



Woodrow Wilson
International Center
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Asia Program



TEN YEARS AFTER: REVISITING THE ASIAN FINANCIAL CRISIS



EDITED BY BHUMIKA MUCHHALA

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Revisiting the Asian Financial Crisis



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GLOSSARY

ABMI	Asian Bond Markets Initiative
ADB	Asian Development Bank
APEC	Asia Pacific Economic Cooperation
ASA	ASEAN swap arrangement
ASEAN	Association of Southeast Asian Nations
ASEAN+3	Association of Southeast Asian Nations plus China, Japan, and South Korea
ASP	ASEAN Surveillance Process
ASR	ASEAN Surveillance Reports
BBPN	Indonesian Bank Restructuring Agency
BI	Bank Indonesia
BIS	Bank for International Settlements
BSA	Bilateral swap arrangement
CBS	Currency board system
CCL	Contingent Credit Lines
CMI	Chiang Mai Initiative
EMEAP	Executives' Meeting of East Asia-Pacific Central Banks
ENSO	El Nino Southern Oscillation
ERP	Economic Review and Policy Dialogue
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Forum
FTA	Free Trade Agreement
G7	Group of Seven

G8	Group of Eight
GDP	Gross domestic product
HIPC	Heavily Indebted Poor Countries
IEO	Independent Evaluation Office of the International Monetary Fund
IIF	Institute for International Finance
IMF	International Monetary Fund
IRB	Internal ratings-based
LDCs	Lesser-developed countries
LTCM	Long-Term Capital Management
NIFA	New international financial architecture
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of the Petroleum Exporting Countries
ROSCs	Reports on the Observance of Standards and Codes
SDDS	Special Data Dissemination Standards
SDRM	Sovereign Debt Restructuring Mechanism
SME	Small and medium enterprise
TOU	Terms of Understanding
IEWS	Vulnerability Indicators and Early Warning Systems
WTO	World Trade Organization

INTRODUCTION

BHUMIKA MUCHHALA

The Asian financial crisis of 1997–98 is now seen as one of the most significant economic events in recent world history. The crisis began in early July 1997, when the Thai baht was floated, and spread into a virulent contagion—leaping from Thailand to South Korea, Indonesia, the Philippines, and Malaysia. It led to severe currency depreciations and an economic recession that threatened to erase decades of economic progress for the affected East and Southeast Asian nations.

The sequence of events triggered a self-reinforcing spiral of panic, which many analysts argue was premised on a confluence of the inherent volatility of financial globalization and the weak domestic financial systems in East Asia. Financial liberalization in the region led to surges in capital flows to domestic banks and firms, which expanded bank lending, ultimately resulting in a rapid accumulation of foreign debt that exceeded the value of foreign exchange reserves. As international speculation on dwindling foreign reserves mounted, the regional currencies came under attack.

During the summer of 1997, Thailand sharply reduced its liquid foreign exchange reserves in a desperate attempt to defend its currency. When the Thai baht was cut loose from its dollar peg, regional currencies plunged in value, causing foreign debts to skyrocket and igniting a full-blown crisis.¹ By mid-January 1998, the currencies of Indonesia, Thailand, South Korea, the Philippines, and Malaysia had lost half of their pre-crisis values in terms of the U.S. dollar. Thailand's baht lost 52 percent of its value against the dollar, while the Indonesian rupiah lost 84 percent. During the last stages of the Asian crisis, the regional “financial tsunami” generated a global one as Russia experienced a financial crisis in 1998, Brazil in 1999, and Argentina and Turkey in 2001.

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The various participants in the Asian crisis ranged from Wall Street to Jakarta. Asian and Western governments, the private sector, and the International Monetary Fund (IMF, or the Fund), established to provide temporary financial assistance to help countries ease balance of payments adjustments, all played crucial roles in the sequence of the crisis. Perhaps the most controversial role was that of the IMF. Its critics argue that the stringent monetary policies and financial sector reforms attached to the Fund's loan programs exacerbated the crisis, while its supporters maintain that those very policies helped to dampen the effects of the crisis. Governments, banks, and firms in the crisis-affected countries were charged with "fundamental weaknesses," in that a lack of transparency and regulatory oversight in domestic financial systems and institutions was at the roots of the crisis. The international market was seen to have acted in panic, as a "herding" effect prompted a massive capital outflow from the East Asian countries.

The resulting economic recession shocked the world with its staggering economic and social costs. Over a million people in Thailand and approximately 21 million in Indonesia found themselves impoverished in just a few weeks, as personal savings and assets were devalued to a fraction of their pre-crisis worth. As firms went bankrupt and layoffs ensued, millions lost their jobs. Soaring inflation raised the cost of basic necessities. Strapped fiscal budgets imposed a financial squeeze on social programs, and the absence of adequate social safety nets led to grim economic displacement. Poverty and income inequality across the region intensified, as a substantial portion of the gains in living standards that had been accumulated through several decades of sustained growth evaporated in one year.

