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GOVERNING THE MARKET: A DECADE LATER

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This Spanish edition of *Governing the Market* goes to press less than two years after most of east Asia experienced a crash that has been even more devastating to people's living standards and sense of security than the Latin America crash of the 1980s.[1] The destruction of what could have remained viable economic activity puts the Asian slump in the same league as the Great Depression of the 1930s. The tragedy is caught in the case of a bicycle rickshaw driver in Indonesia, who found himself, as people began to save money by walking, having to make a choice between continuing to meet the downpayments on the rickshaw or buying painkilling medicines for his mother dying of cancer in his own house.[2] Many millions of households which had been enjoying enough income to meet calorific requirements, buy health care and invest in their children's education have fallen below that level. Some estimates suggest that in Indonesia, Korea and Thailand around 50 million out of their combined population of over 300 million had fallen back below the nationally-defined poverty line between mid 1997 and mid 1998. Many millions more who were confident of middle class status feel robbed of their lifetime savings and security. Public expenditures of all kinds have been cut, creating "social deficits" that match the economic and financial ones. Nature is being pillaged as people hit by calamity fall back on forests, land, and sea to survive.[3]

In terms of real GDP, Indonesia shrank 17 percent in the year to the third quarter of 1998, Thailand 11 percent, Malaysia 9 percent, and Korea between 7 and 8 percent. As of March 1999, however, the mood in western financial markets says that "the Asian crisis is over". Currencies have stabilized, interest rates have fallen, the risk premia on Asian bonds have dropped to near the levels last seen before the crisis erupted in July 1997, and output and demand may at last be bottoming out. But even if growth does resume in 1999, the destruction of wealth and the disruption of lives will be felt for years to come.

Right up to the eve of the crisis in July 1997 these were the "miracle" economies, whose future growth looked to be one of the certainties of our age. They had had an extraordinarily long record of fast expansion. None of the four main crisis-afflicted countries (Korea, Thailand, Malaysia, Indonesia) had had a year of significantly less than 5 percent real GDP growth for over a decade by 1996--in Korea, not since 1980, in Thailand, not since 1972. [4]

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[1] I am grateful to Fernando Clavijo and Rolando Cordera for help in bringing the Spanish edition to fruition.

[2] The case of the Indonesian rickshaw driver is described in the four *New York Times* articles about the crisis, February 15 to 18, 1999. These articles provide a good non-technical overview. In Java the minimum legal daily wage could purchase 6.3 kilograms of rice in January 1997, and only 2.6 kilograms in June 1998. See ILO/UNDP, *Employment Challenges of the Indonesian Economic Crisis,* 1998.

[3] Little systematic information is available on the social and environmental impacts. See Eddy Lee, *The Asian Financial Crisis: The Challenge for Social Policy*, ILO, Geneva, 1998.

[4] My remarks about the Asian crisis are elaborated in "From 'miracle' to 'cronyism': explaining the Great Asian Slump", *Cambridge Journal of* Economics, 22 (6), 1998; and *The Great Asian Crash,* forthcoming 1999.

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The miracles then became the beneficiaries of the biggest financial bailouts in history. The IMF mounted refinancing efforts to the tune of $110 billion, nearly three times Mexico's $40 billion package of 1994-5--the biggest in the IMF's history to that date. Yet the investor pullout continued through 1997 and 1998, the panic feeding upon itself. The fact that the collapse continued in the face of the biggest bailouts in history suggests that something is seriously wrong with the IMF's bailout strategy, a matter of concern to countries elsewhere which may find themselves needing IMF emergency funding in future.

The contractionary wave has hit many other middle income and low income countries beyond Asia, particularly through falls in the price and quantity of commodity exports, like grains, cocoa, tea, minerals, and oil. Russia's renewed financial crisis and default in August 1998 triggered more contractionary shockwaves. Even countries which had followed "model" free market policy prescriptions (such as Mexico) were hurt as investors sold domestic currency for US dollars in fear that *any* "emerging market" could be the next Russia or Indonesia. Latin America in 1998 came perilously close to repeating the East Asian disaster.

Yet through all this Taiwan sailed free—or almost. Charts 1 and 2 illustrate how little Taiwan has been affected compared to all the others, using changes in the exchange rate, in the stock market, and in GDP. A simpler index is "taxi waiting time". The traveller hopping across the region notices that taxis in Taipei are as busy as ever, while everywhere else they wait in long lines to pick up a ride. It is a buyer's market. Moreover, Taipei has a smart new fleet of shiny yellow taxis which put those of New York City or Washington DC to shame. They are emblematic of a city that is at last beginning to look like the capital of an affluent nation.

