950s (Doner and

Seemingly the strong financial intervention and rent absorption by the government in Mexico
may be explained by some initial conditions -- the industrialization of the fourth generation and the
societal recognition of the PRI government’s role in the economy. The other conditions, however,
implied an opposite effect. In the following years after the devaluation of the peso in 1954,
stabilization and less state intervention were required in the economy, as opposed to growth. These
were also a preference of private bankers, who allied with liberal economic ministries and had
influential power on economic policy making (Maxfield 1990). In fact, inflation was controlled
through the late 1950s and the 1960s.

3.3 Shaping the Financial System: Critical Juncture

Initial conditions do not account for the genesis or the origin of financial system, instead only
indicates possible options for it. It was a contingent political process that shaped financial systems in
the three countries.

For the Korean government, the initial purpose of financial intervention was not returning rent to
chaebol, but promoting industrialization through absorbing domestic capital just as Mexicans did.
President Park, who took office by coup d’etat in 1961, hoped to overcome the lack of political
legitimacy by economic development (Hahn 2004:142). Indeed the bank deposits were frozen so
that the surplus funds were directed to the Industrial Development Corporation that would finance the
import substituting industry (ISI). This attempt failed, however, because little deposit remained and both the business sector and the U.S. opposed. Consequently the government reluctantly changed the policy to encouraging savings by raising interest rates in 1965. As a result of the failure of ISI, the officials had no alternative but to return rent to private business, providing preferential credit to the export sector (Kimiya 1996: 65). But this policy change, by decreasing productive costs, benefited the textile industry, which was facing the reduction of U.S. aid and competition with Japanese products. Finally, the government nationalized commercial banks to punish big business for illicit profits. This was also a populist measure to legitimate the regime.

The Thai government, advised by the World Bank and the U.S., started liberal economic policies in the early 1960s, and particularly the Bank of Thailand successfully made efforts to restrain state intervention in financial markets. The central bank, which had confronted the former administration about state intervention, could not implement the liberal financial policy without the support of General Sarit. But interestingly Sarit was much more concerned, for political legitimacy, with social infrastructure and the rural economy than macro-economic management. As such, he left financial policy making to the liberal bureaucrats (Thak 1979). This was the reason why the government adopted a less interventionist financial policy. Also, importantly Sarit obtained funds mainly from the state lottery and some commercial banks; therefore he was relatively free from pressures of the state enterprises for policy loans. Rather, the restraint of selective credit weakened state enterprises that were the economic base of the former ruling elite (Doner and Unger 1993: 103). Similarly the protection of commercial banks was a product of politics. While the officials attempted to consolidate banking regulation, expecting to encourage savings and to channel them toward the promotion of economic development, private banks feared that increased regulation might damage their profits. As such, they requested that the government prohibit new entry, especially of foreigners, to the banking sector. Unofficially this request was granted (Hewison 1989: 188).

The Mexican financial system was shaped in the late 1950s under the long-time dominance of the PRI and is not associated with the change of a political regime, unlike the two Asian countries.
However, in 1958 and 1959, the first years of the López Mateos presidency, violent labor disputes frequently threatened the social stability and the legitimacy of the PRI. There were 740 strikes in 1958 alone, the highest record in the post-WWII years. Moreover, labor disputes simultaneously broke out in many sectors, such as education, railways, and telecommunications. This rise of the labor movement was due to a decline of real wages, and the influence of the communist party and the Cuban revolution. The government feared the diffusion of communism (Ortiz Mena 1998: 76-77), and strongly feared a regime crisis because labor unions were one of the traditional pillars that supported the PRI regime (Pellicer de Brody y Reyna 1978: 157). At that time the government resolved the crisis by using military force, but its impact did not end. It resulted in setting the direction to the “rent-for-government” financial system for two reasons. First, the President and his ministers clearly recognized that the stability of macro economy and exchange rates were necessary for the sustainable growth of real wages and political and social order (Ortiz Mena 1998: 77, 82). Second, the government needed to absorb the financial rent for the fiscal expenditures of education and rural development, which were the interests of workers and peasants (Scott 1971: 305-306). The extent of rent absorption was relatively moderate in the 1960s and increased in the 1970s.

