

The Asian Crisis: The High Debt Model Versus the Wall Street-Treasury-IMF Complex

How could the widely acknowledged real estate problems of Thailand's banks in 1996 and 1997 have triggered such a far-reaching debt-and-development crisis?¹ The devaluation of the Thai baht in July 1997 was followed by currency crises or financial instability in Indonesia, Malaysia, the Philippines, Taiwan, Hong Kong, Korea, Estonia, Russia, Brazil, Australia and New Zealand. Commodity producers around the world have suffered. Yet there were few signs of impending crisis, such as rising interest rates in the G-7 countries or a sudden suspension of capital flows to developing countries after the baht devaluation. On the contrary, bank lending to Asia actually rose to a record level in the third quarter of 1997. The Japanese government's de facto credit rating agency, the Japan Center for International Finance, gave Korea one of its highest credit ratings for any developing country in June 1997. The IMF and the World Bank lavished praise upon the governments of the region through 1997, including on the Korean authorities as recently as September 1997.

What began as a debt crisis has become a fully fledged development crisis. Throughout this most successful of developing regions living standards are falling as unemployment rises and the effects of huge devaluations work through into higher import prices. Many millions of poor people are at risk, and many millions of people who were confident of middle-class status feel robbed of their lifetime savings and security. It is not a humanitarian tragedy on the scale of North Korea, but the loss of security and productivity is a tragedy nonetheless, almost as cruel as war.

Financial crises—speculative bubbles followed by collapse—have recurred throughout the history of capitalism. In the early 1980s Latin America, another fast-growing developing region, suddenly went into debt-and-development crisis and stopped rising up the world economic hierarchy. The Latin American crisis was due, according to the consensus of analysts, to the combination of bad macroeconomic policies and foreign borrowing by governments. That borrowing was wasteful and corrupt because done by *governments* rather than by private firms operating in competitive markets. But the Asian crisis has occurred in the opposite conditions. In East and Southeast Asia today most debt is *private* debt. And prior to the crisis, the macroeconomic ‘fundamentals’ looked fine. The countries in question have had low inflation, budget surpluses or only small deficits, and until recently stable or rising foreign exchange reserves. They have been growing fast. East and Southeast Asia accounted for a quarter of world output, but fully half of world growth over the 1990s and almost two-thirds of world capital spending. Firms throughout the region make products that sell in the most demanding markets—if the exchange rate is right.

There is little agreement on why the magnitude of the crisis has been so large, what can be done to get out of it, who will gain and who will lose, and what changes need to be made in international regimes to reduce the likelihood of repeats. These matters should be the subject of an international debate as important as the Bretton Woods conference at the end of the Second World War.

The New Wisdom

According to the IMF, the solution entails domestic austerity programs to restore the capacity to repay foreign debt, and radical institutional change, including further liberalization of the financial sector. Many analysts have come forward to disagree. Indeed, a new ‘conventional wisdom’ among the IMF’s critics has emerged, which goes like this:² The cri-

¹ Thanks to Paul Streeten, Martin Wolf, Adrian Wood, Peter Evans, J.D. Von Pischke, Francis Daniels, Devesh Kapur, Manfred Bienefeld, Bruce Scott, Richard Donet, Albert Fishlow, Robert Brenner, Thomas Biersteker, David Hale, David Seckler, Ronald Dore and Robert K. Merton for their comments, which do not implicate them at all in the result.

² For example, Jeffrey Sachs, ‘The Wrong Medicine for Asia’, *New York Times*, 3 November 1997; Alice Amsden and Yoon-Dae Euh, ‘Behind Korea’s Plunge’, *New York Times*, 29 November 1997, p. A39; Joseph Stiglitz, ‘How to Fix the Asian Economies’, *New York Times*, 31 October 1997; Stiglitz, ‘More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus’, The 1998 WIDER Annual Lecture, Helsinki, Finland. Stiglitz is chief economist at the World Bank. He has not concealed his disagreements with the IMF’s austerity push. ‘You don’t want to push these countries into severe

sis is a crisis of liquidity more than solvency.³ Creditors have ‘run’ on the currency and on domestic assets, leaving the borrowers unable to continue to finance their loans. It happened partly because of excessive financial deregulation, including, above all, allowing firms to borrow abroad without any government control or coordination. The crisis has then built upon itself as each lender tries to call in loans and firms try to cut operating costs and sell assets, causing unemployment to rise and asset values to crash.

‘Instead of dousing the fire, the IMF in effect screamed fire in the theatre’, says Jeffrey Sachs.⁴ Its insistence on shuttering many banks despite the absence of deposit insurance caused panicky depositors to withdraw their deposits in return for cash. Its insistence on cutting demand and liquidity has caused the bankruptcy or radical devaluation of the value of firms that were efficient and profitable, as well as those that were not. Its push for institutional liberalization in finance, corporate governance and labour markets convinced creditors that the economics were structurally unsound.

The immediate goal must be to restore confidence, which requires overcoming the collective action problem in which no lender wants to re-finance for fear that others will not. Demand and liquidity must be increased, not reduced, in order to keep firms turning over. The IMF should be concentrating its attention on organizing debt rescheduling negotiations and then in helping to erect the structure of financial regulation, especially at the border, that will help to minimize the risks of such a melt-down occurring again.

We agree with this line of argument, as far as it goes. We go further, however, arguing that the long-term damage to Asian economies of the IMF’s prescriptions is likely to be even greater than the critics have recognized. The reason has to do with a neglected dimension of the crisis—the financial structure of East and Southeast Asian economies, that differs from the kind of case the IMF usually deals with. Because of this difference, a unit of IMF ‘austerity’ and ‘financial liberalization’ will have higher costs and smaller benefits in Asia than elsewhere. The slowness of the IMF’s packages for Thailand, Indonesia and Korea to revive confidence, despite being the biggest in the organization’s history, reflects both their imposition of impossibly far-reaching institutional liberalization and their inappropriateness for Asian financial structures.

recession. One ought to focus. . . on things that caused the crisis, not on things that make it more difficult to deal with’, he is quoted in a *Wall Street Journal* story as saying. The article continues, ‘Mr Stiglitz’s critique is a departure from the usual closed-door disagreements between the two institutions... An exchange of views “Isn’t unhealthy”, says IMF Treasurer David Williams, “but we shouldn’t have closely related institutions coming out with different macroeconomic analyses”.’ (*World Bank Questions IMF Plan: Austerity in Asia may Worsen Crisis*, *Wall Street Journal*, 8 January 1998). Stiglitz’s views, however, are not the same as those of the operational part of the Bank dealing with Korea, which are closer to the IMF’s.