* * * *

This sets two questions. Why did most of the "emerging market" economies of east Asia go into crisis? And why did Taiwan escape? We can approach these questions indirectly by going back to the more general argument about the Asian model set out in *Governing the Market* . In the years since it was published the argument has been criticised on the grounds that "There is no Asian model". A Japanese-Korean model, yes, but not a northeast Asian model, say the critics, and still less an Asian model. But similarities and differences are relative. Countries of northeast and southeast Asia share enough features to make a simple picture tolerably accurate (excluding whale-sized China and minnow-sized Hong Kong).[5]

Above all, they save alot compared to western countries, and the savings are done mostly by households. Domestic savings run at a third or more of GDP, over twice the US rate, more than 15 percentage points of GDP higher. Households typically put most of their savings into (low-risk) banks rather than into (higher-risk) equities. Corporate investment is financed in large part by loans from banks.

[5] The following account of the Asian model draws on Wade and Frank Veneroso, "Two views on Asia: The resources lie within", *The Economist*, November 7-13th, 1998, p.19-21. Also "The Asian crisis: the high debt model versus the Wall Street-Treasury-IMF complex", *New Left Review* 228, March/April 1998.

This mechanism of financial intermediation has enabled extraordinarily high rates of investment. In America, by contrast, most household savings go to finance households' own investment in housing and in equities, and most corporate investment in real productive fixed capital is financed by depreciation funds and retained profits, with less reliance on bank debt.

High levels of corporate debt must be buffered by long-term financial relations between firms and banks, with the government standing ready to support both firms and banks in the event of shocks that impact swathes of the economy at once (such as sharp rises in interest rates, or sharp falls in demand). *If long-term relations between banks and firms did not exist, such shocks would prompt creditors to call their loans and liquidate firms; and where debt levels are high, the failure of some firms propagates the failure of others much faster than where debt levels are low.* This is the financial rationale for what used to be called Asian "alliance capitalism", and has now come to be maligned as "crony capitalism". It is also the rationale of the "convoy" system of Japan, where strong companies support weak ones under various kinds of government encouragement.

In some Asian countries, more household savings have been transferred to the enterprise sector through equity markets. Singapore and Malaysia have specialized institutions, such as pension and provident funds financed partly by payroll taxes, which purchase large quantities of equities. In Taiwan both government- and party-directed funds buy equities. However, these are all forms of government-sponsored forced investment regimes. They share with the debt transfer systems long-term relationships between government, finance, and industry.

In a pure Anglo-American free market regime, competition and short-term profit maximizing would cause high debt structures to become unstable in the face of shocks that interfere with debt service payments. Creditors seeking to safeguard their assets would call in loans and liquidate firms. Bank depositors would "run" on banks that might be too exposed to defaults. This collective behavior would cause the whole financial system to shrink, triggering price deflations and even depressions. To avoid these outcomes Anglo-American nations long ago agreed that the state had to create a lender of last resort and a body of regulation that placed limits on the indebtedness of private banks, firms and households. In the absence of Asia's long-term relations these limits of prudent indebtedness were set far below the levels permitted in Asian alliance capitalism.

Asian governments have also been able to use this structure to formulate and carry through an industrial upgrading strategy. The ability to influence the supply of credit to firms and affect their cash flow and profits by other instruments like tax incentives and protection has allowed them to coordinate investments and advance the frontiers of technical capabilities in national firms. Even in Thailand and Indonesia the governments have done this to a degree.[6]

[6] Michael Rock, "Thai industrial policy: how irrelevant was it to export success?", *Journal of International Development*, 7 (5), 745-57, 1995; "Reassessing the effectiveness of industrial policy in Indonesia: can the neoliberals be wrong?", September 1998, *World Development*, forthcoming.

Alliance capitalism sounds like an invitation to corruption and insider dealing, resulting in excessive loans and inefficient investments. The crisis has shown the truth in this allegation, most conspicuously in Indonesia. But there is a larger truth. Until the mid 1990s Asian alliance capitalism generated the highest sustained economic growth rate for any region in world history. It worked not only as a "catch up" strategy for countries far from the world technological frontier, but also for Japan as it reached the frontier in the 1980s. To describe it as "a free-market veneer over a state-managed economic structure", which has "inevitably led to the investment excesses and errors to which all similar endeavors seem prone", in the words of senior officials at the US Federal Reserve, misses the point.

But there was one (almost) necessary condition for the system to work: a partially- and strategically-closed capital account. I spelled out this condition in chapter 11 of this book. The passage begins, "Finally, the government must maintain a cleavage between the domestic economy and the international economy with respect to financial flows. Without control of these flows, with firms free to borrow as they wish on international capital markets and with foreign banks free to make domestic loans according to their own criteria, the government's own control over the money supply and cost of capital to domestic borrowers is weakened, as is its ability to guide sectoral allocation." In other words, high levels of debt, which can be a source of strength (by enabling higher levels of investment), can also be a source of vulnerability if the government gives up managing the economy's external liabilities and coordinating investment.

