WITH A LITTLE (TOO MUCH) HELP FROM FRIENDS

FAYETTEVILLE, Ark. – Economists have debated the cause of the meltdown of the Asian economies since 1997, but University of Arkansas economist Raja Kali has found an answer – crony capital lending. Although other economists had speculated on cronyism as a contributing factor, Kali conducted the first empirical study to show it was an important cause of the Asian economic crisis, which continues to have a profound effect on world markets.

“Firms with crony ties to banks and politicians had far greater access to long-term debt,” explained Kali. “We found that a host of firm characteristics identified as important in the corporate finance literature played almost no role in explaining the allocation of long-term bank credit. Cronyism appeared to be by far the main driver of pre-crisis lending patterns.”

Kali conducted his research along with Chutatong Charumilind of Cornell and Yupana Wiwattanakantang of Hitotsubashi University in Tokyo. He presented their findings at the Asia-Pacific Finance Conference on Rebuilding Our Financial Architecture in Bangkok, Thailand.

Cronyism occurs when bankers give credit to friends and relatives rather than using “hard” market criteria to evaluate creditworthiness. Based on implicit guarantees to banks by the government, this credit often goes to projects of dubious quality promoted by friends or relatives, according to Kali.
“Banks (or bankers) obtain private benefits from such projects if they succeed and do not lose if the projects fail, since they expect to be bailed out by the government,” Kali explained. “This implicit guarantee by the government weakens bank incentives to monitor and liquidate poor quality projects.”

These expectations filter down to the company, which has little incentive to ensure project success, since it expects to be refinanced by the bank because of its close ties regardless of its losses. In emerging economies it may be difficult for the government to monitor firms and prevent long-term refinancing of bad projects.

In the Asian financial crisis, which began in 1994, Thailand was the first “domino to fall,” according to Kali. It was followed by South Korea, Malaysia, Indonesia, the Philippines and, finally, Japan.

Kali’s group examined 270 Thai companies in 42 business categories, ranging from agribusiness to property development. Other major businesses included building materials, food and beverage, textiles, commerce and health care services. To identify cronyism, the looked at bankers who also served on the board or as executives in a firm. The researchers found that in Thailand, as in most developing countries, cronyism was widespread before the financial crisis.

“Thailand provides an excellent ‘natural laboratory’ for testing the effects of cronyism after the crisis,” said Kali. “However, we are inclined to believe that similar results might be found in many other emerging economies.”