AMERICAN RESPONSE TO THE ASIAN FINANCIAL CRISIS

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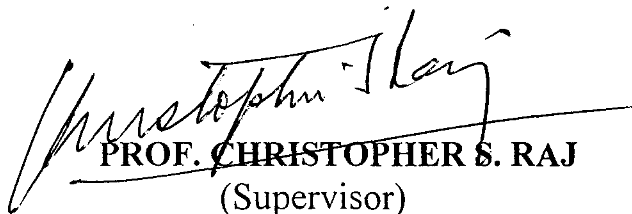

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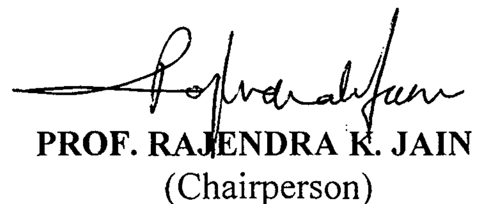

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Dedicated

to...

My Teacher Ms. Sabina Hora

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PREFACE

Very few economic events other than the Great Depression have attracted so much attention or stimulated such a spate of writings as the currency turmoil that ravaged the East Asian economies during 1997-99. This is despite the fact that such crises were by no means rare, nor was the Asian experience the most serious in terms of its intensity and duration. Not only do currency crises have a long history, but since the early 1970's they have also become a fairly regular phenomena, especially in Latin American countries. Compared with the East Asian currency upheaval, the Latin American crises during the 1970's and early 1980's were infact deeper and caused much greater damage to the afflicted economies. What then accounts for such worldwide interest among both economists and the general public in the fortunes of the Asian economies during the closing years of the last millenium?

Part of the answer to the question lies in the sheer unexpectedness of the event and the difficulty of reconciling it with the generally accepted explanations of currency crises developed over the past two decades. Before the Asian debacle, currency crisis had come to be associated with countries in Latin America, notorious for their fiscal profligacy, hyperinflation and lack of export competitiveness. The East Asian economies on the other hand had, throughout been models of fiscal rectitude; had enjoyed unprecedented GDP

and export growth for more than two decades; and were widely expected to become the most prosperous part of the world in a generation or two. The fall of East Asia thus had all the hallmarks of a Greek Tragedy (in a Greek Tragedy, the fall of the hero was ordained by the gods and not due to any intrinsic weakness in his character) and could not but attract attention from all onlookers

The crisis, as well as the plunging currencies and stock markets, called into question the soundness of the international financial and banking system and dramatically underscored the extent to which all countries have become mutually sensitive and mutually vulnerable in a globalized interdependent financial world. This example suggests the growing need for more routinized multilateral mechanisms for policy coordination and cooperation to cope with future crises as global finance becomes increasingly interlocked through massive cross-border transactions beyond the immediate reach of state regulation.

In the present work, an attempt has been made to examine the response of the united states to the Asian financial crisis i.e. how the Asian meltdown challenged the American national interest and what the US did itself and through the instrumentality of the IMF to shore up its interests.

The work is primarily political and not economic and its focus is the struggle for securing their respective national interests by the countries involved. It covers a period starting from January 1997 up to the beginning of

the year 2000. If one could put a date to the beginning of the crisis it would be July 2, 1997-- the day the Thais devaluated their currency-- but the signs of the rot were present much in advance. However, by the beginning of the new millennium, the beleaguered Asian economies were tottering on their path to recovery.

After providing a glimpse of what the crisis is all about and the causes underlying it (Chapter I), an effort is made to understand how the Asian financial collapse threatened American national interests (Chapter II). Next, it tries to explore what the United States did itself and through the instrumentality of the I.M.F. to safeguard its interests (Chapter III). After this, an effort is made at a critical evaluation of the American response to the Asian financial crisis and its ideological position on the appropriate model of development for the third world countries (Chapter IV). Finally an attempt is made to underscore what can be done to make the world capital markets safer so as to prevent such meltdowns in future and help lay the foundations for sustainable economic growth. It also tries to assess what lessons could be learnt from the Asian meltdown by countries like India (Chapter V).

ABBREVIATIONS

APEC	Asia Pacific Economic Cooperation
CAC	Capital Account Convertibility
FDI	Foreign Direct Investment
FII	Foreign Institutional Investors
GDP	Gross Domestic Product
GNP	Gross National Product
IBRD	International Bank for Reconstruction and Development
ICOR	Incremental Capital Output Ratio
IMF	International Monetary Fund
NPA	Non Performing Assets
USA	United States of America

Chapter I

INTRODUCTION

Few could have predicted a year before the Asian financial crisis[1] that Indonesia, South Korea and Thailand would have to go cap in hand to the International Monetary Fund to save them from economic meltdown. These were, after all, the East Asian economies whose economic policies the international financial community was forever applauding. East Asia's three decades of growth, averaging almost 8 percent a year had inspired pride at home and envy abroad.[2] Never before had any economy sustained such rapid growth for so long. The four original 'Tiger Economies' (Hong Kong, Singapore, South Korea and Taiwan) had worked themselves up to developed country status, and Indonesia, Malaysia and Thailand were catching up fast. There was much talk of an 'Asian Century' ahead, when the regions economies would leap ahead of Europe and America.

But plunging currencies and stock markets pushed the economic miracle in the deep freeze and these economies were forced into concentrating simply on survival. At its low point, the Indonesian rupiah

1 "Most of the South East Asian economies are expected to strengthen their performance in 1997 and 1998": Asian Development Bank, Asian Development Outlook 1997 and 1998 (published early second quarter, 1997).

2 Clifford, & Engardio, Meltdown: Asia's Boom, Bust and Beyond, (Prentice Hall Press, Paramus, NJ, 2000). p.3.

was more than 80 percent down against the dollar and the currencies of Thailand, South Korea, Malaysia and the Philippines had all dived by 35-40 percent. The foreign debt burdens of these economies had also swollen alarmingly in local currency terms. The stock markets of all five countries had also seen losses of at least 60 percent in dollar terms since the onset of the crisis and shares in Hong Kong and Singapore too took a severe beating.[3] One conservative estimate put the loss of wealth as a result of the crisis in Indonesia, Thailand, Malaysia and the Philippines at over $600 billion, or about 60 percent of their combined pre crisis GDP.[4]

The Asian Miracle

Recent events aside, the socio-economic performance of East Asia has been called a miracle and rightly so. The economic record of the region over the past three decades is impressive by any measure.[5] Since the beginning of the sixties, the regions economy had been booming. The 'tigers' (South Korea, Hong Kong, Singapore and Taiwan) were followed by 'baby tigers' (Thailand, Malaysia and Indonesia). Policies favouring outward oriented growth, high savings and investment rate and sound fiscal positions contributed to a sustained period of rapid growth. By the 1980's

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3 Donald K, Emmerson, "Americanizing Asia?", Foreign Affairs, (New York), vol. 77, no. 3, May-June 1998, pp. 46-56.

4 Javad Shirazi, Regional Manager, East Asia and the Pacific, World Bank, "The East Asian Financial Crisis: Origins, Policy Challenges, and Prospects", at the Strategic Studies Institutes Conference, "East Asia in Crisis", Seattle, June 10, 1998. (www.worldbank.org).

5 Clifford, & Engardio, n.2, p.3.

most economies in the region were expanding vigorously. Annual GDP growth in the ASEAN-5 (Indonesia, Malaysia, Philippines, Singapore and Thailand) averaged close to 8 percent over the last decade.[6] Indeed during the thirty years preceding the crisis, per capita income levels had increased tenfold in Korea, fivefold in Thailand, and fourfold in Malaysia. Moreover, per capita income levels in Hong Kong and Singapore now exceed those in some industrial countries.[7] Until the current crisis, Asia attracted almost half of total capital inflows to developing countries– nearly $100 billion in 1996. In the last decade, the share of developing and emerging market economies of Asia in world export has nearly doubled to almost one fifth of the total.[8] Thus beginning with a share of 4 percent of the world GNP in 1960, the East Asian economies had cornered a share of 25 percent of world GNP in at the time of the onset of the crisis.[9] This record growth and strong trade performance is unprecedented, a remarkable historical achievement.

Further, rapid growth has been the basis for equally impressive improvements in social indicators: reduction in poverty, increased investment in human capital, improved health care, and lower incidence of

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6 Stanley Fischer, First Deputy Managing Director of IMF, "The Asian Crisis: A View from the IMF", Address to the Midwinter Conference of the Bankers Association for Foreign Trade, Washington, D.C., Jan 22, 1998. (www.unif.org).

7 ibid.

8 ibid.

9 Luc Demaret, "1998-The Year of Living Dangerously", ICFTU Online, 8 December 1997. (www.icftu.org).

disease. Since the 1960's, life expectancy in the region has risen on average from 60 years to 70 years.[10] And in what the World Bank called a "silent revolution," the number of Asians living in poverty dropped by half between 1970 and 1990, to 220 million, even though the regions population had swelled by 425 million.[11] Korea, Malaysia and Thailand have virtually eliminated absolute poverty and Indonesia is within reach of that goal.[12] So how could events in Asia unfold as they did, given so many years of outstanding economic performance.

The Asian Turmoil

The second half of 1997 saw the most severe crisis ever faced by the high performing economies of East and South East Asia. The problem first surfaced on the Ides of May with a speculative attack on the Thai baht which, though warded off for some time through market intervention, finally forced the Bank of Thailand on July 2 to let the currency float and seek 'technical assistance' from the IMF.[13] The Thai baht immediately plunged more than 17 percent against the US dollar and along with it the

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10 Shigemitsu Sugisaki, Deputy Managing Director of the IMF, "Economic Crisis in Asia and its Implications for the International Financial System", Address at the meeting on "Development Co-operation: Responding to the Asia Crisis", Sydney, Australia, March 5, 1998. (www.imf.org).

11 Clifford, & Engardio, n.2, p.3.

12 Alassane D. Ouattara, Deputy Managing Director of the IMF, "The Asian Crisis: Origin and Lessons", Address to the Royal Academy of Morocco, Seminar on "Why Have the Asian Dragons Caught Fire?", Fez, May 4, 1998. (www.imf.org).

13 Mihir Rakshit, The East Asian Currency Crisis, (New Delhi, 2002), p.74.

currencies of the other Asian tigers fell like dominoes.[14] With this followed a chain of events as a result of which in less than one year, Asia was transformed from the worlds fastest growing into its slowest growing region.

After the Thai devaluation, other countries followed suit and devaluated their own currencies and this created an all round panic.[15] Foreigners began pulling out their investment in scripts which, in turn, led to crashing stock markets all over. There was a flight of capital from these countries. The region, which was previously coveted by many investors to offer the most attractive business opportunities, was converted almost overnight into a net capital exporter.

Thus the economic turmoil in East Asia was largely a banking and investment crisis linked to a collapse of investor confidence. Because East Asian economies are closely tied together, a series of problems-- starting with a flawed exchange rate policy in Thailand-- quickly spilled over into neighbouring countries. Five countries were hit the hardest-- Thailand, Indonesia, South Korea and to a lesser extent, Malaysia and the Philippines-- but a total of thirteen countries were affected. Taken together, these economies comprised a third of the world economy. The sums of

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14 Naomi Crain, "Stock Market Plunge in Asia worries Capitalist", The Militant, vol.61, no.31, September 15, 1997. (www.igc.apc.org).

15 Emmerson, n.3, p.46.

money involved made this the largest economic crisis in recent years, far larger than the Latin American debt crisis of the 1980's or the Mexican peso crisis in 1995.[16]

By the end of 1997, it became obvious that the decade long 'roaring' economic growth of Asian tigers was going to end in a whimper. One after another their hidden ills began coming up.

Across the region, expectations about future growth led to extravagance.[17] The capital became cheap, thus encouraging over borrowing. Much of the money was squandered on speculative property investment or the over-expansion of industrial capacity. At the same time a fatal combination of pegged exchange rate and an over hasty opening of economies to short-term foreign capital caused a surge in debt to foreign banks. The resulting financial bubbles were inflated further by inadequate bank regulation and the close, sometimes corrupt, relationship between banks, firms and government, which encouraged borrowers and lenders to believe that governments would bail them out if such need arose.

As we have seen, the first country to succumb was Thailand, where economic indicators had been flashing red for some time. The most worrying of these was a current account deficit of 8 percent of GDP,

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16 Hamilton H.Lee, "Washington Report on the Asian Economic Crisis", Speech in the House of Representatives, Congressional Record, January 28, 1998. (www.access.gpo.gov).

17 Clifford, & Engardio, n.2, p.10.

financed largely by short-term capital inflows. Banks and businesses, convinced that the baht's exchange rate against the dollar would remain pegged (as it had, in effect, been since 1985), borrowed heavily in dollars at much lower interest rates than they could have got at home. Thailand's debt to foreign banks jumped from $29 billion in 1993 to $69 billion by mid 1997, 70 percent of which had a maturity of less than one year.

Most of the other East Asian currencies were also linked to the dollar in some way. This proved to be a big mistake.[18] Not only did it encourage foreign currency borrowing, but the pegged exchange rate also prevented the central banks from raising interest rates to curb an explosion in domestic credit. Economies therefore over heated, sucking in more imports. Then the dollar started to rise, gaining 50 percent against the yen between 1995 and 1997 and pulling the Asian currencies up with it. As producers became less competitive, exports growth slumped and current account deficits widened.

To speculators, the Thai baht looked an irresistible target. Initially the government tried in vain to defend it, and was finally forced to let it float in July 1997. The devaluation meant that all the 'cheap' foreign currency debt suddenly became much more costly to service, since almost all of it was unhedged. Inevitably, too, the property bubble burst, leaving

[18] Garnaut, "The East Asian Crisis" , in Mcleod, R. H., Garnaut R., (ed.), East Asia in Crisis: From Being a Miracle to Needing One?, (Routledge Publishers, London, 1998). p.12.

banks with a heap of bad debts. As fears grew about the ability of the firms to repay their borrowings, foreign capital dried up, foreign exchange reserves dwindled and Thailand had to go to the IMF.

Thailand's weaknesses-- fixed exchange rates, dodgy banking systems with too much exposure to property, massive unhedged short-term foreign debt and a general lack of transparency of business and financial dealings-- were shared by most East Asian economies.[19] So the crisis quickly spread to the Philippines, Indonesia, Malaysia, and South Korea, savaging their currencies and stock markets.

In South Korea politically driven lending exacerbated the problem.[20] For decades the governments had treated banks as tools of its industrial policy, directing them to lend to favoured sectors of the economy at cheap rates. Firms had come to expect the governments to bail them out if need be, which encouraged them to borrow too much and to invest recklessly. South Korean banks and firms also borrowed liberally from abroad. Cheap money encouraged the debt laden conglomerates (chaebols) to diversify into too many areas. At the end of 1996, the top 30 chaebols already had an average debt-equity ratio of 400 percent compared to 70 percent in the USA. When exports slumped and the won tumbled, firms could no longer

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19 Clifford, & Engardio, n.2, p.12.

20 R.C., Mascarenhas, Comparative Political Economy of East & South Asia: A critique of Development Policy and Management, (Macmillan, London, 1999). p.49.

afford to service their foreign loans. Foreign banks became reluctant to roll over short-term loans, thus pushing the country to the brink of default before the IMF came to the rescue.

Indonesia, which also had to go begging to the IMF, initially looked in a much better shape. As early as summer 1996, the economists of IMF and the World Bank had agreed that its economy was fundamentally sound and not at risk of suffering Thailand's problems, because it had a smaller current account deficit and allowed its exchange rate to float within a wider band. However, loose banking supervision, perverse links between borrowers and lenders, directed lending through state banks and heavy unhedged foreign borrowing had left a mountain of debt. As a result of devaluation, the ratio of foreign bank debt to GDP jumped from 35 percent to 140 percent and most Indonesian banks and firms became technically bankrupt.

After this overview the following may be pointed out as the key weaknesses of the East Asian economies.

Firstly, the governments, the central banks and the commercial banks in East Asia had been labouring under the illusion that stable exchange rates would always continue and this is the reason why they did not provide for any eventuality. Consequently, they assumed that they would forever be able to borrow in the US dollars to buy local currency

assets and make profits. When this illusion disappeared and local currencies nose-dived, they were at a loss as to how to service and repay the debts.

There are three ways in which large inflow of foreign capital can undermine the balance of payment viability in the long run.[21]

- One, if borrowing from abroad is used to finance domestic consumption rather than investment, the country will, sooner or later, face difficulties in servicing its debt.
- Second, when inflow of external finance adds entirely to domestic capital formation, widespread inefficiency in the use of available resources may make their returns too low to repay foreign creditors.
- Third, what is relevant is not productivity of investment in physical terms, but addition to foreign exchange in relation to the requirements for servicing external debt. Thus, it is not enough to add to the productive capacity of the economy unless the additional capacity can be converted into extra earnings in terms of foreign currency. Hence, the need for ensuring that export growth of the country will be enough to discharge interests and repayments obligation on account of foreign borrowing.

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21 Rakhshit, n.13, p.52.

All three factors were in play in East Asia. At the end of 1996 foreign currency loans of a maturity of less than two year came to 120 percent of foreign exchange reserves in Thailand and almost 200 percent of reserves in both Indonesia and South Korea. Thus short-term loans were an important feature of the borrowings by East Asian countries and the flows of 'hot money'[22] played a key role in the collapse of the so called Asian 'tiger' economies.