3.4 Persistence of the Financial System

After these critical junctures, each financial system started to develop along its own path. What mechanism made financial institutions persist?

The Korean government and businesses enjoyed the performance of the financial system, such as the expansion of exports, low costs of corporate finance, and consequently, economic growth. Although financial repression tended to raise inflationary pressure, the inflation lowered real interest rates and this met enterprises’ preferences. For banks, the interest rate rising after 1965 contributed to the growth of savings, but financial repression was against their preference. Whether they were good or bad, bankers had little “voice.”

This performance produced two mechanisms of institutional persistence. The first is strategic
complementality. As chaebol found that diversifying business and using preferential credit was strategically adequate behavior, more companies entered the export sector and borrowed money. This behavior resulted in debt accumulation. The problem was that the more chaebol expanded investment, the less the government let them go bankrupt. In fact this happened in 1972 when Park Chung Hee rescued many chaebol companies from the debt crisis in the informal market. Park, confronting emerging political opposition parties and labor disputes, had to avoid bankruptcy of chaebol at all costs (Woo 1991: 112). Moreover in the 1970s the threat of North Korea hastened heavy and chemical industrialization (Horikane 2005). The government resorted to more financial repression and provided chaebol with rent so that the risk of investment would be reduced and they could enter into new sectors (Choi 1993: 36-38).

The second mechanism was that institutional complementality worked. For instance, after the debt crisis in 1972, the government gave licenses to merchant banks to bring the informal money market under control. This helped enterprises to obtain short-term capital. Such institutionalization of the informal market consolidated the “rent-for-enterprises” financial system. Another example was institutional linkages between the government and businesses, which worked for reaching agreements over the content of intervention and rent allocation.

The performance of the Thai “rent-for-banks” system was different. The biggest beneficiary was banks, thanks to the restraint of financial repression, low inflation, and the restriction to new entry. Consequently not only financial deepening was furthered, but also the oligopoly of the five largest banks was strengthened. Financial intermediation to the manufacturing sector was not developed, except short-term capital (Suehiro 1989: 264-265), partly because the government did not cover credit risk as Korea did. In spite of this, enterprises took advantage of low inflation and stable real interest rates to make investments in the ISI. The government succeeded in obtaining economic and military aid from U.S. and the World Bank in exchange for accepting their recommendation for liberal economic policy. This aid helped economic development, which Sarit and his successor Thanom needed to cope with problems of regime legitimacy and threats from communist movements.
And also the military regime received political support from private banks and enterprises for its policy of non-intervention and active invitation of foreign investment.

Moreover, two institutional complementarities made the financial system persist. Organization of conglomerate and liberalization of foreign direct investment (FDI) enabled enterprises to borrow money from their own group and obtain capital through joint venture with foreign companies. Thus they succeeded in extending investment without demanding credit allocation to the government. And the networks with private banks gave the central bank the power of consultation and coordination concerning financial policy (Hewison 1989: 190).

In contrast to Korea and Thailand, the biggest beneficiary actor in Mexico was the government. It succeeded in controlling inflation and financing increased expenditure by absorbing domestic and foreign money through reserve requirements and external borrowing. As a result, the Mexican economy achieved “stabilized development” in the 1960s. This performance provided the PRI government with political legitimacy as well as support from private actors. Banks, while benefiting from macro-economic stability (Maxfield 1990), were not satisfied with micro-economic aspects of the financial system because they were forced to deposit cash and to invest in public bonds or designated sectors. Instead, banks gained some profits from the regulation of deposit interest and the protection of the banking sector. The government complimented the persistence of the financial system with these institutions (Hoshino 2000: 186). Enterprises also accepted, at least did not oppose, the absorption of financial rent by the government because they could finance through retained earnings and linkages with banks in the same grupo (Maxfield 1993: 247-248).