* * * *

Asian governments--pushed by investment bankers, commercial bankers, the International Monetary Fund, the World Bank, the US Treasury, the GATT/WTO, and the OECD (in the case of Korea), and pulled by segments of their policy elites--opened their economies to financial capital flows in the 1990s.[7] The timing was deeply unfortunate. At just this time western financial markets experienced a large surge of excess liquidity, which ushered in another episode when speculating dominates investing, or when "forecasting the psychology of the market" dominates "forecasting the prospective yield of assets over their whole life", in Keynes' words. With rapidly growing volumes of funds at their disposal institutional money managers became ever more focused on short-term trading, and energized their governments and multilateral organizations to give priority to promoting free capital mobility in "emerging markets". And Wall Street investment houses, like Goldman Sachs, wanted to enter Asia in order to

[7] For the Korean case see for example *Korea-United States Cooperation in the New World Order*, (eds.) C. Fred Bergsten and Il SaKong, Institute for International Economics, Washington DC, 1996, especially the essay on the US Congressional agenda by Representative Doug Bereuter ("Now that the Cold War is over, we can and should demand an end to the unfair treatment for the American side in this bilateral relationship").

do the privatizations, securities placements, mergers and acquisitions that were becoming their main growth area.

Asian governments obliged by opening the capital account, and global banks and portfolio investors seeking high short-term returns or fee and commission income flooded in. Not only were growth prospects much better than anywhere else in the world; interest differentials between the major industrial economies and Asian economies were also large, permitting huge and safe profits on lending across the national borders. All the more so because Asian currencies were more or less fixed to the US dollar and everyone assumed the exchange rates would hold—and therefore ignored exchange rate risk, underpricing foreign capital. It was a buyer's market. Money managers fell over each other in hotel lobbies as they rushed to find people willing to take their money. Japanese banks were especially active as Japanese households' high savings continued to flow into bank deposits while the Japanese economy, burdened by overinvestment and overindebtedness caused by the asset bubble of the 1980s, stagnated.

After 1995 the rise of the US dollar and the depreciation of the Japanese yen and the Chinese yuan led to a loss of export competitiveness in Asian economies whose currencies were effectively pegged to the US dollar. The capital inflows exacerbated the real appreciation of the exchange rates. The appreciation raised input prices relative to output prices, squeezing profits and hurting export growth. The Japanese recession reduced export profits. In consequence of these external "shocks" Thailand and Malaysia developed large and out-of-character current account deficits (but not Indonesia).

As manufacturing came under pressure more and more investment, domestic and foreign, went into the property market and the stock market. Asset bubbles began in Thailand, Malaysia and Indonesia, and the fringe of bad industrial investments grew. The increasing inflow of foreign capital—mainly bank loans and portfolio capital rather than foreign direct investment-- went disproportionately into essentially unproductive activities with a large speculative element.[8]

Undoubtedly the external shocks and the domestic bubbles raised the objective probability of debt servicing difficulties. Yet foreign funds continued to pour in (making a clear demonstration of market failure). The ratio of short-term debt to foreign exchange reserves rose in Korea from 160 percent in mid 1994 to 210 percent in mid 1997; in Thailand it rose in the same period from 100 percent to 150 percent; in Indonesia it remained constant at 170 percent. In all of the larger Latin American economies the ratio was below 100 percent, except for Argentina (around 120-130 percent).

These figures show that investment portfolios were *not* divested gradually as the probability of debt servicing difficulties rose; nor did any of the forecasting or ratings agencies indicate serious trouble ahead. We can infer that the changes in "fundamentals" were not big enough to be a sufficient cause of the crisis. Rather, the crisis was in large

[8] For a good account of the crisis which stresses the role of property speculation see Jeffrey Henderson, "Uneven crises: institutional foundations of east Asian economic turmoil", processed, Manchester Business School, University of Manchester.

part self-generated within financial markets, the result of the "endogenous" instabilities of international financial markets in a bubble phase impacting on a fragile, debt-intensive domestic financial structure. What had been a stampede to get in became, after the Thai devaluation of early July 1997, a stampede to get out.

Western banks and portfolio investors had been providing funds to Asian firms with debt ratios and long-term alliance relationships that would have been unacceptable in the West. When the crisis hit, the violence of the outflow across the whole region owed much to the realization that much of the funds should not have been committed in the first place, according to western prudential standards. Hence exchange rates fell and kept falling, even in the face of high real interest rates. Capital then became much too expensive. It became a seller's market. Even big name firms could not get even trade credit, as all creditors tried to pull in their credit lines. The whole supply chain imploded.