³ On a continuum from illiquidity to insolvency, Korea is towards the illiquidity-with-fringe-of-insolvency end, Indonesia towards the insolvency end.

⁴ Jeffrey Sachs, ‘The IMF and the Asian Flu’, *The American Prospect*, March-April 1998, pp. 16-21, citation at p. 17.

The Asian High Debt Model

In a Western, including Latin American, financial system companies normally carry an amount of debt that is no bigger than and generally less than the value of their equity capital; and banks will not, or should not according to standard prudential limits, lend to companies with higher levels of debt. In East and Southeast Asia, and especially in Japan and Korea, corporate debt/equity ratios of the bigger firms are commonly two to one or more.⁵

Why are corporate debt/equity ratios so much higher than in Western systems? First, because savings are much higher. Gross domestic savings to GDP ratios in Asia are one third of GDP or more, compared to 15-20 per cent in Western systems. The savings are done in large part by households.⁶ Households hold their savings mostly in bank deposits, bank deposits being much less risky than equities. Banks have to lend.⁷ When neither households nor government are significant net borrowers, the system is biased towards borrowing by firms. (Lending or investing abroad is only a very partial alternative, given the amount of savings to be absorbed.)⁸

⁵ Reliable comparative data on corporate debt/equity ratios are hard to find, and we are still searching.

⁶ We shall not pursue the question of why household savings are high, except to say that the reasons are not well understood.

⁷ We are puzzled by World Bank and IMF data that suggests that Korea's bank credit/ liabilities to GDP is relatively low, less than the developing East and Southeast Asian average, and are seeking further information on the figures. See for example, Stijn Claessens and Thomas Glaesner, 'Are Financial Sector Weaknesses Undermining the East Asian Miracle?', *Directions in Development*, World Bank, September 1997, figure 1.

⁸ Our argument differs in emphasis from the UNCTAD *Trade and Development Report* 1997. The report claims to find evidence that 'the exceptional savings-investment performance of East Asian economies has been due not so much to household as to corporate savings' (p. 169), and that East Asia is marked out by a high share of corporate retained earnings that are then reinvested. The report therefore downplays the process of bank intermediation from households to firms and highlights reinvestment from retained earnings. We stress, first, that the statistics on savings and profits in developing countries are especially unreliable. Companies hide profits, inflation is difficult to take account of, savings are calculated as a residual, the profits of the informal sector may be counted as household savings, and East Asian *household* savings are a function of bonus payments that are directly related to *corporate* profits. Is it remotely plausible that Peru in 1980-84 had the second highest rate of household savings of the seventeen developing countries plus Japan in the UNCTAD sample (table 44). Second, the UNCTAD data is very old, from the first half of the 1980s or earlier. Third, UNCTAD's own data suggests that in East and Southeast Asia corporate investment exceeds corporate savings by a margin that roughly corresponds to the excess of household savings over household investment (table 44), consistent with the idea of large-scale bank intermediation from households to firms. Fourth, if corporate savings are unusually high in East and Southeast Asia, as the UNCTAD report says, this is not necessarily inconsistent with unusually high corporate debt/equity ratios and unusually large bank intermediation from households to firms. High corporate savings, high bank intermediation from households to firms, and high corporate debt/equity ratios can all occur together when corporate investment (and 'animal spirits') are high. Take Japan in the 1960s where the corporate sector invested about 23 per cent of GDP while corporate savings were about 15 per cent of GDP. Corporate savings financed less than two-thirds of corporate investment, the rest being financed by household (and/or public or external savings). Compare this with the US where corporate savings (8.5 per cent of GDP) financed over 90 per cent of corporate investment (of 9 per cent of GDP). Both debt/equity leverage and corporate savings are higher in Japan. We thank UNCTAD's Yilmaz Akyuz for discussions on these issues.

Second, firms that aim to make an assault on major world industries—as especially in Japan, Korea, Taiwan—must get their hands on very large amounts of resources, which they can do only by borrowing. Neither equity markets nor corporate retained earnings are feasible alternatives for mobilizing resources on the scale required to compete in these export markets and continually upgrade.

High ratios of bank deposits and loan intermediation to GDP, and of corporate debt to equity, make the financial structure vulnerable to shocks that depress cash flows or the supply of bank or portfolio capital. The deeper the intermediation of debt (that is, the higher the ratio of bank deposits to GDP and the higher the ratio of corporate debt to equity), the more likely that any depressive shock will cause illiquidity, default, and bankruptcy. Debt-intensive strategies should be labelled, ‘This product can be harmful to your wealth’.

Such a financial structure requires cooperation between banks and firms, and considerable government support. The trick is to buffer firms’ cash flow and supply of capital against ‘systemic’ shocks, while not protecting firms from the consequences of bad judgement or malfeasance. Restrictions on the freedom of firms and banks to borrow abroad, and coordination of foreign borrowing by government, are a necessary part of this system.

Crony Capitalism?

Western commentators often dismiss the system as ‘crony capitalism’, seeing only its corruption and favouritism. They miss the financial rationale for cooperative, long-term, reciprocal relations between firms, banks and government in a system which intermediates high savings into high corporate debt/equity ratios.⁹ (They also miss the cronyism of US capitalism, generated by the electoral finance regime.)

The need for state support allows the state to influence the decisions of banks and firms in line with a national industrial strategy, by withholding support from banks and firms that operate against the strategy. The whole system can be disciplined by making investment incentives conditional on export performance or on reductions in the gap between the firm’s prices and international prices for the same products.

High household savings, plus high corporate debt/equity ratios, plus bank-firm-state collaboration, plus national industrial strategy, plus investment incentives conditional on international competitiveness, equals the ‘developmental state’.¹⁰ For all the white elephants and

⁹ Legal contracts between Korean and foreign firms engaged in infrastructure projects commonly use language that implies backing by Korean government agencies or by the Overseas Contractors Association of Korea. In practice the taking and enforcing of collateral assets is largely irrelevant; what matters is the implicit government support. Much the same applies elsewhere in East Asia.

¹⁰ See Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*, Princeton 1990; Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975*, Stanford University Press, 1982; Stephan Haggard, *Pathways from the Periphery: The Politics of Growth in the Newly Industrializing Countries*, Cornell University Press, 1990; Linda Weiss and John Hobson, *States and Economic Development*, Cambridge 1995.

corruption—inevitable when a third of national income is being intermediated—the system that allows firms to borrow multiples of their equity has yielded a quantum leap up the world hierarchy in technology and scale, and rates of improvement in living conditions that surpass virtually all other countries.

