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EAST ASIA: FROM MIRACLE TO DEBACLE AND BEYOND?[1]

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While there has been considerable work critical of the East Asian record and potential, none actually anticipated the East Asian debacle of 1997-98 (e.g. see Krugman 1994). Although some of the weaknesses identified in this critical literature did make the region economically vulnerable, none of the critical writing seriously addressed one crucial implication of the greater role of foreign capital in Southeast Asia, especially with international financial liberalisation, which became more pronounced in the 1990s. As previously noted (Jomo 1998), dominance of manufacturing -- especially the most technologically sophisticated and dynamic activities -- by foreign transnationals subordinated domestic industrial capital in the region, allowing finance capital, both domestic and foreign, to become more influential in the region.

In fact, finance capital developed a complex symbiotic relationship with politically influential rentiers, now dubbed 'cronies' in the aftermath of 1997-98. Although threatened by the full implications of international financial liberalisation, Southeast Asian financial interests were quick to identify and secure new possibilities of capturing rents from arbitrage as well as other opportunities offered by gradual international financial integration. In these and other ways (e.g. see Gomez and Jomo 1999; Khan and Jomo 2000), trans-national dominance of Southeast Asian industrialisation facilitated the ascendance and consolidation of financial interests and politically influential rentiers.

This increasingly powerful alliance was primarily responsible for promoting financial liberalisation in the region, both externally and internally. However, in so far as the interests of domestic financial capital did not entirely coincide with international finance capital, the process of international financial liberalisation was necessarily partial. The processes were necessarily also uneven, considering the variety of different interests involved and their varying lobbying strengths in various parts of the region.

History too was not unimportant. For example, the banking crisis in Malaysia in the late 1980s served to ensure a prudential regulatory framework which checked the process from becoming more like Thailand's, where caution was thrown to the wind as early external liberalisation measures succeeded in securing capital inflows. Yet, in both countries, such flows were desired to finance current account deficits. These were principally due to service account deficits (mainly for imported financial services as well as investment income payments abroad), growing imports for consumption, speculative activity in regional stock markets, and output of non-tradables, mainly in the property (real estate) sector. There is little evidence that such capital inflows contributed significantly to accelerating the pace of economic growth, especially of the tradable sectors of the economy. Instead, it is likely that they contributed greatly to the asset price bubbles, whose inevitable deflation was accelerated by the advent of crisis with such devastating economic, social and political consequences.

The objectives of this paper are modest. The first part will review the causes of the crises in the region. Macroeconomic indicators in the three most crisis-affected economies -- i.e. Thailand, Indonesia and South Korea -- and Malaysia are briefly reviewed to establish that despite some misdemeanours, the crises cannot be attributed to macroeconomic profligacy. Instead, the consequences of the reversal of short-term capital inflows are emphasised. In this

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regard, Malaysia will be shown to have been less vulnerable owing to pre-crisis restrictions on foreign borrowings as well as stricter central bank regulation, but more vulnerable due to the greater role of capital markets compared to the other three economies. The role of the IMF and financial market expectations in exacerbating the crises is also considered.

The second part will seek to advance the emerging discussion of economic recovery in the region. It begins by asserting that the recovery in the region, especially in Korea and Malaysia, has been principally due to successful Keynesian reflationary efforts, both fiscal and monetary. This implies that the emphasis by the IMF and the financial media on corporate governance reforms has been misguided and such reforms are not a pre-condition for economic recovery. Instead of the Anglo-American or neo-liberal-inspired reforms being proposed, it is suggested that reforms should create new conditions for further catching up throughout the region. Finally, although pessimistic about prospects for international financial system reform, the chapter concludes by outlining a reform agenda in the interests of the South.

Causing Crises

Rapid economic growth and structural change, mainly associated with export-led industrialisation in the region, can generally be traced back to the mid-1980s. Then, devaluation of the currencies of Thailand, Indonesia and Malaysia, as well as selective deregulation of onerous rules helped create attractive conditions for the relocation of production facilities in these countries and elsewhere in Southeast Asia and China. This was especially attractive for Japan and the first-tier or first-generation newly industrialising economies of South Korea, Taiwan, Hong Kong and Singapore, most of which experienced currency appreciations, tight labour markets and higher production costs. This sustained export-oriented industrialisation well into the 1990s, and was accompanied by the growth of other manufacturing, services as well as construction activity.

Table 1. East Asia Four: Macroeconomic Indicators, 1990-1999

	Unemployment Rate					*Savings/GDP*				
	90	*96*	*97*	*98*	*99*	*90-95*	*96*	*97*	*98*	*99*
Indonesia	n.a.	4.1	4.6	5.5	6.3	31.0	26.2	26.4	26.1	23.7
Malaysia	6.0	2.5	2.4	3.2	3.0	36.6	37.1	37.3	39.6	38.0
Korea	2.4	3.0	2.6	6.8	6.3	35.6	33.7	33.3	33.8	33.5
Thailand	4.9	1.1	0.9	3.5	4.1	34.4	33.0	32.5	34.9	31.0
	Investment/GDP					*(Savings-Investment)/GDP*				
	90-95	*96*	*97*	*98*	*99*	*90-95*	*96*	*97*	*98*	*99*
Indonesia	31.3	29.6	28.7	22.1	19.3	-0.3	-3.4	-2.3	4.0	4.4
Malaysia	37.5	42.5	43.1	26.8	22.3	-0.9	-5.4	-5.8	12.8	15.7
Korea	36.8	36.8	35.1	29.8	28.0	-1.2	-3.1	-1.8	4.1	5.5
Thailand	41.0	41.1	33.3	22.2	21.0	-5.6	-8.1	-0.9	12.8	10.0

Incremental Capital-Output Ratios

	87-89	*90-92*	*93-95*	*97*	*98*	*99*
Indonesia	4.0	3.9	4.4	1.7	0.4	1.8
Malaysia	3.6	4.4	5.0	3.9	28.2	4.3
Korea	3.5	5.1	5.1	4.2	-15.1	3.2
Thailand	2.9	4.6	5.2	12.9	-11.5	14.5

Fiscal Balance/GDP

	90-95	*96*	*97*	*98*	*99*
Indonesia	0.2	1.4	1.3	-2.6	-3.4
Malaysia	-0.4	0.7	2.4	-1.8	-3.2
Korea	0.2	0.5	-1.4	-4.2	-2.9
Thailand	3.2	2.4	-0.9	-3.4	-3.0

Sources: Radelet and Sachs (1998: Table 11); ADB (1999); Bank of Thailand, Bank Indonesia, Bank of Korea, Bank Negara Malaysia.

