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GESTALT SHIFT: FROM "MIRACLE" TO "CRONYISM" IN THE ASIAN CRISIS

Robert Wade[1]

Explanations are about the only thing not in short supply in the Asian crisis. It would be entertaining to plot them on a matrix, with "actors" on one axis and "actions" on the other. Even a small sampling has to include:

- the governments of the crisis-affected countries, individually and collectively (corruption, collusion, nepotism, distorted markets, insufficient democracy, excessive democracy, "crony capitalism", fixed exchange rate regime, implicit government guarantees to banks and big companies in their foreign borrowing, premature capital account liberalization, lack of regional cooperation);
- foreign banks (sloppy credit risk analysis, excessive confidence in currency pegs, moral hazard behavior, Panglossian values, panic);
- domestic banks (ditto);
- investors, domestic and foreign (ditto);
- domestic firms (ditto, plus occult accounting, family control);
- the IMF (pressure for premature financial liberalization, moral hazard, bailout conditionality of excessive austerity and excessive emphasis on structural reforms;
- the US Treasury (pressure for premature financial liberalization, insufficient contribution to bailout funds);
- the Japanese government (insufficient demand stimulus at home, insufficient contribution to bailout funds abroad);
- the Japanese economy (two thirds of the Asian economy, in seventh year of stagnation and getting worse);
- "globalization", with its free floating responsibility.

This rich diversity reflects, in part, participants' attempts to shift the blame onto others. The main external actors blame national actors, governments blame outsiders, and national populations blame everyone but themselves. It also reflects the fact that there is not one Asian crisis, but several countries with different kinds of troubles and backgrounds to which different explanations may apply.

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Beyond this, the diversity reflects deeper differences in beliefs about rationality and markets. Those whose wider world view emphasizes rationality, self-adjusting markets, and market failure as exceptional except when governments introduce distortions see the Asia crisis as the result of rational calculations by rational actors in a situation of market-distorting government interventions. Those whose world view stresses nonrationality (or a different kind of rationality than that assumed by neoclassical theory), routine failure of well-working markets, and the need for government interventions to modify market outcomes see it as the result of nonrational calculations in insufficiently regulated markets.

So, for example, the "moral hazard" story belongs in the first, neoclassical category. Financial inflows were so large, it says, because of moral hazard--lenders lent appreciably more than otherwise because they calculated that they would be protected from losses whether by Asian governments implicitly guaranteeing the borrowings of their banks and big corporations or by the IMF; big corporate borrowers thought the same; and Asian governments felt free to continue irresponsible policies because they knew they could get access to IMF funds in an emergency.[2] Moral hazard behavior hence reflects excessive state and international guarantees—a form of intervention in markets. If governments had not intervened in this way, the lending and borrowing would have been kept to safe levels. Likewise, the information opacity or "lack of transparency" story belongs in the first category. Lenders rationally lent more than otherwise because they did not have access to reliable data about company and bank balance sheets, the level of the foreign exchange reserves, the contingent claims on those reserves, and the amount of short-term debt. With better information they would have lent less.

The outflow, in this interpretation, was basically a rational investor pullout--rational not only individually but also collectively. By the time of the pullout pre-existing real economy vulnerabilities had come sufficiently to light to make it clear that the expected returns on investments would not be forthcoming. The panic was only the messenger delivering the bad news, not the cause of the bad news.

The IMF was correct to insist upon far-reaching structural reforms, because, as First Deputy Managing Director of the IMF Stanley Fischer says, "The faster [the underlying structural problems in the financial and corporate sectors are dealt with], the shorter the period of pain, and the sooner the return to growth".[3] In particular the Fund was right to insist upon further financial liberalization in the crisis-affected countries and further opening—in an "orderly" manner--of the capital account. For financial markets show the same tendency towards equilibrium as goods markets, reflecting regressive expectations of the prices of financial assets towards the normal equilibrium level of prices. There may be "overshooting" in the market for financial assets due to different speeds of price adjustments between different assets and between assets and goods, but these will be temporary and will not alter the equilibrium around which the overshooting occurs.

The other meta interpretation emphasizes a sizable element of nonrational calculation in the build up and unfolding of the crisis, and the predominence of financial factors over real ones. It emphasizes the inflation of inflows by perverse incentives on institutional money managers, such that each knew that they would be penalized if they lost out on business that others were getting but would not be penalized if they lost when everyone else lost too. This story assumes individual rationality but collective nonrationality. The money managers acted in line with the

[2] Paul Krugman, "Will Asia bounce back?", unpublished paper, March 1998, Economics Department, MIT.

[3] Stanley Fischer, "Year of upheaval: the IMF was right on high interest rates and immediate restructuring", *Asiaweek*, July 17, 1998. Compare in the same issue, Joseph Stiglitz, "Road to recovery: restoring growth in the region could be a long and difficult process".

principle of what cognitive psychology calls "confirmation bias", the tendency of people to see in a situation what they have a predisposition to see, ignoring data that would upset their conclusions. For example, they ignored data on such things as the build up of short-term debt that was easily available in the public domain prior to 1997. Notice that moral hazard behavior—which assumes rational calculation of downside risks, such that had the actors not believed that they would be protected they would have made careful assessments of the condition of the economies and the companies—need not enter this explanation of massive inflows at all. (The reasoning is the same as explains why life insurance policies are not normally blamed for suicides.)

The pullout, according to the nonrational theory, was an "overreaction", or in the language of cognitive psychology, the result of a "gestalt shift". A gestalt shift is a refocusing from one configuration to another that takes place suddenly and *in toto.* Think of the celebrated drawing of either a vase or a pair of inturned faces. It cannot be seen as partly vase and partly faces, and the shift from one image to the other takes place instantaneously, not by degrees. This process is a long way from the idea of rational, weighing-up-costs-and-benefits calculation. In the Asian case, one day the speculators and investors saw "the Asian miracle", the next day they saw "Asian crony state capitalism".

The notion of gestalt shift lends support to the "panic" story--that the crisis was caused in large part by speculator and investor pullout from economies that but for the pullout would have remained viable enough to generate returns within the normal range. The panic, in other words, was not simply the "trigger" of a crisis caused by the combination of underlying vulnerabilities plus moral hazard behavior. The panic was itself a primary cause, and it reflects individual rationality but collective nonrationality.

While the rational interpetation sees the IMF's imposition of far-reaching conditions for structural reform as confidence restoring (because investors see the government taking firm action to repair the underlying vulnerabilities), the nonrational one sees the news that a country is negotiating conditionalities with the IMF as only aggravating the loss of confidence, prompting a bigger stampede for the exits; as does the signal that far-reaching—and slow-to-take effect-- structural reforms are essential for growth to be restored.

The debate about the causes is less a debate than a ritual of paradigms ("parrot-times") talking past each other. Clearly some hard testing is needed. The problem is that even in one country, several different explanations, from both sides of the rational/nonrational divide, may contain truth and even reinforce each other, both at the same time and in sequence. But even allowing for country and time differences, "There are not eighteen good reasons for anything", as George Stigler once said.[4] This paper aims, modestly, not at the necessary hypothesis formulation and testing but at an interpretative account of the process of the crisis, thinking of causality as a chain of proximate and more distant events. It gives prominence to the nonrational elements as an offset to the tendency of economists to be much more accepting of stories (such as moral hazard) based on the assumption of rational calculation, simply because more congruent with neoclassical theory. And unlike other accounts, it remains broadly consistent with my own earlier account of east Asia's prolonged prior success.[5]

SCALE OF THE CRISIS

[4] Quoted in Michael Lipton, "The East Asian crises, banking, and the poor", paper for Asian Crisis conference, Institute of Development Studies, Sussex University, 13-14 July 1998.

[5] See Wade, *Governing the Market,* especially chapters 6, 10 and 11.