Notice the parallels with Keynesian theory, which identifies savings rates in excess of investment rates as a cause of depressions and insecurity and even higher savings rates. Keynesian theory, however, posits government deficit spending as the solution. We see in East Asia a model of private debt based on high corporate debt/equity ratios, which give rise to the need for government protection against periodic slippages that would otherwise lead to widespread bankruptcy.

The Impact of Shocks

The other side of the equation, however, is very high levels of corporate debt. It is likely that Korea's corporate debt/GDP ratio is of the order of 30 to 50 per cent higher than the corresponding ratio in the US. This represents a debt mountain that sits at the heart of the Korean problem. The mountain may be less high in other Asian countries, but it remains much higher than is normal in Western systems.

To see the dangers of debt, compare systems with low and high corporate debt/equity ratios. Low corporate debt/equity systems, as are found in Latin America and North America, are not able to invest as heavily as the others but are also less vulnerable to shocks. They can sustain a sharp rise in real interest rates for some time. Corporate gross profits before interest and taxes are more likely to be high enough relative to the higher interest charges that some degree of debt repayment out of cash flow remains possible. Therefore the tendency for real debt to grow as a result of higher real interest charges is less than when debt/equity ratios are high. If the interest rate rises to the point where the firm cannot repay any of the extra cost out of cash flow or reserves and therefore must recapitalize it (that is, add it to its stock of debt), the balance sheet still has room for a higher debt/equity ratio without threatening the firm's viability by wiping out its equity.

The risk that an interest rate above the rate of gross profit has disastrous consequences increases with the debt/equity ratio. In higher debt/equity systems firms have to use more of their gross profits on interest charges. A significant rise in interest costs may not be able to be met out of profits, in which case it has to be recapitalized into debt. But the balance sheet may not have room for more debt without threatening the firm's viability. A rise from 10 to 20 per cent lifts a debt/equity ratio of 80:20 (or 4:1) to 88:12 in the first year—if the interest due is all recapitalized and if the corporation is just breaking even at the start. Replicated across many firms, the country's overall debt to GDP ratio rises. If, in addition, the high real interest rate policy also depresses aggregate demand, it will further depress cash flow relative to interest charges, accelerating the indebtedness of the corporate sector. And all the worse if, as is true in Asia, a substantial share of the debt is foreign debt and the domestic currency is devalued, raising the fixed interest payments on the foreign debt in domestic currency.

A higher debt/equity ratio not only makes for higher borrower's risk; the lender's risk equally rises with the ratio, unless the IMF bails them out. 'Shocks and Debt' (the box at the end of this article) illustrates the contrast between high and low debt/equity systems with a simple example. It shows how a 'Latin American' firm with low debt to equity is able to survive a devaluation, interest rate hike and austerity programme much more easily than an 'Asian' high debt to equity firm.

The Crisis of 1997-98

What made for the high-growth performance of Asian systems in the past has led to or at least amplified the present crisis. Over the 1990s Western and Japanese banks and investment houses lent heavily to Asian companies. They assumed, contrary to all historical knowledge about growth rates, that fast growth (four times the OECD average) would continue, and consequently that exchange rates would remain stable.¹¹ They also each ignored their own prudential limits on lending to companies with high debt/equity ratios, because everyone else was ignoring the limits and they each wanted to win business. International bankers have a powerful incentive to follow the herd, because the banker who does not make money where others are making it risks being seen as incompetent but does not suffer by making losses when everyone else is making losses too.

Meanwhile, Asian governments undertook radical financial deregulation, encouraged by the IMF, the OECD, and by Western governments, banks and firms. They removed or loosened controls on companies' foreign borrowings, abandoned coordination of borrowings and investments, and failed to strengthen bank supervision. By doing so, they violated one of the stability conditions of the Asian high debt model, helping to set the crisis in train.¹² It is particularly puzzling that the Korean government acted in this way, counter to the whole thrust of Korean development policy for decades past. Anecdotal evidence suggests that key people were bribed by Japanese and Western financial institutions. Bribery aside, the government placed great emphasis on joining the OECD, and the OECD made financial openness a condition of membership. As part of the same set of reforms, the government abolished the Economic Planning Board, the main body for making eco-

¹¹ There were, indeed, serious internal obstacles to the continued fast growth and industrial and service sector upgrading of the South East Asian economies. The economies have continued to engage in the world industrial economy largely as sub-contractors, largely for Japanese firms. They have experienced relatively little technology spill-over from the export-oriented sub-contractors to the rest of the economy, so much so that their industrialization has been characterized as 'technology-less', in the sense that even adaptive technology continues to come from abroad. Shortages of skilled people have grown 'from a crisis to a critical emergency', according to a Thai analyst. Thailand's gross enrolment ratio at secondary school level languished at only 37 per cent in 1992, less than half of Taiwan's in 1978 when Taiwan had the same per capita income as Thailand in 1992. In Malaysia, too, the skills shortage has become so acute that some prominent foreign companies long operating in the country have moved production elsewhere, mainly to China and Indonesia. Throughout the region infrastructure is chronically congested, attested to by electricity blackouts, traffic paralysis and the rising cost of water. In short, serious problems in the 'real' economy have been building up, even if they are problems of success. But the calamity unleashed on the region is hugely disproportional to the severity of the problems in the real economy.

¹² See Wade, *Governing the Markets*, p. 367.

nomic strategy since the early 1960s, making the Finance Ministry the economic supremo. In Thailand the central bank undertook capital liberalization just as it and its regulatory agencies were being overwhelmed with other complex issues and political strife.

Domestic corporate borrowers discovered that they could borrow abroad half as cheaply as they could at home. Foreign debt escalated, most of it private and short-term—maturing in twelve months or less. In Korea, foreign debt incurred by its banks and the companies that borrowed from them exploded from very little in the early 1990s to roughly \$160 billion by late 1997.

China's devaluations of 1990 and 1994, together with its lower inflation and faster productivity growth, made the yuan the most undervalued major currency in the world, worsening the export competitiveness of other East and Southeast Asian economies. The US dollar appreciated against the yen after 1995—the result of an agreement between the US Treasury and the Japanese Finance Ministry to help Japan export its way out of trouble and use the resulting surpluses to buy US Treasury bills, thereby allowing US interest rates to be kept at politically desirable levels and assisting the re-election of President Clinton.¹³ This worsened the East and Southeast Asian economies' competitiveness still further, because their own currencies were pegged to the dollar and rose with it. Thailand in 1996 experienced zero growth of exports, the slowest rate of growth of GDP in a decade, and a ballooning current account deficit. The Thai stock market lost a fifth of its value in the first nine months of 1996, and growth of direct foreign investment fell sharply. In Korea, manufacturing production started to fall in 1996, the current account went strongly negative in the same year, and industrial bankruptcies occurred.