Secondly, the banks in these countries indulged in lending, without restraint, against real estate. They were convinced that with a continuous rising demand for office-space, hotels, luxury homes, and so on, the value of real estate would continue to climb up. Hence they invested heavily in construction activities. As ill luck would have it, the supply demand correlation went against them and rents as well as value of real estate sharply declined. *The Economist* (15 November, 1997) reported: "That in turn, has squeezed some of the biggest banks, which now typically have between 10 percent and 35 percent of their loans committed to bricks and mortar. Political meddling made matters worse. Often, to curry favour, financial institutions financed politician's pet projects. Some, especially in Thailand and Indonesia have been little better than political piggy banks."

[22] The term refers to the sudden and speculative shift of investments from country to country.

Thirdly, as *The Economist* (15 November, 1997) report added: "Perhaps the most important error was caused by a mixture of hubris and inexperience. Convinced that rapid economic growth would forever rescue them from bad lending judgements, bankers failed to examine the financial risks they were undertaking. A lunch or a round of golf would do more to inform their credit decisions than spreadsheets of financial data. This 'Asian way'of vetting borrowers has proved costly indeed."

Fourthly, except for regulators in Hong Kong and Singapore, there was hardly any check on commercial banks in South Korea, Indonesia, Malaysia, Thailand and the Philippines. So long as economies were exhibiting fast growth, lending of even dubious type was winked at and nobody bothered that in the process, the banks were becoming more and more vulnerable. In Thailand, for instance, one of the top fifteen commercial banks, Bangkok Bank of Commerce, collapsed because of its bad lending, but even then the central bank and the government did not wake up and realise the need to bring in order and discipline in the banking sector. Without going into its working, the government came forward to its rescue because, as the grapevine had it, the bank had lent huge sums to corrupt politicians who, in turn, put pressure on the government to help it. The central bank in Thailand seldom enforced disclosure rules and banks were allowed to describe a loan performing even though it had not been serviced for a whole year. Besides, when the value of real estate and other

property plummeted, the security pledged to banks became meaning less. By the end of 1997, one estimate put the bad loans of East Asian banks at anything between 10 and 20 percent of their total lending. In the USA such loans seldom exceed one percent limits.

Fifthly, 'crony capitalism' was a phenomena witnessed in all these countries, but more prominently in Indonesia, where the friends and relations of President Suharto grabbed most of the licences and credit and other facilities to emerge as prosperous tycoons.[23] They grabbed government and military positions and contracts. Rules were ignored to help them.[24]

Sixthly, the 'economic miracle' in East Asia had been due to the strategy of export-led growth. It was not oriented towards the home market, but towards the export market.[25] It does not require much intelligence to say that the strategy of export led growth cannot provide stability to the economy. Infact if there is any upheaval in the export market, it is bound to unsettle the economy. This upheaval may be because of a variety of factors, ranging from political instability, growing threats from competitors changing technology, financial problems, policies of

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23 Emmerson, n.3, p.55.

24 George J. Aditjondro, "Suharto & Sons (And Daughters, In-Laws & Cronies)", The Washington Post, Sunday, January 25, 1998, p.C01.

25 W. Bello, S. Cunningham, & L.K. Poh, A Siamese Tragedy: Development Disintegration in Thailand, (Zed Books, London, 1998). pp.10-11.

foreign countries where market is situated and so on. In the year before the crisis a slackening of exports was witnessed in all the East Asian economies.[26]

Finally, lack of political democracy and openness in East Asian countries also contributed to the crisis and its aggravation. Had there been political democracy and various kinds of freedoms and liberties going with it, there could have been some sort of public control on economic policies and their implementation. The kind of situation witnessed in Indonesia, Thailand, and South Korea would not have been there if both the print and electronic media would have informed the people at large of the real state of affairs and there would have been discussions in the public and elected bodies. The governments would have been responsible and answerable to the public and it's elected representatives.

In short, all the East Asian economies suffered from too much cheap money, combined with a financial system that failed to allocate it efficiently. Banks did not assess credit risks properly, lending largely on the basis of personal relationships and taking risks in the belief that the governments would bail them out. Bank supervisors seemed incompetent at best and at worst corrupt.

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[26] Rakshit, n.13, p.54.

Finally a crisis developed in mid-1997 when Asian banks began to topple as a result of a glut in real estate and a slowdown in manufactured exports. That, combined with a wave of currency devaluation's, triggered a massive panic by foreign investors, who quickly sold off their stocks and bonds, sparking the intervention of the IMF. Thus it will not be wrong to surmise that most of the crisis was a creation of the East Asian countries themselves.

Chapter II

US INTERESTS IN THE WAKE OF ASIAN CRISIS

Soon after its onset, the impact of the Asian financial crisis started to the felt around the world, triggering fears of a global depression and deepening the plight of workers and poor everywhere. As the Asian crisis worsened, the specter of the turmoil reaching the American shores started to haunt US policy makers. To Representative Hamilton H. Lee, "The Asian financial turmoil represented a serious threat to global (read American) prosperity."[1] And in the words of Stuart E. Eizenstat, Under Secretary for Economic, Business and Agricultural Affairs, "vital US interests of great importance to the security, the prosperity and the values of the American people... are at stake" in the financial crisis in East Asia.[2] Again in his words: "The economic health of East Asia is important to our own prosperity. The dynamism of the region has provided increasing trade and investment opportunities to American companies, creating jobs here at home. The growth of exports has helped fuel our economic expansion," and "our participation in the global economy has been fundamental to our

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1 Hamilton H. Lee, "Washington Report on The Asian Economic Crisis", Speech in the House of Representatives, Congressional Record, January 28, 1998. (www.access.gpo.gov).

2 Stuart E. Eizenstat, Under Secretary for Economic, Business and Agricultural Affairs, "Asian Financial Crisis: Broader Implications", Remarks before the House ways and Means Committee: Washington, D.C., February 24, 1998. (www.state.gov).

sustained growth, low unemployment and low inflation.'[3] Now let us take a look at what these interests of vital importance to US are.

Impact On Trade

A prime concern of US was adverse impact on trade. The region bought nearly one third of all US exports. A look at individual state figures further underscores the importance of trade to the region. A large portion of the exports from the West Coast states went to East Asia– in 1996, nearly 58 percent for Washington, 57 percent for Oregon and 51 percent for California with a total value of some $76 billion. Even more remarkable are the high numbers in other parts of the country– 45 percent for Nebraska, 42 percent for Utah, 37 percent for Louisiana, 26 percent for Illinois and 21 percent for New York.[4] These figures state the degree to which individual states are tied to Asian economies. And just as the benefits of this growing trade had been spread widely, so would be the costs of the downturn.[5]

In the first one year after the onset of the crisis Asian stock markets declined on average between 40 percent and 60 percent, while the value of most Asian currencies fell between 35 percent and 85 percent against the US dollar. That made it difficult for them to buy US products, while

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[3] ibid.

[4] ibid.

[5] Treasury and Commerce Release, Analysis Showing "Impact of Asian Crisis on Individual States", March 24, 1998. (www.treas.gov).

lowering prices for their own exports by more than half. So they were now exporting more and importing less. As a result, they US trade deficit hit a high of $ 240 billion in 1998.[6]

Rise In Unemployment

Rise in unemployment was also a cause of concern. Over one million industrial jobs in the US were threatened as the Asian countries exported their way out of its crisis.[7] US jobs were also in danger as the Asian goods, which suddenly became less expensive because of currency depreciation, would replace US exports to Asian and other emerging markets. Those job losses were concentrated in key manufacturing industries, including steel, electronics, apparel and automobile. US workers also had a big stake in Asian capital markets through their pension plans and mutual funds. The Wall Street Journal estimated that over 11 percent of the total assets of pension funds are inverted overseas.[8]

Stability of US Stock Markets

The Asian crisis also threatened the stability of US stock and bond market. The ripples of the Asian Crisis were first felt in US on October 27, 1997 when the stock market took a nose dive as investors began to dump

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6 Tim Shorrock, "Asian Financial Crisis", November 13, 1998. (www.foreignpolicy-infocus.org).

7 ibid.

8 Alassane D. Ouattara, Deputy Managing Director of the IMF, "The Asian Crisis: Origin and Lessons", Address to the Royal Academy of Morocco, Seminar on "Why Have the Asian Dragons Caught Fire?", Fez, May 4, 1998. (www.imf.org).

stocks in corporations whose profits had plunged as economic growth in Asia, which buys nearly one third of all US exports, sank to its lowest rates since the early 1960's. On that day, the world wide plunge in stock prices erased more than 7 percent from the Dow Jones Industrial Average and forced the New York Stock Exchange to halt trading.[9] According to economist Ed Yardeni, Chief economist at Deutsche Morgan Grenfell inc. "investors in the US stock market are starting to worry very seriously that the Asian contagion is now spreading to US Stocks. Its increasingly clear that Asia is not a problem that's going to go away anytime soon." The swooning markets were focussed on the fact that Asia is now in the midst of a deep and prolonged recession that poses a major threat to growth elsewhere in the world, including the United States.[10]

Thus the Asian problem clearly threatened to make American investors poor and erode the profits of many multinational companies with operations in Asia. The reaction to the slide in worldwide stock prices also drove many investors into United States Treasury securities, as the safest investment around.[11] Although more money flowing into US from abroad would help drive down interest rates in US markets, it would also cause a

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9 Floyd Norris, "US Stocks Fall 554 Points, Off 7 percent, Forcing suspension in Trading", *The New York Times*, October 28, 1997.

10 Paul Blustien & Kieth B. Richburg, "Fears About Asia Hit World Stocks", *The Washington Post*, Tuesday, June 16, 1998, p.A01.

11 Norris, n.9.

further shortage of capital for investment in the Asian economies, thus adversely affecting their chances of a turnaround in their fortunes.[12]

Contagion Effect

The issue was also important because unless Asia's financial problems were kept in check, the crisis could soon spread to engulf Latin America and other third world regions and eventually pose a risk to the US economy. Brazil's economy was already teetering. Others may fall as well. At the time of the crisis the US economy was booming, with inflation and unemployment both at their lowest levels since the 1960's. In December 1998, the expansion became the second longest on record passing the 1980's and rapidly approaching the 1960's record of 106 months. Employment growth was strong and real GDP was advancing rapidly, buoyed by consumer spending. However, the drag from a sick Asia was slowing the economy and threatened to jeopardize this cozy situation.

Also the IMF had predicted that the crisis would inevitably slowdown world growth.[13] After the crisis, the IMF projected the global economy in 1998 to grow at its slowest pace in five years, an increase of just 3.5 percent. The forecast made in December 1997 represented a 0.8 percentage point reduction from two months ago, when the IMF had

12 David E. Sanger, "On Eve of Key meeting, IMF Paints a Gloomy Global Picture", *The New York Times*, October 1, 1998.

13 Ouattara, n.8.

projected a worldwide growth of 4.3 percent. The IMF also stated that there is no reason to be overly pessimistic and that "the threat to global growth from the present crisis is reasonably limited." Still, it warned that the risk of the Asian trouble spreading to other countries had grown and that there was no way of knowing whether the world had yet seen the worst. As any slowdown in global growth was bound to affect the booming US economy, the US policy makers viewed the IMF warning as a serious cause of concern.

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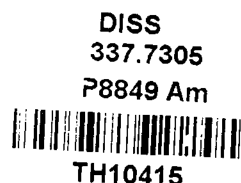

Strategic Interest

A greater fear was that the economic hardships in East Asia might undermine the political stability of the region and affect US security interest. In the words of Secretary Rubin, "the economic wellbeing of South-East Asia is very important to the economic well-being and national security of the United States."[14] In the same vein, Secretary of State Madeline K. Albright said, "the stability of the Asia-Pacific region is in our economic and national security interest. These countries are our friends and allies and their prosperity" is important to us.[15]

Thus the US establishment perceives American national security interest to be closely linked to peace and stability in East Asia– a region

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[14] Robert E. Rubin, Treasury Secretary, Before the Senate Appropriations Subcommittee on Foreign Operations, March 3, 1998. (www.treas.gov).

[15] Madeline K. Albright, Secretary of State, op-ed on "The Economic Crisis in Asia" for *Diario Las Americas*, Miami, Florida, February 1, 1998. (www.state.gov).

where it has fought three costly wars in a span of a little over 50 years & ever since world war II, US security policy in the western Pacific has stressed stability and the deterrence of conflicts.

The region is strategically important because nearly one half of the earth's people live in countries bordering the Asia-Pacific and over one half of all economic activity takes place there. Further, four of the worlds major powers rub shoulders in North-East Asia and some of the most important sea-lanes on the globe pass through the confined waters of South East Asia and specifically, next to or through Indonesia. Apart from its control of shipping routes, Indonesia's importance lay in the fact that it is the world's most populous Muslim nation, which so far had kept good relations with the United States. Also, in the words of Under Secretary for Economic, Business and Agricultural Affairs, Stuart Eizenstat, US is as much "a Pacific nation as an Atlantic nation, and what happens in the Asia-Pacific region directly affects us and has a profound impact in the US"[16]

The strategic importance of the region, for the United States can also be gauged from the fact that US has around 100,000 troops stationed in the western Asia-Pacific region. This forward military presence and active engagement is to increase and bolster stability in the region. And the U.S establishment believes that this stability has been the essential

[16] Stuart E. Eizenstat, Under Secretary for Economic, Business and Agricultural Affairs, "Asian Financial Crisis: Broader Implications", Remarks before the House ways and Means Committee: Washington, D.C.,February 24, 1998. (www.state.gov).

foundation for the unprecedented economic, political and social progress in East Asia over the past several years– progresses from which Americans have greatly benefited. However just as increasing peace and stability have enabled economic progress, so too have economic progress and the better life it has brought to hundreds of millions of people reinforced peace and stability. But the economic difficulties brought about by the Asian financial crisis threatened this stability and much of the progress made over a generation.

Of this 100,000 troops 37,000 were deployed in South Korea to ensure an uneasy peace in the face of the continuing threat from North Korea. A South Korea weakened by economic distress raises the risk of miscalculation by North Korea and conflict on the volatile Korean Peninsula. Economic distress of Korea would make difficult the effort through the Agreed Framework of 1994 and the Korean Peninsula Development Organization (KEDO) to dismantle the dangerous North Korean nuclear program, where a large contribution from South Korea would be necessary. It could also complicate the US effort through the Four Party Talks to secure a permanent peace and bring the Korean War to a formal end: The economic crisis could also strain the ability of countries such as South Korea and Japan to continue to share the financial burden of maintaining security in the region.

Another country struck by the Asian crisis, Thailand, is one of the oldest friends of the US in the region and has been a close, supportive ally for many decades– from the Korean war through the Indochina conflict all the way to the present day. US has had a treaty relationship with Thailand dating from 1954. The two countries enjoy very close military-military relations and US has access to strategic air bases in Thailand. During the Gulf War and subsequent actions against Iraq, Thailand provided US with essential overflight clearances and the use of air bases. The long standing friendship has also resulted in close cooperation on a broad range of issues, including most recently in counter narcotics- where Thailand had extradited an unprecedented 11 indicted traffickers to the US since 1996- environmental protection, medical research and improved intellectual property rights enforcement.

Indonesia too in recent decades played an influential and constructive role in the region and is an important country on US strategic calculus. Indonesia spans important seaways and airways and possesses rich natural resources. Where its assertive nationalism once unnerved its smaller neighbors, in recent decades Indonesia has provided the moderate leadership which has allowed ASEAN to prosper and more recently has been a driving force within APEC in favour of trade liberalization. Indonesia also contributed to peacekeeping efforts in Bosnia and Angola,

supported non-proliferation efforts and joined KEDO– issues close at heart to US.

Just as importantly, Indonesia, a land of many diverse people, languages and cultures, is a moderate secular state with the world's largest Muslim population– more than in the Middle East nations combined. US was also concerned about Indonesia's social problems– problems, which could exacerbate social tensions and rekindle nationalistic excesses.

Another ally in the region, Philippines, was not as hard hit by the financial turmoil as Thailand and Indonesia but it remained vulnerable to the turmoil in the region. The Philippines had been a close friend of the United States since its independence in 1946 and a treaty ally since 1952. In recent years it has achieved remarkable success in the difficult task of rebuilding democracy and economy following the final, chaotic Marcos years and the US would not like that record of success undermined.

Thus the core countries of ASEAN- Thailand, the Philippines, Malaysia, Singapore and Indonesia- have been long time friends and allies of the US whose prosperity and progress had contributed to increasing regional stability. ASEAN founded 30 years ago to bolster regional stability, continues to grow in stature and is presently engaged in a constructive role in stabilizing and bringing about peace in Cambodia. Through its bilateral ties with individual members, its participation in the ASEAN Regional Forum, its other high level dialogues with ASEAN and

by its active role in APEC, the United States had always emphasized on strengthening its overall relationship with the ASEAN.

However, the Asian financial crisis threatened the peace and progress brought by ASEAN to South East Asia. In the South East Asia of the mid 1960's there was tension, there were bloody insurgencies, there were shooting wars, Indonesia's confrontation with its neighbors, and there were communal killings. The changes since then have been astounding, but prolonged economic crisis and the attendant joblessness, impoverishment and despair could revive internal instability in these countries and provide fertile ground for extremism. Also, millions of foreign guest workers work in some of these economies while other ASEAN countries provide large numbers of workers to their neighbors. Due to the economic hardships, there existed increasing pressure to send them home. Thus prolonged instability would generate an increased flow of economic refugees. In a region where old suspicious and ethnic rivalries persist, the risk of instability spreading was very real.