First, a quick overview of the scale of the crisis. Look at table 1. It shows the change in exchange rates and stock prices in East and Southeast Asia between June 1997 and late March 1998. The three countries identified as the worst affected—South Korea, Thailand, Indonesia—have had the biggest falls in exchange rates, ranging from 36 percent to 72 percent. However, Malaysia and the Philippines, generally regarded as having escaped lightly, have had exchange rate declines of not much less than Thailand and Korea. Adding the fall in the stock market to the fall in the exchange rate to get a broader measure of impact, we have to put Malaysia with the group of worst affected countries, with the Philippines just behind. In short, the conventional understanding that only Korea, Thailand and Indonesia have been badly affected is not true by these measures--Malaysia and the Philippines have been hurt almost as much. Even Japan, Hong Kong and Singapore have taken substantial hits. Taiwan and China look to be least affected.

Figure 1 shows trends in exchange rates, stock markets and interest rates from the start of 1997 to late March 1998. The tracings show the economic equivalent of heart attacks. Notice in particular the increased level and volatility of interest rates since the crisis began.

As of July 1998 it is clear that the crisis is not yet in the clearing-up-after-the-storm stage; not a "V" nor a "U" but an "L" or an "S" (or maybe, still, an "I"). After a respite in early 1998, a second great wave of capital outflow occurred in May and June, and forecasters resumed chasing the economies downhill. A recent report in the *South China Morning Post* began, "A cocktail of negative factors is fast unravelling Asian stock markets' first-quarter gains and more losses may be in store as further evidence emerges about the parlous condition of the region's economies"[6]. It is not an exaggeration to liken the Asian crisis to the Great Depression of the 1930s in terms of the scale of the falls in output and consumption and the increase in poverty and insecurity.

THE HIGH DEBT→DEBT DEFLATION STORY

Most commentators agree that the sharp pullout of funds by investors across the region (domestic as well as foreign investors) was the trigger, and that the pullout was panicky. The whipsaw movement from capital inflows to capital outflows was on a scale that could not but tear apart the social fabric of countries subjected to it, especially where political structures are only weakly institutionalized. *Net* private flows to or from the five Asian economies (the ASEAN four plus South Korea) were plus $93 billion in 1996, turning to minus $12 billion in 1997. The swing in one year of $105 billion (with most of the outflow concentrated in the *last quarter* of 1997) equals 11 percent of the combined GDP of the five countries. Asia's experience was worse even than Latin America's in the 1980s. The swing between 1981 inflows and 1982 outflows in the three biggest debtors (Brazil, Mexico, Argentina) amounted to 8 percent of their combined GDP.

An interpretative account has to explain why the inflows were so big, why the outflows were so big, and why the contraction of economic activity has continued to be so sharp. It has to link the banking crisis, the currency crisis and the corporate crisis, and the politics with the economics, without becoming so luxuriant as to be obscure.

The bank-based high debt model

Thanks to relatively equal income distribution the large majority of Asian households are net savers (in contrast to Latin America). They deposit much of their savings in banks. Banks

[6] Jake Lloyd-Smith, "Asia hunkers down for bumpy journey", *South China Morning Post*. May 7, 1998.

have to lend. But not to households and not to governments, which are not sizable net borrowers. Banks have lent largely to firms seeking to borrow in order to invest.

Large Asian firms have tended to finance a large proportion of their investment from bank borrowings, and to carry large amounts of debt relative to equity compared to western or Latin American firms.[7] High debt/equity ratios allowed them to invest much more than through retained earnings or equity finance alone, and high corporate investment helped to propel the region's fast economic development over several decades.

Corporate sectors with high levels of debt are vulnerable to shocks that cause a fall in cash flow or an increase in fixed payment obligations—systemic shocks such as a fall in aggregate demand, a rise in interest rates, or devaluation of the currency (when part of the debt is foreign). [8]

This bank-based system of financial intermediation encourages close relations between bankers and corporate managers, and is sometimes called "relationship" banking. The system often includes government incentives to lend to particular sectors or functions. And it includes, importantly, a closed or partially closed capital account, such that financial capital cannot move freely in and out of the country. Local citizens and foreign residents are not permitted to hold accounts with commercial banks abroad, banks are not allowed to extend loans in foreign currencies in the domestic market, non-bank private corporations are not allowed to borrow abroad, foreigners can not own shares listed by national companies on domestic stock markets, national companies can not sell securities on international stock and bond markets, foreign banks are restricted in the domestic market. This apparatus buffers highly leveraged corporate sectors from systemic shocks and from the prudential limits of western banks, allowing them to sustain levels of investment well above what the risk preferences of equity holders would allow. Very high domestic savings permit the investment to be financed domestically.

At its most fully developed the bank-based high debt model becomes the developmental state. The developmental state was most fully developed in Japan (1955-73), Korea (1961-95), and Taiwan (1955-continuing).[9] Amidst the current talk of the death throes of Asian crony capitalism it is worth recalling that Japan, Korea and Taiwan are the most successful non-city-state developing countries since the Second World War. No other countries have achieved such big gains in the average real wage or the average real wage of the bottom 25 percent. No other countries have risen so far in their technological capacity . Japan takes out more patents in the US than any other country bar the US itself. In recent years, Taiwan has taken out the 6th largest number, Korea the 7th largest, ahead of the middle-ranking OECD countries like Italy, Ireland, Netherlands, Scandanavia.[10] No other developing countries come even close. (But the environmental costs of the model have been very high.)

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[7] See Wade and Veneroso, op.cit., for discussion of the problems of the empirical evidence on debt/equity ratios. Among other problems, the evidence I have seen includes only long-term debt, and in the case of conglomerates it does not properly consolidate debt so as to account for the practice of one affiliate borrowing to buy quasi-equity in another affiliate, thereby spuriously lowering the second one's debt/equity ratio. Evidence on the size of bank intermediation suggests that the ratio of credit to GDP in Asia in 1990-96 ranged from 207 percent in Japan down to 114 percent in Singapore (with Hong Kong, Thailand, Malaysia, and Korea in between, but Indonesia and Philippines around 63-65 percent). Colombia, Brazil, Mexico, Argentina ranged from 42 percent to 18 percent, with Chile at 70 percent. The US figure was 58 percent. Source is Goldman Sachs, elaborated in Michael Pomerleano, "The East Asian crisis and corporate finances: a micro story", preliminary draft, World Bank, May, 1998.

[8] See "Shocks and debt", appendix in Wade and Veneroso, op.cit.

[9] Wade, *Governing*, chapters 10 and 11.

[10] Parimal Patel and Keith Pavitt, "Uneven and divergent technological accumulation among advanced countries: evidence and a framework of explanation", *Industrial and Corporate Change*, v.3, 1994, pp.759-87. Robert Wade,

Singapore and Malaysia are closest to developmental states in southeast Asia, Indonesia is the furthest.

Financial liberalization

Asian governments, encouraged by the IMF and the World Bank as well as by national business elites, liberalized their financial systems through the 1990s, including the external capital account.[11] Liberalization permitted domestic agents to raise finance on foreign markets and gave foreign agents access to the domestic financial market. Hence locals could open foreign bank accounts; banks could extend credit in foreign currencies in the domestic markets; non-bank financial institutions and private corporations could borrow abroad; foreigners could own shares listed by national companies on domestic stock markets; foreign banks could enjoy wider freedom of entry into the domestic banking sector; and off-shore banks could borrow abroad and lend domestically.[12] All this took place in the context of a more or less fixed nominal exchange rate regime, in which the domestic currency was either fixed to the US dollar or moved in close correspondence with it.

The liberalization of capital movements removed some of the buffer mechanisms. Above all, it removed the capacity for governments to coordinate foreign private borrowing. Those who demanded financial liberalization acknowledged the need for *pari passu* strengthening of bank regulation and supervision, but did not constrain their push for liberalization by the pace of regulatory strengthening on the ground.