High growth was sustained for about a decade, during much of which fiscal surpluses were maintained, monetary expansion was not excessive and inflation was generally under control. Table 1 shows various summary macroeconomic indicators for the 1990s with greater attention to the period from 1996. Before 1997, the savings and investment rates were high and rising in all three Southeast Asian economies. Foreign savings supplemented high domestic savings in all four economies, especially in Thailand and Malaysia. Unemployment was low while fiscal balances generally remained positive before 1997/8.

This is not to suggest, however, that the fundamentals were all alright in East Asia (Lim 1999; Rasiah 1998). As Table 1 also shows, the incremental capital-output ratio (ICOR) rose in all three Southeast Asian economies during the 1990s before 1997, with the increase greatest in Thailand and least in Indonesia. The rising ICOR suggests declining returns to new investments before the crisis. Export-led growth had been followed by a construction and property boom, fuelled by financial systems favouring such 'short-termist' investments — involving loans with collateral which bankers like — over more productive, but also seemingly more risky investments in manufacturing and agriculture. The exaggerated expansion of investment in such 'non-tradables' exacerbated their current account deficits. Although widespread in East Asia, for various reasons, the property-finance nexus was particularly strong in Thailand, which made it much more vulnerable to the inevitable bursting of the bubble (Jomo 1998; Pasuk 2000).

Capital Flows

There has been growing acknowledgement of the role of reversible capital flows into the East Asian region as the principal cause of the 1997-98 crisis. It is increasingly widely accepted that the national financial systems in the region did not adapt well to international financial liberalisation (e.g. Jomo 1998). The bank-based financial systems of most of crisis-hit East Asia were especially vulnerable to the sudden drop in the availability of short-term loans as international confidence in the region dropped suddenly during 1997. Available foreign exchange reserves were exposed as inadequate to meet financial obligations abroad, requiring the governments to seek temporary credit facilities to meet such obligations mainly incurred by their private sectors.

Bank of International Settlements data show that the banks were responsible for much of this short term debt, though of course, some of this debt consisted of trade credit and other short-term debt deemed essential to ensuring liquidity in an economy. However, the very rapid growth of short-term bank debt during stock market and property boom periods suggests that much short-term debt was due to factors other than trade credit expansion. In Malaysia, the temporary capital controls introduced in early 1994 by the central bank momentarily dampened the growth of such debt. However, by 1996 and early 1997, a new short-term borrowing frenzy was quite evident, involving not only the banks, but also other large private companies with enough political influence to circumvent central bank guidelines.

As Table 2 shows, in Thailand, Indonesia and Malaysia, the non-bank private sector was the major recipient of international bank loans, accounting for more than 50 per cent of total foreign borrowings by the end of June 1997, i.e. well above the developing country average of slightly under half. In contrast, 65 per cent of Korean borrowing was by banks, with only 31 per cent by the non-bank private sector. Government borrowings were low, and lowest in Korea and Malaysia, although the data does not allow us to differentiate the state-owned public companies or partially private, but corporatized former fully state-owned enterprises.

Table 2. Lending by BIS Reporting Banks to the East Asian Four Economies by Sector, as of end-June 1997 (US$ billion)

	S. Korea	*Thailand*	*Indonesia*	*Malaysia*	*Dev. C'tries*
Total Borrowings	103.4	69.4	58.7	28.8	744.6
Banks	67.3	26.1	12.4	10.5	275.3
(%)	(65.1)	(37.6)	(21.1)	(36.5)	(37.0)
Private Non-bank	31.7	41.3	39.7	16.5	352.9
(%)	(30.6)	(59.5)	(67.6)	(57.3)	(47.4)
Government	4.4	12.0	6.5	1.9	115.6
(%)	(4.3)	(17.3)	(11.1)	(6.6)	(15.5)

Source: Bank for International Settlements

There is strong evidence (see Jomo 2001) of the remarkable growth of (mainly private) foreign debt in the early and mid-1990s, especially in the three most externally indebted economies of Thailand, Indonesia and Korea. While foreign direct investment (FDI) grew in all four economies in the 1990s, it was most modest in Korea. Profit remittances on FDI were least from Korea and Thailand, and highest from Malaysia, reflecting its greater role historically, although FDI Indonesia was actually higher in 1995-96. Portfolio equity flows into all four economies grew tremendously in the mid-1990s.

External debt as a share of export earnings rose from 112 per cent in 1995 to 120 per cent in 1996 in Thailand and from 57 per cent to 74 per cent over the same year in Korea, but actually declined in Indonesia and grew more modestly in Malaysia. By 1996, reserves as a share of external debt were only 15 per cent in Indonesia, 30 per cent in Korea, 43 per cent in Thailand and 70 per cent in Malaysia. By 1997, this ratio had dropped further to 15 per cent in Korea, 29 per cent in Thailand and 46 per cent in Malaysia, reflecting the reserves lost in futile currency defence efforts. Despite recessions in 1998, reserves picked up in all four economies, mainly due to the effects of currency devaluations on exports and imports. Short-term debt's share of total external debt in 1996 stood at 58 per cent in Korea, 41 per cent in Thailand, 28 per cent in Malaysia and 25 per cent in Indonesia.

Table 3 shows that much of BIS bank lending to developing countries was from Japanese, German and French banks, with US and UK banks far less significant. This pattern was quite different from the pattern of lending before the 1980s' debt crises, and suggests that Anglo-American banks were generally far more reluctant to lend in the 1990s after their previous experiences in the 1980s. There is little evidence to suggest that such banks have been more averse to lending either to governments or to developing economies. The pattern of lending in the late 1970s and early 1980s suggests the contrary.