The 1970s was a period of further institutional reproduction in which the government raised the reserve requirement rate and increased foreign debt. This consolidation was triggered by the “Tlatelolco Massacre,” in which the military force opened fire at student and civic movements in 1968. This movement represented people’s dissatisfaction with economic policy for big business and the widening gap between the rich and the poor. Therefore the incident was, in a sense, a result of the economic strategy of “stabilized development” and the “rent-for-government” financial system
in the 1960s. President Echeverría, recognizing that the PRI government lost its political legitimacy in the incident, changed economic policies in order to recover it. The new strategy had two fundamental objectives: rapid growth and income redistribution, in other words, the “shared development” (Newell and Rubio 1984: 130, 203). For this purpose, the financial system was strengthened to such an extent that the government could absorb more domestic capital and increase fiscal expenditures for redistributive policies. Moreover, the government had external loans to make up for a deficiency of the budget. In this respect, the foreign debts also complimented the endurance of the Mexican financial system. External borrowing, however, was stimulated by the oil boom in 1978, and finally led to the debt crisis in 1982.

Concerning private actors, the financial system was increasingly clashing with their policy preferences. A higher reserve requirement and inflation, being raised by the fiscal deficit, were against the interests of financial institutions. Enterprises were facing the crowding out of private investment that was caused by the expansion of the reserve requirement and public investment (Hoshino 2000: 189; Newell and Rubio 1984: 133-134). Therefore these actors strongly protested against the López Portillo government, but their “voice” had no effect and the “rent-for-government” system persisted until the debt crisis.

3.5 Financial liberalization: Institutional Change

The change of financial systems specifically meant a process of financial liberalization. The Korean government set about liberalization in the 1980s mainly for two reasons. To begin with, the officials feared that increased non-performing loans to big business might cause a debt crisis. Chaebol, enlarged in the “rent-for-enterprises” financial system, was so inclined to borrowing and risk-taking that their investments in the heavy industry sector were excessive and continuously required additional capital. It was also worrisome that inflation caused by financial repression was destabilizing economic growth (Woo 1991: 192). Next, the authoritarian government of Chun Doo Hwan also feared that the rise of chaebol would be a political risk. That is because there was public
opinion criticizing that a cozy relationship between business and politics made up the oligopoly of chaebol. The Chun government was very sensitive to the problem of legitimacy since he seized power by suppressing democratic movements at the “Kwangju Massacre” in 1980 (Hahn 2004: 354; Tsunekawa 1996: 310).

Those who positively responded to the government’s actions were bankers, who hoped that the deregulation would make banks more independent of politics and realize more profits. By contrast, for big enterprises the financial liberalization was a double-edged sword. On the one hand, they found a good chance to be freed from political control of finance and to enter the banking sector, but on the other hand, they were reluctant to agree to the deregulation of interest rates owing to the burden of debt. This sequence of reactions of Korean actors influenced the order of financial liberalization.

The process of liberalization began in the domestic market. The national banks were privatized in the 1980s. But, worrying about chaebol’s control of the bank, the government imposed a maximum ownership by any single shareholder to 8 percent in 1982, and kept indirect control over the privatized banks through appointing the top executives and interfering in their budget. It was not until the 1990s that interest rates were freed, and what is more, the process had four stages. The reason for this slow tempo was that the government worried that a hike of interest rates could affect the stability of financial markets and the management of big business, which was highly indebted particularly due to its short term borrowing (Choi 1993: 49-51). This slow process of freeing banks’ interest rates resulted in the growth of the merchant banks that could operate with higher interest rates than the banks.

International capital transactions were gradually liberalized after the late 1980s in the following order: first, short term capital in 1989, then long term capital such as FDI and equity. It seems risky to open the short term capital market before the long term one due to maturity structure and foreign exchange. Why did the government do so? One reason was that public opinion and big businesses were negative about the early deregulation of FDI and equity investment that might give foreigners a chance to acquire Korean companies. Another more important reason was that chaebol strongly
demanded the short term capital because Korean exports were expanding due to the appreciation of
the Japanese yen after 1985. Korean officials were recognizing the risk of short term capital and so
limited exchange for the Korean won with hard currencies. Additionally, speculative capital
investment was regulated in the 1990s. In the end, however, the liberalization of short term capital
corresponded to chaebol’s demand of capital rather than financial risks.