With the end of the cold war the security landscape in East Asia has been evolving. During this transition period, it was important to US interest that the nations of the region remain strong and that confidence in US leadership remained firm. A peaceful and stable Asia-Pacific would remain open to American influence, American ideas and American trade only if it showed continued leadership. But if it appeared disinterested or

unengaged, it would run the risk of ceding to others, political and diplomatic influence– and the economic opportunities that went with this influence.

Arms Sales

The economic hardships brought about by the Asian Financial Crisis also threatened sales of American arms manufactures.[17] As the crisis rippled across Asia, it caused South Korean and Japanese officials to rethink investment in high tech weapons-- AWACS surveillance planes and missile defense systems-- that the Pentagon has urged in a bid to move the countries towards a larger role in their own defense. Similarly, the financial turmoil spurred various Asian nations to delay or cancel arms deals that have helped keep US weapon makers busy at a time when procurements by the Pentagon have tumbled. Thailand, for example, asked the Pentagon for helps in renegotiating a $400 million deal for eight F/A-18 fighter jets, 40 percent built at Northrop Grumman's facilities in El Segundo.[18] While South Korea decided to delay the purchase of four AWACS, the American made electronic surveillance jets. Malaysia, which had seen the value of its currency, the ringitt, drop by half, revised its budget to scrap plans to spend $ 500 million to buy new equipment,

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17 Paul Richter, "Crisis Thwarts Pentagons Efforts to Beef up Asia Military", *The Los Angeles Times*, January 15, 1998. (www.latimes.com).

18 Steven Lee Myers, "Financial Crisis Slows Arms Race in Asia", *The New York Times*, January 13, 1998.

including American attack helicopters, armored vehicles and possibly several F/A-18 fighters.

Asian arms purchases have been strong in recent years and have recently set off a bruising scramble among weapon making countries for deals worth billions of dollars. East Asian military spending reached $165 billion in 1997– twice their 1990 level.[19] Purchases by American companies, which accounted for about 10 percent of US arms exports a decade ago, made up about 25 percent of the $16 billion in weapons that US manufactures sold abroad. Growth has been particularly strong in the fast– growing nations of Southeast Asia such as Malaysia, Thailand, and Indonesia.

After the cold war, the 'tiger' economics in Southeast Asia in particular set out to use their deep financial reserves to modernize their militaries, even though they faced no immediate security threats. Advocates of arms control have sharply criticized the Asian arms buildup, as well as Washington's eagerness to supply it, saying the rush to modernize could destabilize the region by stocking lingering fears and dominant hostilities.

Caleb Rossiter, director of Demilitarization for Democracy, an arms control group in Washington, termed many of the purchases "prestige

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[19] Richter, n.17.

buys," meant merely to enhance the standing of one country or the other in the region. But countries like Malaysia, Singapore and Indonesia had also been trying to expand there ability to use force beyond their borders and into the shipping lanes of South China sea, where there are potentially dangerous territorial disputes over several island groups.

Prospects of declining sales stirred concern at the Pentagon because by providing avenues for US defense manufacturers, these sales have helped lower per-unit prices of aircraft and other weapons for the Pentagon and helped assure that the strained defense manufacturing base would survive its post-cold war retrenchment.[20] But after the crisis South Korea and Thailand have agreed to defense cuts as parts of austerity programs proposed by the IMF in exchange for bailout financing. Other nations in the region also slashed defense spending due to depreciating currencies.[21]

As they threaten US contractors, the Asian defense cutbacks also throw at least a temporary road block in front of the Pentagons effort to strengthen and update its alliances with it key partners in the region and beef up their military strength. US official had been pursuing the South Koreans to spend more for their own defense and urging the Japanese, who had limited their military activities since World War II to expand their role in the regions defense network. Defense officials insisted that the US

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20 Myers, n.18.

21 Richter, n.17.

commitment to the region is steadfast. But amid signs that US forces may need to reduce their numbers in some areas, such as Okinawa, because of local resistance, defense officials wanted assurances that their allies can pick up the slack. In the face of budget pressures at home, they also wanted the US Commitment to be as lean as possible. To accomplish these goals US officials had been urging Asian allies to buy high-tech weapons that would be useful in defending themselves in the first hours or days of an attack. The US had urged the South Koreans to buy AWACS surveillance planes, which keep track of aircraft and missiles, and counter battery radar which enable defensive forces to quickly track and retaliate against incoming artillery fire. Also the United States was pushing the Japanese to take part in a complicated, expensive effort to develop a 'theatre missile defense' program that would provide a shield against short and medium range missiles. But the two countries were reluctant to commit themselves to these defense expenditures due to obvious economic hardships caused by the Asian financial crisis.

American Values

A less tangible but a concern of equal importance was the threat to values dear to American people. Many of the countries that were in the thick of the crisis are societies that had been opening up recently, not only economically but, in many cases, politically as well. This was certainly true of Thailand, South Korea and the Philippines where major advances in

democratization had been made. However the down turn in these countries would have its greatest impact on the emerging middle class and those struggling to climb up from poverty. One of the greatest successes of the so-called Asian Miracle had been to lift tens of millions of families out of abject poverty over the past twenty years. And it is these group who represented the regions greatest hopes for the development of more democratic institutions and greater respect for human rights. Now the course of development preferred by America-- open, more democratic societies coupled with open comparative economies-- was jeopardized by the Asian turmoil. This was true not only within these countries, but also for others in the region as well. It was critical for US that people in the less open countries such as China, Vietnam and Myanmar did not draw wrong conclusions.

Apart from democracy and human rights, environment and labor standard were two other issues, close to the heart of Americans, which were threatened due to economic hardships caused by the Asian crisis. Environment and labor standards are often one of the first casualties of an economy in trouble as producers try to cut down costs by violating environmental norms and degrading working conditions. While economic misery and differing labor standards have long made sweatshops more prevalent in the Third World than in the west, the trend had been toward improved working conditions. But the Asian financial crisis spawned such

desperation that more people than ever were willing to take up grim or dangerous jobs in such factories.[22] In recent years, the rising prosperity of countries such as Indonesia and Thailand encouraged workers to demand better working conditions and more safety. While businesses were doing well enough they could afford to improve conditions as a way of attracting laborers. But after the downturn in the economies of the region, companies, tried to reduce costs to survive, and surging unemployment meant that employees had lost their leverage. After all, it's better to have an unsafe job than no job at all. The American unions were especially concerned with this trend, as it was difficult for American laborers to compete with the cheap wages at which the workers in Asia were ready to work due to rising unemployment.

Social Unrest

Another of US concerns was the spreading of widespread social unrest in the countries of the region due the economic hardships caused by the financial crisis. Apart from destabilizing the political regimes in these countries-- which were generally favorable to US-- social unrest could also lead to resentment against the United States because of its role in proposing tough solutions for the areas economies.[23]

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[22] Nicholas D. Kristof, "Surging Unemployment Drives Asia into Sweatshops", *The New York Times*, June 15, 1998.

[23] Maurice Williams, "Workers in Asia resist Austerity Measure", in *The Militant,* vol.61, no.37, October 27, 1997. (www.igc.apc.org).

One particularly painful consequence, of the Asian financial crisis and also the one with the maximum potential for causing widespread social unrest was the surge in unemployment levels. After the onset of the crisis, unemployment rose sharply in most of the countries. [24] The increase in the number of people without jobs was attributed to massive layoffs of both skilled and unskilled workers, particularly in four Asian countries: Indonesia, Thailand, South Korea and the Philippines. The numbers of unemployed in Indonesia alone was between eight million and nine million in 1998 raising the rate of unemployment there to nine percent. In South Korea and Thailand, the jobless rates jumped from a pre-crisis annual average of under three percent to six percent and eight percent respectively while in the Philippines, the unemployment rates reached ten percent. Unemployment was also up in both Hong Kong and China.

Rising unemployment also forced the repatriation of foreign workers from at least three countries: Malaysia, Singapore & Thailand.[25] During the boom years of the 1980's and 1990's, workers from the poorer Asian countries, such as Indonesia and particularly the Philippines, flocked legally and illegally to wealthier countries such as Malaysia and South Korea and also to Hong Kong to makeup for labor shortages. But when the economic downtown hit the region, among the first and most popular acts

[24] "Unemployment in Asia Alarms UN", *From IPS,* July 28, 1998. (www.ips.org).

[25] ibid.

of governments around the region was to send migrant workers home, restrict the entry of new comers and begin cracking down on illegal labor. Those once welcomed were now largely scorned. Around three million of them had to leave their host countries to free up jobs for national citizens, their return home stood to further weaken the already critical state of the economies of their countries of origin.

In Malaysia. thanks to recession many development projects were suspended and the government announced that it would expel one million immigrant workers– half the countries registered foreign workforce. Over the last decade of continual economic growth, Malaysia became highly dependent on foreign workers to take on the lower paid jobs, scorned by its own workers. In the building industry, 80 percent of the workers were foreign. The immigration department in Malaysia also planned to set up work place inspections to ensure that employers were not illegally employing foreign workers. Official estimates spoke of 800,000 clandestine workers, mainly Indonesian. The problem with the policy was that it did not care to find out whether the local workers were really ready to take on the migrants jobs. If they didn't, the employers would find themselves short of laborers, particularly in the hotel trade & heavy industry.[26]

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[26] Natacha David, "Migrants Made the Scapegoats of the Crisis", *ICFTU Online*, January 8, 1998. (www.icftu.org).

The Thai government also announced its intention of taking measures to repatriate some 300,000 registered migrant workers over the next three years– mainly from Malaysia, South Asia and Indo-china. Among the migrants who would have to leave the country were tens of thousands of Burmese workers, whose return would be even more difficult than most. Many belonged to the ethnic minorities who are constantly harassed by the Burmese army, which forcibly displaced populations to eradicate the resistance of autonomous movement. South Korea too decided to repatriate some 270,000 migrants. [27]

Apart from creating pressure on the already squeezed employment scenario, the return of emigrant workers also meant drying up of a source of foreign currency revenue for these labor exporting countries.

Besides the migrant foreign workers, a vast majority of the newly unemployed were migrant workers from rural areas, the manpower and backbone of the decade long Asian economic boom.[28] According to Thai government estimates, of the newly unemployed, 1.3 million were villagers who were working in the city and most of those, at least 1 million people, had already returned home.

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[27] William Barnes, "Illegal Workers Returned to Burma", *South China Morning Post*, January 17, 1998. (www.scmp.com).

[28] Kieth B. Richburg, "The Path from Boom to Bust Leads Home", *The Washington Post* , September 8, 1998, p.A1.

It was migrant laborers who built Asia's gleaning high-rises. They weaved the textiles and stitched the sneakers and assembled the automobiles and slapped together the plastic dolls that fuelled the Asian economic miracle. But with the regions economy in an unprecedented downward spiral, these laborers were the first to be laid off. The result was a dramatic reversal of the traditional village to city migration pattern that transformed Thailand and other Southeast Asian countries from predominantly agricultural to mainly industrial societies in one generation.

"The migration patterns have reversed in Thailand," said Kul C. Gautam, the East, the East Asian and Pacific Regional Director of UNICEF. "Before, people went from the countryside to the big city, for the bright lights, the jobs and so on. Now it's the other way round. People are going back to the villages." The fallout of this reverse migration was that it was putting pressure on the village economies. They had grown used to these people being in the cities.[29] "There are no jobs in the villages," said Graziano Battistella, director of the Scalabrini Migration Centre in Manila, which tracks the movement of people in the region. "Unless these people have some entrepreneurial skills, or some cash, its very difficult there will be any job creation.... But from a governments perspective, (jobless) people in the villages are much less visible than people in city."[30]

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[29] ibid.

[30] ibid.

There were also serious concerns about the social situation, as the loss of wages and sharply higher inflation substantially reduced the standard of living of wide segments of population and pushed large numbers into poverty.

One consequence of the widespread destitution brought about by the Asian financial crisis was rise is crime rate[31] and also increasing hatred against ethnic minorities– especially in Indonesia.[32] Infact, ethnic Chinese in Indonesia were made the scapegoats for the economic troubles afflicting the country.[33] For years, to be ethnic Chinese in Indonesia usually had meant occupying a place of relative prosperity in a poor but rapidly developing country. Though they represent only 4 percent of population, ethnic Chinese controlled as much as 70 percent of the countries private sector commerce, from small shops to distribution networks to giant banks.[34]

Indonesia's Chinese are part of a sprawling East Asian Diaspora, the descendents of emigrants who fanned out across the region a century or more ago, escaping poverty and persecution in their homeland. Those earlier migrants came mostly penniless but they brought with them the

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31 John Pomphret, "Chinese Crime Rate Soars as Economic Problems Grow", *The Washington Post,* Thursday, January 21, 1999, p.A19.

32 Kieth B.Richburg, "Ethnic Chinese: Indonesia's Scapegoats", *The Washington Post,* Wednesday, December 23, 1998.

33 Clifford, & Engardio, *Meltdown: Asia's Boom, Bust and Beyond,* (Prentice Hall Press, Paramus, NJ, 2000). p.2.

34 ibid.

immigrants drive. For their success, the Chinese were both envied and resented. But for most of the last two decades, after China opened its doors to the outside world to trade and investment, the ethnic Chinese have been one of the engines that drove what became known as the East Asian Economic miracle. Then as the miracle turned into a debilitating economic collapse, the search began for someone to blame. In most places-- Thailand South Korea, Japan-- the anger was directed at governments and ruling establishments, but the so-called 'indigenous' Indonesians, or pribumis, attacked ethnic Chinese, whom many saw as beneficiaries of the old corrupt system. The rioting in May 1998 in Jakarta[35] and a smaller outburst six months later left dozens killed by mobs and scores of women were raped.[36] Thousands fled to safety abroad and those who remained were uncertain about their future in a country where most were born, and where most had no choice but to remain.[37] Theirs was the classic plight of an ethnic minority singled out in a time of economic trouble for blame and retribution.

A direct consequence of this widespread social unrest was change in power in Thailand, South Korea and Indonesia and a change in power equations in Malaysia.

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[35] Clifford, & Engardio, n.33, p.2.

[36] Mark Landler, "Indonesian Capital engulfed by Rioting", *The New York Times*, May 15, 1998.

[37] Clifford, & Engardio, n.33, p.4.

In Indonesia President Suharto, a long time friend of US, stepped down on May 21, 1998 from the post he had held for 32 years, defeated by mounting popular unrest and a collapsed economy he was unable to revive.[38] His handpicked Vice-President, B.J. Habibie was immediately sworn in as head of the worlds fourth most populous nation.[39] For most of three decades, Suharto had been credited with bringing political stability and alleviating poverty across this diverse archipelago. But lately his regime had come to be associated with worsening corruption, the predatory business dealings of his children, and the heavy handed tactics his security forces had used to contain dissent. Long considered a wily political manipulator he was finally outdone by the international financial market place that ravaged his countries economy.

In Malaysia Prime Minister Mahatir Mohammad fired his deputy and heir apparent, Anwar Ibrahim, on Sep 2, 1998, a day after imposing strict new currency controls and other measures that contradicted Anwar's traditional free-market remedies for the countries ailing economy. The sacking of popular Anwar, who was also, finance minister for the last seven years, marked the last step in Mahatir's high risk effort to jettison Western economic orthodoxy in favour of a go it alone approach aimed at

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[38] Keith B. Richburg, "Suharto Steps Down, Names Successor" *The Washington Post*, Thursday, May 21, 1998; p. A 01.

[39] Seth Mydans, "Suharto, Beseiged, Steps Down after 32 Year Rule in Indonesia", *The New York Times*, May 21, 1998.

ending Malaysia's financial collapse. The removal of Anwar left Mahatir firmly in control of Malaysia's politics.[40]

South Korea and Thailand also witnessed change in political leadership in the wake of resentment brought about by the Asian financial crisis.In South Korea Kim Dae Jung came to power in the December 1997 presidential elections[41] and in Thailand Prime Minister Chavlit Yongchaiyudh resigned in November 1997 and Chuan Leekpai was sworn in as Prime Minister.[42]

Challenge to the East Asian Model of Development

The biggest concern of the US political establishment, however, was that the Asian financial crisis led to a general re-examination of the East Asian model of development and as a result, the whole basis of the so called 'Washington Consensus' came to be widely challenged.[43] Washington Consensus is the conviction propagated by IMF & the World Bank, off course with the blessing of US administration, that the expanded liberalization of trade and capital markets, tough policies towards over

[40] Keith B. Richburg, "Malaysian Premier Fires Deputy who Pressed Free-Market Plan", *The Washington Post*, Thursday, September 3, 1998, p. A39.

[41] Donald Emmerson, "Americanizing Asia?", *Foreign Affairs,* vol.77, no.3, May-June 1998, p.51

[42] ibid. p.50.