The severity of the Asian financial crisis came as a genuine surprise to many in the international community because the affected countries were the very economies that had achieved the "East Asian miracle." The East Asian miracle that saw the transformation of East Asian economies from poor, largely rural less-developed countries to middle-income emerging markets has been one of the most remarkable success stories in economic history. Scholars assert that the East Asian miracle was real, as not only had GDP significantly increased, but poverty had decreased, and literacy rates as well as health indicators had improved.² Overall poverty rates for East Asia fell from roughly 60 percent in 1975 to 20

percent in 1997. So, what happened? How did the very economies that were being praised for their dramatic success turn into the same ones being reprimanded for their collapse?

DEBATING THE DIAGNOSIS

The impact of the Asian financial crisis raised deep doubts about the reigning ideology of financial globalization and the design of the international financial architecture. The volume of literature and analyses on the root causes of the Asian crisis, and the lessons that need to be learned, is extensive. Scholars and analysts debate a wide diversity of arguments and counter-arguments, and thus, while popular perspectives abound across different communities, there is no one single consensus on the causes of the crisis.

One group of experts maintains that the crisis resulted from the “fundamental weaknesses in the domestic financial institutions” of the affected countries.³ This group of analysts argues that the liberalization of domestic financial markets was not accompanied by necessary levels of transparency and regulation. Corporate financial structures in the region, too, it is argued, were riddled with governance problems such as endemic corruption, the concentration of ownership, and excessive levels of government involvement. The counter-argument emphasizes that the economic successes of the East Asian economies belies the notion that they were “dysfunctional economies.” This group of analysts states that the lack of transparency and the weakness of financial systems do not necessarily lead to financial crisis—otherwise, what can explain the relative insulation from the Asian crisis for countries such as China and India?

In the ten years since the Asian crisis, many scholarly as well as popular evaluations of the crisis have contended that international financial liberalization, characterized by the free and rapid mobility of short-term capital, played the central role in instigating the crisis. In the decade that preceded the onset of the crisis in mid-1997, East Asian economies had moved toward financial liberalization, which can leave developing countries vulnerable to financial speculation, sudden changes in the exchange rate, and surges in capital inflows, which simultaneously increases the risk of capital outflows. This phenomenon, often referred

to as “hot money,” is a direct result of the intrinsically volatile international financial market. The salience of financial liberalization is reinforced by the fact that the financial crises of the 1990s—Mexico, Turkey, and Venezuela in 1994, Argentina in 1995, and the East Asian countries in 1997-1998—shared the element of sudden, unanticipated, and volatile shifts in global capital flows, which resulted in deep economic contractions.

LESSONS THAT LIVE ON

Voices from around the world have pronounced a wide gamut of lessons that the crisis presented. One of the most widely discussed lessons in the international community is the imperative to build a new international financial architecture. Such a new architecture would ensure the efficient allocation of capital, manage free capital mobility, provide financial safety nets, address information asymmetries, and prevent “herding” in the financial markets.⁴ The goal of this new architecture is to improve the tradeoff between financial liberalization and financial stability, and thereby prevent financial crises or help resolve them at the lowest possible cost should they occur. However, this macro-vision of a new international financial architecture has not materialized, as economists today admit that there still exists a real need for an international financial architecture to design the rules of the financial system in ways that enhance global stability and promote economic growth.

A fundamental lesson that has been reinforced in various global fora is that large capital inflows can potentially have a destabilizing impact on the recipient economy, particularly when the local currency is convertible. Short-term capital inflows, in particular, are inherently volatile in a world of free capital mobility, and can trigger losses in investor confidence that can result in large losses in foreign reserves and currency depreciation. Thus, “excessive reliance on external capital needs to be avoided” through a cautious management of capital inflows.⁵ Joseph Stiglitz asserts that the dangers associated with capital market liberalization are one of the most important lessons of the Asian crisis, pointing out that “it was not an accident that the only two major developing countries to be spared a crisis were India and China. Both had resisted capital

market liberalization.”⁶ Furthermore, the Malaysian experience during the Asian crisis highlights that developing countries that have liberalized their financial sector can still manage their capital flows through certain policy tools, such as selective capital controls or regulations to discourage or prevent speculation.⁷

The crisis-affected Asian countries also learned a critical lesson through their loan programs with the IMF. The Fund provided more than \$100 billion in emergency funds to Thailand, Indonesia, and Korea—the three worst-hit countries—with the goal of restoring investor confidence and ameliorating the economic crisis. However, rather than achieving their stated goals, the Fund’s programs seemed to accelerate capital flight. Steven Radelet and Jeffrey Sachs argue that the IMF’s inappropriate focus on “overhauling” financial institutions in the heat of the crisis worsened investor confidence by re-emphasizing domestic financial weaknesses.⁸

Furthermore, the structural reforms of the IMF programs at the time have since been termed “mission creep,” because they included reforms in areas that are not typical of the Fund’s financial surveillance. Indeed, the Fund’s Independent Evaluation Office revealed in a 2003 report that it was said at the time in policy circles in Jakarta that the list of structural reforms in IMF programs “was grabbed by the IMF team off the shelf of the Jakarta office of the World Bank.”⁹ Critics of the IMF loan programs demonstrate how the high interest rates prescribed by the Fund, and intended to curtail currency depreciation, induced a severe “credit crunch” that exacerbated the financial dilemmas of local banks and firms and had a sharp deflationary effect on domestic economic activity.