When, later, foreign lenders began to worry about currency falls, they 'discovered' their heavy exposure to companies with debt/equity ratios far above their prudential limits. More exactly, they discovered the possibility that others might make a similar 'discovery', the aggregation of which would precipitate falls in the exchange rate—multiplying the loan burden and the risks of default. Hence they have tried in every way to call in their loans and not make new ones. The Japanese banks that lent heavily to firms in East and Southeast Asia have been especially anxious to call in these loans as their domestic position deteriorated with the falls in the stock market and the yen.

This is why the run has been so surprisingly big. International banks have slashed credit lines to all borrowers, including the export-oriented firms that should be benefitting from currency depreciation. Even the big Korean chaebol, with world-wide brand names, are finding it difficult to get even *trade* credit—letters of credit to cover the import of inputs into export production. In Latin America during the 1980s, where companies had much lower debt/equity ratios, foreign lenders found that *companies* continued to meet their test of prudence, even if

¹³ Klaus Engelen, 'How Bill Clinton Really Won', *The European*, 14-20 November 1996; and Chalmers Johnson, 'Cold War Economics Melt Asia', *The Nation*, 23 February 1998, pp. 16-19.

countries did not. Latin American companies therefore did not suffer such a withdrawal of bank credit, though the Latin American countries were far less credit-worthy. As of this time of writing, the IMF, the United Nations and other international forecasters continue to chase the whole world economy downhill, at least for 1998.¹⁴

The IMF to the Rescue?

The IMF is designed to provide bridging finance while a country gets its balance of payments in order. IMF programmes normally seek to reduce current account deficits, keep inflation in check, and keep domestic demand constrained. Such objectives are set out in the opening lines of the IMF stand-by agreement with South Korea, dated December 5, 1997:¹⁵

1. Objectives The program is intended to narrow the external current account deficit to below 1 per cent of GDP in 1998 and 1999, contain inflation at or below 5 per cent, and—hoping for an early return to confidence—limit the deceleration in real GDP growth to about 3 per cent in 1998, followed by a recovery toward potential in 1999.

From this point on the IMF programme for Korea goes well beyond standard IMF programmes, calling for structural and institutional reform, even though they are not needed to resolve the current crisis. It requires major financial restructuring to make the financial system operate like a Western one, though without actually saying so. It includes closing down or recapitalizing troubled financial institutions; letting foreign financial institutions freely buy up domestic ones; requiring banks to

¹⁴ Every step in our argument should be treated as hypothesis in need of testing, especially against regional variation. The high debt-developmental state model applies more in East than in South East Asia; within the latter, it applies more to Malaysia than to Thailand, and least to Indonesia. In the current crisis, some countries have suffered more of a financial shock than others, and the same sized shock has caused a bigger deterioration in economic performance in some than in others. Our argument emphasizes the debt/equity ratio as an important factor in both the size of the shock and the effect on economic performance. But the effect on performance is also function of the degree of latent social conflict in the society and the robustness of institutions for conflict management, among other things. Taiwan has been relatively little affected, its currency falling only about 13 per cent in the latter part of 1997 and 20 per cent between the start of 1997 and early 1998, while growth has remained fairly steady at 6 per cent and inflation around 1 per cent. Why? Taiwan has towering foreign exchange reserves, and a very low ratio of short term foreign bank debt to foreign exchange reserves; it has moved counter-cyclically, its property and stock market bubble bursting in the early 1990s and most of the consequences for bank balance sheets having been absorbed by 1997; it has lower savings debt/equity ratio. It is also linguistically and ethnically relatively homogenous, with relatively robust institutions for conflict management. Singapore and Hong Kong provide more regional variation, though we find it hard to treat these city states as equivalent to nation states, as so much of their dynamics comes from their role as regional hubs. Chile is an interesting comparison outside the region: it saves at near East Asian rates (29 per cent of GDP in 1995), its corporate debt/equity ratios are close to 'Western' norms, it has discouraged surges of capital inflows by in effect taxing them, and it has enjoyed fast growth over the past decade. It has been affected by Asian contagion through trade, with pressure on the exchange rate and the current account due to falls in exports and copper prices, but has experienced little financial instability.

¹⁵ The IMF requirements are summarized in 'Republic of Korea: IMF Stand-by Arrangement: Summary of the Economic Program, December 5, 1997'.

follow Western ('Basle') prudential standards; requiring 'international' (read 'Western') accounting standards to be followed and international accounting firms to be used for the auditing of financial institutions. It requires the government to undertake not to intervene in the lending decisions of commercial banks, and to eliminate all government-directed lending; and to give up measures to assist individual corporations avoid bankruptcy, including subsidized credit and tax privileges.

The Fund also requires wider opening of Korea's capital account, to enable even freer inflow and outflow of capital. All restrictions on foreign borrowings by corporations are to be eliminated. The trade regime, too, will be further liberalized, to remove trade-related subsidies and restrictive import licensing. Labour market institutions and legislation will be reformed 'to facilitate redeployment of labour'.

The IMF programs for the other Asian cases differ from case to case, but they also push for capital account opening and financial sector deregulation, as well as high real interest rates and other measures to restrict domestic demand.

Conflicting Objectives

In terms of the first set of objectives—to remove the current account deficits and achieve macro-economic balance—we are already seeing, at current heavily depreciated exchange rates, big trade *surpluses* from several Asian countries. Korea ran a giant current account surplus of \$3.7 billion dollars in December 1997, equivalent to something like 15 per cent of Korean GDP when annualized at the post-devaluation exchange rate of 1,600 won to the US dollar. Thailand ran a current account surplus for the last several months of 1997. So did Malaysia. So far the surplus is due more to falls in imports than to rises in exports. But the majority of imports are capital goods and industrial materials and fuel rather than consumer goods, and their cutback hurts exports. Only truly heroic improvements in the trade balance could garner enough foreign exchange to cover interest payments falling due in the next several years.

The difficulties of doing so are compounded by the costs associated with the Fund's second set of objectives, those to do with liberalizing the financial sector both domestically and externally. Movement in this direction will face very large 'transitional' costs; and in any case, even if a 'Western' look-alike system is established it would not be stable given the high flow of savings. It would also sacrifice the developmental advantages of a high debt system.

The transitional difficulties relate to the implications of the existing debt. Before Western prudential limits can be viable, before the financial system can be made to work like a Western one, the debt mountain must be brought down. The IMF seems not to have thought through the consequences of doing this.