[43] Shorrock, n.6.

leveraged corporations and banks, and a blanket rejection of controls on capital flows constitute the only path to economic prosperity.[44]

But the Asian financial crisis has shown that making markets work requires much more than government getting out of the way. It requires an active government role in regulation of the financial markets and active policy for promoting competition, facilitating transfer of technology and providing for specific measures essential for economic growth. In the crisis affected countries, the government policies of deliberate inaction in several fields, especially in the financial sector, were responsible for the impressive growth in East Asia. They were also the primary cause of the current crisis. The non-intervention of the government could not be regarded any more as promoting efficient operation of the market. This was a direct challenge to the trio of US administration IMF and the World Bank.

From this overview, it is obvious that US has critical economic and national security interest in Asia which were threatened by the economic crisis afflicting the countries in the region. The next chapter explores what the US administration did, itself and through the instrumentality of the IMF to safe guard American national interest.

[44] Joseph Stiglitz, Senior Vice President and Chief Economist of The World Bank, Address to The Chicago Council on Foreign Relations, February 27, 1998. (www.worldbank.org)

Chapter III

US RESPONSE TO THE ASIAN CRISIS

Following the Thai devaluation of its currency in July 1997, a rescue operation was undertaken by the IMF and several other countries including Japan. However the US did not join these efforts-- for reasons of domestic opposition to be explained later in the chapter and also because the administration did not perceive any immediate threat to the US economy and US national interest from the Asian Financial Crisis.

By August 1997, the IMF wading through the problem areas of Asia, offered credits of $ 17.2 billion, including $ 4 billion from Japan and $ 1 billion from China to help Thai borrowers.[1] The Japanese were anxious to develop a high profile as underwriters of a kind of Marshall Plan for Asia that will help Thailand and other Asian countries. In doing so Japan however was bailing out its own banks and companies that had invested heavily in the Asian tigers. The cry in Japan after 1989 was to invest heavily in Asia, especially the Asian Tigers and China. As a result, heavy investment by Japanese banks and companies contributed to the increase in productive capacity in Asia and ultimately to the excess supply of goods that plagued Asian producers and their lenders.

1 Paul Blustein, "At the IMF, a Struggle Shrouded in Secrecy", *The Washington Post,* Monday, March 30, 1998, p.201.

Though Japan attempted to fill the role of the generous lender in the Thai crisis, it was in no position to offer the kind of help needed to shore up all the deflationary economies of Asia due to its own deflationary problems. A slowdown in export growth to other Asian countries, themselves struggling with excess capacity was tipping Japan into recession, thereby adding to the self-reinforcing nature of the emerging Asian deflation.

Although the IMF took the lead in providing aid to Thailand, it seemed to be unaware of the potential danger of a self-reinforcing Asian deflation. Thus while expediting Thailand's request for additional financial aid, the IMF simultaneously recommended that Japan and US Central Banks raise interest rates. Now an increase in interest rates in Japan at this time was not advisable. By now, Japan's construction companies, no longer buttressed by heavy government spending packages, had begun to fail. Japanese Banks had made short-term loans to those companies at interest rates of just 6 percent or about ten basis points above the Bank of Japan's official discount rate and thirteen to fourteen basis points above overnight lending rates. If the Bank of Japan were to raise rates, say to 1.0 percent, the number of non-performing loans in Japan, especially to construction companies would surge, to as much as three times the current level of non-performing loans. Thus it was difficult to understand why the IMF would recommend that the Bank of Japan raise interest rates in this

environment. Japan's problems with its internal balance sheet were bad enough and were set to deteriorate further. With the difficulties among the Asian Tigers, the problems of Japan's banks with balance sheets outside Asia and Japan were bound to worsen.

U.S: A Delayed Response

As stated earlier, the US administration kept mum in the initial stage of the crisis and let IMF, Japan and other, countries cobble together a rescue effort for Thailand. This was largely because there was no perceptible effect on the US economy. At the Asia-Pacific conference in Vancouver, US president Bill Clinton dismissed Asia's economic troubles as a few small "glitches on the road".[2] Besides the Congress was unwilling to approve any new large allocation for the IMF

It was not until the crisis hit Hong Kong, prompted a brief but impressive sell-off in New York,[3] swamped South Korea and then threatened Tokyo that Americans really woke up to the market disaster hovering across the pacific. But once the ripple effects of the crisis began to be felt on the US economy, the administration swung into action. It realised that the Asian crisis might be contagious and spread to other

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[2] Marcus Gee, "Asian Stocks, Currencies Thumped. Hong Kong Shares Drop Nearly 9%", *The Globe and Mail*, January 13, 1998. (www.theglobeandmail.com).

[3] Floyd Norris, "US Stocks Fall 554 Points, Off 7%, Forcing suspension in Trading", *The New York Times*, October 28, 1997.

countries posing a risk to the US economy. Besides, at home the Clinton administration was under fire for being too late in recognizing (Thailand's problems began showing up as early as February 1997) and in moving to contain the Asian financial crisis. (When Thai markets collapsed the administration decided not to participate in the resulting rescue). Critics urged that Washington should assume the primary role, as it did in the 1982 Latin American debt crisis, in assembling financial rescue packages and by working vigorously behind the scenes to push financially troubled countries to reform.

Actually, the administration faced serious constraints in reacting to the Asian crisis. Officials feared that the Congress, already miffed over the administrations handling of the Mexican financial debacle in 1995, might move to block a US sponsored bailout of Thailand. Senate Banking Committee Chairman Alfonse D' Amato, R-N.Y., clearly opposed any such measures.[4]

The administration was also facing a growing backlash over globalisation and US foreign economic policies. Lawmakers rejected its proposed "fast-track" legislation, which would have enabled it to negotiate

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[4] Close-up: "US Response to Economic Crisis in Asia-Too Little, Too Late?", *The Los Angeles Times*, Friday, November 28, 1997. (www.latimes.come).

trade treaties with other countries without fear that Congress would amend them.[5]

Jeffery Garten, a former Commerce Department economic strategist and the Dean of the Yale School of Management, contended that "the administration had to keep a low profile at first, lest it set off a stampede of countries requesting bailouts" that might not be productive.[6] Analysts suggested that the United States has more resources at its disposal than the budget might suggest. The Treasury maintains a $40 billion "exchange stabilization fund", which the Reagan administration used routinely in the 1980's to make temporary loans to financially troubled countries. The Federal Reserve too has a similar fund. Still analysts cautioned that, with the IMF cash pool limited and Japan unable to help as much as it had in previous crises there was a potential for coming up short if the turmoil spread. The Japanese economy was also tottering and leading Japanese banks began to crumble by November 1997 under the weight of nearly $ 1 trillion in bad loans, that they had accumulated since Japan's "bubble economy" burst in the early 1990's. They were now withdrawing from the world markets at a dizzying pace, even as the government desperately tried to recapitalise the banking system to revive its ability to lend.

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5 ibid.

6 ibid.

But now a more active role was urged because of the impending danger to the American economy from the crisis in Asia. W. Bowman Cutter, a former White House economic-policy maker in the Clinton administration said that US must intervene as only America has the economic power and political influence to manage a major global financial rescue program. "Our role needs to be a lot more like the one we played after the Mexican crisis (in 1995) than it has been so far", Cutter said, "And I think the American People have to understand why this situation is so scary."[7] The U.S. delay and Washington's decision not to contribute directly to the August 1997 IMF package for Thailand also rankled the South East Asians.[8] Few were persuaded by the IMF's defense that the U.S. had been indirectly helpful by virtue of the longstanding support for the IMF. Knowledgeable South East Asians were concerned by what many of them saw as Congressional indifference, if not hostility, toward helping the region recover.[9]

Consequently the administration became more active and at the meeting of Pacific Rim Countries in Vancouver, British Columbia in November 1997 it pushed through a proposal that reaffirmed the central role of the IMF in handling future bailouts. Morris Goldstein, an analyst at

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7 ibid.

8 Donald K, Emmerson, "Americanizing Asia?", *Foreign Affairs*, (New York), vol. 77, no. 3, May-June 1998, p.49.

9 ibid.

the Institute for International Economics, rightly said that there was little choice but for the U.S. to lead. Without proper management, he said, "you will sow the seeds for the next crisis." And that may be a whole lot worse.[10]

Together the IMF and the US Treasury crafted the largest rescue plan in history, to bailout four troubled Asian economics-- South Korea, Thailand, Indonesia and the Philippines.[11] Over $120 billion from the IMF, the World Bank, the US government and other institutions went to these countries, to help them pay billions of dollars owed to US, European and Japanese banks, to reestablish business confidence, and to persuade foreign investors to return to their markets. In exchange the four countries agreed to restructure their economics by shutting down insolvent enterprises and banks, ending monopolies, phasing out government restrictions on investment, and opening their markets even further to foreign capital. The bailout package of Thailand was finalised at $17 billion in August 1997, of Indonesia at $ 43 billion in October 1997, of South Korea at $ 57 billion in December 1997. Philippines also received $1.2 billion in July 1997. Now let us consider the case of individual countries.

[10] Close-up, n.4.

[11] Tom Shorrock, "IMF and US Response to the Asian Financial Crisis", *Foreign Policy in Focus*, Volume 3, no.8, April, 1998. (www.foreignpolicy-infocus).

Indonesia

President Suharto of Indonesia initially dithered over implementing the demanding terms of the $43 billion bailout package.[12] He was concerned about the possibilities of social unrest resulting from the austerity measures.[13] So in January 1998 he announced a budget with a 32 percent increase in government spending. It included construction projects in which his family had a financial interest. This however violated the IMF-imposed austerity measures. As soon as the budget was announced, the Clinton administration and the IMF denounced it. The IMF also threatened to withhold its next $3 billion payment scheduled for March 1.[14]

President Suharto was however finally made to fall in line. US Deputy Treasury Secretary Lawrence Summers and State Department official Stanley Roth arrived in Jakarta on January 12 and asked him to reduce fuel subsidies, cancel infrastructure projects, close down involvement banks and repeal limits on foreign ownership of property and financial institutions. IMF Deputy Chief Stanley Fischer held negotiations with Indonesian officials and US Secretary of Defense also met President Suharto. Adding to the pressure on Jakarta, Suharto received phone calls

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12 Ross H. Mcleod, "Indonesia", in Mcleod, R. H., Garnaut R., (ed.), *East Asia in Crisis: From Being a Miracle to Needing One?,* (Routledge Publishers, London, 1998), p.40.

13 ibid. p.41.

14 Barrie Mckenna, "US Reads the Riot Act to Indonesia, Economic Crisis Deepens: Suharto Shoulders Blame", *The Globe and Mail,* Saturday, January 10, 1998. (www.theglobeandmail.com).

from US President Clinton, German chancellor Helmut Kohl, Japanese Prime Minister Ryutaro Hashimoto and Australian Prime Minister John Howard urging Jakarta to impose the IMF austerity package. Finally President Suharto had to relent and agreed to implement the IMF package.[15]

A further complication was created by Suharto's insistence on changing Indonesia's monetary system radically by adopting a Hong Kong style 'currency board' in which the value of the rupiah would be rigidly fixed against the dollar and the Indonesian authorities essentially would abandon control over interest rates. A John Hopkins University professor, Steve H. Hanke, championed Suhartos currency board plan. Under a currency board, a countries monetary authorities essentially pledge to put stability in the exchange rate above all other objectives, including economic growth, cheap credit and employment. They maintain a large reserve of dollars available to exchange the local currency at the fixed rate and promise not to print more money without adding to their reserve of dollars.[16]

The IMF staff backed by the US treasury and economic officials in other major countries opposed the plan saying that Indonesia way at

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15 BBC World Service, "Suharto Agrees to New IMF Package", January 17, 1998. (www.signet.com.sg).

16 Paul Blustein, "Currency Dispute Threatens Indonesia Bailouts", *The Washington Post*, Saturday, February 14, 1998, p.A01.

present incapable of credibly sustaining such a fixed exchanged rate. The IMF Chief Michael Camdessus wrote to Jakarta that if it implemented the move, he would urge the board of the 182-nation organisation to suspend the $43 billion bailout of Indonesia's economy. In a speech, Camdessus said he was of "the strong view" that the time for a fixed currency in Indonesia "has not yet come", because "a number of preconditions have to be satisfied." Among these, he said, was the need for Jakarta to obtain substantial reserves of dollars and strengthen the countries battered banking system. He argued that if Indonesia fixed its exchange rate without holding more dollars in reserve, it would invite speculators to attack the rupiah, and Indonesia's cash-strapped banks might collapse if the authorities gave up their ability to print money.[17]

In his letter, Camdessus wrote: "In he present circumstances... if a currency board proposal were adopted, we would not be able to recommend to the IMF Board the continuation of the present program because of the risks to the Indonesian economy. This would be a very unfortunate development, as it would shrink even further the reserve basis for the currency board and further undermine its very slim chances of success." After this strong reaction from the IMF and the US Treasury,

[17] ibid.

President Suharto realised his compulsions and relented on the idea of a currency board.[18]

Later in April 1998, Indonesia and the IMF reached another basic agreement in which the fund made concessions that permitted President Suharto to continue heavy subsidies on food and fuel-- the prospect of ending the subsidies had led to anti-government riots. Suharto also made concessions, including closing more insolvent banks belonging to his close friends and supporters. American and IMF official described the accord as Indonesia's last chance at fiscal redemption. But it also marked an effort to show some deference to Suharto, and fund officials went to considerable pains to portray parts of the program as Indonesia's own initiative, rather than their own. That is in sharp contrast to when the last agreement was signed, on January 15, 1998. At that time Michael Camdessus, the managing director of the fund, stood over Suharto with his own folded. The image of the fund appearing to dictate terms brought a political backlash in Indonesia and emboldened the government to ignore many of the conditions placed on the $43 billion aid program Suharto, however, knew very well that he could not openly defy the IMF for fear of permanently scaring away investors, many of whom were of the opinion that they will

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[18] ibid.

not return to Indonesia until they were convinced that Suharto's rule will not end in a bloody struggle for succession.[19]

Later in May, 1998 the US gave Indonesia $ 1 billion in loan guarantees, free of any conditions concerning human rights abuses surrounding the protests against President Suharto's rule. Almost simultaneously, the Pentagon, citing the unrest, cancelled a joint training exercise with the Indonesia military. The two actions underlined how the Clinton administration had been sending seemingly conflicting signals to Suharto's government. While the State Department warned Indonesia several times about the dangers of further repression and the kidnapping of dissidents, it declined to link those warnings to the aid being sent to ease the country's economic crisis.[20]

This billion dollar loan package was put together by the Export-Import Bank of the United States, an independent government agency charged with promoting US exports. The President of the Ex-Im Bank James Harmon, said that by helping Indonesia obtain the raw materials it needs to get its factories running again, "we hope to contribute to stability to calm the social situation." The Ex-Im Bank Chiefs role is to ensure that American companies can sell their goods in countries with difficulties

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[19] David E. Sanger, "Indonesia, IMF Reach Latest Economic Agreement", *The New York Times,* April 8, 1998.

[20] David E Sanger, "US Grants Indonesia $1 billion in Loan Guarantees", *The New York Times*, May 9, 1998.

receiving financing from banks and other private lenders. The bank essentially guarantees payments to the American companies or the private lenders who facilitate the deal.[21]

Meanwhile, the Pentagon, clearly worried about its association with the Indonesian military when its troops were suppressing riots and demonstrations, called off an ongoing military training exercise with Indonesia. Moreover, it also decided to review its entire joint command exercises and training with Indonesia. A White House official argued that there was no inconsistency in providing further economic aid while pulling back involvement with the military. The administrations strategy, the official said, was to prevent worsening instability that is triggered by the huge run-up in prices of basic commodities. The prices were increasing for two reasons: the dramatic drop of Indonesia's currency, the rupiah, and the government's gradual withdrawal of subsidies, which it could no longer afford. "Our national interest is in seeing the economic reforms go forward," the White House official said. "There is no inherent contradiction between that goal and postponing military exercises until the return of stability." But several administration officials conceded that it was a risky strategy. "The bottom line is that there is no way to stabilise the economy without appearing to bolster Suharto," the official said. Similarly the military exercises help the United States better understand the

[21] ibid.

Indonesian military-- the most powerful institution in the country-- while appearing to put the Pentagon on the same side as Suharto's protectors.[22]

Indonesia's beleaguered President Suharto finally stepped down, on May 21 1998, from the post he held for 32 years, defeated by mounting popular unrest and a collapsed economy he was unable to revive. In Washington, President Clinton welcomed Suharto's decision as "an opportunity to begin a process leading to a real democratic transition for Indonesia," the White House said in a statement. Clinton also urged the new leadership "to move forward promptly with a peaceful process that enjoys broad pubic support."[23]

Later in that year Indonesia raised further US concern by targeting cronyism. Struggling to recover from the devastation caused by the Asian financial crisis, Indonesia's government was trying to rid the economy of the "crony capitalism" that flourished there for decades with a vengeance that was worrisome.

The new buzzword was the "Peoples Economy". It stood for the governments plan to end the economic dominance of the large conglomerates run by tycoons who enjoyed close ties to former President Suharto, and his family. Instead of conglomerates the government of

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[22] ibid.

[23] Keith B. Richburg,"Suharto Steps Down, Names Successor", *The Washington Post*, Thursday, May 21,1998, p.A01.