Where were governments in all of this? Afterall, private agents were taking on foreign exchange obligations that posed a systemic risk, and it has been a responsibility of governments since the beginning of governments to stop private agents from acting in ways that cause systemic risks. It is beyond question that had governments acted to stop the property bubble and stop the build-up of short-term foreign debt—to maintain a short-term foreign debt to foreign exchange ratio of less than 120 percent, for example—the crisis would have been both less likely and less severe. But governments in southeast Asia, both on their own and as a result of their association with Overseas Chinese business interests, had strongly vested interests in the property market, in which it is possible for well-placed individuals and companies to make very high short-run returns. Manufacturing, on the other hand, tends to be dominated by foreign firms from Japan, the US, and more recently Taiwan and Korea. Governments therefore had little interest in developing the regulatory mechanisms for diverting investment into productive activities in manufacturing and services, where returns tend to be long term. And their lack of material interest was legitimized by the "Washington Consensus" that market liberalization is the key to prosperity for all. Hence they liberalized capital inflows and paid little attention to the build up of foreign debt, believing that because it was private-to-private market competitition would keep it within safe limits.

Korea did not have a property bubble. But it did have an industrial capacity bubble, as middle-ranking conglomerates (*chaebol*) competed against each other to expand by enough to enter into the top ranking. The conglomerates wanted free access to cheaper foreign capital. By the early 1990s the government—an elected civilian government for the first time—removed restrictions on the conglomerates' access to foreign finance (some of which flowed back to government officials under the table). Most of the finance was subject to short-term payback clauses, but invested in long-term projects. Some conglomerates developed debt to equity ratios of more than 20 to 1. Three conglomerates defaulted on their debts in the first half of 1997. When southeast Asia began collapsing in the second half of 1997 the combination of conglomerate difficulties and southeast Asian devaluations triggered a panic among creditors and a struggle to recover debts, leading to a collapse of the won in late 1997. The Korean story, then, shares with the southeast Asian story the failure of government to regulate foreign borrowing and to divert investment from unproductive uses. It differs from the southeast Asian story in that the bubble occurred in industry rather than property; and that the Korean government dismantled a previously effective developmental state during the 1990s, whereas the southeast Asian countries always had a much lower level of state capacity for investment coordination and financial regulation.

In short, the severity of the Asia crisis and its timing (the fact that it took place in 1997 and not, say, 1993), can be explained in terms of the conjunction of (a) pre-existing domestic financial fragility, (b) growing excess liquidity in the major industrial countries over the 1990s, in the hands of money managers caring little about long-run fundamentals and seeking high *short-term* returns wherever they could find them, (c) opening the capital account over the first half of the 1990s, and (d) a surge of momentum-driven private-to-private capital inflows into Asia that were largely unregulated by governments. This line of argument suggests that financial deregulation and unstrategic opening of the capital account was a decisive factor in the built-up to crisis and in the intensity of the subsequent slump. If so, those who pushed for it without constraining their push by the capacity of the financial regulatory apparatus on the ground—Wall Street investment banks, the US Treasury, the IMF, and segments of domestic policy elites--were grossly irresponsible.

The International Monetary Fund's "rescue" interventions made things worse. Having praised the governments' economic management up to shortly before the onset of the crisis in July 1997, the Fund then panicked as much as the investors, its panic compounding their pullout. The Fund immediately called for the closure of insolvent finance companies and banks without seeming to worry about how uninusured depositors were to be treated, which triggered bank runs; and it identified fundamental structural problems which had to be fixed before growth could resume, sending a message to investors that the economies were basically unsound.

Based largely on the Fund's experience in Latin America it imposed on Thailand, Indonesia and Korea a prescription of high real interest rates and fiscal restriction. In Latin America fiscal deficits have tended to be large and inflation chronic. Currency devaluations set off hair-trigger inflationary expectations. The cure, quite plausibly, was IMF-style austerity. High real interest rates could be tolerated because corporate debt/equity ratios were quite low, because inflation kept eroding the real burden of the debt.

In Asia, the Fund failed to see the danger of fiscal restriction where budgets had long been roughly in balance. And it failed to see the danger of high real interest rates in economies with high levels of private indebtedness and low inflationary expectations. Here, high real interest rates have disastrously deflationary consequences, which prompt capital outflows regardless of the attractions of high interest rates.

Further, the Fund attempted to strengthen weakened Asian financial structures by imposing western measures of financial restructuring. Basle rules of capital adequacy ratios were to be applied. Highly indebted banks and firms were to be closed. Labor laws were to be changed to make it easier to fire workers, facilitating the closures. Regulations on foreign ownership were to be lifted in order to allow foreign banks and firms to buy domestic banks and firms, injecting needed capital and skills.

Somewhat similar measures were applied in a much narrower setting to solve the American savings and loan crisis in the late 1980s and early 1990s, and they worked. But it is one thing to undertake such reforms where real interest rates are very low and indebtedness not high (as in the US in the late 1980s), and another thing to undertake them where both real interest rates and indebtedness are high. In these conditions such restructuring leads to closures and layoffs, with deflationary knock-on effects and more investor pullout. In short, the Fund's initial insistence on fiscal contraction, cuts in aggregate demand, and large-scale institutional reform accelerated debt deflation dynamics by cutting profits and the capacity to service debt.

This is why the IMF's strategy for Asia has not worked. The currencies did stop falling in early 1998. But by May the deepening economic contraction, the rising unemployment and the fear of social unrest combined to produce a second wave of capital outflows and renewed falls in currencies and stock markets.