In Korea, the Kim Young Sam government of 1993 sharply accelerated the process of financial liberalization, including, for the first time, substantially opening the capital account. This was done to meet the conditions for joining the OECD, a primary policy goal of the Kim government. It also happened because the big private firms had by this time high enough credit ratings in international financial markets for them to borrow easily on their own account, and they stopped wanting government support.[13]

As part of the liberalization, the government licensed nine new merchant banks in 1994 and 15 more in July 1996, in addition to the six that existed before the 1993 liberalization. These inexperienced merchant banks drove the explosive growth of Korea's foreign debt. The debt rose from $44 billion in 1993 to $120 billion in September 1997, most of it private and roughly 65 percent of it short term.[14]

"Globalization and its limits: reports of the death of the national economy are greatly exaggerated", Suzanne Berger and Ronald Dore (eds.), *National Diversity and Global Capitalism*, Ithaca: Cornell University Press, 1996.

[11] Japan resisted the push for financial liberalization in developing countries. Its conflicts with the World Bank and the IMF on this matter in the Asian context gave the impetus to the World Bank's *The East Asian Miracle* study. See Wade, "Japan, the World Bank, and the art of paradigm maintenance: *The East Asian Miracle* in political perspective", *New Left Review*, 217, May-June 1996, pp.3-36.

[12] Azizul Islam, "The dynamics of Asian economic crisis and selected policy implications", Development Research and Policy Analysis Division, UN ESCAP, July 1998.

[13] Chang, Park, and Yoo, **FULL REFERENCE**.

[14] Bank of International Settlements, "The Maturity, Sectoral and Nationality Distribution of International Bank Lending", May 1998, Basle. Korea's figure fell from 68 percent at end 1996 to 63 percent at end 1997. Indonesia's figures for the same years, 62 percent and 61 percent, Thailand's 65 percent and 66 percent. These figures are for lending to the country by foreign banks, where "to the country" means to any entity in the country, including subsidiaries of foreign firms. The World Bank's figures on total debt and short-term debt in *Global Development Finance* tend to be appreciably different from the BIS figures. The BIS uses creditor statistics (from the loan-extending banks), the World Bank uses debtor statistics (from the debtor governments). The BIS figures cover only bank lending, the Bank also covers non-bank, specifically government or public loans. Yet the Bank's figures are often smaller. The differences reflect first, the poorer quality of debtor statistics (there are many more debtors than

The design of the liberalization program itself encouraged *short term* foreign borrowing, because the application procedures for short term borrowing entailed much lower transaction costs than those for long term borrowing.[15] Moreover, the government allowed non-bank firms to borrow abroad on their own account without central coordination. About a third of Korea's total foreign debt is accounted for by these non-bank firms. This borrowing was outside the scope of bank regulation and supervision, yet constituted foreign exchange liabilities for the central bank.

Across southeast Asia, too, domestic enterprises became free to borrow abroad on their own account with no more public supervision than in Korea. An even higher proportion of total foreign borrowing was by non-bank firms than in Korea: around 60 percent in Malaysia and more in Indonesia.[16] All this escaped bank regulation.

In Thailand radical financial liberalization began in 1988 with the country's first fully civilian government and intensified with the new civilian government of 1992. It included opening to foreign borrowing and the creation of a large number of new finance companies able to compete with the commercial banks.[17] These developments gave politicians plenty of opportunities to raise campaign finance. Political competition undermined any independent monitoring or regulation by the central bank (see below).

In Indonesia, "the economy's vulnerability to financial collapse can be traced to the mid-1980s, when Indonesia opened the banking industry to competition but never put modern bank regulations in place. 'It's as if the Government had gotten rid of the policeman at every corner, but didn't bother to put up stop signs or lights', suggested [an economist at the University of Indonesia]. 'The traffic moved faster, but was prone to accidents.'"[18]

Liberalizing the financial sector and opening the capital account is dangerous when the banks are inexperienced and when non-banks also borrow abroad.[19] It is doubly dangerous in the context of a bank-based financial system and a high debt-to-equity corporate sector. It is triply dangerous with a fixed exchange rate regime. When the banks and non-banks are essentially unsupervised a banking-cum-currency crisis is just waiting to happen. In Asia, swift external financial liberalization with unsupervised banks and fixed exchange rates undermined the previous system of industrial and banking cooperation and exposed fragile debt structures to unbuffered shocks.

Some explanations of the crisis give central importance to "weak domestic financial structures". This is questionable. First, the domestic financial structures had been described as "weak" for many years, and had not markedly deteriorated in the run up to the crisis. Second,

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creditors, and debtor banks are less well supervised) and second, differences in methodology (on such things as treatment of subsidiaries of banks and non-banks, and the entities whose debts are to be included in external debt--all residents, including subsidiaries of foreign companies, or only nationally-owned debt, including debt of foreign subsidiaries of domestic firms).

[15] Chang, Park, and Yoo, op.cit.

[16] Bank for International Settlements, "The Maturity, Sectoral and Nationality Distribution of International Bank Lending, First Half 1997", Basle, January 1998, Table 1, cited in Yilmaz Akyuz, "The East Asian financial crisis: back to the future?", UNCTAD, processed, n.d. (January 1998).

[17] In March 1993 the Bank of Thailand opened the Bangkok International Banking Facility (BIBF), intending to make Thailand a regional financial hub. In practice it mostly intermediated between Thai borrowers and foreign lenders, all in foreign currency. See Ammar Siamwalla, "Can a developing democracy manage its macroeconomy? The case of Thailand", paper for Asian Crisis conference, Institute of Development Studies, Sussex University, July 13-14 1998.

[18] Peter Passell, "Experts say Indonesia can boom, long-term", *The New York Times*, May 22, 1998, p.A10.

[19] Martin Wolf of The Financial Times has repeatedly stressed this point. See, for example, "Caging the bankers", *Financial Times,* 20 January 1998.

they may not have been as weak as commonly thought, given that they intermediated huge amounts of savings into mostly profitable and productive investments (until the foreign inflows were well advanced). Third, financial structures were exposed to unbearable strain by the fast opening of the capital account. The causality lies principally with the opening of the capital account.[20]

Inflows

The capital inflow side of the story starts with the extraordinary growth of international capital flows in recent years, that now amount to well over 70 times the volume of world trade. The flows are mostly short-term; 80 percent of net global foreign exchange transactions have a maturity date of seven days or less. [21] The growth of these flows reflects, in part, the efforts of central banks in Europe and Japan to stimulate their economies by means of loose monetary policy.

The growth also reflects the imbalance between savings and investment in Japan. For many years the Japanese, the fastest aging population in the world, have been saving hard for the approaching years of long retirement. (The average Japanese family saves more than 13 percent of its income, the average American family 4 percent.[22]) The economy is mature, among the richest in the world, and not able productively to utilize enough investment to absorb the savings. The result is an excess of domestic savings over domestic investment that manifests itself in chronic current account surpluses matched by capital exports.[23]

Japan's imbalance between saving and investment grew after the early 1990s because of the bursting of the property, stock market and currency bubbles. Japanese banks found themselves with many bad loans. Banks near to insolvency tend to take big risks unless they are recapitalized, merged, or forced into bankruptcy. Rather than follow one or other of these solutions the Japanese government decided to allow them to write off the bad loans gradually (to "trade through"), giving them extra profits via a low bank rate and tax-avoiding declarations of losses.[24] Meanwhile the voracious Japanese appetite for savings continued, the savings going

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[20] In *Governing the Market* I specify the stability conditions of the bank-based high debt model as follows. "'The government must maintain a cleavage between the domestic economcy and the international economy with respect to financial flows. Without control of these flows, with firms free to borrow a they wish on international 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. Speculative inflows seeking exchange rate gains can precipitate accelerating movements in exchange rates, with damaging consequences for the real economy. Uncontrolled outflows can leave the economy vulnerable to an investment collapse and make it difficult for government to arrange a sharing of the burden of adjustment to external shocks between the owners of capital and others; "the others" are likely to be made to take the burden, with political unrest, repression, and interruptied growth as the likely result" (p.367).