TEN YEARS ONWARD: WHERE IS ASIA NOW

Ten years onward, the economies once under attack in the Asian financial crisis have demonstrated what many experts claim is a remarkable “V-shaped recovery.” The macroeconomic indicators of the region today illustrate that after a deep decline in 1998, the average GDP of the region climbed back to 4–6 percent annual growth between 1999–2005, although this is still lower than the average of 7–9 percent the region experienced in the pre-crisis years of 1991–1996.¹⁰ The lower growth rates

are attributed to lower investment levels, which unlike regional GDP, did not exhibit a V-shaped recovery. Currency depreciation, however, has not fully recovered. The Korean won has recovered to 95 percent of its pre-crisis level, the Thai baht and Malaysian ringgit to 70 percent, the Philippine peso to 50 percent, and the Indonesian rupiah, faring the worst, to 25 percent.

However, the once near-depleted foreign reserves of the economies in crisis are now teeming in surplus as the region has learned to “self-insure” itself against the dire balance-of-payment difficulties that it endured a decade earlier. In fact, by February 2007, the foreign currency reserves of the region exceeded \$3.2 trillion, of which China’s reserves constituted \$1.1 trillion. There is also evidence that the lessons of unbridled financial liberalization have been absorbed by regional policy-makers and firms, as they now issue fewer external bonds.

The Association of Southeast Asian Nations (ASEAN) plus 3 (China, Japan, and South Korea) have established a number of regional financial initiatives in order to strengthen the region’s economic resilience. The best known of these initiatives is the Chiang Mai Initiative (CMI), which entails a network of bilateral swap arrangements among the member countries of ASEAN+3. In May 2007, finance ministers from the 13 ASEAN+3 nations agreed to pool part of their foreign exchange reserves in order to “multilateralize” the CMI. News analyses report that Asian governments are driven to prevent a repeat of the crisis that depleted the region’s holdings ten years ago, as well as to avoid having to rely on institutions like the IMF. The CMI and other related ASEAN+3 frameworks reflect the logic of East Asia’s “counterweight strategy,” in that the region aims to develop its own financing leverage and potential financing alternatives. This strengthens the region’s influence in the evolution of the Fund and other Bretton Woods institutions without provoking the key global powers in the West.¹¹ Such a counterweight strategy empowers the region to sustain its crucial relationships with the G7 countries and institutions without being vulnerable to unfavorable changes in the international financial system.

To mark the passing of ten years since the Asian financial crisis, on May 16, 2007, the Woodrow Wilson International Center for Scholars hosted a day-long conference organized by the Center’s Asia Program, in co-sponsorship with the Sasakawa Peace Foundation and the Center

for Economic and Policy Research. Conference participants were invited to analyze the causes, symptoms, and aftermath of the crisis, identify and assess which lessons have been learned, and forecast the regional outlook. The conference sought to re-visit the debates on the Asian crisis in light of global and regional economic changes that have occurred over the years. Ten years onward, it is an opportune time to re-examine the fundamental issues of financial liberalization and financial sector reforms. It is also imperative to evaluate the recovery paths adopted by the crisis-affected countries, particularly in terms of their implications for equitable and sustainable development. This publication is an outgrowth of that Wilson Center conference.

In this volume's opening essay, Jomo Kwame Sundaram, assistant secretary-general for economic development at the United Nations Department for Economic and Social Affairs and a development economist, provides an account of the divergent diagnoses of what caused the Asian financial crisis. The Asian crisis transformed the previously favorable opinions of the East Asian miracle to condemnation of the region's "crony capitalism," where government and corporate officials provided lucrative opportunities for their friends and relatives. However, Jomo's paper points out that industrial conglomerates, informal agreements, and other stereotypes of Asian management may have been optimal in a context of underdeveloped legal systems and powerful political decision makers, and may have, at one point, been conducive to the region's rapid growth. Instead, he contends that the Asian crisis was the consequence of international financial globalization, based on the free global flow of easily reversible capital. Weak corporate governance in East Asia was not the sole determinant of the crisis; rather, it became problematic due to domestic financial sector liberalization.

The severity of the Asian financial crisis was exacerbated by two important international institutions: financial markets, and the IMF's policy-setting influence. The policy response of the Fund was to recommend augmenting fiscal surpluses to the crisis-affected countries, instead of attempting to offset the economic deflation through counter-cyclical macroeconomic policies. The author writes that the Fund's directive also included raising interest rates in order to win back investor confidence and re-stimulate foreign capital flows. This caused local liquidity to tighten, which squeezed domestic businesses and undermined their

potential to contribute to the rebuilding of local economies. Learning from the past, Jomo emphasizes the need to “formulate counter-cyclical macroeconomic policies that reduce financial volatility,” the importance of expansionary fiscal policies to propel economic development, and the challenge of creating “an inclusive international financial system” where all levels of society can access credit.