In short, the order of financial liberalization in Korea reflected the rising power of big business.
The “rent-for-enterprises” financial system enlarged chaebol, and after the democratization in 1987
politicians increasingly relied on their political contributions (Tsunekawa 1996: 310). Although the
government intended to restrain the expansion and debt dependence of chaebol, they now had a huge
influence on the national economy and politics to such an extent that the government had to
implement policies which chaebol preferred. As a result, big business began to finance by corporate
bonds, equity and external short term borrowing in addition to state-controlled bank credit. This
made Korean big enterprises more independent of the government, and at the same time, contrary to
the initial expectations of the government, they became more enlarged and indebted.

In Thailand, before the financial liberalization occurred, minor actors demanded institutional
change. This took place during the democratic transition in 1973. The urban middle class,
university students, and peasants objected to the widening economic gap between cities and villages
and economic concentration of conglomerates. In the end, this movement did not bring about
fundamental financial changes, but the dissatisfaction of the actors remained. It was not until the
1990s that liberalization changed the financial system. The Thai government also aimed to improve
the systemic function of finance and the imbalance of power. Specifically, the tasks were to
strengthen economic competitiveness and to invite more foreign capital to fill the investment-savings
gap. At the same time, the officials intended to tackle those problems that society had vehemently
criticized in the 1970s, the economic dominance of big business and the oligopoly of commercial
banks (Pasuk and Baker 2002: 164-166).

The reactions of the private sector to this campaign varied as follows: enterprises welcomed it
and banks opposed or reluctantly accepted. This affected the order of liberalization in Thailand. Enterprises expected that financial liberalization would enhance competition in the financial sector and reduce the cost of finance. Especially newly emerging enterprises needed foreign money to invest in internationally competitive sectors, such as infrastructure, services, and real estate, since the profitability of the export sector declined in the 1990s (Pasuk and Baker 2002: 168-172). Banks’ reactions differed according to the object to be liberalized. First, they opposed freeing interest rates because they would face more intense competition for deposit mobilizations and higher operating costs. In fact, they organized an interest rate cartel to weaken the effect of liberalization. Second, the Thai Bankers’ Association and the Bank of Thailand resisted the deregulation of foreign entry into the banking sector. They feared it would destabilize the banking system and intensify competition with foreign banks. Accordingly, although the U.S., the World Bank and domestic industrialists pressured the government, the deregulation was not realized (Zhang 2003: 120-124). In 1996, foreign banks were permitted to establish full-branches. But the effect to stimulate competition was small, and the entry of new domestic banks was not allowed until the financial crisis in 1997.

In contrast to the liberalization of domestic market, bankers generously accepted the international capital transactions including the launch of an offshore market (the Bangkok International Banking Facilities: BIBF) where they could mobilize more foreign funds at lower costs. Although the BIBF would expose Thai banks to fierce international competition, they did not oppose it because they were offered the tax incentives of the BIBF and foreign BIBF banks had a limited scope of operations (Zhang 2003: 130). On the contrary, the banks increased external borrowing through the BIBF, when they faced other competitive pressures, as Thai non-financial enterprises could directly mobilize foreign funds.

Briefly, the government set about the liberalization in order to limit the power of private banks and to meet the domestic demand for funds to invest. Thai banks, however, had been enjoying their oligopoly of the “rent-for-bank” system so they strongly resisted the move. Thus, without touching on entry deregulation, the officials liberalized international capital transactions first. This sequence
of deregulation provided not only banks but also enterprises with foreign money at lower cost. Facing competition with enterprises for mobilizing funds, Thai private banks continued to expand loans. However, they had not sufficiently developed the capacity for financial intermediation because of the long-time protective banking policy. Therefore their loans were concentrated in the non-productive sector.

In Mexico three problems that the “rent-for-government” system had entailed emerged after the debt crisis. They were (i) the rise of banks’ power, (ii) insufficient investment in industrial sectors, and (iii) financing government fiscal deficit by domestic financial assets. Similar to Thailand, the initial reaction to these problems was not the financial deregulation, instead, it took the form of the nationalization of commercial banks (including nonbanks such as security companies and insurance companies) by President López Portillo in 1982 (López Portillo 1982: 939-940; Maxfield 1990: 140, 154, 161). This radical and controversial reform contributed to financing the fiscal deficit to a certain extent by consolidating its rent absorption. Since international capital inflow stopped after the debt crisis, the government could not help depend on borrowing and public bonds in the domestic market.