Table 3. Exposure of BIS Reporting Banks to Non-BIS Borrowers, end-June 1997 (US$ bn)

Total	*1054.9*
Germany	178.2
Japan	172.7
USA	131.0

France	100.2
UK	77.8
% of private non-bank borrowers	45%

Source: Bank for International Settlements

Table 4. Maturity Distribution of Lending by BIS Reporting Banks to Selected Asian Economies, 1996 (US$ million)

	All Loans			*Under 1 Year*			*1-2 Years*		
	June 1996	*Dec. 1996*	*June 1997*	*June 1996*	*Dec. 1996*	*June 1997*	*June 1996*	*Dec. 1996*	*June 1997*
S. Korea	88,027	99,953	103,432	62,332	67,506	70,182	3,438	4,107	4,139
Thailand	69,409	70,147	69,382	47,834	45,702	45,567	4,083	4,829	4,592
Indonesia	49,306	55,523	58,726	29,587	34,248	34,661	3,473	3,589	3,541
Malaysia	20,100	22,234	28,820	9,991	11,178	16,268	834	721	615

Source: Bank of International Settlements (BIS)

From the beginning of the decade, Thailand and Malaysia sustained significant current account deficits. Over-investment of investible funds in ‘non-tradeables’ made things worse. In so far as such investments – e.g. in power generations and telecommunications – did not contribute to export earnings, they aggravated the problem of currency mismatch, with foreign borrowings invested in activities not generating foreign exchange. An additional problem of 'term mismatch’ also arose as a high proportion of these foreign borrowings were short-term in nature (Table 4), but were deployed to finance medium to long-term projects.

Foreign capital inflows into East Asia augmented the high domestic savings rate to raise the domestic investment rate as well as East Asian investments abroad in the 1990s. Thus, though there is some evidence that foreign capital inflows may have adversely affected the domestic savings rate indirectly, foreign capital inflows generally supplemented, rather than substituted for domestic savings (see Wong with Jomo 1999). It is difficult to be conclusive on this point as the nature of foreign capital inflows has changed significantly over time. Hence, even if earlier foreign capital inflows may once have adversely affected domestic savings, it is also possible that the changed composition of foreign capital inflows just before the crisis no longer adversely affected domestic savings.

Increased foreign capital inflows have also reduced foreign exchange constraints, allowing the financing of additional imports, but thus, also inadvertently encouraging current account deficits. Finally, foreign capital inflows into most certainly adversely affected factor payment outflows, export and import propensities, the terms of trade and capital flight, and thus, the balance of payments. These results suggest caution in determining the extent to which foreign capital inflows should be encouraged. Also, the Southeast Asian three’s heavy dependence on foreign direct investment in gross domestic capital formation, especially for manufacturing investments, has probably also limited the development of domestic entrepreneurship as well as many other indigenous economic capabilities by requiring greater reliance on foreign capabilities, usually associated with some types of FDI (Jomo *et al*. 1997).

After mid-1995, the Southeast Asian currency pegs to the US dollar — which had enhanced the region’s competitiveness as the dollar declined for a decade after the 1985 Plaza accord — became a growing liability as the yen began to depreciate once again. The overvalued currencies became attractive targets for speculative attacks, resulting in the futile, but costly defences of the Thai baht and Malaysian ringgit, and the rapid regional spread of herd panic termed contagion. The resulting precipitous asset price collapses — as the share and property market bubbles burst — undermined the East Asian four’s heavily exposed banking systems, for some (e.g. Malaysia), for the second time in little over a decade, undermining financial system liquidity, and causing economic recession.

Undoubtedly, international financial liberalisation succeeded in temporarily generating massive net capital inflows into East Asia, unlike many other developing and transitional economies, some of which experienced net outflows. But it also exacerbated systemic instability and reduced the scope for the developmental government interventions responsible for the region's economic miracle. In Southeast Asia, FDI domination (well above the average for developing countries) of internationally competitive manufacturing had weakened domestic industrialists, inadvertently enhancing the dominance of finance capital and its influence over economic policy making.

Table 5. East Asian Four: Debt Service and Short-term Debt, 1980-1996

	Debt Service as a Proportion of Exports (%)			*Short-term Debt (US$ billion)#*				*Current Account Deficit plus Short-term Debt as Share of International Reserves (%)**			
	1980	*1992*	*1995*	*1992*	*1994*	*1995*	*1996*	*1992*	*1994*	*1995*	*1996*
Indonesia	13.9	32.1	30.9	18.2	14.0	16.2	17.9	191	139	169	138
Malaysia	6.3	6.6	7.8	3.6	7.6	7.5	8.5	29	46	60	55
S. Korea	14.5	6.9	5.8	11.9	31.6	46.6	66.6	133	125	131	127
Thailand	18.9	14.1	10.2	14.7	29.2	41.1	44.0	101	127	152	153

Sources: UNCTAD (1997: Table 14); World Bank (1994: Tables 20, 23; 1997: Table 17).
Notes:
- year-end figures;
* - as a percentage of reserves, measured by dividing the current account deficit plus short-term debt by international reserves (1992 figures computed from World Bank data).

As noted earlier, three major indicators began to cause concern from the mid-1990s. The current account of the balance of payments and the savings-investment gap were recording large imbalances in the Southeast Asian economies, especially Thailand and Malaysia. However, as Table 5 shows, short-term foreign debt and the current account deficit as proportions of international reserves in Malaysia were better than in South Korea, Thailand and Indonesia, thereby later averting the need for IMF emergency credit. Domestic credit expansion had also soared in all four countries by the mid-1990s. Prior to the crisis, there had been a steady trend towards financial liberalisation in East Asia, dating back to the mid-1980s. This had included bank liberalisation, considerable promotion of the region's 'newly emerging' stock markets and greater capital account convertibility. Thus, East Asia succeeded in attracting a great deal of capital inflows.

Whereas the other three crisis-affected East Asian economies succeeded in attracting considerable, mainly short-term US dollar bank loans into their more bank-based financed systems, Malaysia's vulnerability was mainly due to the volatility of international portfolio capital flows into its stock market. As a consequence, the nature of Malaysia's external liabilities at the beginning of the crisis was quite different from that of the other crisis-stricken East Asian economies. A greater proportion consisted of equity, rather than debt.