The second quarter resumption of the collapse is what finally forced Asian governments to begin to turn away from the initial IMF strategy. They began to bring down interest rates and turn fiscal restriction into fiscal expansion. Malaysia--which had not been under a formal IMF program but had been following the IMF recipe (and seen a contraction of credit growth from 30 percent in 1997 to minus five percent in 1998, reflecting a massive pullback of bank loans)-- slapped on exchange controls in September 1998, the better to engineer an expansion at home without risking further currency falls. Six months later *The Economist* described the controls as having done "short-term wonders" in assisting recovery.[9] Korea has used government funds to buy out bad loans and finance bank mergers to the tune of more than 20 percent of GDP, and has installed new bank managers with a mandate to *lend*. Behind a veil of laissez faire pronouncements (made with an eye on the WTO and OECD audiences) the government is intervening massively to restructure the large firms. Japan is seriously discussing nationalizing some of the banks so as to break out of its current trap, in which the attempt to maintain Basle standards of capital adequacy while bank equity falls prevents the needed expansion of credit. Japan is also discussing the reintroduction of exchange controls to allow rapid monetary expansion without depreciating the yen (which might destabilize other currencies in the region and make trade frictions worse); and managed exchange rates between the yen, the US dollar and the euro. Governing the market, though not described as such, is back in legitimate discussion in Asia.

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Taiwan has escaped relatively lightly for several reasons. Some reflect policy choices. First, the government has long maintained famously large foreign exchange

[9] "Asian economies: ready for more?", *The Economist*, February 13, 1999, p.70.

reserves, the biggest in the world in per capita terms. This reflects less some abstract principle of prudent economic management than the presence of China only 150 kilometers across the straights. China's number one foreign policy objective is to get Taiwan back under its control. The Taiwan government wants the reserves as a buffer against disruptions from which China could profit.

Second, and for the same reason of limiting the economy's vulnerability to external shocks, the government has maintained control over the inflows and outflows of financial capital. Taiwan did not follow Korea's radical and unstrategic integration into world financial markets in the 1990s. For example, privately-owned commercial banks--including new ones allowed to be created since the late 1980s, bringing the total to 17 by 1993—have a reserve requirement (compulsory deposits at the central bank) of 24 percent, very high by international standards. And the government has a large role in appointing the top-most managers of the bigger "private" commercial banks.

More basically, Taiwan had by the mid 1990s developed a less financially fragile economic structure than the others. It had a substantially higher per capita income ($13,000 in 1996, compared to Korea's $10,500, Malaysia's $4,600, Thailand's $2,900).[10] It saved a sedate quarter of GDP, compared to over a third in the others; and its gross investment was less than its gross savings, again in contrast to the others. It therefore had less need to borrow abroad. This plus its capital controls help explain why its ratio of short-term debt to foreign exchange reserves was so much less than the others, a modest 20 percent in the mid 1990s.

Furthermore, Taiwan now has somewhat lower corporate debt/equity ratios than some of the other Asian countries, notably Korea. (Taiwan's own statistics claim a ratio of less than 100 percent, compared to 150 percent in the US and 200 percent or higher in Japan, Thailand and Korea. But Taiwan statistical officials readily admit the figure is biased downwards.) The lower debt/equity ratio in turn meant that its financial system was less vulnerable to shocks, because companies can experience bigger increases in interest rates, bigger devaluations, or bigger reductions in cash flow and still have enough to meet their debt repayments.

Taiwan's industrial and service exports are more diversified than Korea's, and less concentrated in the big, capital-intensive commodity manufactures like steel, petrochemicals, ships and memory chips that are prone to cycles of excess capacity world-wide.

Finally, its population is more homogeneous, linguistically and culturally, and its institutions for conflict management are more robust, compared to some of the other Asian countries. The effect on economic performance of a given external shock is therefore likely to be less than in countries that have more latent social conflict and less robust institutions of governance—Indonesia most strikingly.

[10] *Taiwan Statistical Data Book 1998,* Council for Economic Planning and Development, Republic of China, 1998.

Then there are a number of more contingent factors, such as the fact that Taiwan had its own stock market and property bubble in the late 1980s and early 1990s. [11] The Taiwan Stock Exchange Index, having taken 25 years to rise above 1,000, in late 1986, rose like a rocket to reach over 12,500 by early 1990. Teachers stopped teaching, government officials stopped administering, taxi drivers stopped driving, housewives abandoned their children—to sit in smoke-filled brokerage houses lined with flashing screens, playing the stock market in the belief that everyone could become rich. The average price-to-earnings ratio reached 100 by late 1989, roughly double the average in Japan, whose stock market was then near the peak of its own overvaluation. Taiwan's overvaluation was in a class by itself. Then the market fell and kept falling, bottoming out at 2,500 in October 1990. The 80 percent fall matches the Dow Jones Industrial average's fall of 89 percent between the 1929 peak and the 1933 trough. It did not have the same contractionary effect, however, because relatively few companies were then listed (so the impact of the fall on overall investment was not great) and because stock purchases were made out of savings, not out of borrowed money.