[21] John Eatwell, "International financial liberalization: the impact on world development", Discussion Paper, Office of Development Studies, UNDP, n.d. (1997), p.4.

[22] Jacob Schlesinger and David Hamilton, "The more the Japanese save for a rainy day, the gloomier it gets", *Wall Street Journal*, July 21, 1998, p.A1.

[23] Martin Wolf, "Saving Japan: a permanent cure", *Financial Times,* April 7, 1998.

[24] The approbrium now directed at the Japanese government for not moving earlier to clean up the banking system conceals the point that as of 1996, before the wider crisis, the trading through strategy seemed to be working tolerably well compared to the likely alternatives. And it ignores the point that the US government waited from 1984 to 1988 before it developed a comprehensive wind-up rescue plan with public money to clean up the Savings and Loan crisis. The US's disregard of the wider impacts of its macroeconomic policy choices (as in the Volker interest rate hike, undertaken with no thought to its impact on Latin America, and its reluctance to contribute to the Bretton

mostly into the banks. The banks had to lend. The "near to insolvency —> high risks" pressure therefore continued.

Japanese banks aggressively sought high returns from foreign lending, much of it in risky loans to southeast Asia. Then in 1994-95 the yen appreciated against the US dollar, causing southeast Asian currencies, tied to the dollar, to depreciate against the yen. This redoubled the impetus of Japanese capital to move out to more competitive locations in Asia. Japanese banks and firms found themselves able to borrow both domestically and abroad at low rates. They lent short term to southeast Asian banks and firms at appreciably higher rates, confident that southeast Asian currencies would remain pegged to the US dollar. They thereby earned both an interest gain and (as the yen depreciated against the US dollar after 1995) a currency gain. European banks also lent heavily, especially after the flight from Mexico in the wake of the Mexican crisis of 1994/95. By mid 1997 European banks accounted for the largest share of the region's external bank debt, with 39 percent. Next came Japanese banks, with 33 percent.[25]

On the demand side, banks and firms in Korea and southeast Asia rushed to borrow abroad. Borrowing abroad at roughly half the cost of borrowing domestically and on-lending domestically seemed to be a one-way bet. You could only win. The proviso was that the currency peg to the US dollar be maintained, precluding exchange rate risk. (The higher credit-rated banks and enterprises of Korea not only borrowed abroad and lent domestically, they also on-lent to southeast Asia.)

At the same time, capital flowed in to accommodate the excess of investment over savings. Gross domestic investment was even higher than gross domestic savings, itself about the highest in the world at well over one third of GDP.

In short, the inflows were driven both by the need to accommodate the excess of investment over savings (manifested in current account deficits, see below), and by the opportunity, thanks to capital account opening, for foreign creditors to get higher returns and domestic borrowers to borrow more cheaply. They were also driven by the image of "miracle Asia". A success gestalt and confirmation bias carried them along.[26]

Woods institutions and the UN) does not qualify it to be self-righteous about Japan's choices. On alternative methods of debt workouts see Wade and Veneroso, op. cit.

[25] "Asia and Europe: Hard talking" , *The Economist*, April 4, 1998, p.42. The Asian countries in the calculation include South Korea, China, Indonesia, Thailand, Taiwan, Malaysia, Philippines. US banks accounted for only 8 percent of external bank debt as of end-June 1997. However, derivatives complicate the picture. American banks hold a large amount of derivatives contracts with Asian entities, probably more than other banks. For example, J.P. Morgan, which probably has the most at stake of the American banks, had $116 billion total credit risk from derivatives at the end of 1997. A loss of one tenth of that amount would wipe out its equity. In 1997 90 percent of its nonperforming loans were defaults from Asian derivatives counterparties. Derivatives are more likely to be defaulted on than loans, because the counterparty "can always say [it] didn't understand the derivative or the bank tricked [it] or whatever", and hence "Companies do not view a default on derivatives as face losing" (financial analyst with Standard and Poor's). Bernard Baumohl, "Asia crisis: The banks' nuclear secrets", *Time*, May 25, 1998, pp.46-47, 50.

[26] It will be interesting to read future histories of the World Bank, the IMF and the rating agencies to see how contrary information was kept out of their reports, and what happened subsequently to the responsible managers. See Marcus Brauchli, "Speak no evil: why the World Bank failed to anticipate Indonesia's deep crisis", *Wall Street Journal*, July 14, 1998. (Thanks to Laura Resnikoff for drawing it to my attention.) As an example of the problem, the staff of the World Bank's resident mission in Indonesia prepared a speech for President Wolfesohn to deliver during his visit in the autumn of 1997, praising Indonesia's performance but also containing a strong warning of serious difficulties that needed urgent attention. Wolfensohn himself deleted the passage, substituting an even more fulsome endorsement of Indonesia as an Asian miracle. As another example, the Bank's lead economist for Thailand in 1994 wrote the (confidential) annual report on the economy and the Bank's strategy (the Country Assistance Strategy), and warned of major problems associated with the build up of foreign debt. His division chief removed most of the bad news. The division chief was promoted, the lead economist left the division. Neither Wolfensohn

The inflows put *upward* pressure on the exchange rate. The attention of the monetary authorities and of speculators and investors was on the chances of preventing appreciation of the nominal exchange rate. Nobody was thinking depreciation. Nobody was hedging against a currency sell off.

Real Vulnerabilities

The proximate source of real economy vulnerability was the deterioration in the current account in all the affected countries, especially in 1995 and 1996. The deficits for 1996 ranged from 3.5 percent of GDP for Indonesia to 8 percent for Thailand. The most rapid increase occurred in Korea, which went from one percent in 1993-95 to 5 percent in 1996.

Falling export growth was the main cause of the rising deficits. This in turn reflected a fall in demand for some of the main exports, notably semiconductors in the case of Korea (semiconductors being Korea's biggest single export item). Falling export growth also reflected declining competitiveness as a result of domestic costs rising faster than productivity. Capital inflows combined with the currency peg caused appreciation of the domestic currency--the real exchange rate appreciated in all five of the most affected countries in 1995-96, choking exports.[27]

The devaluation of the yen against the dollar that began in 1995 worsened Asia's export competitiveness still more, especially against China and Japan. Meanwhile the terms of trade (export prices over import prices) were trending downwards, due especially to competition from China. China gobbled up exports markets in the US and Japan over the 1990s, raising its overall share of US merchandise imports from 3 percent in 1990 to 6 percent in 1994 and its share of Japanese merchandise imports from 5 percent to 10 percent. Its share of US footwear imports rose from 16 percent to 45 percent in the same years, its share of Japanese clothing imports rose from 28 percent to 54 percent.[28]

As investment surged throughout the region, much of it into a narrow range of sectors, productivity and profits began to suffer. At the margin companies put more and more of their investment into essentially speculative ventures. A rising share went into non-tradeables, especially property and land. Thailand, Malaysia, and Indonesia all experienced speculative property balloons fed by foreign finance. The borrowers received returns in local currency and had to replay in foreign currency. They began to accumulate a massive currency mismatch.

In terms of their structural position in the world economy the southeast Asian economies have been much more dependent on foreign expertise and foreign capital than were the east Asian economies at the same average income level. The prospects of them following the east Asian trajectory were always much more uncertain. They have remained in a subcontractor role. They have seriously under-invested in education, resulting in secondary school enrollments in Thailand and Indonesia half or less than half those of Korea and Taiwan at the same per capita income level. They suffer serious infrastructure congestion. These endowment problems, combined with Chinese competition from below and Korean, Taiwanese, Japanese and European competition from above, have pinned them in a medium technology trap.