Much more of the liabilities, including the debt, were private -- rather than public -- compared to foreign debt exposure in the mid-eighties. Also, compared to the other three, much more of Malaysian foreign debt in the late 1990s was long-term -- rather than short-term -- in nature. Monetary policy as well as banking supervision in Malaysia had generally been much more prudent compared to the other crisis victims. Banks in Malaysia had not been allowed to borrow heavily from abroad to lend in the domestic market, as in the other economies. Such practices involved currency and term mismatches, which increased financial system vulnerability to foreign bankers' confidence as well as pressure on the exchange rate pegs.

These differences have lent support to the claim that Malaysia was an 'innocent bystander' which fell victim to the regional contagion for being in the wrong part of the world at the wrong time. Such a view takes a benign perspective on portfolio investment inflows, and does not recognise that such inflows are even more easily reversible and volatile than bank loan inflows. The magnitude of the gross inflows and outflows reflect the much greater volatility of these flows, often obscured by focussing on net flows. However, contrary to the 'innocent bystander' hypothesis, Malaysia's experience actually suggests greater vulnerability due to greater reliance on the capital market. As a consequence, the Malaysian economy became hostage to international portfolio investor confidence. Hence, when the government leadership engaged in fiery rhetoric and market-insensitive policy initiatives that upset such investor confidence, Malaysia paid a heavy price as capital flight accelerated.

Role of the IMF

Critical consideration of the causes and consequences of the East Asian crises requires close and careful attention to the nature and implications of IMF 'rescue' programs and conditionalities, as well as policies favoured by the international as distinct from the domestic financial communities and others affected. IMF prescriptions and conventional policy-making wisdom urged bank closures, government spending cuts and higher interest rates in the wake of the crisis. Such contractionary measures transformed what had started as a currency crisis, and become a full-blown financial crisis, into a crisis of the real economy. Thus, Indonesia, Malaysia and South Korea -- that had previously enjoyed massive capital inflows in the form of short-term bank loans or portfolio investments -- went into recession during 1998, following Thailand, which went into recession in 1997.

Not only did the IMF under-estimate the severity of the collapse in all the East Asian economies, it also under-estimated the speed and strength of the recovery (IMF 1997, 1998; Lane *et al*. 1999). This suggests that the IMF not only did not understand the causes of the crises but was also incapable of designing optimal policies in response. There is still considerable doubt as to whether the IMF actually recognised the novel elements of the crisis and their implications ('old medicines for a new disease'), especially at the outset. The apparent failures of the IMF — to anticipate the current crisis in its generally glowing recent reports on the region, and also to effectively check, let alone reverse the situation despite interventions in Thailand, Indonesia and Korea — certainly did not inspire much confidence. And though the Philippines had long been under IMF programs and supervision, it was not spared the contagion.[2]

There is considerable international scepticism about the IMF's role in and prescriptions for the East Asian crisis. Most economists now agree that the early IMF programs for Thailand, Indonesia and South Korea were ill conceived, though there is little agreement over why the IMF made such mistakes. Perhaps partly out of force of habit in dealing with situations in Latin America, Africa, Eastern Europe and elsewhere, where fiscal deficits had been part of the problem, the IMF insisted on the same prescription of deflationary policies in its early policy responses to the East Asian crisis.

Thus, many of its programs were effectively contractionary in consequence, although this was sometimes disguised by poorly conceived measures to provide social safety nets for the poor. Hence, what started of as currency and financial crises, led -- partly due to IMF-recommended or imposed policy responses -- to economic recessions in much of the region in 1998. The accounts, of course, vary with the different countries involved, e.g. see Jomo 1998; *Cambridge Journal of Economics*, November 1998; Jomo 2000: chapter 1 for an account of the Malaysian experience.

2 Arguably, the Philippines currency has not taken quite as hard a hit, in part because their (colonial-inherited) banking and accounting standards are considered relatively better, but also because short-term capital inflows have been relatively lower.

The early IMF policy prescription to raise domestic interest rates[3] not only failed to stem the capital flight, but instead exacerbated the impact of the crisis, with financial pain caused by currency depreciation, stock market collapse and rising interest rates. But even if higher interest rates succeeded in doing so, such capital flight can only be temporarily checked, and even so, at great and permanent cost to productive investments in the real economy. And when inflows are eventually reversed in the precipitous manner experienced by East Asia from the second half of 1997, much collateral damage is inevitable.

Despite their sound fiscal balances before the crisis, the East Asian economies were also asked to cut government spending to restore confidence in their currencies, despite the ominous implications for economic recovery. Although all the affected East Asian economies had been running fiscal surpluses in the years before the crises (except Indonesia, which had a small deficit in 1996), the IMF expected the governments to slash public expenditure. With the possible exception of Indonesia (which could not raise the financing required), the other crisis-affected economies eventually ignored this advice and began to undertake Keynesian-style reflationary counter-cyclical measures from the second half of 1998, which have been primarily responsible for economic recovery since.

Incredibly, the Fund did not seem to be very cognisant of the subjective elements contributing to the crisis, and seemed to approach the crises as if they were solely due to macroeconomic or financial system weaknesses. Examining the changing risk premiums on Eurobonds issued by East Asia, Woo (2000b) found evidence of “irrational exuberance”, implying that the potential for investor panic also existed. Also, though the risk premiums on Thai Eurobonds increased by 10 basis points following the July 1997 devaluation, they jumped by four times as much with the acceptance of the IMF program for Thailand in August 1997. This suggests that the latter’s deflationary macroeconomic policies and abrupt closure of financial institutions had undermined -- rather than restored -- investor confidence.

Insolvent financial institutions should have been restructured in ways so as to avoid the possibility of triggering bank runs and consequent social instability. By insisting on closing down banks and other financial institutions in Thailand, Indonesia and South Korea, the IMF undermined much of the remaining confidence there, inducing further panic in the process. Anwar Nasution (2000) points out that the IMF way of taking insolvent banks out of the Indonesian financial system in late 1997 exacerbated the country’s economic crisis. He argues that the Indonesian government should have taken over the insolvent banks temporarily --rather than have them closed them down suddenly -- to sustain credit to solvent borrowers and retain depositors’ confidence. Also, while the IMF insisted on greater transparency by the affected host governments and those under their jurisdiction, it continued to operate under considerable secrecy itself.