The relevance of all this to Taiwan's later experience is that by 1997, the damage to the banking system of the stock market and property market crash had largely been worked through. The banks' balance sheets were in good shape, thanks partly to an intensification of bank oversight and regulation instituted after the crash (by authorities who were well aware of how financial instability had undermined the KMT government on the mainland before 1949).[12] In short, Taiwan moved counter-cyclically relative to the other economies and had tighter financial regulation and oversight.

The Ministry of Finance has put together a large emergency fund to deal with bank or stock market crises, and keeps emphasizing that it is ready to deal with any emergencies. These declarations, however, attract criticism from many in the policy elite who—believing in Chicago-esque free market economics as a matter of faith—do not think the government has any business to "intervene" in market forces. "What about moral hazard?", they cry. (Moral hazard is a term from the economics of insurance, referring to the proposition that insurance reduces the incentives for prudence.) So when in December 1998 a medium-sized private bank went bankrupt, the much vaunted Ministry of Finance emergency fund did *not* become involved. Rather, the bank was quickly taken over by the Party Enterprise Committee of the KMT (the ruling political party). The Party Enterprise Committee is technically an independent holding organization, so the deal can be presented as *private*. A very characteristic Taiwanese fudge.

Again, when the Taiwanese dollar came under intense speculative attack in the middle of 1998, especially in August after the Russian default and devaluation, the government stepped in to intensify existing controls.[13] The offshore market in New

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[11] See the rollicking account in Steven Champion, *The Great Taiwan Bubble: The Rise and Fall of an Emerging Stock Market*, Pacific View Press, Berkeley, California, 1998.

[12] I have not seen serious research on how exactly Taiwan recovered from this terrible boom and crash.

[13] Robert Wade and Frank Veneroso, "The gathering world slump and the battle over capital controls", *New Left Review*, 231, September/October 1998.

Taiwan dollars was closed. The central bank shut down trade in futures instruments which had been used to pressure the local currency, and required that all foreign capital inflows destined for the stock market be subject to central bank approval. Western bankers and investors were no happier with this intervention in market forces than they had been when the Hong Kong Monetary Authority did much same, nor were the free marketeers in Taiwan's policy elite.

These free marketeers are especially strong within the Council for Economic Planning and Development, which is often at loggerheads with the financially more cautious central bank and finance ministry. The council, allied to the External Trade Bureau of the Ministry of Economic Affairs (that has now grown to eclipse the Industrial Development Bureau), has its eyes on joining the WTO before China becomes a member and tries to block Taiwan's application. Whatever the other advantages of opening the capital account, says the council, Taiwan has to open up in order to enter the WTO before China. For the moment the central bank and the finance ministry appear to have the upper hand. But if the American stock market crashes from its current dizzying heights capital may rush back into Asia, and Taiwan's restrictions will come under great pressure.

Certainly the role of the government in governing the market has been under intense challenge from domestic elites over the past decade. But the larger point is that, for all the challenges, the Taiwanese government continues to be intensely involved in technology acquisition and in driving the small and medium enterprises to upgrade their products and processes, and in mediating the integration with the international economy. Much of the regulation and the assistance is now camouflaged to make the economy look WTO-compatible, and much of the policy work is done away from the traditional industrial policy agencies, which look to have been either eviscerated or captured by free marketeers. The difference with Korea is that the Korean government really had been dismantling state capacity to govern the market during the 1990s. This difference, I argue, is important in understanding why Korea collapsed and Taiwan did not. Post crisis, the Korean government seems to have reasserted Korean dirigisme in the restructuring of the conglomerates, while it appears to be moving ahead with full-scale financial liberalization even beyond what the IMF wanted; but Korean liberalizations should never be taken at face value, and it remains to be seen what covert financial controls remain in place.

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Governing the Market was finished in the late 1980s, as Taiwan switched from a one-party state to a competitive electoral democracy. In the intervening decade, a vigorous democracy has taken root. The political repression that I describe in this book—including censorship of the print media, and prison sentences for political dissidents--has gone. Genuine opposition parties exist and have won substantial power. Indeed, in the early years after the switch to democracy the KMT (which had ruled since the government came to Taiwan in 1949 and for decades on the mainland before then), looked like it might fall apart. An opposition party, the DPP (Democratic Progressive Party), identifying itself as pro-native Taiwanese, pro-independence from China, and anti-KMT-corruption, won many elective posts. The other real opposition party, the New Party, comprised people, mainly "mainlanders" and children of mainlanders, who used to be KMT supporters but who felt that the KMT had become too beholden to the native Taiwanese majority; it did not win so many seats but it did become a real thorn in the side of the KMT.