President B.J. Habibie aimed at building an economic system based more on cooperatives and small and medium sized business.[24]

While it sounded like a refreshing shift from an era characterized by corruption and collusion, it stirred considerable concern that Indonesia may be simply replacing one rotten system with another. For one thing, the initiative was fraught with ethnic politics. Most of the large conglomerates are run by members of Indonesia's ethnic Chinese minority, whose entrepreneurial talent played a key role in the country's rapid growth over most of the past three decades. Although the government denied that any ethnic group is being singled out, many analysts feared that Habibie, was running roughshod over ethnic Chinese interests to bolster his political standing and the fortunes of Muslim controlled businesses allied with him. This could result in a fresh blow to investor confidence, especially among the ethnic Chinese whose businesses had been frequently targeted in recent months. "The politicians are weak, so the most appealing policies are populist ones," said Alex Wreksoremboko then head of research at Merrill Lynch and Co.'s Jakarta Office. "And sequestering assets from rich Chinese is of course very popular."[25]

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24 Paul Blustein, "Indonesia Raises Concern by Targeting Cronyism", *The Washington Post*, Friday, November 27, 1998, p.F01.

25 ibid.

The government's new emphasis on increasing support for cooperatives was also causing consternation among economist. Established during the 1950's as a counter weight to avaricious capitalism, thousands of co-operatives operate at the village level and above in Indonesia, acting in a variety of financial roles, such as making small loans, marketing crops and buying products at cheap bulk prices. Critics accuse them of corruption and inefficiency. Now what's happening was, "an attempt to go back to this tired old 1950's paradigm, and its a very basic philosophical break with the way Indonesia has been run, at lest in recent years," said Eugene Galbraith a Hong Kong based brokerage firm executive.[26] Obviously concerned at these developments, the IMF managed to block some of the more extreme schemes related to the cooperatives.

South Korea

South Korea agreed to the terms of the record $57 billion bailout on December 3, 1997, thus subjecting its once thriving economy to the tough dictates of the IMF.[27] The agreement prompted predictions of increased bankruptcies, layoffs and other economic turmoil in South Korea as the authorities acted on the IMF demands to close banks and dismantle many government controls over the nations market and financial system. Finance

26 ibid.

27 Peter Passell, "Economic Scène: South Korea Facing Difficult Economic Choices", *The New York Times*, December 18, 1997.

minister Lim Chang Yuel warned the nation of wrenching adjustments to come, but said he had little choice but to submit. "These pains and burdens are the costs our economy has inevitably to pay to revive and recover our lowered credibility in the world financial society," Lim said.[28]

In Washington, US officials expressed satisfaction that the IMF had extracted major concessions from the Koreans that would force significant changes in government practices responsible for causing the crisis, such as state directed bank loans to favoured industries and companies.

This $ 57 billion loan package was aimed primarily at restoring investor confidence and convincing foreign financial institutions that Korean borrowers would be able to pay tens of billions of dollars in short-term debt that are soon coming due. The package included loan pledges of $21 billion from the IMF, $10 billion from the World Bank and $ 4 billion from the Asian Development Bank. In case these kinds proved insufficient to restore investor confidence, several countries pledged to provide backup loans. Japan promise of $ 10 billion and the US pledge of $5 billion were the biggest, and several European nations also chipped in, including Britain Germany, Italy and France. Treasury Secretary Robert E. Rubin defended the US contribution of $ 5 billion to the backup loan pool. "We have a vital national economic and security interest in helping Korea to restore market

[28] Paul Blustein, & Sandra Sugawara, "Seoul Accepts $55 Billion Bailout Terms", *The Washington Post*, Thursday, December 4, 1997, p.A01.

stability as soon as possible," he said in a statement. "In this new global economy, American stability and prosperity is closely linked with the stability of the international finance system and the strength of our trading partners."[29] The US money should it be disbursed was to come from a special fund administered by the Treasury that did not require Congressional approval.

The IMF objectives in Korea were to break as much as possible a cosy network of relationships between the government, banks and giant industrial conglomerates that helped make South Korea a potent competitor on world export markets but eventually created serious problems for its banking system.

The nations industrial planners used the banks to fund the growth of giant corporations in sectors such as auto, Computer chips and steel, with the main aim being the creation of high-skill jobs rather than profits. But the system, which worked beautifully when South Korea's economy was growing at 8 percent, began to come apart as half a dozen debt-laden conglomerates were forced into bankruptcy. The IMF conditions were hardly likely to eliminate the power of the Korean bureaucracy. But, according to a senior Treasury Official, "the program will bring about substantial changes in the financial sector which in turn have the potential

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[29] ibid.

to open up the Korean economy and move it toward one that is much more dependent on the operation of market forces and less dependent on industrial policies."[30] Seoul was forced to "make it possible for foreign banks to buy Korean banks and operate in Korea," the official said. That could weaken the state planners power, as could other concessions by the Koreans to allow industrial companies to raise money directly from foreign financial institutions.

Thailand

The IMF stepped in, Thailand in mid-August 1997 and organised a bailout package of $17.2 billion in loans to Thailand from various Asian nations.[31] The main condition of the bailout package was a baht 60 billion budget surplus, which meant that the government's revenues would have to exceed its expenditures by that amount. This led to huge cuts in government expenditures, in the neighbourhood of 100 billion baht. But even with these cuts, unless the government was able to raise more revenue, it was not able to attain a 60 billion baht surplus. Thus, the value-added tax was increased from 7 percent to 10 percent and other taxes on luxury items were imposed.[32] However, even with the spending cuts and

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[30] ibid.

[31] Kirida Bhaopichitr, "Thailands Road to Economic Crisis", *The Nation (Bangkok)*, December 1997. (www.twnside.org.sg).

[32] W. Bello, S. Cunningham, & L.K. Poh, *A Siamese Tragedy: Development Disintegration in Thailand*, (Zed Books, London, 1998). p.45.

higher tax revenues, the government was still 40 billion baht short of meeting the surplus requirement.

Malaysia

Malaysia, however, decided to inflict its own economic medicine.[33] For months Malaysia resisted the pain, blaming foreign speculators, playing down its economic problems and leading analysts to brand it a country in denial.[34] Desperate to avoid the ministrations of the IMF already underway in Thailand, Indonesia and South Korea, the government Indonesia and South Korea, the government swung into action in December 1997.

Over a period of 10 days, the government announced a program of austerity measures that some Malaysians called a home grown IMF plan-abandoning the aggressive growth policies the country had pursued for a decade. The measures were a belated but ambitious effort to rescue the economy. "We must reassure the world that we will carry out what we have undertaken to do at whatever cost," Prime Minister Mahatir Mohammad said dropping his resistance to economic changes.[35]

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33 Seth Mydans, "Malaysia is Ready to Inflict its own Economic Medicine", *The New York Times*, December, 16, 1997.

34 Prema – Chandra Athukorala, "Malaysia", Mcleod, R. H., Garnaut R., (ed.), *East Asia in Crisis: From Being a Miracle to Needing One?*, (Routledge Publishers, London, 1998). p.95.

35 Mydans, n.33.

Malaysia economic retrenchment was outlined in a series of statements by Deputy Prime Minister Anwar Ibrahim, who was also finance minister and something of a foil to his aggressive boss, Mahatir. Government spending was cut by 18 percent and official's salaries, by as much as 10 percent. Several of Mahatir's ambitious building projects were put on hold, and expensive imports like aircraft and ships were halted. Military spending was cut and most lending for construction was frozen. In what amounted to a swallowing of national pride, Anwar cut a previous estimate of annual growth in coming years to 4 percent or 5 percent, down from a projection of 7 percent before the crisis struck. In addition to less growth, the analysts said, the austerity measures also meant an increase in interest rates, a wave of bankruptcies and a rise in inflation.

The new austerity measures were a severe blow to the 72 year old Mahatir's ambitions, which have been expressed in showy and expensive building projects with a goal of making Malaysia a fully developed nation by the year 2020. "We must make sure that we no longer spend as we used to," Mahatir said in a statement in which he called on Malaysians to seek economies in their daily lives. "Small things like reducing the consumption of sugar from four spoonfuls to three or two will help," he said.[36]

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[36] ibid.

When currency traders attacked the Malaysian ringgit after the onset of the financial crisis, touching off a sharp fall in its value, Mahatir took aim at foreign speculators. He pointed his finger at American financier George Soros[37] and also said that Malaysia might have been a victim of a Jewish "agenda." Economic analysts said that his remarks only heightened the country's problems, raising doubts about its seriousness in dealing with the crisis and contributing to investors nervousness. These new measures addressed some of the causes of Malaysia's problems, particularly the big infrastructure projects that had been handed out over the years to well-connected companies, without competitive bidding.

Later in Sep 1998 Mahatir fired his deputy Anwar, one day after imposing strict new currency controls[38] and other measures that contradicted Anwar's free-market remedies for the countries ailing economy.[39] The sacking of Anwar marked the last step in Mahatir's high-risk effort to jettison western economic orthodoxy in favour of a go it alone approach aimed at ending Malaysia's financial collapse.[40]

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37 Emmerson, n.8, p.48.

38 ibid.

39 Kotler, & Kartajaya, *Repositioning Asia: From Bubble to Sustainable Economy,* (John Wiley, Singapore, 2000).

40 Kieth B. Richburg, "Malaysian Premier Fires Deputy Who Pressed Free-Market Plan", *The Washington Post*, Thursday, September 3, 1998, p.A39.

Japan

At the same time, US administration was very much concerned about the Japanese economy. Japan, once the driving force of the Asian economy, had also fallen into decline.[41] The big question hanging over the region was the status and fate of Japans banking and financial system which had begun to crumble in November 1997 under the weight of nearly 630 on dollars in bad loans,[42] twice that when insurance debt other non-bank debt was factored in, that they had accumulated since Japans bubble economy burnt in the early 1990's.[43] If the Japanese financial system were to collapse under the weight of its bad loans, it was bound to lead to a global economic meltdown.[44]

Thus Japan faced an extraordinarily difficult situation and the way authorities dealt with it was significant not just for Japan but for the entire global economy. US administration officials viewed Japan as "the last firewall of the Asian crisis, and contended that if that wall was breached, it was only a matter of time before Asia's troubles leapt the Pacific.[45] The

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41 Edward J. Lincoln, "Japans Financial Mess" *Foreign Affairs*, vol. 77 no. 3, May – June 1998, p. 57.

42 ibid. p.60.

43 Tim Shorrock, "Asian Financial Crisis", November 13, 1998. (www.foreignpolicy-infocus.org)

44 Keith, Richburg, "Asia Looks for Cash for its Ailing Banks", *The Washington Post*, Monday, March 30, 1998, p.21.

45 David E. Sanger, "Analysis: As Japan Goes So Goes the Neighborhood", *The New York Times*, June16, 1998.

weaknesses of the Japanese economy, and its dithering over economic reforms were getting reflected in the rapid fall of the yen. This was a cause of concern because a declining yen created pressure on the capital markets and currencies of other countries in the region.[46] Because Japanese industry competed in export markets with Korean, Taiwanese and other Asian industries, each downward click of the yen made it more difficult for the rest of Asia to remain competitive. At the same time, Japan's ability to continue as a major importer of Asian goods as well as a major lender to Asian enterprises was weakened.

Thus, fully realizing the need of strong Japanese economy for bringing about recovery in the crisis struck Asian economies the US administration urged two strategies to revive the Japanese economy and avert a meltdown. The first was to provide for a substantial fiscal expansion—a combination of deficit spending and tax cuts. Secondly the government needed to deal decisively with the weaknesses in the financial sector.[47]

US also urged Japan to deregulate its economy in order to revive it. Analysts argued that if Japan could muster the political will to address its

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46 Stanley Fischer, First Deputy Managing Director of the IMF, "The Asian Crisis and the Implciations, for Other Economies", at Seminar on "The Brazillian and the World Economic Outlook", Organised by Internews, Sao Paulo, Brazil, June 19, 1998. (www.imf.org).

47 "IMF Warns Money Crisis Will Spread" from the *Toronto Star*, 21 December 1997. (www.hartford-hwp.com).

bad loans problems instead of letting them fester, if it could deregulate transportation, retailing, finance, agriculture, pharmaceuticals and other industries, the result would be a burst of energy that would revitalize Japan and stimulate all of Asia.

The Japanese government made some head way on these counts but not much.[48] As a result the yen continued to slide and a crisis within a crisis developed when the yen hit a low of 146.78 yen to a dollar on June 16 1998.[49] This fall reflected a serious lack of confidence, provoked by Japans sluggish reaction to an economic slowdown and the crisis in its financial institutions.

Next day, the Clinton administration joined Japan in a dramatic rescue operation to halt the yens slide and prevent potentially devastating devaluation's of Chinese and other Asian currencies. Abandoning a long standing US policy of non-interference in foreign exchange markets, the two governments shocked financial markets by buying an estimated $2 billion worth of yen in exchange for dollars, using the New York Federal Reserve Bank as their agent.[50] The move was swiftly followed by

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48 The government passed a fiscal expansionary package amounting to over 2 per cent of GDP and committed public funds amounting to six percent of GDP to deal with banking sector weaknesses.

49 Paul Blustein, "U.S., Japan Intervene to Prop up Yen", *The Washington Post*, Thurday, June 18, 1998, p.A01.

50 ibid.

announcements in both Washington and Tokyo that Japan has pledged to take major steps to revive its faltering economy.

The operation achieved smashing success and the dollar-yen exchange rate plummeted 4.4 percent, with the dollar changing hands at 136.37 yen.[51] This rebound of yen bought a window of opportunity for Japan to reverse the course of the whole Asian financial crisis by announcing moves to resurrect its swooning economy. The stock markets too reacted exuberantly and the Dow Jones industrial average surged 164.17 points, or nearly 2 percent erasing most of its steep losses in the week on apprehensions about Japan's weaknesses.[52] Infact stack markets throughout Asia climbed sharply. In Tokyo the Nikkei index surged 616.09 point or 4.19 per cent, Hong Kong's Hang Seng index soared nearly 8 percent, Singapore's main index was up 4.4 percent, South Korea's and Malaysia's jumped nearly 7 percent, and Indonesia's was up 3.39 percent.

The US decision to drive down the dollars value by selling massive amounts of greenbacks came as a particular surprise to the markets because Rubin had often declared that "a strong dollar in the US interests" and that currency intervention works only temporarily. Infact he was strongly reluctant to help buoy the yen, asserting that changes in Tokyo's economic

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[51] ibid.

[52] David E. Sanger, "US Intervenes in Currency Markets to Support the Yen", *The New York Times*, June 18, 1998.

policies offer the only realistic hope for lifting the Japanese currency. At a White House briefing, Rubin denied any shift in his fundamental approach, saying that the strong dollar policy still stood and that he had acted because "the renewed weakness of the yen has had a destabilizing effects on the rest of Asia."[53] What made intervention more acceptable to him, US officials said, were pledges from the Japanese government that it would finally respond in a forceful way to Washington's repeated please for a cleanup of Japans troubled banking system.

Halting the slide of yen was a major accomplishment because financial markets in Asia and elsewhere had been seized with fear that the problems in Japan would trigger a cascading series of currency declines. Among the biggest worries weighing on the markets was the prospect that China, which had held its currency stable amid the turmoil in Asia, would devalue it to make its exports more competitive and boost sagging growth. All along China was under extreme pressure to devalue the yuan to prevent its once fast growing economy from slowing down further. Worries about a Chinese devaluation were checked when China's central bank governor pledged, during the visit of US Treasury official, Lawrence Summers, that Beijing would not devalue its currency despite competitive pressures from other Asian countries. Summers said that the pledge was "the most

[53] Blustein, n.49, p.A01.

important contribution that China could make to stability in Asia."[54] Chinese officials, however, still complained that Washington was'nt doing enough to stem the fall in the yen, and US officials acknowledged that concerns about Beijing played a role in the decision to intervene.[55]

The Debate in U.S.

In Washington, the Asian financial crisis and the Clinton administrations request for $18 billion in additional funds for the IMF sparked a lively debate about the IMF and future US economic Policy.[56] Groups on both the left and the right challenged the IMF programmes in Asia as a waste of US tax payers money to bail out international banks that poured capital into questionable Asian projects.

But the Clinton administration, led by Treasury Secretary Robert Rubin, mounted a strong counter attack, arguing that the IMF bail out was necessary to restore economic stability in Asia and to prevent a broader crisis that could cause serious damage to the US economy and an even greater loss of jobs. The administration also linked the Asian crisis to US national interest, saying that serious social unrest in Indonesia and other Asia countries could somehow lead to involvement by the US military and

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54 Steven Pearlstein, "Understanding the Asian Economic Crisis", *The Washington Post*, January 18, 1998, p.A32.

55 Blustein, n.49, p. A01.

56 Shorrock, n.11.

could threaten the use of Indonesian sea-lanes, through which about 30 percent of global shipping passes. At the same time Rubin described US involvement in the IMF effort as a "second line of defense" which he declared would be tapped only when all other aid was exhausted. While this conveyed the symbolism of US commitment to Asia's stability, it allowed the administration the political cover of arguing that no US cash was at risk.[57]

The US Senate, with strong support from the business community (and with organized labor largely on the sidelines), passed the bailout legislation by a vote of 84-16 in March 1998.[58] In the House most of the opposition come from Republican Conservatives who believed that the IMF was violating free market principles. Democrats who opposed fast-track trade legislation, such as Rep. David Bonior, D-MI, and Rep. Barney Frank, D-MA, agreed to support the IMF replenishment on two conditions: that IMF pay more attention to labour and environment issues, and that Treasury establish an advisory panel from US business and labour to review IMF programs. Meanwhile US steel, shipbuilding and semiconductor industries secured an amendment that will: 1) impose penalties on Asian countries that dump their goods in the US market by

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[57] Sanger, David E., "Analysis: Asian Crisis May Take a painful Step", *The New York times*, Dec, 29, 1997. (www.nytimes.com)

[58] Shorrock, n.11

selling them at below market prices, and 2) prohibit the IMF money from being used to increase capacity in certain industries.