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[3] Furman and Stiglitz (1998) have critically reviewed the relevant literature to argue against raising interest rates to protect the exchange rate. Especially where leveraging is high, as in East Asia, high interest rates will take a huge toll by weakening aggregate demand and increasing the likelihood and frequency of insolvencies. Unexpected interest rate hikes tend to weaken financial institutions, lower investments and hence, output. They offer three main reasons why keeping interest rates low while letting the exchange rate depreciate may be preferable option in the face of the trade-off involved:

- To avoid crisis, there should be greater concern about interest rate increases than exchange rate declines (Demirguc-Kunt and Detragiache 1998).
- Invoking a moral hazard argument, they suggest that any government intervention to stabilise the exchange rate is likely to encourage economic agents to take positions they would otherwise not take, later compelling the government to support the exchange rate to avoid the now larger adverse effects.
- Invoking an equity argument, they ask why borrowers, workers, firms and others adversely affected by higher interest rates, should be compelled to pay for speculators’ profits. When a government defends its currency, it is often making a one-way bet, where the expected loss is speculators’ expected gain. In contrast, if the government does not wager any reserves, the gains of some speculators are simply the losses of others” (Furman and Stiglitz 1998: footnote 132).

Such IMF double standards, also reflected by its priority in protecting the interests of foreign banks and governments, also compromised its ostensible role as an impartial agent working in the interests of the host economy. The burden of IMF programs invariably fell on the domestic financial sector and, eventually, on the public at large who have borne most of the costs of adjustment and reform. The social costs of the public policy responses have been very considerable, usually involving bail-outs of much of the financial sector and the corporate sector more generally.

There has also been considerable unhappiness in East Asia about how differently the IMF had responded to the East Asian crises compared to the earlier Mexican crisis. It is widely believed that the IMF was far more generous in helping Mexico due to US interest in ensuring that the tequila crisis not be seen as an adverse consequence of Mexico's joining the North American Free Trade Agreement (NAFTA). In contrast, East Asians saw the IMF as far less generous and also more demanding with all three countries, which had long seen themselves as US and Western allies.

Liabilities and other commitments to foreign banks have invariably been given priority by the Fund, even though both foreign and domestic banks may have been equally irresponsible or imprudent in their lending practices. As the Bank of International Settlements (1998) noted, 'In spite of growing strains in Southeast Asia, overall bank lending to Asian developing countries showed no evidence of abating in the first half of 1997' (also see Raghavan 1998). In the year from mid-1996 to mid-1997, South Korea received US$15 billion in new loans, while Indonesia received US$9 billion from the banks. Short-term lending continued to dominate, with 70 per cent of lending due within a year, while the share of lending to private non-bank borrowers rose to 45 per cent at the end of June 1997. The banks were also actively acquiring 'non-traditional assets' in the region, e.g. in higher yielding local money markets and other debt securities. Most of this lending was by Japanese and continental European banks.

Thus, Western and Japanese banks will emerge from the crisis relatively unscathed and stronger than the domestic financial sectors, which have taken the brunt of the cost of adjustment. Some merchant banks and other financial institutions will also be able to make lucrative commissions from marketing sovereign debt as the short-term private borrowings — which precipitated the crisis — are converted into longer-term government-guaranteed bonds under the terms of the IMF programmes. Hence, the IMF programmes have been seen as primarily benefiting foreign banks, rather than the East Asian economies or people.

Recovery and Reform

For the first year after the East Asian crises began in mid-1997, there was limited interest in the West with respect to growing calls from East Asia and elsewhere for reforms to the international monetary and financial systems. A Japanese government initiative from the third quarter of 1997 to set up a regional monetary facility with US$100 billion to deal with the crisis was opposed by the IMF. This opposition was endorsed by the Western powers as well as China, which was suspicious of Japanese intentions to take advantage of the crisis to secure regional leadership.

However, the situation changed dramatically a year later as the East Asian crisis seemed to be spreading West, via Russia and Brazil. In the USA, there was a scare on Wall Street after the collapse of the LTCM hedge fund, subsequently rescued thanks to an initiative of the US Federal Reserve Bank. The second half of 1998 saw much greater Western concern about the international financial system, and the possible damage its vulnerability might cause. Various government leaders began a briefly animated international discussion about the need for a new international financial architecture, leading to some initiatives to promote greater international financial stability.

Macroeconomic Recovery

As noted earlier, before the East Asian crisis, there were no clear macroeconomic warnings of imminent crisis. The countries sustained high growth with low inflation. Their public finances were sound, with both the external debt and the current account deficit manageable. Thus, East Asian government officials kept reiterating 'healthy fundamentals' up to the outbreak of the full-scale crisis. Many attempts have since been made to explain the causes and consequences of the crisis, but there has been relatively little attention to the recovery.

With the possible exception of Indonesia, largely due to its complicated political transition, the other three East Asian economies are now clearly on a path of recovery from financial crisis, with the pace of economic recovery far quicker than most early forecasts, including those by the IMF. Hence, the speed of the recovery has been as surprising as the earlier spread and deepening of the crisis (see the official IMF publications during 1997-2000). Initial IMF predictions were that growth would be stagnant for at least three to four years after the crisis (U-shaped recovery). In late 1997 and early 1998, the IMF failed to anticipate the sharp downturns of 1998. Then, once deep recession was evident, it anticipated continued recession in 1999 and very modest recovery from 2000. Instead, the Korean, Malaysian and, arguably, Thai economies have quickly recovered after sharp drops in 1998 (V-shaped recovery).

The turnaround in economic performance can mainly be attributed to Keynesian[4] macroeconomic measures. Both the Korean and Malaysian economies recovered due to reflationary macroeconomic policies. Also, among financial reform measures, the swift recapitalisation of commercial banks from mid-1998 in both Malaysia and South Korea is now acknowledged as having been crucial for their recoveries. However, a much lower share of recent Malaysian bank lending is going to productive purposes compared to the other three economies with their more bank-based financial systems. In 1999, only 19 per cent of commercial bank loans and advances went to manufacturing in Malaysia, compared to 35 per cent in Korea (in 1998), 30 per cent in Thailand and 36 per cent in Indonesia (Jomo 2001). However, the restoration of bank liquidity through such measures is not what is usually meant by the structural reforms desired by the IMF. In fact, such measures have been much criticised as likely to perpetuate, if not exacerbate the problem of moral hazard in the economy. After all, as Shin (2000) notes, 'the injection of public money is necessary to revive its financial sector whether a government is committed to reform or not.'