Historically, debt mountains have been reduced in one of four market-based ways. The first is through inflation: the debt is vaporized by means of a domestic inflation that causes real interest rates to turn *negative*. The

second is bankruptcy: existing creditors lose some of the value of their assets as the debt is written down, the new creditors reorganize the assets and (hopefully) make the company viable again at the lower level of debt. The third is repayment of the debt out of cash flow. The fourth is by debt-to-equity swaps. The government can also absorb the debt and finance its repayment out of taxation. But this is not a market-based response.

All of these have social costs, but some more than others. A country that goes along the bankruptcy route will suffer major social disruption and loss of output while ‘resources’ (including people) are reallocated. The principal lenders are banks, which are always highly leveraged—have high debt/equity. When banks write down the debt of the companies to whom they have lent, they lower their own asset base, and jeopardize their own ability to meet their principal and interest payment obligations on deposits. They may have to stop refinancing sound companies that then become insolvent, in turn transmitting insolvency pressures to their customers and suppliers. Asset prices may begin to collapse as foreclosing creditors sell at firesale prices, causing further problems for holders of existing assets who see their value knocked down. Fears of bank deposit failures increase the demand for currency relative to bank deposits. The banking system may undergo a multiple contraction of deposits and loans. Layoffs proliferate. Consumers cut back. The disinflationary impetus is reinforced.

The bankruptcy route has been an integral part of all great depressions. Irving Fisher observed that the central propagating mechanism of the Great Depression of the 1930s was the rising real value of dollar liabilities—a rising real interest rate. As the price level fell, the real value of the principal of the debt rose. Firms found themselves facing higher and higher levels of indebtedness and repayment obligations, and banks called their loans and refused to lend. The resulting bankruptcies deepened and propagated the deflationary dynamic just described.

The repayment-out-of-cash flow route is likely to be protracted—if the existing levels of debt and interest rates are not too high for it to be workable from the start. As firms use most of their return on assets to repay principal and interest, their investment falls. This route is associated with prolonged stagnation. It takes many years to pay down the debt to the point where Western prudential standards can be met. Japan has tried to follow this route during the 1990s. We can see its costs in the very slow growth of the Japanese economy since the stock market and property market bubbles burst in 1990.

The inflation route also has social costs, but historically the costs have tended to be lower than those associated with the others. Provided the inflation is kept at 40 per cent or less the social costs are small.¹⁶ This approach requires the price level to be rising fast enough to make real

¹⁶ See for example Michael Bruno and William Easterly, ‘Inflation Crises and Long-Run Growth’, *Journal of Monetary Economics*, February 1998. They put the threshold above which countries fall into a high inflation/low growth trap at between 30 and 50 per cent per year. Below the threshold, the social costs can be fairly easily mitigated by means of indexing.

interest rates low or negative, and it requires a semi-closed capital account in order to check capital flight.

The IMF prescriptions preclude the inflation route. They call for *high* real interest rates—in order not only to curb demand but also to encourage a reversal of the capital outflow. And they emphatically call for the capital account to be opened wide.

The Second Opium War

Debt-to-equity swaps were used to help reduce the Latin American debt crisis of the 1980s. In the Asian context, where debt to equity ratios are much higher, it is not clear that they could be used on a scale sufficient to make a big difference. In any case, given the lack of equity resources now held by post-crisis Asian nationals, a significant reduction of debt by this method implies massive foreign ownership positions in Asian firms and banks. Vast swathes of the corporate sector would end up in foreign hands. Already we are seeing Japanese and American companies jumping from minority to majority owners of Southeast Asian firms in return for a writing down of the debt. And debt-to-equity swaps aside, the devaluations enable foreign companies to pick up Asian companies at fire-sale prices—or in the current Korean phrase, ‘IMF cold wave prices’. We are already seeing a political backlash against the sudden jump in foreign ownership. Korean and Southeast Asian editorialists have started to write about ‘The Second Opium War’ and US/IMF imperialism.

If the debt claims were swapped for equity claims held by domestic banks, the banks would end up as huge equity holders, something that banks are not supposed to be. If the debt claims were transferred to the state, and the state in return acquired a voting interest in the company, this would amount to nationalization—not something the IMF or the US Treasury wish to encourage. Morgan Bank has suggested government guarantees for private foreign borrowing, in the hope that this would allow foreign lenders to resume lending to highly indebted firms on the grounds that the guarantee makes the debt look like sovereign debt. But the debt mountain would remain.

If the IMF prescriptions for reshaping Asian financial systems into something more like the Western model require, as a condition of viability, a running down of corporate debt, and if the inflation route is ruled out, then the social costs are likely to be huge and long-lasting—especially because of the sheer amount of corporate debt relative to GDP that has to be shrunk to Western levels. Inflation is the only way to reduce such a debt mountain without years of stagnation, nationalist backlash, or chaos.

The Fund’s much higher real interest rates will tip many high debt/equity firms into bankruptcy—and the resulting financial instability and unrest may cause net capital *outflow* instead of the inflow that the Fund expects. Meeting Western standards for the adequacy of banks’ capital requires a rapid fall in banks’ debt/equity ratios, and a sharp cut in their lending, causing more company bankruptcies. Opening up the financial sector to foreign banks will result in a large-scale take-over, because after the bankruptcies and liquidations foreign banks and

companies will be the only ones with the capital for recapitalizing the domestic ones. But foreign banks may not lend to high debt/equity local companies, and may not participate in the kind of alliances between government, the banks, and companies that a high debt/equity financial structure requires. If Citibank buys up Korean banks and applies its normal prudential limits (by which lending to a company with a debt/equity ratio of 1:1 is getting risky), it will not lend to Daewoo with a debt/equity ratio of 5:1. The amount of restructuring of Daewoo before its debt/equity ratio comes close to 1:1 is hard to imagine.

It seems particularly unwise for the IMF to insist that companies receive even more freedom than before to borrow on international capital markets on their own account, without government coordination, when it was their uncoordinated borrowing that set up the crisis in the first place. This will make the country more, not less, vulnerable to capital flight.

In short, the IMF approach is likely to generate large social costs long before there is any significant amount of debt reduction, all because of a short-term and unforeseeable run by mobile capital. It aims to dismantle the high debt system, its developmental advantages notwithstanding. And it wants to see a Western-type financial system in its place that can only work with a huge reduction in levels of corporate debt. The Fund has not properly weighed the economic and social costs of such actions. Eventually Asian economies will start to grow again, for their ‘fundamentals’ are strong—but by then their fundamentals will not be as strong. There will be an inner source of instability created by the attempt to integrate the massive flow of household deposit savings with a financial structure based on Western norms of prudent debt/equity ratios. And by then they will have a rather different pattern of ownership, with foreign firms and banks—in particular, US firms and banks—having much more control than before and receiving much more of the profits. They will have given up the developmental advantages of a high debt system based on government-bank-firm collaboration in return for somewhat lower risks of financial crashes.