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nor the division chief had independent empirical grounds for reversing the judgment of their subordinates. "We were caught up in the enthusiasm of Indonesia", said Wolfesnsohn to critics in Jakarta in early 1998—with disingenuousness in the "we".

[27] Raphael Kaplinsky, "'If you want to get somewhere else, you must run at least twice as fast as that!': The roots of the East Asian crisis" , paper for East Asian conference, Institute of Development Studies, Sussex University, 13-14 July 1998.

[28] Kaplinsky, ibid.

The advent of democratically-elected civilian governments in Thailand and Korea added to their vulnerabilities. In Thailand this began in the late 1980s with the first democratically-elected government, and intensified under the next civilian government of 1992.[29] These governments began to undermine the previously high level of autonomy and competence of the economic technocracy. Their constituency lay predominently in rural areas well away from Bangkok. Candidates who purchased votes to win parliamentary elections ran up huge obligations. The successful candidates, eyes on their warchests, set about capturing income and power in the state bureaucracy. The first civilian government was popularly known as "the buffet cabinet"in tribute to its appetite for money. "To them, and more importantly, to their constituents, the public treasury is a milchcow, and the MPs' central chore is to milk that cow and bring the milk back home to their constituents". [30] The finance ministry and the central bank, whose independence and technocratic excellence had helped previous military governments maintain macroeconomic stability, came under their sway. Political appointees went into senior positions and corrupted decisions about economic policy.

In Korea, the first democratically-elected civilian government, under President Kim Young Sam, came to power in 1993 committed to far-reaching liberalization. It abolished the investment coordination superministry (the Economic Planning Board), folding it into the Ministry of Finance. At the same time it allowed some of the *chaebol* to become closer to, more personalistically involved with the regime than had its military predecessors since the beginning of the 1960s.

Problems were also building up in Korea's corporate sector. A series of bankruptcies occurred in 1997 that contributed to the November 1997 crash.[31] The bankruptcies were concentrated in the middle-ranking *chaebol* rather than among the biggest. The middle-ranking ones had over the 1990s borrowed the most relative to their equity in order to grow and diversify as fast as possible, seeking to catch up with the leaders. They were able to borrow so much because company accounting practices allowed them to cross-guarantee the debts of one affiliate with promises from other affiliates instead of presenting stand-alone business investment projects independently collateralized. The practice of cross-guarantees between the affiliates of a *chaebol* exposed the whole conglomerate to the default of one of the components. The middle-ranking *chaebol* were also allowed to borrow so much because they bribed the relevant bankers and politicians; and because international banks based in Japan, Europe and the US practically begged them to take the money.

The bankruptcies in Korea revealed serious shortcomings in several institutions, including irregular supervision of the banks, feeble supervision of company accounting practices, and growing dishonesty among public officials. Above all, they illustrated how the *chaebol* dominate the economy, marginalizing small and medium enterprises and robbing Korea of an equivalent to Taiwan's swarms of small, nimble, niche-seeking firms. Indeed, some of the IMF's conditions on such matters as corporate governance—matters that seemed a long way from the solutions to the immediate crisis—were inserted with the encouragement of Korean Ministry of Finance officials, who saw the crisis as a golden opportunity to force through

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[29] The first government was headed by Chartchai Choonawan and lasted from 1988 to 1991. After a military interlude the second civilian government was headed by Chuan Leekpai from 1992 to 1995.

[30] Ammar Siamwalla, "Can a developing democracy manage its macroeconomy? The case of Thailand", op.cit. See also Richard Doner and Ansil Ramsay, "Thailand: From economic miracle to economic crisis", unpublished paper, Political Science Department, Emory University, January 1998. Donald Emmerson, "Economic rupture as political rorschach: paradigmatic aspects of the east Asian crisis", unpublished, Political Science Department, University of Wisconsin, Madison, March 1998.

[31] John Mathews, "Fashioning a new Korean model out of the crisis", this volume.

structural changes which they had long wanted but which had been blocked in the Korean political process.[32]

Over and above the condition of each country was the fact that they were fairly highly integrated (roughly half of total trade was intra-regional) *and* moving cyclically rather than countercyclically. Had they been less integrated or less cyclical, the regional multiplier effects would have been much smaller. (Taiwan has survived relatively unscathed partly because it had had its boom and bust in the early 1990s. By the time this crisis hit the region Taiwan's financial sector had worked out its debt problems.[33]) The third vital part of the regional picture, after integration and cyclicality, was Japan's stagnation.

In short, the vulnerability of the real economy in Asia did increase in the few years before the crisis. Price and investment trends led to growing current account deficits. Also, at least in Thailand and Korea, new democratic regimes corrupted the central policy-making technocracy and lost focus on *national* economic policies. Cronyism multiplied. Government-bank-firm collaboration came to be steered more by the narrow and short-term interests of shifting coalitions. Their experience is bad news for the proposition that more competitive politics yield better policies.

Some commentators point to the high share of short-term debt in total debt as a vulnerability factor. This was something about which information was fairly easily available in Bank for International Settlement and World Bank statistics, but overlooked until the eve of the crisis.[34] It is true that the figures are of uncertain reliability, as indicated by big differences from one source to another in the amount of short-term debt. But that aside, the "high proportion of short term debt" theory lacks plausibility. For one thing, the ratio was constant since 1993 (according to BIS figures). For another, it was not so much higher than Latin America's, which was on a rising trend.[35] Rather, it is the rise in the ratio of short-term debt to *export earnings* that seems to have been a bigger concern—reflecting the main "real economy" cause of the crisis, the fall in export growth. But again one comes back to perceptions, to what the speculators and investors actually paid attention to. Plenty of other developing countries have had worse vulnerability indicators without crisis—bigger current account deficits relative to GDP, bigger

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[32] Mathews, op.cit., based on interviews with Korean officials in January 1998.

[33] On Taiwan's experience see Wade and Veneroso, op.cit., p.11.

[34] The Bank of International Settlement's statistics tracked the build-up of short-term debt, and its commentaries highlighted the relevant figures from the start of *1996* onwards. For example, in its report of January 1996 it said, as the opening sentences under "Asian countries", "Claims on Asian countries continued to expand at a brisk pace in the first half of 1995 ($33.7 billion), with two-thirds of the new funds taken up by local banking systems. The predominance of primarily short-term interbank funds helped to push the proportion of the 'up to and including one year' maturity band in outstanding claims on the region to 64% at mid-1995." It went on to say, "South Korea and Thailand have experienced particularly rapid increases in their liabilities to reporting banks in the recent past, and are currently the two largest debtors to banks amongst Asian developing countries, well ahead of China and Indonesia." It drew attention to the "expansion in the overseas operations of Korean companies" as a source of "increased foreign currency financing". (Bank for International Settlements, "The Maturity, Sectoral and Nationality Distribution of International Bank Lending, First Half 1995 ", January 1996, Basle, p.5.) In its annual report for 1996, dated June 1996, the Bank for International Settlements reported that "the total volume of banking funds channeled to the developing world reached an all-time record", fueling "concerns related to the sustainability of the rallies seen in securities markets, the instability of short-term bank flows, and the spreading of the market tiering faced by Japanese banks to a broader spectrum of participants". (Bank for International Settlements, *66th Annual Report, 10 June 1996, Basle, p.141.*

[35] In 1996 the East Asian average ratio of short-term claims to total claims was about 63 percent, the Latin American average was about 53 percent (Bank for International Settlements, "International Banking and Financial Market Developments", June 1998, and "Consolidated international banking statistics for end-1997", press release, 265, May 1998).

short-term debt to total debt, bigger short-term debt to exports, and more corrupt government-business links. These vulnerabilities in Asia were neither necessary nor sufficient conditions of crisis.