Interest rates were reduced drastically -- almost in defiance of IMF prescriptions -- to boost corporate recovery. The IMF's initial macroeconomic policy emphasis involved retrenchment. By insisting on sharply higher interest rates, corporate failures soared, making voluntary corporate reforms even more difficult. Figure 1 shows interest rates peaking in Thailand in September 1997, in Korea in January 1998, in Malaysia in April 1998 and in Indonesia in August 1998. Of the East Asian four, interest rates had risen least in Malaysia, by less than three percentage points. And although capital controls introduced in September 1998 succeeded in consolidating the downward trend in interest rates, Thai interest rates soon fell below the Malaysian rates from much higher levels earlier. Interest rates fell throughout the region in the second half of 1998. This was helped by changed monetary policies in the

[4] As Keynes (1973: 322-323) argued, the remedy for crisis is lowering, rather than increasing interest rates: "The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom. ... [A] rate of interest, high enough to overcome the speculative excitement, would have checked, at the same time, every kind of reasonable new investment. Thus an increase in the rate of interest...belongs to the species of remedy which cures the disease by killing the patient."

West, and it is not clear whether Malaysia's capital controls were really necessary for bringing down interest rates by the third quarter of 1998.

The depreciation of the region's currencies due to the crisis (see Table 6 and Figure 2) may also have helped corporate recovery and contributed to improved trade balances as well as foreign reserves among the four economies. Jomo (2001: Figure 2) also shows that exchange rate volatility declined significantly after mid-1998 except in Indonesia due to political instability. Jomo (2001) shows that interest rates were highest when exchange rates were lowest, indicating that all four governments responded similarly by raising interest rates in response to the contagion of spreading currency crises and falling foreign exchange rates. The self-fulfilling nature of such crises suggests that little else could be done in the face of such capital flight with open capital accounts. It is also difficult to determine how futile these initial monetary policy responses actually were.

Table 6. East Asian Four: Exchange Rates & Depreciation Against US$, 1997-2000

	Exchange Rate (monthly average)				Depreciation		
Currency	*Jan 1997*	*Jan 1998*	*July 1998*	*July 2000*	*Jan 1997 to Jan 1998*	*Jan 1997-July 1998*	*Jan 1997-July 2000*
Indonesia Rupiah	2,369	9,767	14,233	8,249	312.2%	500.7%	248.2%
Thailand Baht	25.72	53.12	41.22	39.29	106.5%	60.3%	52.8%
Malaysia Ringgit	2.491	4.363	4.151	3.800	75.2%	66.7%	52.6%
Korea Won	850.6	1,700	1,294	1119	99.9%	52.1%	31.5%

Source: Computed from *Financial Times*, Extel data

The currency depreciations generally more than compensated for the declining export prices due to global price deflation of both primary and manufactured commodities associated with international trade liberalisation. The Malaysian ringgit was fixed to the US dollar from early September 1998 in an effort originally intended to strengthen its value. Fortuitously, lower US interest rates in the aftermath of the Russian, Brazilian, LTCM and Wall Street crises of August 1998 served to strengthen other East Asian currencies, causing the ringgit to be undervalued instead from late 1998. To ensure Korean exchange rate competitiveness, the Seoul authorities intervened in the foreign exchange market to slow down the pace of won appreciation from late 1998.

As Figures 5a and 5b show, budget deficits substantially increased in 1998, especially in the second half. While government revenues were probably adversely affected by the economic slowdown, government expenditure also rose with efforts to reflate the economy from around mid-1998. Government funds went to re-capitalise financial institutions and for increased spending, especially for public works and to provide the 'social safety nets' advocated by the Fund and the Bank. The re-capitalisation of financial institutions[5] has been crucial for recovery by taking out inherited systemic risk from the banking system, thus restoring liquidity. The modest budget surpluses during the early and mid-1990s before the crisis were replaced by significant budgetary deficits to finance counter-cyclical measures. Thus, the balanced budgets of the pre-crisis period were crucial to helping overcome the

[5] For instance, the re-capitalisation of Korean commercial banks in September 1998 involved an injection of 64 trillion won. Similarly, the Malaysian effort involved over RM47 billion to take non-performing loans out of the banking system and another RM5-7 billion to re-capitalise the most distressed banks.

crisis. It should be emphasised that such Keynesian policies were not part of the IMF programs.

Without capital controls, the East Asian economies could not reverse monetary policy without further adverse effects due to international exposure. Hence, monetary policy remained cautious until mid-1998. Thus, regional macroeconomic policies could only be changed after conducive changes in the international economic environment. Interest rates could only be lowered after the G7 took concerted action to lower interest rates and increase money supply to avoid financial turmoil after the Russian crisis led to the collapse of Long Term Capital Management (LTCM) hedge fund. In other words, East Asian Keynesian policies were made possible by international responses to the fear of global financial collapse from the third quarter of 1998. Ironically, this only became possible over a year after the East Asian crisis began when it seemed to threaten the rest of the world, especially Wall Street.

Reform of Corporate Governance[6]

Many institutional arrangements in the most affected economies probably at least once contributed significantly to 'catching-up', and while many features may no longer be desirable or appropriate, corporate reform advocates usually fail to even acknowledge that they were at least once conducive to rapid accumulation and growth. This is largely due to ideological presumptions about what constitutes good corporate governance, usually inspired by what has often been termed the Anglo-American model of capitalism. From this perspective, pre-crisis economic institutions were undesirable for various reasons, especially in so far as they departed from such a model. Worse still, with minimal evidence and faulty reasoning, the 1997-98 crises in the region have been blamed on these institutions as if they were crises just waiting to happen. Not surprisingly then, from this perspective, thoroughgoing reforms should be the top priority and the pre-crisis systems need to be abandoned altogether.