Soedradjad Djiwandono, who was the governor of Bank Indonesia from 1992 to 1998 and a key player in Indonesian policymaking during the Asian financial crisis, provides an Indonesian insider’s view of the Asian crisis. The crisis, as it occurred in Indonesia, was not just a financial crisis, Djiwandono emphasizes, but a historical chapter for the nation, as it triggered the fall of strongman Suharto, which led to a national transition to democracy. The Indonesian crisis was instigated by “an external financial contagion” that started with the rapid depreciation of the Thai baht in early July. When the contagion hit Indonesia’s structurally weak institutions, such as the banking and corporate sectors, the result was a destructive attack on the Indonesian rupiah. Djiwandono argues that the cause of the Indonesian crisis cannot be assigned to either external shocks or domestic weaknesses; rather, the root causes have to be understood as having stemmed from both the external and internal factors, the sum of which was “further complicated by the inconsistent responses of the IMF and the private sector.”

Indonesia’s decision to invite IMF assistance, writes Djiwandono, sought to restore “market and public confidence in the Indonesian economy.” Thus, when the closure of 16 banks in September 1997 was required for an IMF stand-by loan, the local authorities complied. But the bank closure turned out to be a “total disaster.” The explosive mix of bank closures and tightened monetary policies pushed Indonesian banks to the brink, catapulting a banking crisis into a complete economic crisis, which “utterly failed to bring back market confidence.” Another financial crisis is not imminent, Djiwandono asserts, because of stable regional economic conditions, exemplified by the region’s large foreign reserves, and because current accounts are in surplus and exchange rates are flexible. However, he warns against being complacent, as today’s unsustainable global imbalance poses a “threat with huge risks of unwinding.”

Meredith Jung-En Woo, a professor of political science at the University of Michigan, provides a unique account of a “new” Sino-

centric order that unfurled across East Asia in the aftermath of the 1997–98 crisis, and its implication for a “significant reorientation of East Asia toward the Chinese fold.” In her paper, Woo states that the rapid recovery experienced by the crisis-affected countries occurred in the context of China’s rise to power, to which the crisis-affected economies had to accommodate themselves. Woo contends that the growth of Korea and the Southeast Asian “tigers” took place “on borrowed time until China would roar back into the world market.” The “sequestration of China since 1949” constituted a primary prerequisite upon which the crisis-affected economies were able to achieve sustained economic growth from the mid-1980s to the onset of the Asian crisis in mid-1997. Another key precondition for East Asian growth was the minority populations of ethnic Chinese entrepreneurs residing in the East Asian countries—who were “the true locomotive of the region’s spectacular rise.”

The Asian financial crisis, Woo states, was a historical marker, in that it marked the end of the “East Asian Miracle,” and simultaneously, the rise of Chinese economic power. “It is no longer the Japanese who march through Southeast Asia in search of investment in natural resources and manufacturing,” writes Woo, “Now, it is the South Koreans who do so, and most importantly, the Chinese, who are increasingly replacing the Japanese as the main source of foreign investment in the Asia Pacific region.” The sequestration of China now over, the Chinese diaspora across Southeast Asia “stitches East Asia into a coherent regional order” by intermediating between Chinese capitalism and local East Asian economies.

David Burton, the director for the Asia and Pacific department at the IMF, offers the perspectives of the Fund on the causes of the crisis. In his essay, he illustrates how Asia has strengthened its economic foundations as well as the ways in which the IMF has reformed itself over the last ten years in response to the Asian financial crisis. The crisis-affected Asian economies have made significant progress in three key ways. First, macroeconomic policy frameworks have been strengthened, particularly through the substantial accumulation of foreign reserves. Second, the transparency of policies has increased, as reflected in the routine disclosure of external debt and reserve information by Asian authorities. Third, corporate governance has improved through the reform of regulatory and supervisory systems. The author asserts that the Fund’s role

has changed significantly since the Asian crisis, in that “the Fund no longer has programs with emerging market countries.” Burton provides an account of the significant ways in which the Fund has reformed itself in response to the Asian crisis, for example, through financial sector surveillance, recognition of the importance of “country ownership,” improvements in the Fund’s crisis prevention tools, and reforms in the internal governance of the Fund in order to ensure greater “voice and representation” of Asian countries.