Other problems remained unsolved, however. First, although officials attempted to promote financial intermediation to industry, bank lending to productive activities were declining because the demand for industrial investment was crowded out by accelerated rent absorption through the nationalized banks (Peñaloza Webb 1989: 518). Second, despite López Portillo temporarily succeeding in weakening the power of commercial banks via nationalization, former owners and executives of banks were about to recover damages by acquiring stocks of nonbanks reprivatized in the mid-1980s (Heredia 1995: 201-202). Since the private actors had lost confidence in the PRI government due to the nationalization of banks, President de la Madrid who took office in 1983 intended to restore it by reprivatizing nonbanks (Kessler 1999: 56). He sought economic and political support and the cooperation of private businesses to cope with the economic crisis and the challenge by the opposition parties. The privatized nonbanks grew rapidly in the mid-1980s because
they made profits from the stock market boom caused by increased public bond issues. The de la Madrid government abandoned the purpose of weakening the bankers’ power and now initiated a new task of reestablishing the relationship with private actors.

By the end of the 1980s, the problems of the Mexican financial system had transformed into mainly three: (i) financing the fiscal deficit, (ii) improving the government-big business relationship, and (iii) corporate finance of productive sectors, especially of small and medium-sized enterprises (Aspe 1993: 64-65, 71-76). Thus the management of these problems was the purpose of the financial liberalization that the de la Madrid and Salinas governments began. First, from 1991 to 1992 all 18 commercial banks were reprivatized and came under the umbrella of financial groups. Second, by the end of the 1980s various kinds of public bonds were introduced to meet investors’ demands and foreign investors were permitted to participate in the stock market. As a result, the stock market made rapid progress in the early 1990s and there was a particularly sharp rise in the transaction of short term government bonds such as Cetes and Tesobonos. These institutional changes provided the government with “instruments” (various kinds of public bonds) and “actors” (financial groups and foreign investors to buy the bonds) in order to finance the fiscal deficit without inflationary pressure (Hoshino 2000: 197). In this situation, the reserve requirement that had constituted a central institution of the previous “rent-for-government” system was no longer necessary, rather it was an impediment to new banking in the stock market. So the reserve requirement was abolished in 1988 and deposit interest rates were deregulated by 1991. The government also could recover its relationship with big business, particularly financial groups, because the financial liberalization met their preferences. By contrast, a series of liberal reforms did not favor those small and medium-sized enterprises to which equity financing was not available.

3.6 Outbreak of Financial Crisis and Government Response: An Outcome of Path

The institutional paths of the financial systems in Korea, Thailand and Mexico lead to grave social outcomes in the 1990s: the peso crisis in 1994-1995 and the Asian crises in 1997. The crises
broke out commonly due to the loss of credibility of the domestic market and the massive flight of foreign short term capital. But the processes in which the crises occurred were different, reflecting their own path of financial system. When focusing on domestic sectors in which short-term capital was invested, and government-business relations that influenced massive capital flight, we can find three types of crisis: a Korean “big enterprises-manufacturing overinvestment” crisis, a Thai “financial institutions-asset bubble,” crisis, and a Mexican “government-portfolio investment” crisis (See Table 1).

In Korea, *chaebol*, now financially independent of the government, rushed to compete in the investment in heavy and chemical industries. Given the excessive supply of semiconductors and shipbuilding in the international market, the increase of labor cost, and the technology lag, this competition caused overinvestment, aggravating the debt-equity ratio and return on assets for the *chaebol*. This overinvestment in heavy industry involved two kinds of risk. The first was the double-mismatch that foreign short term capital entailed. On the one hand, banks and merchant banks borrowed short term capital and lent it to *chaebol* in the long term. This maturity mismatch can cause a liquidity crisis when the inflow of short term capital stops and long term debts are not collected. On the other hand, banks borrowed in dollars in the international market and lent in the Korean won in the domestic market. The mismatch of foreign exchange can give rise to currency crisis when massive capital flight happens in a country without sufficient foreign reserves. The second risk was *chaebol* ’s heavy indebtedness involving a high degree of risk. The cause was moral hazard generated by previous implicit guarantees of debt such as the rescue of *chaebol* in 1972 (Lim 2003: 40-48). Therefore, even after the financial liberalization, *chaebol* was not prepared to take the risk of investment which the government and society had previously taken, and worse, banks had no incentive to monitor borrowers. *CHAEBOL* and banks counted on the government to come to their rescue.