The IMF pushed for radical corporate reforms claiming that corporate structure was at the root of the crisis, with some reform-minded East Asian governments agreeing. However, it is doubtful that corporate structure was a major cause of the crisis though there were some symptoms of corporate distress in all the crisis-affected economies before the crisis. First, corporate profitability was deteriorating, more rapidly in Thailand, but also elsewhere in East Asia. Second, indices of investment efficiency, such as the ICOR, were rapidly deteriorating. Some of the economies (especially Thailand and South Korea) began to experience corporate failures from early 1997.

After Thailand, South Korea and Indonesia went to the IMF for emergency credit facilities, the Fund kept emphasising microeconomic reform as central to its recovery program, especially in Thailand and South Korea (e.g. Neiss 1999; Lane *et al*. 1999). The newly elected reformist Thai and South Korean governments, led by Chuan Leekpai and Kim Dae Jung, agreed with the IMF's insistence on the urgency of comprehensive corporate reforms, although there was some dissent over the Fund's punitive macroeconomic policies. These reforms generally sought to transform existing corporate structures, regarded as having caused over-investment and other ills, in line with ostensibly 'global' Anglo-American standards. Shin (2000) describes how Korean corporate reforms sought to remould its corporate structure along more American lines.

From recent East Asian experiences, it was clearly better to first improve the macroeconomic environment and remove systemic risks in the financial system. There is no evidence whatsoever that the simultaneous attempts at radical corporate reforms helped recovery in any decisive way. The agenda for corporate reform needs to be determined after

[6] This sub-section and the next draw from Furman and Stiglitz (1998).

careful consideration of existing weaknesses, rather than by presumptions about what may be best according to some textbook, ideological or policy driven agenda. An economy's corporate structure is inevitably the consequence of evolutionary developments including cultural heritages including colonial inheritances. Most economies accommodate a diversity of corporate structures. Inappropriate arrangements would have perished unless propped up by patrons such as the state. While others may have become dysfunctional due to changing circumstances, there is no universally optimum corporate structure (Chandler 1990).

The East Asian experiences also suggest that the IMF programs were generally not conducive to corporate reforms. The programs tended to exacerbate corporate failures sharply and made corporate as well as financial adjustments more difficult. The East Asian experiences, especially those of South Korea and Malaysia, suggest that improvements in macroeconomic conditions, especially interest rate reductions and appropriate increases in government spending, were necessary to facilitate adjustments and reforms. New stock issues, asset sales and foreign capital investments, all necessary for corporate restructuring, only became possible with the more buoyant economic conditions from 1999.

It has also been argued that in all the East Asian cases, corporate reform efforts thus far have hardly succeeded in achieving their objective of correcting the structure of high debt and low profitability, but have instead imposed large costs on the economy. This view is seen as self-evident in the case of Malaysia, owing to the regime's approach, and for Indonesia owing to the political uncertainties since the crisis, but is also held to be true, albeit to lesser degrees, for Korea (Shin 2000) and Thailand (Pasuk 2000).

Enterprises anywhere that are otherwise well managed and profitable may find themselves in serious financial distress owing to developments beyond their control. During the East Asian crisis, sudden and steep currency devaluations increased firms' import costs and unhedged external liabilities denominated in foreign currencies, usually the US dollar. As these devaluations were accompanied by financial crises, limited access to emergency finance threatened the very survival of firms in the affected countries, especially small and medium-sized enterprises. Such firms face insolvency or being taken over at 'bargain basement' or 'fire sale' prices, usually by foreign interests unaffected by the crisis. For a whole variety of microeconomic reasons, such take-overs are unlikely to result in superior management. Such elimination of otherwise viable enterprises would most certainly undermine the processes of capacity and capability building deemed essential for catching-up development.

Shin (2000) argues for building a second stage catching-up system for Korea, instead of IMF and other proposed transitions on ostensibly Anglo-American lines. Other similar arguments from elsewhere in the region acknowledge that there were considerable abuses of the pre-crisis system by politically powerful rentiers, and these should, of course, be eliminated (e.g. Gomez and Jomo 1999). Nevertheless, the other crisis-affected Southeast Asian economies still need reforms to ensure more appropriate developmental regimes in line with changing circumstances and challenges. States need to develop a new range of institutions for more effective selective intervention to accelerate the development of new industrial, technological, organisational and managerial capabilities to face the various new challenges associated with accelerated globalisation in the last decade and a half.

There are also grave doubts as to whether the reforms have improved corporate resilience for the long term. Shin (2000) has argued that foreign capital returned to Korea because the economy began picking up from November 1998, after uncertainties were substantially reduced, rather than the return of foreign investment having led the recovery, as hoped for by the IMF. The recovery has been mainly driven by typically Keynesian policies, and certainly not by reforms in corporate governance.

In light of the basis for and nature of the recent recovery, the earlier and ongoing emphasis on the urgency of corporate reform was clearly ill informed and ill advised.

Corporate profitability has undoubtedly improved. But there is no clear evidence that corporate reform was key to bringing about these recoveries. In fact, it has been noted that many corporate reform measures have been intended to prevent future crises, even at the cost of short-term economic recovery. With their earlier predictions of imminent 'doom without corporate reform' not realised, those insisting on such reforms as a prerequisite for recovery have now switched to warning of a second downturn for countries like Malaysia where resistance to reform has been officially articulated.

New International Financial Architecture[7]

As noted earlier, recent trends in the IMF and the WTO after the East Asian crises began are unlikely to make prevention of future crises any easier. By keeping open the capital account and allowing freedom for trans-border movements of funds, it becomes difficult not only to have measures to prevent financial crises, but also to introduce effective financial safety nets at the national level. Past IMF consultations with various governments have been unable to prevent major financial turmoil, with the frequency of currency and financial crises increasing, rather than decreasing with financial liberalisation in the last two decades. Despite its grudging acceptance of the efficacy of capital controls in Chile, Colombia and elsewhere, the Fund has been reluctant to urge countries to control short-term inflows before a crisis occurs.