In his essay, Burton attributes the Asian crisis to financial and corporate sector weaknesses in the region, particularly the fixed exchange rates of crisis-affected Asian countries that encouraged unhedged foreign borrowing, insufficient foreign reserves, and a lack of transparency. Burton commends the crisis-affected Asian countries for not withdrawing from financial globalization, and for acting on the principal lesson of the Asian financial crisis—that a robust financial sector is essential for reaping “the potential gains that financial globalization offers.” This is in sharp contrast to Jomo, who attributes the Asian crisis to international financial liberalization, and the exacerbation of the crisis to the policies and programs of the IMF. Meanwhile, in her essay Woo describes the financial crisis as a “liquidity crisis, exacerbated by idiosyncratic institutional practices in the affected countries,” while Djiwandono writes that the crisis was the result of both domestic weaknesses of economic management, and external shocks of financial globalization, and was “further complicated by the inconsistent responses of the IMF, the private sector, and other stakeholders.”

A professor of international political economy at the London School of Economics, Robert Wade provides a detailed analysis of the development of “comprehensive and universal standards of good practice in global finance” in the decade since the onset of the Asian financial crisis. These standards, Wade writes in his essay, are enforced by market reactions to information about national compliance with the standards, “such that countries, banks, and firms which comply more with the standards gain better access to finance.” He terms this process the post-Asian financial crisis “standards-surveillance-compliance (SSC) system.” While the SSC system may, at first glance, seem like a supplement to the “Washington consensus,” Wade argues that the SSC system signifies an augmented level of “supranational authority” on international financial

markets. The author outlines a set of key issues to justify his conjecture, such as the increased propensity of financial market participants to “herd” due to the effects of the SSC system, thereby increasing the volatility and pro-cyclicality of international capital in developing countries. The SSC system confers structural advantages, writes the author, to developed country banks and structural disadvantages to developing country banks through, for example, the “capital adequacy requirements” imposed on banks in developing countries.

Wade suggests that the current international financial system contains a “liberal paradox,” in that the liberal value of “free markets for market participants” is not balanced by the liberal values of “national choice of policy framework” and democratic participation, as developing countries are not adequately represented in financial standard-setting fora. In conclusion, the author advocates three changes to the SSC system—a revision of the IMF’s surveillance standards in order to place greater emphasis on the global economy and cross-border “policy spillovers,” a revision of financial standard-setting processes so as to give developing country governments and banks more voice, and an international acceptance of capital controls as a “legitimate instrument” of developing country financial system management.

Ilene Grabel, professor and director of the graduate program in Global Trade, Finance, and Economic Integration at the University of Denver, contextualizes the financial crises of the 1990s as having occurred in “financially fragile environments fueled by speculative booms made possible by misguided programs of internal and external financial liberalization.” In her contribution to this volume, Grabel argues that the diagnosis of the crisis that attributes its roots to the lack of transparency about the true conditions of firms, banks, and governments in the crisis countries obscures two central lessons of the crisis: first, that “unrestrained financial liberalization, especially concerning international private capital flows, can aggravate or induce macroeconomic vulnerabilities that often cumulate in crisis,” and second, that “temporary, market-friendly capital controls on global capital flows can play an important role in mitigating financial crises.” The wide range of countries that had implemented capital controls to an extent—such as India, Chile, and Malaysia—had been able to weather the Asian financial crisis successfully. There is something to be learned by their examples, Grabel asserts, noting that the “center of

gravity” has now shifted away from complete opposition to any interference on capital flows to a kind of “tepid, conditional support for some types of capital controls.” However, she cautions that although this may be a move in the right direction, it is still not enough to prevent another economic crisis on the scale of the crisis of 1997–98.

Grabel outlines how recent trade and investment agreements have become a “new Trojan horse” for obliging developing countries to carry out domestic and international financial liberalization. Trade agreements establish mechanisms that punish developing countries for enforcing temporary capital controls and for temporarily halting exchange rate flexibility or adjustments, as these policies can now be viewed as expropriation of foreign investment. The post-crisis policy consensus does not go far enough, Grabel writes, as it fails to endorse the case for meaningfully increasing policy space for developing countries to promote financial stability. Financial stability needs to be placed at the center of a policy agenda that uses “the resources of domestic and international capital markets in the service of economic and human development.” This can be achieved through, for example, developmental financial policies such as strategic lending, credit programs, development banks, or credit guarantee schemes and risk-reducing subsidies on local bank lending. Financial policies in developing countries, Grabel concludes, must focus on generating, mobilizing, and allocating capital to where it has the largest developmental payoff and where important social ills can be addressed.

While Grabel makes the case for “temporary, market-friendly capital controls on global capital flows,” Burton argues that in addition to being difficult to impose and often counterproductive, “capital controls can create doubts about the future direction of economic policy, potentially discouraging foreign direct investment.” Surges in the flow of capital are a “feature of financial globalization,” writes Burton, and there is no “magic bullet” for addressing global capital mobility. The best policy is a combination of “exchange rate flexibility and limited intervention to smooth exchange rate movements.” He states that sharp shifts in capital flows can be offset by deepening financial markets and “further liberalization of restriction on outflows—as warranted by the pace of financial market reform.”