The APEC Meet

Another major US initiative came when in mid November 1998, President Clinton traveled to Malaysia to attend the annual meeting of the Asia pacific Economic Cooperation council a group of Asian and Pacific rim countries committed to free trade and liberalized capital markets.

At the meet, President Clinton and his Chief economic advisors, Treasury Secretary Robert Rubin and Deputy Secretary Larry Summers defended the Washington Consensus-- which is the conviction that the expanded liberalization of trade and capital markets, tough policies towards over-leveraged banks and corporations and a blanket rejection of controls on capital flows constitute the only path to economic prosperity.

The US, as the largest donor to the IMF also defended IMF policies in dealing with the Asian crisis. The IMF administered multi-billion dollar bailout in Asia had become the target of fierce criticism at home and abroad for pushing Asia further into recession with its demands for high interest rates and rigid monetary and fiscal policies. Although the IMF later

softened its policies, at APEC, Clinton Rubin and the IMF found themselves isolated particularly on the issue of flows of 'hot money'.[59]

Economic policy divisions had particularly widened in September 1998 after Malaysia, an autocratic state friendly to MNC's, decided to yank its currency from the market and banned foreign investors from withdrawing their capital for one year.[60] The idea of some kind of capital controls gained support in Japan and other Asian countries too. Even some mainstream US and World Bank economists supported the concept of capital controls.[61] The Clinton administration however stuck to its stand. Shortly after Malaysia's announcements, Summers said, "it would be a catastrophe if countries developed the idea that withdrawing from the global system was right and building a better functioning market economy was wrong."[62] US APEC ambassador, John S. Wolf said: "We think its important to avoid excessive government interference or rigid controls which would shrink the pool of capital that is available. That would make the cost of capital prohibitive for emerging markets".[63] But clearly hot money was one of the factors behind Asia's collapse.

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59 Shorrock, n.43

60 ibid.

61 Louise Ucihitelle, "Crash Course: Just What's Driving the Crisis in Emerging Markets", *The New York Times*, January 29, 1999.

62 Shorrock, Tim, n.43.

63 John S. Wolf, US APEC Ambassador, Speech at APEC meet, November 1998. (www.usinfo.state.gov).

To sum up, the basic strategy of the IMF in handling the Asian crisis had three components:

(a) to tighten macroeconomic policies in the initial stage in order to stabilize exchange rates, and stop capital flight and inflation and to encourage lenders to renegotiate their loans to make it easier for borrowers to repay.

(b) to mobilize large scale external assistance from multilateral and bilateral sources, to help break the vicious cycle of capital outflows, currency depreciation and deterioration in the financial sector.

(c) to tackle the key structural problems (mainly in the financial sector), to address the root cause of the crisis.

With these broad goals in mind the IMF with the blessings of the US administration worked to restore investor confidence and financial market credibility of the crisis struck economies.

Chapter IV

THE EAST ASIAN MODEL OF DEVELOPMENT CHALLENGED

Until 1997, economists were unanimous with regard to the superiority of the East Asian model of development characterized by among other things, rapid capital accumulation backed by exceptionally high domestic savings, state guided allocation of finance and close cooperation between the government and the private sector. Little wonder then that the travails of Thailand in 1997 were, for quite a while, viewed as no more than a little difficulty, and practically all commentators expected the financial turmoil to blow over fairly soon without doing any serious damage to Thailand and her neighbors. However, with the deepening and widening of the crisis across the region, there was a sea change in the climate of opinion concerning the economic strength of these nations. Characteristics hitherto regarded as sources of strength were now identified as factors responsible for the regions economic woes: the relation between the government and the private sector came to be viewed as crony capitalism; directed credit as the mainspring of inefficiency; and large savings as an important reason for exceptionally high debt-equity ratio in the corporate sector.

The Asian crisis also forced economists to think anew on open economy macroeconomics and generated heated debates on important policy issues. Perhaps the most controversial issue in this connection has been that of the US advocated and IMF administered assistance programs for the beleaguered nations: economists are split down the middle, one side maintaining that these programs helped in resolving the crisis while the other side holds that they aggravated the problem. No less diverse in this context have been economists views on the role of capital mobility and the need for its control.

Problems with US Policy

In Explaining the Asian crisis to the American people, ignoring other factors, the Clinton administration focussed primarily on the structural problems caused by the so-called 'crony capitalism'– the incestuous relationship in Asia between governments, banks and corporations. Under the leadership of Japan, Treasury Secretary Summers said, East Asian countries "favored centralized coordination of activity over decentralized market incentives. Governments targeted particular industries, promoted selected exports, and protected domestic industry. There was a reliance on debt rather than equity, relationship driven finance not capital markets, and informal rather than formal enforcement mechanisms." Ultimately this style of capital formation led to bad business

decisions, or in Summers words, "money borrowed in excess and used badly."

Indeed crony capitalism did create serious impediments to sustainable development in Asia-- a point often made by Asian unions and social organizations-- they are just one piece of the total picture. The administration here was ignoring the key role played by US in developing and sustaining Asian style capitalism.

Until very recently, the Asian economies were praised by the IMF, the World Bank, and the US business elite as miracles of growth. Though Asian growth rate were impressive by any standard, the pattern of development in Asia closely followed two historical developments: the export led economic agenda advocated by the United States and adopted by South Korea and other US allies during the cold-war, and the rapid opening and deregulation of capital markets in the developing world in the 1990's.[1]

Export led development follows a rather simple formula: countries peg their growth to producing and selling manufactured goods, agricultural products, and natural resources overseas. This is accomplished by attracting foreign investment and loans and then siphoning it into industries designated by economic planners and businessmen as competitive on the

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1 Tim Shorrock, "IMF and US Response to the Asian Financial Crisis", *Foreign Policy in Focus*, vol. 3, no. 8, April 1998. (www.foreignpolicy-infocus.org).

world market. In nearly every country where this pattern has been followed, the policies have been guided by authoritarian governments who favored certain business groups and maintained low wages by stifling labor unions and independent political organizing.[2] This was the case in South Korea, which was under military dictatorship from 1961 to 1987, and also in Indonesia till General Suharto stepped down in May 1998 after 32 years of authoritarian rule.[3] All four countries who received the IMF bailout are key US military allies and major recipients of US military aid.

The spread of export led capitalism has also been accompanied by policies, championed by the US government and its allies in the IMF and the World Bank, to deregulate the flow of capital around the world. After the Latin American debt crisis of the 1980s, private bond and investment markets replaced the IMF, the World Bank, and government development funds as the primary suppliers of capital to foreign countries and corporations. By 1996, according to the World Bank, private capital flows to the developing world had jumped from $44.4 billion in 1990 to $243.8 billion, constituting 85% of total investment in those countries. This figure included $109.5 billion in foreign direct investment, $88.6 billion in bonds (long-term loans purchased by foreign inventories), and $45.7 billion in

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R.C. Mascarenhas, Comparative Political Economy of East & South Asia: A critique of Development Policy and Management, (Macmillan, London, 1999). pp.49-50.

nald K. Emmerson, "Americanizing Asia?", *Foreign Affairs*, (New York), vol. 77, no. 3, June 1998, p.50.

portfolio investment in the stock market. Over 75% of this private foreign investment went to the developing countries, led by China, Indonesia Mexico, South Korea and Brazil.[4]

In Asia the first phase of export led industrialization was financed by Japanese banks and corporations, which invested heavily in manufacturing. The surge in Japanese capital began during the Vietnam war and was encouraged by the United States after its defeat in Indochina as part of a cold war strategy to encourage market capitalism and discourage the spread of planned socialist economies. But the flow of Japanese capital to the region began to wane in the early 1990's, partly the result of Japanese banks taking heavy losses from speculative investments in real estate– a mistake that was later repeated in Thailand and other Southeast Asian countries.

To attract foreign investments from other countries, governments in the region raised domestic interest rates and pegged their currencies to the dollar. The IMF, the World Bank and the Clinton administration strongly backed these policies, which brought billions of dollars from private investors in the United States and Europe. Between 1985 and 1995, GNP in South East Asia grew between 6 percent and 10 percent a year.

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3 Do.

May- ck, n.1.

But a crisis developed in mid 1997 when Asian banks began to topple as a result of a glut in real estate and a slowdown in manufactured exports. That, combined with a wave of currency devaluation's, triggered a massive panic by foreign inverters who quickly sold off their stocks and bonds, sparking the intervention of the IMF.

Thus the Asian financial crisis has revealed that export led growth is not sustainable.(reasons explained in chapter I). It also brought forward the need for some form of control on the flow of capital around the world.

The IMF Ministrations not on Target

The IMF led rescue operation to contain the Asian crisis also drew a lot of flak from analysts. Indeed the crisis appeared to have become deeper with the widening scale of IMF intervention and vigorous pursuit of conventional policies by all countries, including those, which did not seek IMF support. The ineffectiveness of these measures was attested to by the uninterrupted fall in stock and currency prices everywhere. Not only market participants took a dim view of the policy programs, but international agencies two made their assessment clear through downgrading of the ratings of Thai, Korean, Japanese and other banks in

the region, even after the announcement of huge financial support for Korea.[5]

The sources of the policy failure of the IMF may be traced to two factors.[6] The first consists in the failure to distinguish between long term policies and measures required for crisis management. The enforcement of strict prudential norms and closure of non viable banks when the economy is booming promote financial efficiency, but may be instrumental in hastening or deepening the crisis when it looms large or has surfaced. Second, there was an utter lack of appreciation of the spill over effects of domestic polices on other countries and the reinforcing mechanism operating in the course of the currency crisis. To illustrate, consider the package of measures under the IMF bailout programs:

- cuts in government expenditure, increase in taxes, and reduction of fiscal deficit,
- tight money policy,
- closing down of ailing banks,
- financial liberalization with removal of restrictions on entry of foreign banks; and

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5 Mihir Rakshit, *The East Asian Currency Crisis,* (Oxford University Press, New Delhi, 2002), p. 116.

6 ibid.

- removal of trade barriers.

Thailand closed down 56 out of 58 suspended finance companies, initiated moves towards financial liberalization, followed a restrictive monetary policy, and adopted measures to reduce government expenditure. Malaysia and the Philippines also adopted austerity programs in their budgets. Even Japan started following policies very similar to those advocated by the IMF. In a bid to reduce the fiscal deficit to less than 3 per cent of the GDP, Japan raised tax rates, announced substantial cuts in public expenditure, and adopted a reform program with deregulation as one of its principal components.

Now, the adoption of these measures by a group of countries, whose economies are closely interrelated, tends to deepen the crisis and trigger of a chain reaction with a strong feedback. The reinforcing mechanism runs from the set of measures to the significant slowing down of the real sector, high interest rates with severe credit rationing, cutbacks in investment, production and employment, sharp falls in profitability with a melt down in stock and currency markets, a jump in non performing assets of banks and finance companies, loss of investors confidence and so on. This chain of events is amply illustrated by the Asian experience.

Thus, the rapid spread of the financial turmoil and the accompanying meltdown were due in part to an unduly large reversal of

investor's expectations and herd behavior, but the IMF administered medicine played no small part in driving, these expectations.

For one matters were made worse by banking sector reforms, the fiscal squeeze, highly restrictive monetary measures, and other polices proposed to be undertaken under the IMF bailout package for Thailand announced on August 11, 1997. Further, the IMF assistance sought by Indonesia on October 8, 1997 and closure of a number of banks along with adoption of highly restrictive monetary and fiscal measures as part of the IMF program (announced on November 1, 1997), set the stage for sucking the rest of the region into the vortex of the financial turmoil. The despondency was deepened in the last quarter of 1997 by a depreciating yen, along with a fall in GDP, industrial production, and retail sales in Japan. The sharp downgrading of the East Asian economies by international credit rating agencies, information concerning the critical payments position of Korea and the announcement of the IMF bailout program for the country strengthened the financial turbulence during the closing months of 1997.

Asian Crisis and the Washington Consensus

The Asian crisis has also led to a general re-examination of development polices and as a result, the whole basis of the so-called Washington Consensus has come to be widely challenged. That term was

coined in 1990 to describe what the US government, the IMF and the World Bank together were recommending as the appropriate policy framework for development in the '80s and the early '90s. Although there were differences in the details, the programs of all the countries whether in the aftermath of a debt crisis or in the process of structural adjustment, adopted the same basic approach, when they were financially supported by the IMF and the World Bank. The Washington Consensus was the ruling paradigm of development policy.

There is now hardly any disagreement about the underlying principle of that paradigm that economic policy should make markets work better. Everybody has learned that markets cannot be supplanted by any regime of dictates, and that market mechanism is the only instrument of organizing economic activities in a complex society of interacting individual agents. The difference comes about in prescribing how to make markets work better and what role the government should play. Do the markets work better if the government completely got out of the way? Or do they require an active government specifically intervening in the markets to make them work better? If the latter is true, the policies for improving the market mechanism cannot be separated from identifying and improving the implementation of the appropriate role of the government. As we have developed a better understanding of how the markets operate,

we have also learned to recognize the complementarity between the role of the government and the market.

According to Joseph Stiglitz, Chief Economist of the World Bank: "The Washington Consensus held that good economic performance required liberalized trade, macro-economic stability and getting prices rights. Once the government handled these issues-- essentially, once the government 'got out of the way'-- private markets would produce efficient allocation and growth." Stiglitz then goes on to say that the policies advanced by the Washington consensus are "hardly complete and sometimes misguided" and that making markets work required much more than government getting out of the way. It requires an active government role in regulation of the financial markets and active policy for promoting competition, facilitating transfer of technology and providing for specific measures essential for economic growth.

Markets need more often than not, policy interventions by the government for working efficiently to achieve the goals of development. It is by now well established in economic theory that even if those goals were limited to maximizing output and employment markets left to themselves would not always get them. If, however, the goals included other objectives like equity, human development or social security, market failures would

be more apparent, calling for more, well targeted government intervention. Why was it then that the Washington Consensus flourished for so long?

The protagonists of 'minimal government' who were championing the case for the Washington consensus chose to ignore the problems of market failure for two reasons. The first was their ideological bias against any government action putting forward a case for collective welfare over individual interest, in the name of equity and justice. The cost of that action would be too high and it would be better to live with the inequities and market failures than trying to correct them. The second reason is their belief that whatever might be the theoretical instances of market failures, in practice they were not important, and did not call for any positive action.

East Asia both in its twenty years of success and during its current crisis challenged these positions. The large increases in per capita GDP of the countries in East Asia, the increased life expectancy, health and education and sharp reduction in poverty, or even the increase in industrial production and export earnings, all had the stamp of effective government intervention. Even many of their public enterprises, including the most efficient steel plants in Korea, were testimony to the success of government. To be sure, these countries were also following the free market polices under macro-economic stability as suggested by the Washington Consensus.

The picture changed after the crisis. All those who were extolling the East Asian achievements were discovering the symptoms of crony capitalism in the government directed investment policies in which finance played a key role.

It is now clear that in addition to the enormous achievements in the social sector and human development, the government polices of deliberate inaction in several fields, especially in the financial sector, were responsible for the impressive growth in East Asia. They were also the primary cause of the current crisis. One example was allowing the Korean corporate sector to expand its investments with a very high debt-equity ratio. Another was allowing domestic companies to expand investment even in non-tradables through international borrowing on short-term. A cash crunch, either because of rising interest rates or of currency depreciation triggered, as would have been expected, a major crisis. The non-intervention of the government could not be regarded any more as promoting efficient operation of the markets.

Shift in Policy Stance and Turnaround in Asia

The failure of IMF medicine in Asia is attested to by the fact that the turnaround in Asia started with change in policy stance in the face of falling domestic production and rising unemployment. Following the IMF prescription and conventional wisdom, all countries in the region, barring

China, initially tried to stem the tide of currency turmoil through restrictive monetary and fiscal policies along with structural reforms in the financial and corporate sectors. The expectation was that these measures would restore investors' confidence and the export growth resulting from the lowering of real exchange rates would prevent a slide in the real sector. As the failure of the policy mix became more and more glaring over the course of the crisis, the International Monetary Fund showed signs of relenting, and the countries gradually shifted their policy stance. Instead of trying to generated fiscal surpluses, as planned earlier, the governments started planning to run, first moderate, and then substantial, budgetary deficits. Monetary policies were also being relaxed at the same time, with the central banks scaling down interest rates, in some cases to below their pre-crisis levels.[7].

The chain of events clearly underlines the close connection between policy changes and the onset of the East Asian recovery. Korea, the second largest economy of the region, led the recovery posting positive and sustained industrial growth from November 1998.soon other countries joined Korea, and by February 1999, output and unemployment were on the rise over the entire region.

[7] ibid. p.223.