These conditions led to a series of bankruptcies of *chaebol* and financial instability, and finally the government-chaebol relations triggered off the Korean crisis. When *chaebol* such as Hanbo
steel and Kia Motors fell into crisis, the Kim Young Sam government vacillated between rescue and bankruptcy, and moreover, even after deciding how to manage the crisis they delayed the process of liquidation. This lack of consistency and speed of the government made the Korean market lose credibility, and consequently accelerated capital flight. In fact, the roll-over ratio of foreign short term capital by Korean financial institutions was declining, as bankruptcies of chaebol repeated (Kim and Yeom 2000).

After the outbreak of the financial crisis, the Kim Dae Jung government did not only accept IMF conditionality of tightening fiscal expenditures and domestic credit, but also actively tackled restructuring of private financial institutions, particularly reforming chaebol (See Table 1). It was evident that the critical problem was chaebol that had been enlarged and induced the crisis under the “rent-for-enterprises” financial system. The officials, on the one hand, nationalized problem-banks and disposed the non-performing loans through the Koran Asset Management Corporation (KAMCO). On the other hand, they took drastic measures for corporate restructuring: the so-called Big Deals. Under this program, the big five chaebol (e.g. Hyundai, Samsung) swapped their major business among themselves so that they could realize efficient investments and reduce surplus capacity.

In Thailand, different from Korea, foreign short term capital was invested, through domestic banks and finance companies, in the service sector, such as real estate and securities. Domestic financial institutions sought profits for the non-productive sector, since manufacturing companies could finance by retained earnings and FDI, as well as bank loans (Mieno 2000). Generally speaking, when domestic financial institutions with an underdeveloped capacity of intermediation face keen competition, they tend to lend to the non-productive sector for easy profits. It is not surprising that this situation led to an asset bubble, which had the same two kinds of risk as in Korea: double-mismatch of short term capital and increased credit risk. The latter was due to the moral hazard generated by the long-time protective banking policy (Doner and Ramsay 1999: 184-186).

When the asset bubble burst in 1996, however, banks’ balance sheet imbalances were rapidly
aggravated because they loaned holding mortgages on real estate and other assets. In fact, the bad loan problem of the Bangkok Bank of Commerce and the defaulting of finance companies such as Finance One caused financial panic. Despite widespread fears in the financial market, the government was slow to take resolute action on the budget and regulating problematic banks and finance companies. It was pointed out that legislators of the government parties and high ranking officials had close relationships with financial institutions. These policy failings contributed to the massive capital flight by weakening confidence in the Thai market.

In the post crisis period, the Chuan government initiated the macro-economic adjustment that was the conditions of IMF assistance. The structuring adjustment, however, was less successful than in Korea. In respect to the financial sector, although several small and medium-sized banks were nationalized, the disposing of non-performing loans was delayed and any public organization for asset management like that of KAMCO in Korea was not built until 2001. This delay and indecisiveness of government response was due to concern about the loss to banks. On the other hand, corporate governance reform was left to the voluntary decision of each company. In Thailand, after all, the reform of big enterprises was not so critical an issue to solve as it was in Korea.

In contrast to the Korean and Thai markets, the Mexican market attracted foreign portfolio capital, such as government bonds and equity rather than bank loans. Equity issuance grew rapidly in the early 1990s, though issuers were limited to a small number of large enterprises. Government bonds, which financed fiscal and current account deficits, accounted for a large amount of annual transactions in the stock market (Kessler 1999: 106-107). The transactions of government bonds were concentrated on the short term ones, in which domestic private enterprises and individuals mainly invested during the latter half of 1980s and, after 1992, foreigners were the central investor (Hoshino 2000: 211). This capital inflow made the financial market vulnerable to investors’ sentiment.