On the other hand, Wade, in concurrence with Grabel, stresses that the scope for using capital controls should be increased. Wade asserts

that the international community has witnessed in the experience of the Asian financial crisis how surges in capital inflows result in exchange rate appreciation, domestic credit booms, and loss of export competitiveness. These effects raise the risk of a sudden “bust” triggered by investor panic and rapid capital withdrawal from a country, thus instigating an economic crisis. Developing countries should “draw the implied lesson,” Wade emphasizes; “they have to protect themselves.” The author advocates that multilateral rules on financial policy should recognize the right of countries to enforce capital controls, for reasons both of national sovereignty and for preventing financial crises.

In his essay, Mark Weisbrot, co-director at the Center for Economic and Policy Research in Washington, argues that the most important long-term impact of the East Asian financial crisis has been that it began a process that led to the collapse of the IMF’s influence over middle-income countries. This was partly a result of the Fund’s role in the crisis, detailed in the paper, which was widely seen as a major failure. Partly as a result of this experience, the middle-income Asian countries have accumulated large reserve holdings and have, for the most part, removed themselves from the influence of the Fund. The author writes of the process through which the authority and credibility of the Fund was further undermined in the Argentine crisis of 1998–2003. In recent years the availability of alternative sources of credit, especially in Latin America, has led to the collapse of the IMF’s “creditors’ cartel” in that region and among middle-income countries generally. The author argues that this is the most important change in the international financial system since the breakdown of the Bretton Woods system in 1973.

For the foreseeable future, any financial reform will be made at the national and regional level—for example, through the extension of arrangements such as the Chiang Mai Initiative. Weisbrot states that this is because the high-income countries are not significantly closer to supporting reforms at the level of the international financial system and its institutions than they were a decade ago.

Several of the essays presented here highlight the new institutional frameworks designed by ASEAN+3 (ASEAN plus China, Japan, and South Korea) that seek to promote regional financial stability, cooperation, and policy dialogue. Worapot Manupipatpong, the principal economist and director of the Association of Southeast Asian Nations

secretariat office in Jakarta, describes four key regional initiatives that aim to strengthen the region's capacity to prevent and manage future financial crises. The ASEAN Surveillance Process monitors and analyzes recent economic and financial developments in the region, identifies any emerging or increasing vulnerability, and raises key policy issues for the consideration of the ASEAN finance and central bank deputies and the ASEAN finance ministers during their peer review. Under the Economic Review and Policy Dialogue, the ASEAN+3 finance ministers meet once a year and their deputies twice a year, to discuss economic and financial developments in their countries as well as emerging policy issues. These first two initiatives, the author explains, "help ensure that macroeconomic policies are not only sound but also coherent and consistent across the region" through asserting peer pressure and support for countries to develop and maintain robust financial systems.

The CMI, Manupipatpong writes, "serves as the region's self-help mechanism" by providing short-term financial support to any ASEAN+3 member that may be experiencing a balance of payments difficulty. The author clarifies that the CMI is intended to be, above all, a quick financial facility for short-term liquidity support; but it also supplements the financing of the IMF. The multilateralization of the CMI, in the author's view, will increase its effectiveness as a financing facility. The goal of the Asian Bond Markets Initiative is to deepen and develop the regional bond market through promoting bonds in local currencies and by creating an enabling environment that facilitates both the issuance of as well as investment in bonds. The author writes that such a regional bond market initiative provides a "viable alternative to bank financing," while enabling a "greater variety of issuers to tap the bond market for funding, including local small and medium enterprises."

While Manupipatpong asserts that regional initiatives will ensure that the region's economies remain robust, Weisbrot takes a different view with regards to the CMI, highlighting that the CMI does not yet represent regional financial autonomy, as any "country wanting to tap into more than 20 percent of the agreed upon reserves would need an IMF agreement." On the other hand, Burton claims that the regional frameworks enhance the "strength and resilience of Asia's financial sectors," thereby strengthening the region's ability to "benefit from the globalization of finance." He suggests that the regional initiatives mentioned

above may have been inspired by a stronger sense of regional identity that resulted from the Asian crisis.

For years to come, the Asian financial crisis of 1997-98 will symbolize for some the catastrophic effects of economic globalization. The crisis heightened the determination of the region to strengthen its financial footing globally. The economic policy debates continue to abound, as analysts still argue over whether the crisis was due to unhinged global capital mobility, or to the “crony capitalists” of the region, made infamous by the authoritarian regime of Soeharto in Indonesia. Meanwhile the IMF suffered a crisis of credibility in the post-crisis years and as a result, has transformed its modus operandi to financial surveillance, assessment programs, and the development of universal best practices in financial standards.

Is the region now forever insulated from the threat of financial crises, or could a repeat of 1997-98 be possible? Looking forward, what are the key challenges and opportunities facing the region? Do the macroeconomic policies and the financial institutions of the region reflect priorities of sustainable and equitable development? Do the new initiatives of ASEAN+3 address the prevailing social inequalities of the region? The eight authors featured in this volume reflect a diverse array of perspectives and inclinations, and address a rich palette of issues. This collection of papers attempts to breathe life back into the events that took place ten years ago, provide powerful analyses of the yet unresolved issues from the Asian crisis that are just as important today, and offer innovative policy recommendations, or warnings, for the future of both the region, and the world at large.