Once the crisis is passed, some renegeing on IMF agreements may occur. But by that time foreign banks and other financial institutions may be well established, making the high debt/equity system difficult to rebuild.

An Alternative Path

The high savings of Asian households impart a bias towards high levels of corporate debt. Household saving rates may come down over the next several decades. But saving rates much higher than in the West are likely to be a feature of these economies for many years to come, and the current crisis will only intensify households’ wish to save.

Households’ risk aversion precludes transfer of more than a small part of the savings through equity markets. Equity markets will of course develop over time as the infrastructure for a well-working stock market is gradually built up. But even in the most highly developed equity markets only a few percentage points of GDP or less are transferred. In the

United States, where the equity market is a celebrated national institution, net savings transferred to the corporate sector through the equity channel have averaged less than 1 per cent of GDP, and have often been negative over the past decade. Such small flows may be meaningful in a country like the US where household savings are only 4 per cent of GDP, but are trivial where household savings are more like 12 per cent of GDP. Moreover the current crisis has caused huge losses for most of the Asian households that have recently begun to participate in national stock markets. This makes it all the more likely that sizeable development of equity markets is a dead issue in Asia for another decade at least. The Japanese experience is cautionary. Since the crash of 1990, over 90 per cent of the mutual fund holdings accumulated over the 1980s have been redeemed.

If Asia continues to save at anything close to current levels, there is an inescapable problem of how to invest the savings productively. It is a fine irony, since Asia's high savings have been instrumental in its fast growth and the envy of the rest of the world.

We argue that high savings and high corporate debt yield powerful advantages in terms of national development. The high levels of debt can be sustained under normal conditions provided that banks and firms have mutual understandings about the refinancing of the debt, and provided the government supports them. This in turn requires, above all, closing or semi-closing the capital account, so that mobile capital cannot go freely in and out.¹⁷ In such high saving societies, foreign savings are not needed; it is already difficult enough to allocate domestic savings to efficient investments at the margin. These arrangements may stop well short of a developmental state on the model of Japan, Korea and Taiwan, but they are well along in that direction, and far from the IMF's model of a desirable financial system.

To resolve the crisis, inflation is the least costly way to reduce debt. Real interest rates have to be kept negative or at least very low, which would also reduce the pressure for bankruptcies and financial instability more generally. Household savers have been content with the low rates they have been getting, so there is no reason to raise the rate above the level of inflation. The government would let the exchange rate float, removing the impetus to raise interest rates in order to keep the currency stable. The IMF assumes that low real interest rates will lead to net capital flight and greater refinancing difficulties. It is not obvious that *high* real interest rates will not have an even worse effect on capital flight, because of the magnitude of bankruptcies and financial instability caused by high rates in the context of high debt/equity ratios. At the least, the trade-off has to be raised as an issue, as the IMF, reading from the script prepared for low debt/equity situations, has not.

¹⁷ Jagdish Bhagwati, professor of economics at Columbia University, agrees. '[Capital markets] are very volatile. Suddenly expectations can turn around. You may be very healthy but sudden you can catch pneumonia. And then you may have to do unspeakable things to your economy just to regain that confidence because you are now hooked into the system. Markets may do something when you've done nothing wrong and you may have to do something wrong in order to convince the markets that you are doing something right! I would put off [capital account convertibility] for quite a while' (interview in *Times of India*, 31 December 1997).

The government should push weak banks to merge with strong domestic ones. It should use its own strong balance sheet to support existing banks, not close them down or let them be bought by foreign banks. Many of these banks are insolvent only by Western standards and under transitory crisis conditions, not according to the rules of the developmental state in conditions of reasonably fast growth.¹⁸

Hence the government should step in to reintroduce controls on capital movements, to create credit in order to cover the extra costs of foreign debt incurred by the devaluation—injecting equity into banks, directly buying loans from foreign creditors, and so on—thereby setting off a controlled inflation which will spread the ultimate costs among the whole population of savers and the consumers of imports.

The Advantages of Bankruptcy

Why should not Korea, for one, not just declare a debt moratorium and set about exporting its way out of trouble, using internal financing drawn from its high domestic savings? The vast increase in the servicing and repayment costs of foreign loans due to the devaluation is a national disaster, the costs of which should be borne collectively. Let belts be tightened, to the extent of refusing any new reliance on external finance. In any case it would not take long for a Korea to be able to borrow again. The government might even put aside its anxiety to remain in the good books of the OECD and focus more on the *region* for a change, taking the lead in bringing in China and in organizing a debtors' cartel with Thailand and Suharto's successor in Indonesia to bargain for better terms from the Fund and Western banks. After all, default is perfectly consistent with certain American values. Personal bankruptcies in the US rose last year from \$30 billion to \$40 billion. One can find in any newspaper advertisements reading 'Personal bankruptcy may be a way out of your problems, call now: 212-BANKRUPT'.

The Japanese government, which for a time seemed to be moving towards the IMF approach—particularly in allowing the bankruptcy of even large banks and security houses—appears now to be changing course. The vice minister for international finance emphasized on national television recently that, 'We should make clear to the public that we will not allow banks to fail. We should not let securities companies of considerable size fail either. The United States and the United Kingdom have not done it either. This is the global standard.'¹⁹ He went on to say that it is up to politicians and bureaucrats to save the banks from failing and it is up to banks to prevent companies from failing. The Ministry of Finance has announced a \$98 billion fund for bailing out the

¹⁸ Our argument needs to be tested against answers to the following questions: would a low real interest rate hinder a rise in the exchange rate? What would be the impact on firms of continuing to carry the higher principal of foreign debt? Would the costs of more bankruptcies among firms with large dollar debts exceed the costs of the more extensive bankruptcies caused by high real interest rates that hurt all domestic companies? How much would the low real interest rate discourage personal savings? Could domestic demand be sustained by fiscal stimulus (a government deficit) coupled with relatively high real interest rates?

¹⁹ Eisuke Sakakibara, quoted by Reuters, 28 December 1997.

Japanese financial sector. With this fund the government will inject capital into the banks, which are now paralyzed as they try to meet Western capital adequacy standards in the face of declining asset values. The government may also use the fund to boost the stock market, which will raise asset values. It is dramatically expanding the monetary base, to increase economic growth and corporate returns to assets as well as to generate an inflationary reduction in debt. It may also ask financial institutions to buy domestic bonds, and perhaps to sell some foreign bonds. One hopes it will become active in creating an organization of the most affected countries to coordinate their bargaining strategies, and involve China.