It was in this situation that massive capital flight occurred during 1994. It is often argued that interest rates rising in the U.S. was an important factor, but it was not a sufficient cause since capital
outflow did not reverse even when interest rates in Mexico rose later. Therefore it is required to examine domestic factors that induced the crisis. The first was political instability, which meant higher risk to foreign investors. Particularly in 1994 there were many political incidents, such as the violent uprising in Chiapas, assassinations of the presidential candidate and the secretary general of the PRI, and kidnappings of big company executives. Every time these incidents occurred, short term capital flowed out of the country and the foreign exchange reserves reduced. The second was economic policy failings (Ito1997: 27-29). As domestic interest rates went up because of capital outflow, the economy took a downturn and non-performing loans of private banks began to increase. The government tackled this problem by expanding central bank credit to private banks. But this action increased the money supply and strengthened selling pressure of the Mexican peso. The PRI government also expanded the fiscal expenditure for the presidential election campaign in 1994 so that the fiscal balance of the year became slightly negative. On the other hand, Mexican officials increased the issuance of short term Tesobonos, a dollar-denominated government bond, to reduce inflation and the foreign exchange costs of foreign investors and to bring back international capital. As the political stability worsened, however, the growing amount of Tesobonos was reaching the upper limit of foreign reserves and this eventually fueled expectations of the peso devaluation (Ito 1997: 29).

After the crisis, Mexican officials also accepted IMF conditionality in order to reduce the current account deficit and inflation. The macro-economic adjustment included cuts in fiscal expenditure, an increase in the value-added tax rate, a hike in interest rates, and the tightening of domestic credit. The structural reform, however, was less successful. While problem-banks were nationalized in Korea and to a lesser extent in Thailand, Mexican officials simply purchased the non-performing loans of banks without nationalizing them. Worse, those loans included the corporate debt that companies under the umbrella of financial groups held. Consequently, the government generously rescued the problem-banks and their financial groups instead of reforming the ownership and management of the banks. Regarding corporate governance reform, although there was an advance
in information release, no ownership structure changed. Thus, the government did not have strong incentives for structural reforms since the essential cause of the crisis was the government itself, not excess investments and lending by private enterprises and banks.

4. Conclusion and Implications

The analysis here has argued that the difference in the processes of the “21st century financial crises” and the post-crisis reforms in Korea, Thailand and Mexico were determined by the different paths of the financial systems. Other studies have identified the key factor as being patterns of government-business relationships after financial liberalization. Such relationships, however, are influenced by the politics of finance during the pre-liberalization period. Therefore it is necessary to analyze historical paths of financial systems. In this study we have traced origins of the financial systems back to the late 1950s and the early 1960s when governments chose their modes of intervention in financial markets and the allocation of rent. This critical juncture put the financial systems on their own paths so that institutional persistence and change (financial liberalization) was path dependent and endogenous.

This paper emphasizes that the patterns of the crises and the financial and corporate reforms in the 1990s were historically rooted in the choice of financial systems about 40 years earlier. The origins of the chaebol-induced crisis and the relatively successful structural reforms in Korea can be found in the genesis of the “rent-for-enterprises” financial system. Similarly the “financial institutions-asset bubble” crisis and the insufficient reforms in Thailand came from the “rent-for-banks” system. And the Mexican “government-portfolio investment” crisis and the failed structural reforms had its origins in the “rent-for-government” system. Importantly, the formation of these financial systems was not determined by initial conditions, but they were chosen in contingent political processes. The path dependent development of financial systems in later years was an
unexpected result for the actors -- government, enterprises, and financial institutions -- at that time. In this sense we can claim that those political processes were critical junctures.

It is important to note some implications this analysis has raised. First, much research on international economic crises and globalization has accounted for the difference in policy choice by static factors: domestic institutions and preferences of actors such as political parties and interest groups. By contrast, the argument here suggests that these factors have been shaped in historical processes that have origins in a time when crucial political events happened. In this respect, this study sets the future direction of the research on policy choice toward historical institutionalism or comparative historical analysis (Mahoney and Rueschemeyer 2003).

Second, this paper suggests the possibility to apply the path dependence approach to cases of political economy in developing countries. Many studies of this approach have been conducted mainly on welfare states, labor institutions, and taxation systems in the developed world, and on political regimes and transitions to capitalism in the developing world (e.g. Collier and Collier 1991; Johnson 2001; Kato 2003; Mahoney 2001; Thelen 2004). This study claims that the framework of path dependence is also effective in the analysis of developing countries’ financial systems to which little attention has been given in the path dependence literature.