The sequence of policy changes is worth recounting in order to appreciate their role in (aggravating and) resolving the currency crisis. Under the Stand-By Arrangement with the IMF (approved on December 4,1997), apart from undertaking rapid structural reforms, Korea was required to tighten monetary policy and aim for a fiscal surplus of about 2 per cent of GDP in 1998 (compared to the then estimated fiscal deficit of over 1 per cent during 1997). Under the IMF's first quarterly review, completed on February 17, 1998, the fiscal target was lowered to a deficit of 0.8 percent of gross domestic product, but monetary measures were scheduled to remain restrictive until the currency market had stabilized. Further declines in output and employment made the IMF relent somewhat in the second quarterly review (ending on May 29, 1998), and the fiscal stance was permitted to be neutral, by way of letting the autonomic stabilizers work. However, monetary policy was still to focus solely on securing stability of the currency market. The major shift in the Korean policy stance came only after the IMF's third quarterly review (completed on August 28, 1998), when a supplementary budget, incorporating substantial increases in government expenditure and targeting a fiscal deficit of 4 per cent of GDP, was introduced in September 1998. Monetary policy was also loosened, with the central bank cutting interest rates from 16 per cent in June 1998 to 7 per cent by the end of September 1998. The steps on the fiscal and monetary front were supplemented by (a) a 64

trillion won ($47 billion) injection into the financial system in September; (b) setting up of the Corporate Restructuring Fund in October 1998 with an initial capital of about $1.1 billion in order to provide credit to smaller firms, and (c) announcement in December 1998 by state controlled banks to help restructure the conglomerates through conversion of major part of their debts into equalities. In the light of these policy initiatives, it is not very difficult to appreciate why there was a robust financial recovery in Korea from the last week of September 1998, and an expansionary process in the real sector was clearly discernible with a lag of about a month.

Similar chains of events could be observed in other crisis-ridden countries as well. Highly contractionary fiscal and monetary policies pursued in Thailand since early August 1997 were slightly modified after the IMF's second quarterly review (completed on March 4, 1998), when the fiscal stance was made somewhat accommodating and a 2 per cent deficit was allowed in view of the expected fall in GDP. Under the third quarterly review, completed on June 10, 1998, the fiscal deficit target for 197-8 was raised further, to 3 per cent of GDP, with no sign as yet of bottoming out of output and employment; but the budgetary measures were still far from expansionary, and monetary policies directed solely towards attaining exchange rate stability. Only after the fourth quarterly review (September 11, 1998) was the policy framework changed in order to

promote recovery through budgetary expansion and lowering of interest rates.

Even though Malaysia did not seek IMF assistance, her overall policy response after the onset of the currency crisis was basically the same as that of the other crisis countries. However, unlike these countries, Malaysia had already had restrictions on short tem borrowing in foreign currencies before the crisis, and supplemented these measures on September 1, 1998 by (a) further controls on capital account, of which the most important was banning of repatriation of funds from the stock market for one year, and (b) pegging the ringgit to the US dollar at a rate substantially higher than the previous month's close. The tighter control of capital movement was immediately followed by a host of expansionary measures: the government announced a planned budget deficit of 6.1 per cent of GNP; interest rates were cut; and banks were offered funds for recapitalisation and urged to expand credit.

Among responses to the crisis perhaps that most bizarre was the way Indonesia tried to tackle the problem at its inception. Before the currency turmoil hit the Asian shores, Indonesia had generally had a fiscal surplus and a moderate current account deficit. Even so, the Stand-By Arrangement with the IMF, approved on November 5,1997, imposed measures for strengthening the fiscal position, apart from recommending

raising of interest rates, tightening of credit, and financial restructuring (including closure of problem-ridden banks). A strengthened program was announced on January 15, 1998 in order to arrest shaper decline in the rupiah, but large scale financial distress forced the Bank of Indonesia to provide liquidity support to banks. In the context of the unabated currency depreciation and raging inflation, the IMF's first quarterly review (finalized on May 4, 1998) programmed for (a) further tightening of monetary policy by way of sharp rise in interest rates and strict control over central bank's credit to the domestic sector; (b) some modification of fiscal targets in order to allow for the cost of bank restructuring and anti-poverty measures required under the sharply deteriorating economic conditions; and (c) rapid reforms, with emphasis on restructuring of banks, privatization and removal of price controls. The new program was, however, derailed by severe civil unrest, fuelled by soaring food prices that culminated in the President's resignation on 21 May 1998. Under the IMF's second review (July 15, 1998), Indonesia's access to funds under the Stand-By Arrangement was raised by US $1 billion, fiscal policy was eased, but inflation and the exchange rate were to remain the prime concern of monetary measures. Sharp shrinkage of output and employment led to further fiscal easing in October 1998 and lowering of interest rates from December 1998, but it took a considerable while before the domestic

policy reversal and improvement in the rest of Asia could extricate the Indonesian economy from the depths to which it had sunk.

Among the East Asian countries, China was the only one which consistently tried to counter reversionary tendencies by stimulating domestic demand, without taking recourse to devaluation- a policy initiative the country could take with relative impunity, in view of restrictions on capital movements already in force. From mid-1998, backed by further tightening of capital controls, China stepped up public investment on a massive scale, reduced deposit rates by 1.25 percentage points during the year, and continued to lower interest rates in 1999 as well. The result was that the GDP growth in China jumped from 7.6 percent in the third quarter of 1998 to 9.6 percent in the next quarter and amounted to a healthy 8.3 percent during January -March 1999.

Much more important for the crisis countries was the mending of ways of Japan and Singapore, the two countries having the strongest economic ties with the rest of the region. From August 1998, there was a significant shift in polices pursued by Singapore: interest rates were brought down sharply and fiscal tightening gave way to substantial budgetary expansion. The first sign of Japanese policy reversal came in April 1998 when, in the context of the continuing fall in output and employment, the governing announced a supplementary fiscal package of

20.7 trillion yen ($158 billion). However, the amount was too small to arrest, let alone turn the tide of economic contraction and restore investors' and consumers' confidence. The decisive shift in Japan's policy stance occurred in November 1998 when the government finally announced a wide ranging fiscal stimulus plan, involving an additional sum of 42 trillion yen ($372.2 billion). The expansionary program of the Ministry of Finance was supported by easy money policy, with the Bank of Japan pushing down short term interest rates to the near-zero level. Though there was a lag before production and employment recorded positive growth, the policies went a long way in reversing the slide of the yen from September 1998 and produced a positive impact on the rest of the region.

We have already examined how strong trading and financial links among East Asian countries caused a vicious circle in the process of their economic downturn. When countries in the region started to provide stimulus to their domestic demand more or less simultaneously, the circle turned virtuous, with expansion in one country helping recovery in others. The important point to note here is that had one country tried on its own to follow expansionary monetary and fiscal policies, it would have benefited others, but in the process the country itself would have incurred trade deficits, and perhaps, been subjected to stronger pressure in the currency market. The East Asian expansionary process could become mutually self-

supporting primarily since the major players in the region unfolded their stimulus packages a almost in unison.

External Stimuli

An important reason why domestic policies of East Asian economies could contribute to their financial stability and engineer real sector recovery from the last quarter of 1998 was the relatively favorable environment prevailing in the rest of the world. The Asian crisis, for one thing, did not produce any seriously debilitating impact on financial sectors in North America and Europe. Having burnt their fingers in the Latin American debt crisis during the early 1980s, major banks in the USA and other advanced countries (barring Japan) had already completed their risk management exercise well before the currency turmoil broke out in Thailand. These banks, with relatively small and well-provisioned on-balance-sheet exposures to the Asian-5, did not, as a result, create any systemic difficulties, and were able to resume their advances in the region once the crisis showed signs of waning.[8]

Second, pursuit of expansionary monetary policies by East Asian economies was greatly facilitated by interest rate cuts in western countries. Of particular importance was the series of reductions effected by the Federal Reserve Board of the United States: the federal fund rate,

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[8] ibid.p.229.

prevailing at 5.5 per cent since March 25, 1997, was brought down to 5.25 per cent on September 29, 1998, to 5.0 per cent on October 15, 1998, and finally to 4.75 per cent on November 17, 1998. Great Britain and quite a few other European countries outside the Euro zone also reduced their interest rates over 1999. By the time the federal fund rate was brought back to the 5.5 per cent level in three steps between July 1, 1999 and November 17, 1999, the financial as also real sectors of the crisis countries, had staged a robust recovery.

Finally, given the high degree of openness of the East Asian countries, the importance of export growth (which turned negative in 1998) for sustaining recovery can hardly be overemphasized. We have already dwelt on the role that intra-regional trading links played in aggravating the crisis, as also in acting as a reinforcing device in the course of the upswing.

However around 50 per cent of East Asian exports were to the rest of the world, so that in the absence of a substantial rise in demand from this source, recovery in the real sector would have required either (a) a further fall in real exchange rates; or (b) massive inflow of foreign capital. Fortunately for the region, demand for East Asian exports rose substantially during 1999. Unlike the early 1980s, when depressed economic conditions in the USA and Europe put obstacles to speedy resolution of the Latin American crisis, the United States in 1999 bettered

her already impressive record of high GDP growth during the decade, and growth in Western Europe also started picking up in the same year. This expansionary process in advanced countries, together with substantial improvement in world demand for electronic goods including memory chips, provided a considerable boost to East Asian exports, promoted investors confidence and permitted expansion in domestic demand, unconstrained by adverse developments in the sphere of external trade or international finance.

Thus, the recent currency turmoil in South East Asian countries has underscored the severe difficulties that even (apparently) robust economies may face under the prevailing system of international finance. Since the mid-1980's the ASEAN countries in general, and Thailand in particular, have been hailed as the newly emerging economic tigers and their macroeconomic performance and policies cited as models for low income countries in the rest of the world. The South East Asian experience illustrates both the opportunities and dangers attendant upon economic liberalization under globalized financial market and indicates the limitations of conventional wisdom in evaluating macroeconomic scenarios and suggesting policy programs suited to the present day environment of world trade and finance.

Chapter V

CONCLUSION: SAFER CAPITAL MARKETS

Asia's financial crash showed the fragilities of global capital markets and prompted a number of calls for improving the international financial system. But before taking a look at how to make the global capital markets safer let us make an overview of the crisis.

An overview of the Asian Crisis

The first to sink in the Asian financial turmoil was Thailand, when she gave up defending the baht against speculative attack and let the currency float on July 2, 1997. Soon other East Asian economies were infected by the Thai virus, and at one stage it appeared that the contagion would spread to the financial systems, not only of emerging market economies elsewhere, but even of advanced industrialized nations. The trouble turned out to be quite transitory in other parts of the world; but East Asia was not so fortunate. By far the hardest hit were the Asian tigers, who had to endure severe meltdown in their financial markets and suffer from a sharp decline in output, employment and standard of living.[1]

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[1] Mihir Rakshit, *The East Asian Currency Crisis*, (Oxford University Press, New Delhi, 2002). p.183.

Indeed, during the closing days of October, 1997 not only the whole of East Asia, but other emerging economies elsewhere also experienced substantial pressure in their financial markets. While other parts of the world recovered fairly soon, until late December 1997 and January 1998, the pressure remained practically unabated in all East Asian economies including Japan, Singapore, Hong Kong, and Taiwan. By far the most seriously afflicted were the ASEAN-4 and Korea, where exchange rates and share prices recorded almost a free fall.

Interestingly enough, the spread of the crisis across the Asian economies and its accompanying financial meltdown occurred despite a series of rescue operations mounted under the IMF sponsorship and pursuit of widely recommended policies on the part of the beleaguered nations. The Philippines was the first to obtain a modest support of US$ 1.2 billion form the IMF. Over the period July 29, 1997 to December 3, 1997, the IMF put successively in place, bailout packages amounting to US$ 17.2 billion for Thailand, US$ 42 billion for Indonesia, and US$ 58.2 billion for Korea – an exercise that did not, however, seem to cut much ice with domestic or foreign investors.

Temporary Turnaround: The turnaround in Asian financial markets was led by Korea, where both the exchange rate and share prices started recovering from the last week of December 1997. Interestingly the

intensification of the crisis prior to this was also a fall-out of the revelation in early December of the precarious state of Korea's foreign exchange reserves in relation to her short term external debts. The announcement of 3 December of the US$ 58 billion IMF bailout package was of little avail, if not positively counterproductive, in stemming the rising tide of financial turbulence. The first sign of Korean recovery was discernible only after most of the country's bank creditors had agreed, in late December, to roll over the short tem loans. With a lag of a couple of weeks, followed recovery of financial markets in other afflicted economies of the region.

This financial recovery did not prove enduring; but neither was it quite insignificant. Though exchange rates showed signs of improvement, much more prominent was the recovery of share prices. Stock markets were also the first to turn bearish later on, significantly ahead of development of renewed pressure in foreign currency markets.

Renewal of Pressure in Financial Markets: The second wave of meltdown in Asian financial markets started from the first week of March 1998, when the Korean and Thai share markets became jittery, and by early April, stock prices in all the 5 crisis countries were on a steeply downward course. The foreign exchange markets, as we have just seen, were the laggards in this period of the financial turmoil, but they were the first to recover from the downward thrust. By the third week of June 1998,

exchange rates stabilized everywhere in the Asian-5, but bottoming out of share prices came two to three months later. The extent of currency depreciation was also much less than the fall in share prices. In fact, September 1998 saw all the five share price indices plunge to their all-time minima; but, except for the Indonesian rupiah, the new lows of other currencies were higher than those obtaining at the end of December 1997.

The behavior of share prices in terms of US currency suggests that the renewed financial pressure lasted until August-September 1998, when the bearish tendencies gradually tapered off. Except for Korea, the share prices in the other four Asian-5 economies hit their ten-year minima. Compared to its pre-crisis level, the index, at the time of bottoming out, showed a loss of 74 per cent in Thailand and Korea, 76 per cent in the Philippines, 82 per cent in Malaysia, and 92 per cent in Indonesia. While Indonesia's was a basket case for a variety of reasons, figures for other countries also indicate the enormous pounding the stock and currency markets in the Asian-5 had to endure before the financial turmoil finally started abating, more than a year after the outbreak of the Thai crisis.

Recovery: The recovery in the Asian-5 currencies after September 1998 constituted, by and large, a process of correction from their unduly depressed levels and adjustment towards their new equilibrium values. The adjustment process was more or less monotonic and the new equilibrium

appears to have been attained by November 1998 in the Philippines, and by January 1999 in Thailand and Korea. The behavior of the Malaysian and Indonesian currency markets deserves special mention. The slide in the ringgit was quite moderate, and it started bottoming out in early July 1998, two months before the currency peg was introduced (at 3.81 ringgit per dollar). Only in Indonesia did stability in the currency market prove elusive until the last quarter of 1999.

After September 1998 the share prices in all the five crisis-ridden economies staging a substantial recovery, but the upward adjustment was cyclical, rather than monotonic. The recovery was almost uninterrupted between September 1998 and July 1999, when share prices (in terms of both domestic and US currency) stood at their highest levels since the outbreak of the currency crisis. Over the next three months or so, stock markets experienced some downward thrust, but displayed unmistakable signs of stabilization and recovery during the last quarter of 1999. The signification point to note in this connection is that in all the Asian-5 economies, the troughs of the two stock price indices during the downturn in the third quarter of 1999 were at much higher levels than the corresponding minima during the earlier stock market meltdown. Indeed, September 1998 was the dividing line between deepening of the East Asian crisis and the process of recovery of the battered region.

The enduring nature of the financial market turnaround since September 1998 was attested by other factors as well. First, recovery and stabilization in the currency markets took place along with substantial build-up in foreign exchange reserves. Second and more significant, exchange rates gained and moved within narrow bands even while the central banks were pushing interest rates downward, ultimately to below their pre-crisis levels by several percentage points. Interest rate reductions of such order without a crash in the exchange rates would have been impossible, were there no dramatic turnaround in market perception regarding the financial health of the East Asian economies.

It is to be noted that though the financial turmoil engulfing the East Asian countries was quite severe there recovery was much faster and more robust than most observers– including the IMF could foresee. Indeed while the Latin American Countries had to suffer for nearly 7 to 8 years from the impact of the currency crisis erupting in the early 1980s, it took the Asian economies less than 18 months to recover and start recording sustained growth in their industrial output and gross domestic product.

With the benefit of hindsight, it is not very difficult to identity the major factors contributing to the turnaround of the East Asian economies. Arguably the most basic of these factors was the strong fundamentals which distinguished the Asian economies from their Latin American

counterparts. The rapid and uninterrupted advancement of these economies between the early 1960s up to 1997 was driven by high domestic saving, export competitiveness, and remarkable fiscal prudence.[2]

Except for Thailand and Indonesia, external balances of these countries were also quite comfortable before the onset of the currency crisis. The result was that the countries were well placed to take corrective steps in order to counter the economic downturn. The Asian paradox, it thus seems, consists not so much in the rapidity of the regions revival, but more in why countries with such strong fundamentals had to endure such suffering for so long.

How Can The Global Markets Be Made Safer

In the aftermath of the Asian crisis a number of suggestions came forth to make the global capital markets safer. Robert Rubin, America's Treasury Secretary, wanted to "modernize the architecture of the international financial markets." Eisuke Sakakibara, Japan's top international finance official, is thought of a "Bretton Woods II." Alan Greenspan, Chairman of the US Federal Reserve, wanted to review the "patchwork of arrangements" governing international finance.[3]

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2 Lemco, Jonathan and MacDonald, Scott B, "Is The Asian Financial Crisis Over?", *Current History*, (Philadelphia, P.A.), vol. 98, no. 632, December 1999, p.433.