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WHAT DID WE REALLY LEARN FROM THE 1997–98 ASIAN DEBACLE?

JOMO KWAME SUNDARAM

Financial globalization began to gain momentum following the debt crisis of the 1980s. In Southeast Asia, financial globalization took shape in particular ways. The region was less affected by the debt crisis than Latin America as Southeast Asian countries did not borrow international capital as heavily in the 1970s, and thus, were not as vulnerable as Latin American countries were. Nonetheless, the mid-1980s in Southeast Asia saw three devaluations in Indonesia, a single devaluation in Thailand in 1994, and a depreciation of the Malaysian ringgit after the Plaza Accord of September 1985. These devaluations were accompanied by other elements of domestic and international financial liberalization.

THE REGIONAL CONTEXT OF FINANCIAL GLOBALIZATION IN ASIA

In the early 1990s in Indonesia, it became easier for people to borrow directly from foreign sources and for foreign banks to have offices outside Jakarta. This undermined the ability of the Indonesian central bank to

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exercise real authority and effective surveillance. There was a proliferation of banks between 1988 and 1997—before 1988, there were less than a hundred banks, and by the time of the crisis in 1997, there were more than 240 banks.

In Thailand, financial deregulation gained momentum after the 1991 coup, when General Suchinda Kraprayoon toppled the civilian government of then-prime minister Chatichai Choonhavan in a bloodless takeover. The new authorities were induced by foreign advisers to envision Bangkok as a new regional financial hub, as Hong Kong was going to revert to China in 1997. The authorities were encouraged to undertake a number of new financial liberalization initiatives to facilitate this process in Bangkok. Following the restoration of parliamentary rule, the Bangkok International Financing Facility was established in 1993 and the Provincial International Banking Facility was established in 1994. Thus, people throughout Thailand could now access international finance more easily with correspondingly less central bank surveillance.

In Malaysia, developments were very different due to a recession in the mid-1980s and the banking crisis that followed, which led to a tightening of regulatory control with the Banking and Financial Institutions Act of 1989. At the beginning of the 1990s, there was an attempt to increase capital market activity in Malaysia, with the split between the previously linked stock exchanges of Singapore and Kuala Lumpur. The Malaysian authorities organized “road shows” to lure foreign investors to the Malaysian stock market. These efforts were successful, and from 1992 to 1993, there was an influx of capital into the Malaysian stock market. However, toward the end of 1993, there was a sharp reversal with capital flowing out of the country, resulting in a collapse of the stock market. In early 1994, Malaysian finance minister Anwar Ibrahim introduced capital controls to reduce speculative financial inflows. These controls were subsequently lifted in the second half of 1994 due to effective lobbying by those with a strong interest in seeing a dynamic stock market.

In Korea, a different series of developments occurred from 1988 to 1997. The country lost Most Favored Nation status in 1988, and in 1993, joined the Organization for Economic Cooperation and Development (OECD). International experts, including advocates of economic liberalization such as Ronald McKinnon, argued that Korea’s sequencing was

flawed as capital account liberalization should be last. Instead, one of the first things Korea implemented was capital-account liberalization, which enabled and encouraged the financial managers of *chaebol* industrial conglomerates to access international finance, weakening their focus on industrial development in favor of more speculative investments.

CAUSES OF THE CRISIS

The previously mainly favorable opinions of the Asian miracle were radically transformed from praise to condemnation by the Asian currency and financial crises of 1997–98. Once identified and acclaimed as central to the Asian success story, business-government relations became the most obvious example of this rapid shift in opinion. Now denounced as “crony capitalism,” these relations were alleged to have been responsible for the crises.¹ Most analytical accounts characterize the crises as the consequence of international financial liberalization and increased, easily reversible, international capital inflows.² Many accounts have also emphasized the role of the International Monetary Fund (IMF, or the Fund)—particularly its policy prescriptions and conditionalities attached to loans—in exacerbating the crises.³

By the mid-1990s, there were various types of new vulnerabilities in the four economies of Indonesia, Thailand, Malaysia, and Korea, exacerbated by the phenomenon of “herd behavior” among investors, particularly foreign portfolio investors. Thus, the float of the Thai baht on July 2, 1997 had a neighborhood effect, or contagion, as the currency crisis spread. This contagion spread quickly due to the financial “globalization” that had already been occurring across the region.

The financial crisis and contagion were exacerbated by two important international institutions. First, financial markets tend to be pro-cyclical. Various financial market institutions essentially intensified the severity of the financial crisis by inducing pro-cyclical responses. When the economic health of the region was perceived to be good, money poured into the region. Unlike much of the rest of the developing world, the Asian emerging markets attracted vast amounts of capital in the early- and mid-1990s. However, foreign capital suddenly withdrew in 1997, first, from Thailand, and then from the rest of Southeast Asia.