In the most recent "national" elections of December 1998, however, with both the DPP and the New Party wracked with internal dissension, the KMT did much better than in several previous elections.[14] It secured a large majority in the parliament (Legislative Yuan), having previously governed with a thin majority; and it recovered the key elected office of mayor of Taipei. In the end, decades of KMT organization and resource-mobilization right down to the grass roots paid off. For all the institutionalization of democratic institutions, Taiwan's politics remain determined less by issues or ideologies than by the appeal of individual candidates. The appeal of KMT candidates is greatly enhanced by their ability—thanks to *party* resources--to pay for votes ("pay for transport to the polling station" is the way it is legitimized), also to send high party or government officials to funerals, weddings and birthdays of potential supporters, and to use the vast and still Leninistically-shaped KMT organization to get out the vote.

And the KMT under (native Taiwanese) President Lee Teng-hui has taken other steps to win support among the native Taiwanese majority. Of great importance—far beyond the position of the KMT—is the constitutional amendment of 1997 to "freeze" the province of Taiwan. For many years after 1949 about the only thing that the Chinese Communist party-government on the mainland and the KMT party-government on Taiwan agreed about was that Taiwan was a province of China—they disagreed which of them was the rightful ruler of the whole of China. To uphold this fiction Taiwan maintained a structure of government with a "national" government nominally responsible for the whole of China but in practice only for Taiwan, as well as a "provincial" government with many powers and agencies that paralleled, overlapped, and fought with the "national" counterparts, and then lower level county and city governments. After democratization in the late 1980s all levels of government were made elective, including the post of Governor of Taiwan. The constitutional amendment of 1997, however, "froze" the province by reducing the provincial government to a set of empty boxes, with no more functions than an eyebrow. But the boxes do still exist, filled by appointed and do-nothing officials. The structure must be kept intact to satisfy China, which has made it clear that the abolition of the provincial government would be construed as a step on the way to a declaration of "Taiwan independence"—a declaration which would be met with an armed invasion. The frozen status of the provincial government is another typically Taiwanese compromise of form but not of substance. All reforms that might affect the island's constitutional position vis-a-vis China are being done very carefully, very slowly, very skillfully, making maximum use of smoke, mirrors, shadows, and dummies, on a time scale that brings to mind Chou En- lai's reply to the question, "What are the effects of the French Revolution?". "It is too soon to tell", he said.

[14] I thank Professor Ying Mao Kau for discussions about what follows.

Meanwhile, democratization is driving the creation of several features of a social democratic system. Taiwan has put in place a national health service covering the entire population, which makes health care accessible in return for a small fee. The DPP party started to pay old age pensions within the counties it controlled as a way to attract electoral support. The counties soon ran out of money, whereupon the DPP blamed the KMT and the central government for turning their back on the elderly—forcing the KMT to start to introduce a national pension scheme. Labor movements have been rather inactive through all this--except for the organization of prostitutes surrounding the parliament building in protest at government attempts to clamp down on their activities.

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With luck the experience of the crisis will support a sustained move throughout the region away from the simple-minded neoclassical economics that has rationalized the economic and financial liberalizations, away from the "neoliberal" or "Washington Consensus" or "globalization" kind of economics that says, "Governments are guilty until proved otherwise, markets are innocent until proved otherwise". We need to keep the historical precedent in mind. By the early years of the twentieth century, the increasing integration of the world economy (or what we would today call "globalization") was considered by most thinking people in Britain and the United States as, in Keynes' words, "normal, certain and permanent…any deviation from it as aberrant, scandalous and avoidable". Keynes warned of the dangers of such thinking—dangers realized in the ensuing Depression. The experience of the Depression in the United States paved the way to the New Deal and to the replacement of neoliberal with Keynesian economics.

But any deviation from full-scale liberalization in Asia will encounter powerful resistance.[15] It comes not only from those with obvious vested interests in free financial markets—such as Wall Street investment firms like Goldman Sachs wanting the world to open up for their business—and from the US Treasury, which has been unusually responsive to Wall Street wishes during the Clinton administrations. It also comes from professional economists in Asia, most of the influential ones of whom have been trained in the United States. The training of foreign economists is perhaps the US's single most socially profitable export. The economists go back home convinced that there is only one effective way to organize an economy in today's global realities, a way that corresponds with an Anglo-American model of free, arms-length markets. They set about pushing their own governments to undertake free market reforms in the name of efficiency and progress. Because the kind of mono-economics they learn in America gives little attention to "development", or "technological learning", or even to the idea that markets are sustainable only insofar as they are embedded in social and political institutions, they fail to see that what may work well enough in America—which is already at the world frontier of many industries and services, which is the unchallenged economic and military superpower, and which has one of the least competent governments in the world when one controls for skill levels in the population at large—is unlikely to support the learning and the national econmic strategies needed for a country to enter major world industries.

[15] See further Wade "The fight over capital flows", *Foreign Policy*, Winter 1998/99.