3 "The perils of global capital", *The Economist*, Apr 11, 1998.

After East Asia's unfortunate crisis, policymakers worried that today's financial architecture, designed at Bretton Woods in 1944 for a world of limited capital mobility, may not be capable of dealing with an ever more global capital market for international finance has been revolutionized. Formerly closed economies have cast off controls and embraced foreign funds. Better technology and financial innovation have made it easy to move money instantaneously.

Yet bouts of activism have occurred before. After the demise of the fixed exchange rate system in the early 1970s, a group of finance ministers and central bank governors, "the Committee of 20", set out to design a wholly new architecture. As the oil shock hit, Henry Kissinger had big ideas for the International Energy Agency. During the 198o's debt crisis, a score of new bureaucracies, such as an International Debt Discount Corporation, were mooted. But actual innovation was modest and incremental. After the fixed exchange-rate system collapsed, today's non-system of floating rates emerged from the wreckage. After the oil shocks, the IMF created new credit lines to help countries cope with sudden shifts in commodity prices. The debt crisis was finally resolved with the introduction of Brady bonds. Since Mexico's most recent crash in 1995, the G-7 has led more tinkering, including a new credit line to lend the IMF money in an emergency.

Cumulatively, such changes have allowed the post-war blueprint to evolve. At issue is whether it has evolved enough.

First identify the problem: Much depends on what caused East Asia's crash. Explanations abound, but-with some simplification-they divide into two broad categories. One emphasizes that the crisis was homegrown, the product of crony "Asian capitalism". The other emphasizes panic It points out that no one foresaw the crisis; that by conventional indicators of economic health (budget deficits and so forth) the Asian economies were in good shape; and that no economic change occurred in 1997 to justify such a massive loss of confidence.

There is probably some truth to both interpretations, and most observers believe the crisis was a combination of the two. Where analysts differ is the relative weight they assign to each. American triumphalists and some academics, such as Paul Krugman, emphasize 'crony capitalism.' Others, notably Jeffrey Sachs of Harvard University and Joseph Stiglitz, chief economist at the World Bank, believe panic was more important.

Crucially, these two interpretations imply different conclusions about how best to prevent and deal with future crises. If you regard Asia's crash essentially as a crisis of Asian capitalism- especially its opacity, poor regulation and cronyism- then systemic reforms should be geared towards reinforcing transparency, improving supervision and limiting moral hazard.

But if the crisis was primarily one of panic, then the goal should be to control unstable markets while providing more public money or creating new, reassuring rules. The market-reinforcing view starts by calling for greater transparency. Thailand's secret sales of foreign-exchange reserves in the forward markets made a mockery of its official reserve levels. No one had any idea how enormous South Korea's short-term debt burden was. This opacity worsened the crisis, suggesting global markets would work better if there were more information, of better quality, on a broader range of economic items.

Since Mexico's crash in 1994-95 there have been efforts to improve the information available to investors. But too many emerging economies are still too secretive. Only 39 countries post their economic statistics on the IMF's new electronic bulletin board. Few countries (rich or poor) publish details of their forward foreign-exchange operations. Worse, much important information is simply not collected, or collected too late. Aggregated information on firms' foreign indebtedness, for instance, simply does not exist. Sorting out these statistical shortcomings is an obvious priority.

Policing the banks: A second reform to reinforce capital markets is better regulation. Banks are uniquely vulnerable institutions, capable of wreaking havoc if inadequately supervised. Countless banking crises, in

rich and poor countries alike, have shown that the combination of free capital flows and badly regulated banks is disastrous. To improve supervision, the Basle Committee of international bank supervisors issued "25 core principles" of sound banking last year. For many observers, however, East Asia's crisis shows that more needs to be done. Perhaps the standards of financial safety themselves need updating. The key internationally agreed rules for banks are the Basle capital-adequacy standards set up by the industrialized countries in 1988. Now, they look inadequate and arbitrary. The minimal capital necessary for safety in a developed banking system may be insufficient in volatile emerging markets. And it seems odd that lending short term to banks, particularly emerging-market ones, is considered always less risky than making long-term loans to companies such as Microsoft.

Others go much further, arguing that a global capital market needs global financial regulation, not a hotchpotch of national supervisors of varying quality. Henry Kaufman, an American markets watcher, has put forward the most ambitious proposal. He wants to create a new international institution that would supervise participants in global capital markets. It would establish uniform trading, reporting and disclosure requirements, set minimum capital requirements and eventually rate the credit quality of institutions under its jurisdiction. Some of these ideas have found resonance in official circles. Stanley Fischer, Deputy Managing

director of the IMF, is wary of creating a new institution but keen on more systematic supervision of existing regulators.

Cut moral hazard: A third market-reinforcing reform is to reduce moral hazard. Bailouts, in this view, breed more crises. For many conservatives, particularly in America's Congress, the answer is to curb, or even eliminate, the IMF. It is the prospect of bailouts, they argue, that encourages governments to profligacy and investors to recklessness.

The most libertarian want nothing in the IMF's place. They argue that governments can protect themselves privately against sudden flights of capital. In 1995, Argentina faced a liquidity crisis, as capital fled in the aftermath of Mexico's crash. To avoid a repeat, the Argentines entered into $6.7 billion worth of "reverse repo" arrangements with 14 international banks. For promising to provide liquidity should capital suddenly flee, the banks charge Argentina a fee and demand Argentine bonds as collateral. Many reformers think this approach is the best way to avoid liquidity crises. They may be right, but it is untested. Some argue that public money can bolster such private liquidity lines. The Argentines, for instance, have suggested that international institutions could give guarantees in place of the collateral banks now demand. Ricardo Hausmann, chief economist at the Inter American Development Bank, wants international institutions to promote this market by offering countries such liquidity lines jointly with

commercial banks. This way, public money helps boost liquidity without worsening moral hazard, and private creditors cannot simply flee when panic hits.

If credit lines could preempt crises of liquidity, that still leaves the problem of insolvency. Or, put another way, the question of how Asia's mess should have been dealt with. Again, the most orthodox free-market types would say that South Koreàn, Thai and Indonesian banks and firms should simply have defaulted, making foreign bankers and other investors lose money. International default, however, is thought to come at a heavy price. Countries that reneged on their bonds in the 1930s did not regain access to capital markets for decades. This history has spawned a deep seated fear of formal default (though many poor countries have had defacto defaults as their debts have been rescheduled). Formal cross-border default seems frightening, for it takes place in a legal and institutional vacuum. Hence a further market-reinforcing reform aims to fill this void: to find a way in which creditors can take a hit without the chaos of uncontrolled default. Unfortunately no one has worked out how to do it. Jeffrey Sachs is the most ambitious. He would like a fully-fledged international bankruptcy framework, modeled on American bankruptcy law. His proposals would not only ensure that creditors took a hit, but would also provide debtors with a framework within which they could gain access to new credit. He claims that South Korea's "voluntary" rescheduling of its short-term debts

was the right approach. It should simply be formalized. Many "pro-market" reformers abhor the idea of debt workouts. They argue that a generous international bankruptcy procedure would worsen the problems of moral hazard, as default became an easy option.

In official circles the idea of such "orderly work-outs" was carefully studied after Mexico's 1995 crisis. The conclusion was that the legal problems surrounding a world bankruptcy court were insurmountable. But more modest reforms were suggested: including "default clauses" which stipulated a work-out procedure in future bond contracts, and allowing the IMF to lend to countries that had defaulted, thereby implicitly sanctioning a default. Such notions are back in vogue. But no concrete, workable blueprints yet exist. And it will be a complicated business. Not only are there two main types of creditors (banks and bondholders), but also several kinds of debtors (sovereign governments, banks and firms). A "work-out" system that reinforced, rather than undermined, market discipline must be sufficiently systematic to prevent chaos, but tough enough to avoid moral hazard.

Or channel the flows: For those who see East Asia's crisis primarily as one of panic, these market-reinforcing reforms mostly miss the point. Far more urgent is the need to control the capital flows themselves.

Ironically, the most ambitious of such proposals is touted by George Soros, a man who made his fortune and reputation in financial markets. He now believes the private sector is ill suited to allocating international credit and thinks bureaucrats would do a better job. He wants to create an International Credit Insurance Corporation. This bureaucracy would, for a modest fee, guarantee all international loans to a country up to a debt level it deemed appropriate. Any further lending would be uninsured.

This proposal has so many weaknesses it is hard to believe anyone takes it seriously. Consider only two. Blanket insurance up to a cut-off point would precipitate a rush to lend up to a country's limit (with commensurately bad investment decisions). And there is no evidence that bureaucrats are any better at determining optimal debt levels than the market.

While most policymakers consider Mr Soros's ideas crazy, a far broader consensus surrounds the usefulness of capital controls. For those who are uneasy with the speed with which funds flow around the globe, the perennial idea of a tax on currency transactions has surfaced again. Even more popular is the idea of "prudential" capital controls on short-term inflows. The World Bank's Mr Stiglitz is a big fan. He likes to compare global capital markets to a wild and choppy sea: small economies, like small boats, can easily sink. Chile is often cited as an example of a country

that has flourished using such controls. It discourages hot money by demanding that 30% of all inflows be deposited without interest at the central bank for one year. For short term inflows this implies a hefty tax.

Judging by Chile's performance, such controls may work. But they come at a price. Chile's real interest rates are higher than they need be, and its financial markets are segmented: big firms borrow abroad; small ones face high rates at home. And, most importantly, sophisticated financiers eventually find ways around them.

While less hot money might reduce the risks of a market panic, it would not eliminate it entirely. Hence a further reform option is to create a true global lender of last resort. The IMF partially fulfills the role but compared with a central bank (the domestic lender of last resort), it is severely constrained: it cannot print money and so cannot lend freely. Its resources are paltry compared with today's cross-border flows. It does not lend at penal interest rates (though it attaches exacting conditions to its money) and does not demand collateral.

In serious crises, the IMF has not been the main lender of last resort. In 1982, when Mexico teetered on the edge of default, it was the United States that stepped in, prepaying for $2 billion of Mexican oil. When Mexico hit trouble in 1995, it was again the Americans that provided most of the instant money. Recent reforms have made the IMF more like a

lender of last resort. A new credit facility allows countries in trouble to borrow more money, quickly, at penal interest rates (but still with economic conditions attached). Its capital base is being expanded. But even with a capital increase, the IMF will have only another $90 billion in its kitty. To be a credible lender of last resort would demand much more.

With such an array of possible reforms, it is hardly surprising that international officials are confused and uncertain. The issues are complicated, and many proposals inconsistent. What is to be done?

A few reforms are easy, obvious and make sense whatever interpretation of Asia's crisis you hold. Better information, for instance, cannot do anything but good. A second category of possible reforms also makes sense, but will be politically difficult. Creating a truly global overseer of regulators will be vehemently resisted by national bodies. Imagine America's Securities and Exchange Commission, for instance, being dictated to by some supranational body. Similarly, attempts to change capital-adequacy standards or broaden the reach of supervision beyond banks will all take a long time. The Basle capital-adequacy standards took the best part of a decade to evolve.

But most difficult-conceptually, politically and practically-is the question of minimizing moral hazard versus creating a better lender of last resort. Or, put another way, the dilemma of ensuring that private investors

pay the price of their bad decisions, but that countries are not unfairly punished for investor panics.

Theoretically, the logic of a vast international lender of last resort to cope with panics is impeccable. In practice, it is difficult to distinguish between unwarranted panic and real problems. It is virtually impossible to imagine generating political consensus for an IMF that was big enough to be a credible lender of last resort. Even those, such as Mr. Sachs, who believe that East Asia's crisis was mainly a panic, do not conclude that a bigger Fund is the answer. He believes the only way forward is through some form of systematized debt workouts, where creditors take a hit.

Yet the hurdles to this are equally immense. Despite an ever more global capital market, legal authorities are still nationally based. Practicalities aside, a framework that was too clear-cut (and too kind to debtors) might invite poor-country recklessness or, more likely, might ensure that foreign capital flows simply dried up.

These conundrums will not be solved simply. Modest improvements can be made quickly. But no single institution or innovation will magically make capital markets safe and sound. As they prepare for reforming, the post-Asia activists would do well to take a look at "*Manias, Panics and Crashes*", the definitive analysis of financial crises by Charles

Kindleberger, and America's foremost economic historian. The book's first sentence is a salutary reminder:

"There is hardly a more conventional subject in economic literature than financial crises."

But thanks to the gyrations of the Asian financial markets, economists are now better aware of the limitations of their discipline. They have come to recognize some important but hitherto neglected inter-linkages between the domestic and the international economy and have renewed their search for policy packages (including reorganization of global financial institutions) that can hopefully make nations less vulnerable to currency crisis, or at least, contain their deleterious impact.

Lessons for India

The strategy adopted by East Asian countries during the last two decades has been very different from that of India. Trade and manufacturing activities were mainly with the private sector and the Government concentrated on social services. In India, on the other hand, the Government controlled the commanding heights of the economy, directly involving itself in manufacturing and trade. Since most of the Government run enterprises did not generate surpluses, the government was compelled to subsidies their activities through budgetary transfers.

Practically, the entire budgetary expenditures went towards salaries to the bureaucracy, subsidies, interest payments and transfer of funds to loss-making enterprises. Consequently, very little was left to spend on social service activities such as health, education housing, social security, welfare and community amenities. Thus, during 1995 the Indian Government spent less than 12 per cent of its budget expenditures on social services, while Indonesia spent over 70 per cent. Thailand 58 percent, Malaysia 48 percent and Korea 42 percent. The East Asian strategy of the Government concentrating on social services while leaving industry and commerce to the private sector yielded better results in terms of economic and social indicators, including making a dent on poverty.

The idea is not to argue that all is well with the East Asian economies. Instead, the purpose is to view the turmoil in the proper perspective so that inappropriate lessons are not drawn for India.

The turmoil in East Asia was chiefly the result of financial factors. In particular, most of the local banks borrowed heavily from foreign banks in foreign currency. In addition, Korea and others discouraged foreign banks from operating in their countries. Because of this policy these banks did not have any stake in the local financial markets. As a result, the foreign lenders had no qualms about withdrawing funds or demanding payments from the local institutions. Fortunately, the Indian case is

different. Indian banks have not borrowed from abroad. Moreover, foreign banks are not lending to Indian institutions from abroad but operate from India. Therefore, they also have a stake in the Indian financial sector. In this matter, India can offer lessons to East Asia.

Foreign portfolio investments, that is foreign institutions and individual buying and selling shares in the national stock exchanges, as distinct from direct investments aimed at owning and operating units, can be destabilizing. Portfolio capital is mainly speculative and can trigger a crisis. India should learn its lessons from the East Asian crisis and introduce regulations in foreign portfolio investments. India should learn first and foremost that a fairly high rate of growth of GDP alone is not an indicator of strong economic fundamentals. If that were the case, the exchange value of the Indian rupees would not have tumbled the way it did in the post-reform period in spite of an average annual GDP growth of seven per cent during the last three years of the Eighth Plan period.

A high growth of GDP should be accompanied by reasonably low fiscal deficit-GDP ratio, strong and efficient infrastructure, robust export growth on a continuing basis, high rates of savings and investment, low levels of subsidies, a healthy banking and financial sector with low percentages of non-performing assets, high productivity and so on. On most of these counts, our country's performance is far from satisfactory.

Second, the East Asian crisis has brought to the fore the need for institutional reforms and strengthening the institutional structure. The crisis in all the economies discussed above was triggered by the weaknesses in their banking and financial sectors. This highlights the imperative need for not only reforms in these sectors but proper systems of regulation and regular monitoring.

We have still a long way to go in this area, looking at the high levels of non-performing assets, bad debts, and scams that have been surfacing at regular intervals. Our capital market reforms so far are also far from satisfactory, and the investors have suffered huge losses. The legal and regulatory framework continues to remain weak. In most cases, we see the syndrome of putting the cart before the horse.

Third, our economy is beset with highly inefficient infrastructure whether it is power, coal, roads, rail transport or ports. Infrastructural constraints are proving to be a major drag on industrial production as well as export growth. The reforms have not made any significant headway in improving the performance of infrastructure or in attracting the much needed private investment. The state electricity boards are in a bad shape because of mis-management and irrational tariff structure. The cargo handling facilities at the country's major ports are pathetic. Indian banks have not learnt to evolve new methods of appraising risk, especially for infrastructure finance. As chances for economic growth in world trade are

infrastructure driven and infrastructure needs in India are vast and unmet, the role of banking institutions in this area assumes added and urgent significance.

Last, the developments in the South East Asian countries and the subsequent pressure on the Indian rupee call for abundant caution in our moving towards capital account convertibility. Under a regime of full CAC, there would certainly have been a flight of capital from the country in the midst of the volatile and declining rupee.

A substantial portion of our foreign exchange reserves is in the nature of FII inflows and NRI deposits or what can be termed 'hot money'. Control of fiscal deficit, sustained high export growth, low rate of inflation and better control of government expenditure through reduction of subsides should precede capital account convertibility.

Indian can learn its lessons from the East Asian achievements and failures. The Government should spend more on education, health, civic amenities and other social services. This can be achieved by the government withdrawing from direct manufacturing and trade activities and targeting expenditures towards achieving social goals. The size of the Government should be drastically pruned to make it more purposeful and powerful. A large and flabby Government can be neither strong nor effective.

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