Outflows

Granted that the whipsaw movement of capital inflows and outflows is the main proximate cause of the crisis, could it have happened without underlying vulnerabilities in the real economy? Almost certainly, yes. We know from history that financial crises can indeed occur in the absence of *ex ante* signs of rising vulnerability (even though any self-respecting analyst can always find vulnerabilities *ex post)*. Indeed, when times are good and demand is fast growing, firms tend to assign increased weight to past positive experience and reduce the probability of loss associated with some of their investment projects. They may cut back their cushion of safety (probable cash flow minus probable fixed payments) and thereby become *more* vulnerable to a downturn.[36] This is how, paradoxically, the passage from a sound to a fragile to an unstable financial system can occur even faster after a period of good times than after a period of uncertain times.

Also, we know that bankers tend to exhibit herd-like behavior driven by the incentive that any individual banker or individual bank will be faulted by management or shareholders for missing out on business that others are getting, but will not be faulted for making losses when everyone else is making losses.

Asia's very fast growth in the years leading up to 1997 explains both the increasingly vulnerable state of firms' balance sheets and the rush of international bankers to get in. Thin cushions of safety in corporate balance sheets and herd-like behavior of lenders then explain why shocks that were quite small in the wider scheme of things—such as the widely anticipated Bangkok property crash of 1996 and 1997—triggered a rush to get out that became self-propelling. Investors' subsequent "discovery" of underlying vulnerabilities that they had earlier overlooked only accelerated the rush.

In Thailand, the private-sector-generated property bubble burst in 1995 and the stock market crashed in mid 1996. The property market, like the stock market, is a market where small withdrawals can have a big effect on prices and leave the banking system in the sort of danger that makes depositors withdraw their money. The property market crash ripped through the whole financial sector and on into the foreign exchange market as foreign investors saw that a devaluation would render domestic borrowers less able to meet the now more expensive debt service charges on their short term foreign loans. With a baht devaluation in sight (a breaking of the peg), companies in Thailand, both foreign and domestic, tried to sell their baht for dollars. There were runs on the baht in mid 1996 and again in early 1997. The Thai central bank bought baht to prevent the price fall, but eventually gave up as reserves fell to dangerously low levels. It also resorted secretly to borrowing abroad and including the borrowed funds in its officially declared reserves.[37]

Meanwhile worries were circulating about the slowing of exports and economic growth in the region at large. At the same time, the outlook for speculators and investors in the European and US markets improved in 1996 and 1997. Interest rates looked set to rise, presenting lenders with opportunities for higher risk-adjusted returns than from further Asian

[36] Jan Kregel, "Yes, 'it' did happen again—a Minsky crisis happened in Asia", March 1998, unpublished, Jerome Levy Institute, New York.
[37] For more on the chronology of the crisis see Wade, "The Asian debt-and-development crisis of 1997-?", op.cit.

investments. Equity markets soared. [38] In Japan, on the other hand, the outlook turned for the worse in the second quarter of 1997. In early May 1997, Japanese officials, concerned about the decline of the yen, hinted that they might raise interest rates. The threat never materialized. But the combination of the threat of a rise in Japanese interest rates in order to defend the yen, plus the worries that were circulating about Thailand's currency, plus the brighter opportunities in the US and Europe, raised fears among commercial bankers, investment bankers, and others about the safety of big investment positions throughout the region that were predicated on currency stability.[39] Japanese banks, in particular, began to pull back their lending at home and in Asia, especially in Korea.

Investors scurried to sell holdings in local currencies, especially in Thai baht. When its (spuriously inflated) reserves failed to restore confidence the Thai central bank abandoned the defense. The baht was floated in early July 1997, and sank. The IMF entered the scene in August 1997 with a support package and conditionality measures that included the freezing of many finance companies. This was the start of what Jeffrey Sachs has called the IMF's screaming fire in the theater.[40] The freezing of finance companies sent uninsured depositors into a panic. Later the IMF imposed the closure of some domestic banks in Indonesia with the same result (inevitable where deposits are uninsured).

Taiwan's small (12 percent) devaluation in October, despite its towering foreign exchange reserves, acted as a firebridge from southeast to east Asia. After Taiwan's unexpected devaluation, the Hong Kong dollar and the Korean won suddenly looked vulnerable. In October to December Japanese and European bankers demanded full repayment of interest and principal from their Korean borrowers as short-term loans came due, and the Korean government had no option but to turn to the IMF. The IMF and the Korean government signed a $57 billion rescue package in early December. In mid December the Koreans revealed that their short term debt was nearly double what they had said the previous week, or $95 billion. The comparison between $95 billion and $57 billion left scarcely a dry pair of pants in the official community on either side of the Pacific.

In short, the Asia crisis began as a huge liquidity crisis in Thailand. First the Thai property and stock market bubbles burst. Later the foreign banks realized they had large short term foreign exchange loans to Thai borrowers that were unhedged and uncovered by Thai reserves. Knowing that the profitability of their loans depended on the currency peg they raced for the exits at the first signs that the peg might not hold. The stampede was led by the Japanese and Korean banks, being in parlous condition at home.

A very big rescue package at this point could have stopped the crisis from spreading. In its absence a gestalt shift occured, locking in the region-wide perception of "Asian crony state capitalism" and "busted bank". The label "crony capitalism", originally coined by activists in the anti-Marcos struggle in the Philippines, was now appropriated to convey a told-you-so moral about the dangers of government intervention.[41]

This process was amplified by real economy problems manifested in falling export growth and widening current account deficits. But these were amplifiers, not major causes.

Debt deflation and import inflation

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[38] Chris Rude, "The 1997-98 east Asian financial crisis: a New York market-informed view", Department of Economic and Social Affairs, UN, July 1998.

[39] Jonathan Fuerbringer, "Markets are bolstered as investors flee rout in Asia, *New York Times*, May 14, 1998.

[40] Jeffrey Sachs, "The IMF and the Asian flu", *The American Prospect*, March-April, 1998, pp.16-21.

[41] A point for which I thank Donald Emmerson, personal communication, 2 May 1998.

Once floated the currencies fell in vicious iteration with domestic bankruptcies (which no amount of developmental state socializing of risk could avoid). As foreign banks that had been routinely rolling over their short-term loans began to demand repayment not only of the interest but also of the whole of the principal, highly leveraged firms found their cash flow insufficient to cover their now much higher payment obligations. They started to reduce their cash outflows by delaying payments to suppliers, cutting back on expenditures, raising cash by selling inventories at cut-rate prices, selling assets at whatever they could fetch, and firing employees. In Korea and Southeast Asia the proportion of technically insolvent large companies (unable to pay interest charges out of net cash flow) is expected to jump between 1997 and 1998 from 21 percent to 32 percent in Korea; Malaysia, from 11 percent to 19 percent ; Indonesia, 16 percent to 46 percent; Philippines, 11 percent to 18 percent.[42] The calculations date from February 1998. More recent ones would show higher figures for 1998. The tragedy is that many of these insolvent companies were well managed and profitable in competitive markets.

The process is feeding through from firms to banks as banks write off loans and write down assets. Their calling in of loans puts pressure on their borrowers, and those that go bankrupt put pressure on their lenders. There is a vicious interaction between the financial economy and the real economy.

This is "debt deflation", akin to the Great Depression of the 1930s.[43] Debt deflation is a downward pressure on prices of both products and of assets at a time when investment demand is falling, resulting in a *rising* real value of debt. It is given a vicious twist in Asia by the steep rise in the price of imports, including intermediate goods and medicines. Asia is now caught in the slow, painful unfolding of debt deflation with import inflation. It is all the worse because of Asia's high debt/equity ratios, that impart a bigger multiplier effect to a given reduction in demand and cash flow. This is how, in the chaos theory metaphor, the butterfly that flapped its wings in Thailand caused a tornado in Korea.