Capital Opening and the Wall Street-Treasury-IMF Complex

Why is the Fund saying what it is saying? It has gone far beyond its traditional concern with balance-of-payments adjustments partly because it had already crossed the line in dealing with the former Soviet Union and Eastern Europe, and legitimized its expanded agenda in that context. Those countries needed advice about the creation of basic market institutions, and the Fund was able to get its advice accepted because it brought vital financial rewards. In its next great intervention, in Asia, the Fund has continued to operate over this much wider jurisdiction, seeking to impose on Thailand, Indonesia and Korea institutional free-market reforms as comprehensive as those imposed on Russia—even though such reforms in the Asian case are not necessary to restart the flow of funds.²⁰

The legitimizing precedents of the former Soviet Union and eastern Europe is one thing. But the deeper answer involves the interests of the owners and managers of international capital. The reforms sought by the Fund are connected in one way or another with further opening up Asian economies to international capital. Why is the Fund insisting on capital account opening in countries that are awash with domestic savings? Why has the Fund done so little by way of organizing debt *rescheduling* negotiations, preferring to administer bail out funds *in return for structural and institutional reforms*? James Tobin, the Novel laureate in economics, observes that, ‘South Koreans and other Asian countries—like Mexico in 1994–95—are . . . victims of a flawed international exchange rate system that, under US leadership, *gives the mobility of capital priority over all other considerations*.’²¹ Jagdish Bhagwati, professor of economics at Columbia University and champion of free trade, takes the argument further. Asked why the IMF was seeking to open financial markets everywhere he replied,

Wall Street has become a very powerful influence in terms of seeking markets everywhere. Morgan Stanley and all these gigantic firms want to be able to get into other markets and essentially see capital account convertibility as what will enable them to operate everywhere. Just like in the old days there was this ‘military-industrial complex’, nowadays there is a Wall St.-Treasury complex’ because Secretaries of State like Rubin come from Wall Street. . . So today,

²⁰ Martin Feldstein, ‘Refocusing the IMF’, *Foreign Affairs*, March/April 1998, pp. 20–33.

²¹ James Tobin, ‘Why We Need Sand in the Market’s Gears’, *Washington Post*, 21 December 1997.

Wall Street views are very dominant in terms of the kind of world you want to see. They want the ability to take capital in and out freely. It also ties in to the IMF's own desires, which is to act as a lender of last resort. They see themselves as the apex body which will manage this whole system. So the IMF finally gets a role for itself, which is underpinned by maintaining complete freedom on the capital account.

Bhagwati goes on to observe that many countries have grown well without capital account convertibility, including China today and Japan and Western Europe earlier. 'In my judgement it is a lot of ideological humbug to say that without free portfolio capital mobility, somehow the world cannot function and growth rates will collapse.'²²

What Bhagwati calls the 'Wall St-Treasury complex' has helped over the past year to push the process of amending the IMF's articles of agreement to require member governments to remove capital controls and adopt full capital account convertibility.²³ The extended Wall St-Treasury-IMF complex has likewise worked to promote the World Trade organization's agreement on liberalizing financial services being hammered out in 1996-97. Many developing country governments, including prominently several Asian ones, opposed the WTO's efforts to liberalize financial services. In response, 'Executives of groups including Barclays, Germany's Dresdner Bank, Société Générale of France and Chubb Insurance, Citicorp, and Ford Financial Services of the US... agreed discreetly to impress on finance ministers around the world the benefits of a WTO deal'.²⁴ Then came the financial crisis that ricocheted around the region from one country to another. By December 1997 the Asian leaders agreed to drop their objections, and on 12 December, more than seventy countries signed the agreement that commits them to open banking, insurance and securities markets to foreign firms. By then the Asian holdouts—including Thailand and Malaysia—saw no choice: either they signed or their receipt of IMF bail-out funds would be complicated. Meanwhile the OECD has been pushing ahead quickly with the negotiation of the Multilateral Agreement on Investment, that liberalizes all direct foreign investment restrictions, requiring signatory governments to grant equal treatment to foreign as to domestic companies. It will preclude many of the policies of the developmental state.

The Winners

These events—the revision of the IMF's articles of agreement, the WTO's financial services agreement, and the OECD's Multilateral Agreement on Investment—are the expression of a Big Push from international organizations, backed by governments and corporations in the rich countries, to institute a world-wide regime of capital mobility that allows easy

²² Interview in *Times of India*, 31 December 1997.

²³ The process of modifying the articles of agreement to require countries to adopt capital account convertibility has been under way for about a year. At the Hong Kong Annual Meetings of the Fund and Bank in September 1997, the Interim Committee agreed in principle that the Fund should adopt an aggressive policy to encourage countries to institute full convertibility.

²⁴ Guy de Jonquières, 'Vision of a Global Market: WTO Members are Hoping to Deregulate Financial Services', *The Financial Times*, 10 April, 1997, p. 28.

entry and exit everywhere. If the agreements are ratified and enforced, they will ratchet up the power and legitimacy of the owners and managers of capital in the world at large. Yet, for all their implications for sovereignty, democracy, and social stability, they are being negotiated with scarcely any public debate. They have been protected from public concern partly because the champions of the wider movement towards free capital movement and lifting of government regulations have managed to harness to their cause the most self-justifying of slogans, 'stopping corruption'. Capital freedom, we are invited to believe, checks corruption (Asia's 'crony capitalism'), and is therefore self-evidently a good thing. The next step will be an international agreement to deregulate labour markets, intended to make them more 'flexible' while stopping short of open migration. This would further consolidate the global governance of capital.