Finally, this essay provides theoretical insights into the broader literature on issues of institutional evolution. The path dependence approach is effective to account for stages of an institutional path, especially for institutional change. The punctuated equilibrium model has regarded institutional change as being exogenous. There should be possibilities of endogenous change, however. This study has analyzed how endogenous institutional changes occur, focusing on two factors that are entailed in mechanisms of institutional persistence: functional disorder and imbalance of power. These factors of institutional change are just possibilities, but our discussion can contribute to the understanding of how institutional change is related to institutional persistence in a path dependent way.
Table 1. The process of financial crises and government responses

<table>
<thead>
<tr>
<th>Inflow of foreign short term capital</th>
<th>Korea</th>
<th>Thailand</th>
<th>Mexico</th>
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<tbody>
<tr>
<td>Type of capital</td>
<td>Bank credit</td>
<td>Bank credit</td>
<td>Portfolio capital</td>
</tr>
<tr>
<td>Investment and economic sector</td>
<td>Overinvestment in manufacturing sector</td>
<td>Overinvestment in real estate, securities (asset bubble)</td>
<td>Government bonds, equity</td>
</tr>
<tr>
<td>Uncertainty in financial market</td>
<td>Government-chaebol relationship</td>
<td>Government-financial institutions relationship</td>
<td>Economic policy failings, political instability</td>
</tr>
<tr>
<td>Pattern of crisis</td>
<td>Big enterprises - manufacturing overinvestment</td>
<td>Financial institutions - asset bubble</td>
<td>Government - portfolio investment</td>
</tr>
<tr>
<td>Macro-economic adjustment</td>
<td>Successful (IMF conditionality)</td>
<td>Successful (IMF conditionality)</td>
<td>Successful (IMF conditionality)</td>
</tr>
<tr>
<td>Structural adjustment</td>
<td>Active financial and corporate restructuring</td>
<td>Insufficient financial restructuring, voluntary corporate governance reform</td>
<td>Purchase of non-performing loans, no reform of corporate ownership structure</td>
</tr>
<tr>
<td>Government response to crisis</td>
<td>Relatively successful</td>
<td>Temporarily successful, but insufficient reform</td>
<td>Successful tightening policy, but almost failed structural reform</td>
</tr>
</tbody>
</table>
Figure 1. Analytic Framework of Path Dependent Explanation

Table 2. The types of financial system

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<th>Beneficiary of financial rent</th>
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<tr>
<td></td>
<td>Enterprises</td>
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<td>financial market</td>
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<tr>
<td>intervention by</td>
<td>Strong</td>
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<td>government</td>
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<tr>
<td></td>
<td>Weak</td>
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References


* Kim, Wonjung and Dong-Ho Yeom (2000) “The Financial Crisis and Reform of Systems in


Britain, the United States, and Japan, Cambridge U.P.


1 They are called “twin crises.”
2 For example, Kessler 1999; Doner and Ramsay 1999; Pasuk and Baker 2002; Pempel 1999; Zhang 2003.
3 See, for example, Gourievitch 1986; Haggard and Kaufman 1992; Simmons 1994. See also Garrett 1998 on policy divergence under the pressure of globalization.
4 However their cases do not include the Mexican crisis but only the Asian crises.
5 As for political regimes, Maxfield focuses on the presidential or parliamentary regime, and Rosas examines the democratic or authoritarian character.
6 This study refers to Aoki and Okuno-Fujiwara (1996) for the two complementarities.
7 For example, Kathleen Thelen introduces two modes of institutional change. One is institutional “layering” and the other is institutional “conversion” (Thelen 2003: 225-230). See also Greif and Laitin (2004) as an attempt to tackle the question of endogenous change from a rational choice perspective.
8 This generation of industrialization after World War II includes Latin American “NICS” (Newly Industrializing Countries) and East Asian “NIES” (Newly Industrializing Economies). On the other hand, countries of “the third generation” are Italy, Russia and Japan (Kim 1988. See also Gerschenkron 1962).