The IMF's role

The IMF's interventions in Thailand, Indonesia and Korea (and informally, without funding, in Malaysia) have made things worse than need be, according to this story. Misdiagnosing the problem as a macroeconomic balance of payments problem (the type of problem it is used to dealing with) rather than as a microeconomic debt deflation problem, and as a crisis of excess consumption rather than excess investment, it insisted on a domestic austerity package and on fundamental structural reforms in return for bailout funds.[44] It justified big increases in real interest rates on the grounds that high rates would incentivize domestic capital to stay at home and foreign lenders to resume lending, which would boost the currency.

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[42] A comparable calculation for Thailand, for 1996 and third quarter 1997, gives a jump from 12 percent to 36 percent. The figures are to be taken as no more than rough approximations. They are based on Goldman Sachs, *Asset Quality for Korean Banks, Part II, Bottom-Up Approach for Estimating NPLs*, February 19, 1998, William Mako, *Thai Corporates: Origins of Financial Distress and Measures to Promote Voluntary Restructuring,* as elaborated by Michael Pomerleano, "The East Asia crisis and corporate finances: a micro story", preliminary draft, World Bank, May 1998.

[43] Jan Kregel, op.cit., Wade and Veneroso, op.cit., Wade 1998, op.cit.

[44] The Fund's conditions in Asia are open to the same critique as Mark Blaug makes of economists' advice about the transition problem in Eastern Europe. "We have not been very good at thinking about the transition problem in Eastern Europe because we have not been thinking about how market economies actually work and what is required to make markets function. So our advice to Eastern Europe has been very wooden…". Mark Blaug, "The state of modern economics: the problems with formalism", interview, *Challenge*, May-June 1998, pp.35-45, at p.43.

The currency boost would both make it less expensive for domestic firms to repay their foreign debts and check the dangers of competitive, 1930s-style devaluations.

This was the theory. In practice, the increase in real interest rates, combined with other elements of the austerity package (tax increases, cuts in government expenditure), only depressed firms' cash flow and raised their fixed payment obligations, tipping more and more into insolvency, accelerating the outflows and reducing the inflows. In prioritizing the return of capital flows the Fund forgot that private capital flows are cyclical rather than countercyclical. When a whole economy is sinking and instability abounds foreign capital will not return whatever the interest rate. Certainly the high real interest rates did not have the effect of reversing the currency falls in Asia. And the cross-country evidence shows no clear relationship between the level of real interest rates and changes in the exchange rate. [45]

A sharp dose of austerity may make sense for a Latin American-style excessive consumption crisis. But the Asian crisis was related to excessive investment (much of it in nontradeables), not excessive consumption. IMF demand compression worsens already existing problems of excessive capacity.

Similarly, being required to undertake fundamental structural reforms at the height of the crisis worsened confidence, reinforcing the "cronyism-failure" gestalt. Requiring a sharp rise in bank capital adequacy standards in the midst of the crisis caused a cut in credit, a rise in nonperforming loans, and further bankruptcies. The Asian experience confirms that the middle of a liquidity crisis is a bad time to make radical financial reforms.

These various policy mistakes help to explain why the crisis has been so protracted. Their effects are compounded by the high debt/equity ratios of the corporate and financial systems, by the relatively high level of regional integration, the synchronous movement of all the regional economies except Taiwan, and by Japan's stagnation. Mexico in 1994 recovered relatively quickly by exporting to the enormous expanding market to the north, whose political structure was sufficiently institutionalized to accommodate a $20 swing in trade balances in one year. Had Japan been expanding it might have played a similar role as the US to Mexico. Fears of further falls in the Japanese yen (even after the steep fall of June 1998 to 147 yen to the US dollar) add to the continuing reluctance to invest and raise fears of competitive devaluations, notably in China and Hong Kong.

THE FUTURE

As of July 1998 governments of the region are beginning to follow an expansionary policy, lowering real interest rates, expanding the monetary base, and running bigger fiscal deficits. This represents a considerable change of direction.[46] It sets aside the central bank orthodoxy that has dominated the discussion, according to which very low inflation, restrained demand, and high real interest rates are the top priorities. Governments now have to channel credit into export industries, generate an export boom taking advantage of exchange rates, and let the profits therefrom reinforce inflationary expectations in reflating domestic demand. Hopefully inventory depletion will be followed by a bounceback in demand.

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[45] See Joseph Stiglitz, "Knowledge for development: economic science, economic policy, and economic advice", Annual Bank Conference on Development Economics, World Bank, Washington DC, April 1998.

[46] The Fund has endorsed some relaxation. It is not clear how much the Fund had a change of mind and how much it is making the best of fait accomplis. See Wade, "Asian water torture", *Financial Times*, June 23, 1998, Wanda Tseng (acting director, Asia and Pacific department, IMF), "Near-zero interest rates are no panacea for Asia", letters, *Financial Times*, July 6 1998, Wade, "IMF and US Treasury playing catch up on Asia strategy", letters, *Financial Times*, July 14 1998.

Governments may have to reintroduce some form of cross-border capital controls for this strategy to be viable. Indeed, it is not obvious why Asia needs to draw capital from the rest of the world (except in the form of foreign direct investment, a small proportion of the total). Its savings are more than enough to support the volume of investment that is productive and profitable without being speculative. Of course, the reintroduction of some forms of capital controls in Asia would be a major setback in the current Big Push for liberalization of capital movements world-wide, and would be fiercely resisted by western financial interests.[47]

The escape from crisis could be much accelerated through regional cooperation between the governments and their central banks. The lack of deliberately concerted regional expansion is one of the most striking features of the whole story. The region has the means to solve the crisis if only it could put them to work: some $700 billion of foreign exchange reserves between China, Hong Kong, Taiwan and Japan, growing current account surpluses in the crisis-affected countries (even if due more to import compression than export expansion), net creditor positions in terms of foreign asset ownership, and huge savings.

These endowments could easily provide the basis for an Asia Fund. The Fund would help member countries in replenishing reserves as soon as signs of distress become obvious, thereby reducing the chance of investor pullout. It would be designed to be quick disbursing and lightly conditional. Even the first moves towards an Asia Fund might have a gestalt-shifting effect on confidence and send western capital racing to take positions before prices rise—especially if western stock markets fall from current valuations that are, in the US case, twice the previous historic highs. [48]

The main obstacle is political. Japan's proposal for an Asia Fund, made in mid 1997, was shot down by the US Treasury, which wanted any such thing to be within the IMF. Japan has since exercised negligible leadership, and remains paralyzed by the power struggle between big manufacturing, wanting a weak yen, and banks, wanting a strong yen. China has shown a moderate amount of leadership, and emerges from the crisis with its reputation enhanced relative to Japan's. But it is the US Treasury under Secretary Rubin and Under Secretary Summers that has been shaping the overall strategy, both directly and indirectly via the IMF.[49] The US emerges from the crisis with much greater power in the region than it had before. And the US does not want an Asian initiative that would exclude it from a central role.[50] Nor does China want a Japanese-led fund.

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[47] See Wade and Veneroso, op.cit., and Wade, "The Asian debt-and-development crisis of 1997-?", op.cit. Chris Rude, "The 1997-98 east Asian financial crisis", op.cit., emphasizes the ambiguity in the minds of Wall Street money managers about what to do. Wearing their "market professional" hat they are sympathetic to the idea of various forms of capital controls, temporary or otherwise, because they see—not just in the Asian crisis—that international financial markets can be severely dysfunctional. Wearing their "businessman" hat, however, they want total freedom and national treatment. This suggests that a serious push for a more regulated international monetary system, complete with potential for capital controls, might not be as strongly opposed from Wall Street as is generally thought.

[48] The record-breaking rise in American stocks has been propelled partly by capital coming out of Asia. See Jonathan Fuerbringer, "Markets are bolstered as investors flee rout in Asia, *New York Times*, May 14, 1998.