There is always a fine line to be trod between an interest-based theory and a conspiracy theory—for all that everyone accepts the former and hardly anyone accepts the latter. It is difficult to know to what extent and at what point some events in the Asian crisis were deliberately encouraged by those who stood to gain from the sudden loss of resources by Asian governments and from the opportunities to gain control of Asian companies at knock-down prices. Certainly the role of the US Treasury in stiffening the IMF's insistence on radical financial opening in Korea is documented. The Treasury made it clear that Korean financial opening was a condition of US contributions to the bail-out, on the understanding that financial opening would benefit US firms that would in turn give political support for US contributions.²⁵

Financial crises have always caused transfers of ownership and power to those who keep their own assets intact and who are in a position to create credit, and the Asian crisis is no exception. Whatever their degree of intentionality and their methods of concerting strategy, there is no doubt that Western and Japanese corporations are the big winners. The transfer to foreign owners has begun in a spirit of euphoria captured in the remark of the head of a UK-based investment bank, 'If something was worth \$1 billion yesterday, and now it's only worth \$50m, it's quite exciting'.²⁶ The combination of massive devaluations, IMF-pushed financial liberalization, and IMF-facilitated recovery may even precipitate the biggest peacetime transfer of assets from domestic to foreign owners in the past fifty years anywhere in the world, dwarfing the transfers from domestic to US owners that occurred Latin America in the 1980s or in

²⁵ See Paul Blustein and Clay Chandler, 'Behind the S. Korean Bailout: Speed, Stealth, Consensus', *The Washington Post*, 28 December 1998, p. 1. The US Treasury likewise managed to bury Japan's attempt at long-promised but never delivered international leadership, in the form of a summer 1997 proposal to create an Asia fund with which to redeem some of their fellow Asians' debts. Not wanting the Japanese to send their capital to Asia rather than to the US, and not wanting Japan to emerge as the Asian bail-out leader, the Treasury (Deputy Secretary Lawrence Summers, most emphatically) insisted that the cleanup be entrusted to the IMF. The Japanese agreed to desist in a November 1997 meeting in Manila. See Johnson, 'Cold War Economics Melt Asia'.

²⁶ Clay Harris and John Riddings, 'Asia Provides Golden Buying Opportunities', *Financial Times*, 26 February 1998, p. 16. See also 'South Korea: Bargains Galore', *The Economist*, 7 February 1998, pp. 67-8.

Mexico after 1994. One recalls the statement attributed to Andrew Mellon, 'In a depression, assets return to their rightful owners'.

The crisis has also been good for the multilateral economic institutions, including the IMF, the World Bank, and the WTO. The ability of the IMF and the Bank to provide refinancing and to link refinancing to governmental acceptance of WTO rules gives all three organizations leverage with which to cajole Asian governments to reshape their domestic economies in line with Western models. For them the crisis is a short-run blessing not even in disguise. But both they and the incoming foreign firms may eventually suffer from the mounting political backlash. As Henry Kissinger recently warned, 'Even [Asian] friends whom I respect for their moderate views argue that Asia is confronting an American campaign to stifle Asian competition'. 'It is critical that at the end of this crisis', he went on to say, 'when Asia will re-emerge as a dynamic part of the world, America be perceived as a friend that gave constructive advice and assistance in the common interest, not as a bully determined to impose bitter social and economic medicine to serve largely American interests'.²⁷

How long will it be before the affected countries regain 1996 levels of output and wealth? Korea escaped the debt trap of the early 1980s in a couple of years, unlike the Latin American countries, partly because it was able to resume fast export growth. But it was able to do so partly because the Latin Americans were out of the market. Today, every Asian country is seeking to export its way out of trouble at the same time. How long the crisis lasts depends partly on how successful they are, which depends on the growth of the Japanese, US and European markets and their access to them. It also depends on the extent to which international lenders co-operate among themselves and the borrowers to reschedule the loans. This in turn depends on whether the IMF concentrates on helping them to co-operate, and softens its demand for fundamental restructuring. If Asia resumes fast growth within the next two years and if in the meantime the US goes into recession as the stock market and currency bubbles burst, we may again look to Asian models, as in the 1980s, for lessons on how to improve the parlous performance of American capitalism.

Restricting the Free Movement of Capital

The great lesson of the Asian crisis is that the desirability of free movements of short-term capital has to be put in question. We have tended to lump together trade liberalization with capital liberalization, and discuss them as though what applies to one also applies, more or less, to the other. Bhagwati's point is their effects are fundamentally different. He argues for trade liberalization without capital account liberalization. Significantly, Martin Wolf of the *Financial Times* largely agrees. The question that arises from the Asian crisis, he says

is what to do about capital account liberalization, which the IMF is strongly promoting in all its programmes . . . The evidence now

²⁷ Henry Kissinger, 'The Asian Collapse: One Fix does not Fit all Economies', *The Washington Post*, 9 February 1998, Op-Ed, p. A19.

seems clear that any substantial net draft on foreign savings creates huge risks . . . almost any large-scale international borrowing, even by non-banks, threatens economic stability if it becomes big enough to threaten the currency . . . At the least, there is an overwhelming case for permanent prudential regulation of foreign borrowing, particularly short-term borrowing, by commercial banks . . . Unregulated flows of short-term international capital are a licence to rack up losses at the expense of taxpayers,²⁸

And a senior economic advisor at the World Bank, Pieter Bottelier, argues that 'The world needs to understand more fully what the consequences are of unlimited international freedom of capital movements between countries that have vastly unequal levels of economic development and vastly different standards for monitoring their financial systems.' He raises the question of whether to equip the World Bank and the IMF with better monitoring tools or perhaps even the power to impose sanctions to protect the system.²⁹ When influential voices at the World Bank and the *Financial Times*, joined by academic champions of free trade, begin to question the benefits of capital opening, the idea of a new Bretton Woods conference is not quite as far-fetched as at first it seems.

In the end we come back to the mysteries of finance and financiers. In good times we tend to think of them as being like engine oil, necessary to make the engine work but neither part of the engine nor its fuel. The analogy is misleading, however, because the structures of financial intermediation are as much part of the 'engine' as the stocks of human resources, capital, technology and organizations. The contrast between the development performance of Latin America and East and Southeast Asia shows how some financial structures can help the economy to grow faster than others. The contrast in their debt crises shows how the same Asian high-performance financial structures can respond to shocks in ways that make the economy not just grind to a halt, but go haywire. As the Cambridge economist A.C. Pigou said with the Great Depression in mind, finance, far from being merely 'the garment draped around the body of economic life', can take on the appearance of 'an active and evil genius'.³⁰ For just this reason John Maynard Keynes famously proposed, 'Ideas, knowledge, art, hospitality, travel—these are things which should of their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible; and above all, let finance be primarily national.'³¹ But we now have in place a powerful phalanx of international organizations and multinational corporations devoted to maximizing the freedom of financial capital around the world. The question is what institutional muscle can be brought to bear by those convinced that such untrammelled freedom is even more dangerous for human welfare today than it has been in the past.

²⁸ Martin Wolf, 'Caging the Bankers' *The Financial Times*, 20 January 1998.

²⁹ Pieter Bottelier, speaking at World Bank conference on the Asian financial crisis, cited by Reuters, Paris, 2 February 1998.

³⁰ A.C. Pigou, *The Veil of Money*, London 1949.

³¹ John Maynard Keynes, *Collected Writings of John Maynard Keynes*, vol. xxi [1933]: *Activities 1931-39*, edited by Donald Moggeridge, London 1982, p. 237