Too little attention is being paid to the policies of the developed countries, especially the major economic powers, despite their impact on exchange rates in the rest of the world, especially in developing countries. Akyuz (2000a) has noted that all emerging-market crises of the last two decades have been associated with large changes in the exchange rates of the major industrial economies. Developing countries seem generally incapable of maintaining exchange rate stability while the major currencies experience big fluctuations. Hence, currency co-ordination among the US, Europe and Japan is desperately needed for the stability of their own currencies as well as other currencies in the world today. Despite frequent G7 meetings, existing arrangements leave much to be desired. Consequently, there are fluctuations of up to 20 per cent within a week. The effects of such huge swings on smaller open economies are not well understood, though they are expected to simply adjust to such changes.

Since the East Asian crisis, the international discussion on international financial reform to prevent future crises has emphasised questions of transparency and greater supply of information. However, there is no evidence that having more information will be enough to prevent crises. Also, efforts seem to be directed mainly to getting more information from governments, especially from the developing countries, with little done to get information on the various financial markets, especially the most volatile and vulnerable ones such as those involving highly-leveraged institutions and offshore markets.

A global system of prudential controls should accommodate the existing diversity of national conditions as well as regional arrangements. However, the currently favoured approach to prudential regulation is to formulate international standards for countries to implement and enforce. In the recent past, such standards have usually been set by the Bank of International Settlements (BIS), which serves banks in the OECD economies. There are several problems with this approach (Akyuz 2000a; 2000b). First, such standards do not specifically take into account the risks associated with international lending. Currently, credit rating agencies are relied upon to fill the vacuum, but they have a tendency to be pro-cyclical, thus exacerbating -- rather than checking -- fluctuations. Second, the standards have mainly been designed to protect creditors, not debtors, and the countries they belong to. A similar

[7] This section draws heavily on Akyuz (2000a; 2000b).

level of exposure may imply different risks to different creditors as well as debtors. Third, the one-size-fits-all approach implicit in setting standards tends to gloss over important variations, thus undermining the efficacy of this approach. Although there is currently agreement that the IMF should not set standards, it is likely to be involved in policing the enforcement of such standards, which would raise similar concerns.

After the East Asian crises, there seemed to be agreement that short-term capital flows needed to be regulated. But while developing countries currently have the right to control short-term capital flows, the lack of international endorsement for such measures serves as a major deterrent for those considering their introduction.

Instead, developing countries are currently being encouraged to either fix (through a currency board system or even dollarization) or freely float their currencies, but are being discouraged from considering intermediate alternatives. However, studies have shown that a float system is associated with the same degree of volatility as a fixed system (Akyuz 2000a; 2000b), with the principal difference between the two being that of how external shocks work themselves out. It is crucial to insist that countries should be allowed to choose their own exchange rate regime, which should not be imposed as an IMF conditionality.

In managing crises, the recent East Asian experiences highlight the crucial importance of ensuring international liquidity by quickly providing foreign funds to economies experiencing crisis. Currently, such international liquidity provision is being frustrated by:

- Multilateral institutions generally do not have the necessary finances readily at their disposal. Although the IMF nominally has the requisite facilities, it lacks the required funds, which have to be raised with the approval and active support of its principal shareholders. This de facto requirement subjects the process to undue political influence, as was clear in the international financial community's changing responses to the East Asian crises as it unfolded from mid-1997.
- The IMF-imposed policy conditionalities accompanying the provision of such emergency liquidity have also been onerous. The East Asian experiences suggest that these conditionalities actually exacerbated the macroeconomic crises.
- Such funds should be used to support a currency against speculation, but instead, currencies were allowed to collapse first with the emergency funds going to pay off creditors.

Recent experiences underline the crucial importance of facilitating fair and orderly debt workouts to restructure debt payments due. Existing arrangements tend to treat debtor counties as if they are bankrupt without providing the protection and facilities of normal bankruptcy procedures[8]. With such a bankruptcy procedure, a debtor would have certain rights, including getting a temporary standstill on debt payments, continued financing for on-going operations, and orderly debt restructuring. While the IMF's Articles of Agreement allow for such temporary standstills, this has not actually occurred.

Despite the IMF's Articles of Agreement providing for a temporary standstill, in the recent South Korean case, the creditors got together and struck an agreement with the government after a private meeting, raising three problems:

- The government was thus coerced to take over responsibility for private debt.
- The creditors thus got better debt restructuring terms, whereas debtors would be more likely to get better terms in a bankruptcy court.
- The new finance went to the creditors, instead of supporting the debtor.

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[8] Henderson (1999) has argued that rather than invoke US bankruptcy procedures for private firms (Chapter 11) (see Cui 1996), the more relevant and appropriate reference point for developing country governments are the provisions for municipal authorities (Chapter 14).

Closing Remarks

The experiences of the three Southeast Asian economies of Thailand, Indonesia and Malaysian have been compared and contrasted with that of the other badly effected economy, namely South Korea. Except for Malaysia, the other three sought IMF emergency credit facilities and were thus subjected to its conditionalities. The review of macroeconomic indicators in the four economies clearly shows that despite persistent current account deficits in Thailand and Malaysia, the crises cannot be attributed to macroeconomic profligacy.

Instead, investor sentiment, herd behaviour, trans-border contagion and the reversal of short-term capital inflows were primarily responsible for the crises throughout the region. Malaysia was less vulnerable thanks to pre-crisis restrictions on foreign borrowings as well as stricter central bank regulation. However, it was more vulnerable due to the greater role of its capital market unlike the other three economies with more bank-based financial systems. IMF policy conditionalities clearly exacerbated the economic contraction in the other economies. While deflationary fiscal and monetary policies were temporarily introduced in late 1997, they were less severe and of shorter duration. Instead, as the introduction suggested, contrarian rhetoric and policy initiatives were probably far more important in exacerbating the economic decline in Malaysia. In this regard, financial market expectations also served to exacerbate the crises.

More recently, recovery in the region, especially in Korea and Malaysia, has been principally due to successful Keynesian reflationary efforts. The recovery suggests that the emphasis by the IMF and the financial media on the prior necessity of corporate governance reforms has been misguided, i.e. such reforms are not a pre-condition for economic recovery. Instead of the Anglo-American-inspired reforms proposed, reforms should create new conditions for further catching up. The last section of the chapter outlined an agenda for international financial system reform in the interests of developing countries, although reform prospects have worsened with economic recovery and the apparently receding threat of fresh crises.

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