[49] Jacob Weisberg, "Keeping the boom from busting", *The New York Times Magazine*, July 19, 1998, p.24 ff. Also Wade and Veneroso, op.cit., Wade, "The Asian debt-and-development crisis". Note that the State Department, Commerce Department, National Economic Council, National Security Council and CIA have had virtually no role; Treasury has called all the shots.

[50] At the Hong Kong Annual Meeting of the Fund and the World Bank in late September/early October 1997 Eisuke Sakakibara, Japanese vice-minister of finance for international affairs, called a meeting of senior Asian finance officials without informing the Americans. When word reached Treasury Under Secretary Summers he left his meeting, entered the room where the Asian officials were gathered, sat down at the table and said, "Now where were we?". From a source who requests anonymity.

Until Asian governments—very much including the Japanese government-- adopt expansionary policies, take control of short-term capital movements, and cooperate within the region, the crisis is likely to drag on and on, like water torture, bringing poverty and insecurity to hundreds of millions of people and turning parts of Asia into a dependency of the IMF and its number one shareholder.

CONCLUSION

"Real" or "financial" causes? Rational behavior, boundedly rational, or nonrational? Individually rational and collectively nonrational? Specific and exceptional market failure or well-working markets producing massive economic, political and social failures? Suffice to say here that nonrational behavior--steered by a gestalt rather than by careful information search and analysis of costs and benefits, risks and rewards--is deeply implicated. And that, for this reason, the scale of the inflows and the outflows was hugely disproportional to the underlying prospects for returns—both ways.

The inflows and outflows themselves reflect, first, capital account opening, second, fixed exchange rates, third, lack of bank supervision, fourth, relative returns to financial assets in Asia, the US and Europe (first higher in Asia, then higher in the US and Europe).

Had the massive outflow not occurred in Thailand or had it been reversed in a matter of a couple of months the crisis would probably have been contained. One can see several turning points where things might have taken a different course. For example, had the Japanese government, in August 1997, matched its pledge to play a big role in promoting financial stability in the region with a contribution to the Thai bailout of $10 billion rather than $4 billion, confidence may have been restored. Similarly had the US Congress not declined to provide more funds to the IMF in November 1997 because of a dispute about an *abortion*-related amendment to the country's foreign aid program. Had the Japanese government not made a colossal macro error in the spring of 1997 of raising taxes as the economy was slowing the Japanese economy might still be expanding and able to act as locomotive for the region.

It took the conjunction of many events that could easily have been different to produce a crisis on anything close to this scale, and in that sense it was under-determined. This is to make the contrast with interpretations that stress major vulnerabilities in the real economy as the causes, according to which a major crisis was bound to happen, and any of many events could have triggered it; in this sense the crisis was over-determined. As I read the evidence the real economy trends, notably falling export growth and widening current account deficits, were amplifiers, not prime causes.

In particular, and contrary to a bedrock assumption of the IMF strategy, the "weaknesses" of domestic financial, corporate and labor systems cannot be central to the explanation. These weaknesses had not prevented several decades of exceptional growth. We have no theory that can explain why the systems might suddenly turn dysfunctional. Invoking their dysfunctionality as important causes is little better than tautology.

China stands as a counter point. It has many characteristics of the crisis countries, pre-crisis, only more so: great dynamism and huge structural problems. Its banking system is in worse shape than Thailand's or Korea's before the crisis. Its escape from a direct hit reflects its closed capital account, implicit government guarantee of deposits, and big foreign exchange reserves.

However the explanation is parsed, capital account opening stands at the center. Yet the IMF and the US and UK Treasuries insist that the crisis demonstrates the importance of

liberalizing the capital account even more—though in an "orderly" way. [51] Orderly means with a proper regulatory and supervisory regime in place. The way to create that regime, they say, is to bring in foreign banks and financial services firms to operate in the domestic market. They will demand an effective regime and help to supply the skills to operate it with. In return, they will require freedom to enter and exit as they wish, and national treatment (parity with domestic firms, or better).

Even with a sizable sector of foreign financial firms, developing an effective regime will take many years. And duration aside, regulation according to whose norms? The norms of a capital-market-based Anglo-American system are very different to those of a bank-based Asian system. The latter reflect the functioning of a system that allows firms to carry much higher levels of debt than consistent with Anglo-American prudential limits. The system has powerful developmental advantages as well as higher risks of financial instability. And it also seems to be a response to very high levels of household savings that are deposited in banks. A regulatory regime based on Anglo-American norms of prudent debt/equity ratios will probably not work in these conditions.

The idea that the way to avoid more Asian-style crises is to integrate national economies even more fully into world capital markets is folly. As Dani Rodrik remarks, "Thailand and Indonesia would have been far better off restricting borrowing from abroad instead of encouraging it. Korea might just have avoided a run on its reserves if controls on short-term borrowing had kept its short-term exposure to foreign banks, say, at 30 percent rather than 70 percent of its liabilities. On the other hand, which of the recent blowups in international financial markets could the absence of capital controls conceivably have prevented?"[52] There is little empirical evidence that capital account opening improves economic performance.[53]

The greatest concern about capital account convertibility, however, is that it brings economic policy in developing countries even more under the influence of international capital markets—the influence of a small number of country analysts and fund managers in New York, London, Frankfurt, and Tokyo. Even if it were the case that free capital movements, in spite of susceptibility to panics, do lead to efficiency *in the allocation of capital* and as such do maximize the returns to capital world wide, governments have much more than the interests of the owners of capital in view—or ought to have. They want to maximize the returns to labor, to entrepreneurship, to technical progress, and to maximize them within their own territory rather than somewhere else; they want to provide public goods that contribute to the good life. Only blind faith in the virtues of capital markets could lead one to think that maximizing the returns to capital and promoting development goals generally coincide.

At the least we should insist on a linguistic convention. "Investor" should be used only for someone who allows his money to be used for the production of goods and services in return

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[51] See for example the lead article in the *IMF Survey*, vol. 27, n.6, March 23, 1998, "An 'irreversible trend': Seminar discusses the orderly path to capital account liberalization". It quotes Managing Director Camdessus saying that the trend toward capital account convertibility is "inevitable" and "all countries have an important stake in seeing that the process takes place in an orderly way".

[52] Dani Rodrik, "Who Needs capital account convertibility?" paper to be included in a publication of the International Finance Section, Princeton University, Harvard University, February 1998.
p.3. Also Jagdish Bhagwati, "The capital myth: the difference between trade in widgets and dollars", *Foreign Affairs,* May 1998.

[53] See Stiglitz, "Knowledge for development", Rodrik, "Who needs capital account convertibility?", Bhagwati, "The capital myth". But see Dennis Quinn, "The correlates of international financial deregulation", *American Political Science Review*, v.91, September, 1997, pp.531-51. Using a large cross-country sample covering the 1950s to the 1990s Quinn finds benefits of capital account opening in terms of economic growth, corporate tax collection, increases in government transfer payments; and also a strong association with rising income inequality.

for a share in the proceeds, including the purchase of new shares. Someone who buys financial assets in secondary markets in the expectation of subsequently selling them at a profit due to exchange rate shifts or asset price shifts related not to dividend flows but to the number of buyers and sellers is properly called a “speculator”. The distinction helps to avoid assuming that what is good for speculation is also good for investment.

END

TABLE 1: CHANGE IN EXCHANGE RATES AND STOCK PRICES IN ASIA
(% between June 2 1997 and March 24 1998)

East Asia

	Exchange Rate Against US$	Stock Index	Total
Japan	-11	-17	-28
China	0.2	-11	-11
South Korea	-36	-34	-70
Hong Kong	-0.1	-22	-22
Taiwan	-15	10	-5

Southeast Asia

	Exchange Rate Against US$	Stock Index	Total
Thailand	-36	-17	-53
Malaysia	-31	-34	-65
Indonesia	-72	-24	-96
Singapore	-11	-20	-31
Philippines	-29	-18	-47
United States	---	+24	+24