Development is a hard slog, and very few countries have succeeded in reducing the relative income gap between themselves and the core industrial countries in the second half of the twentieth century. Yet Anglo-American economics gives the impression that it is as easy as leap frog provided governments do not excessively intervene.[16] The Russian disaster of the 1990s is one demonstration of the falsity of this view, for the whole Russian strategy rested on the dogma that as the state was removed from the economy real market capitalism would blossom. The Asian crash—that followed liberalization of capital markets on the assumption that they would be more or less self-regulating if the state were removed—is another.

How many more crashes like the Asian one, the Russian one, or like the Latin American- and North American-crashes-to-come will we have to endure before we realize that the whole project of constructing a single integrated world market, with universal standards—the culmination of the European Enlightenment ideal—is a mistake? And that it is a mistake especially in finance, because finance is very difficult to regulate beyond the boundaries of nation states and yet financial markets need regulation even more than other markets if they are to avoid bandwagoning overbuying of financial assets and herd-like dumping of the same?

In particular, we need to recognize that encouraging capital inflows into high saving Asia is a mistake. Asia already has difficulty in finding economically efficient investments at the margin. Capital inflows, to the extent that they increase investment, also increase the risks of inefficient and excessive investment. To the extent that the inflows occur through credit channels they add to already high levels of private debt, and increase the risks of financial disruption. Asia needs to retain the ability to use capital controls to restrain the quantity and quality of capital inflows (but needs always to refer to them not as capital controls but as "prudential regulations").

The international rules for capital flows need to allow this option. More generally, the rules of the international economic order—including those promoted by the IMF, the WTO, and the like--should give scope for different forms of national capitalisms to flourish, and aim at international economic stability rather than at maximum free movement of goods and capital.[17] If this sounds pie-in-the-sky, recall that the Bretton Woods system met these criteria and delivered magnificent economic performance. If it is said that global financial markets are now much too big and digitized to be subject to any form of cross-border controls, recall that the regime for tracing drug money across borders has proven to be quite effective; which suggests that unauthorized capital movements could be subject to the same sort of penalties as tax evasion.

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[16] Robert Wade, "East Asian economic success: conflicting paradigms, partial insights, shaky evidence", *World Politics*, 44 (2), 1992, pp.270-320. Henry Bruton, "A reconsideration of import substitution", *Journal of Economic Literature*, 36 (2), June 1998, pp.903-936.

[17] Dani Rodrik, "The global fix", *The New Republic*, November 2, 1998. Wade, "Globalization and its limits: Reports of the death of the national economy are greatly exaggerated", *National Diversity and Global Capitalism*, eds. Suzanne Berger and Ronald Dore, Cornell University Press, 1996, pp.60-88.

As part of this non-convergence scenario, we need to build up *regional*-level organizations, so that markets can be embedded not only nationally but also in regionally distinct configurations, with policy solutions tailored to the different vulnerabilities of different countries and regions. This is the point that the two Korean labor federations had in mind in their remarkable statement to US Treasury Secretary Rubin in early July 1998. "The Asian development model, while containing some of the key elements which gave rise to the current crisis, also contains the very dynamic elements which made the 'miraculous' growth over such a short period….The IMF policy regime, however, has overlooked…the positive and dynamic elements in its virtual blanket disavowal of the Asian economy…. It may be necessary, therefore, for Asian nations to build a body…which can serve as an Asian monetary fund."[18]

When the Japanese government (secretly prodded into action by the IMF's Camdessus, afraid the IMF would run out of money) proposed the idea of an Asian Monetary Fund in August 1997, after the crisis broke, and quickly got pledges of support from Asian governments amounting to roughly $100 billion, the US Treasury made killing it a top priority. It succeeded in doing so, with late help from China wary about Japanese leadership. In December 1998 the Japanese government revived the idea.[19]

Whatever happens to the idea of an Asian Monetary Fund, it is an example of just the sort of regional initiative that a desirable international economic and financial regime needs to be able to accommodate—as part of a wider accommodation of a variety of non-convergent national capitalisms and their development strategies, such as the ones described in this book. These developments might have as a not unimportant by-product a flourishing diversity of approaches to economics in place of the current Anglo-American mono-culture--one that takes a more discriminating approach to finance (that distinguishes, for example, between the useful task of collecting people's savings and lending them on to producers and the less useful speculative dealing in secondary markets), and one that sees the tension between free markets and a high quality-of-life in a decent society.

[18] "The KCTU proposal", document presented at KCTU-FKTU meeting with US Treasury Secretary Rubin, 1 July 1998.
[19] "Japan in fund proposals", *Financial Times,* December 16, 1998. An American coopting strategy is outlined by Fred Bergsten, for an Asia *Pacific* Monetary Fund to include the US. The fund would tie its lending and other operations to prior IMF approval. See "Reviving the 'Asian Monetary Fund'", *The International Economy*, November/December 1998.