Capital-account liberalization in the East Asian region was the larger context which facilitated processes leading to the crisis.

The Asian financial crisis was also exacerbated by the policy conditionalities and influence of the IMF, now widely acknowledged. In dealing with the crises, the IMF was initially influenced by the first- and second-generation currency crisis theories, presuming trade/current account and fiscal deficits respectively. Thus, instead of responding with counter-cyclical policies, the IMF pressured the affected governments to achieve fiscal surpluses.

One of the central IMF recommendations was to raise interest rates in order to attract international capital flows. This caused local liquidity to tighten, which in turn squeezed local businesses and undermined their potential to contribute to rebuilding the local economies. Midway through the crisis, perhaps after recognizing the errors of its early diagnoses and prescriptions, the IMF and others began to emphasize failures of corporate governance without explaining how this could explain the timing of the crisis. Thus, the IMF also recommended redefining the rules of the game, for instance, by reducing in half the time period after which a loan would be considered a “non-performing loan.” As a consequence of these sorts of measures, in the second half of 1997 and in early 1998, bankruptcies increased sharply across the region.

Beginning in early 1998, there was growing recognition, expressed through extensive criticism and debate at the global level, that the analysis of the financial crises was flawed. A remarkable change in thinking occurred in January and February 1998. Three of the most influential people in international finance essentially changed the establishment interpretation of the Asian crisis. The first person who blamed poor corporate governance in Asia was Alan Greenspan, chairman of the U.S. Federal Reserve. The second was Larry Summers, then deputy secretary of the U.S. Treasury Department, and the third was Michel Camdessus, the managing director of the IMF. Their statements contributed to a new focus on corporate governance, placing the blame for the crisis on “Asian cronyism.” Cronyism became the new analysis, and reform of corporate governance in Asia became the new rallying cry for reform in response to the crisis. In countries like Korea and cities like Hong Kong, there were strong shareholder movements emerged to facilitate new initiatives on corporate gover-

nance. However, in other affected Asian countries, reforms were led by the authorities and the domestic elite.

In 2003, the IMF indirectly acknowledged that its policy responses to the Asian financial crises had been wrong. With two major mea culpas while visiting Malaysia, Horst Köhler, then managing director of the IMF and now president of Germany, acknowledged that under the IMF's Articles of Agreement, member states had the right to impose capital controls on capital outflows, especially in emergency situations. Less than a year after suggesting that Nobel laureate Joseph Stiglitz's 2002 book severely criticizing the IMF was paranoid, Harvard Professor Ken Rogoff, then chief economist of the IMF, acknowledged in two papers written with other IMF staff that "financial globalization" had not contributed to economic growth in developing countries, but had instead exacerbated financial volatility and instability.

INTERNATIONAL RESPONSES AND ATTITUDES TO THE CRISIS

Responses in the region to the crisis varied. Thailand staged a protracted defense of the Thai baht beginning in 1995, when the Thai economy was adversely affected by China's abandonment of a dual exchange rate in favor of a single rate. As Thai exports and growth declined sharply, the Thai baht came under sustained attack by currency speculators. After the crisis broke in Thailand in July 1997, the Malaysian government spent about 9 billion Malaysian ringgit, at that time worth almost U.S. \$4 billion, in less than two weeks in defense of the ringgit before giving up. Other countries in the region did not defend their currencies for as long and therefore did not lose as much money doing so.

The region's economies responded to the crisis in ways primarily influenced by prevailing market sentiment and the IMF. The partial exception was Malaysia, which tried to counter the crisis through a number of initiatives. After a falling out among Malaysian political leaders, there was a brief period from December 1997 when IMF-type policies became more influential. The proposal of an Asian monetary facility in the third quarter of 1997 by Eisuke Sakakibara, Japan's vice minister of finance for international affairs at that time, involved a financing facility with about \$100 billion in resources to deal with the crisis. This was rejected

by the dominant Western financial powers and the Fund. Another type of response, from the second quarter of 1998, was to reflate, as opposed to deflate, the economies in the region by fiscal means. Some East Asian authorities also created agencies to take over non-performing loans, refinance distressed banks, and facilitate corporate debt restructuring.

In mid-1998, an important change occurred in American attitudes towards the Asian crisis. During the first year of the crisis, from mid-1997, the official American response seemed to be one of benign indifference. However, by mid-1998, there was a growing sense that the crisis might not simply be an Asian phenomenon, and that it might spread to Latin America, as well as Russia. In San Francisco, U.S. President Bill Clinton talked about the need for a new international financial architecture. By September 1998, the Russian crisis had reverberations on hedge fund activities, particularly on Long-Term Capital Management (LTCM). This resulted in a private sector bailout for LTCM coordinated by the head of the Federal Reserve Bank of New York. This inadvertently served to legitimize other bailouts, setting an important precedent in the international financial system. The U.S. Federal Reserve also reduced interest rates in the United States, which led to a flow of funds back to the Asian region, which in turn contributed to a rapid “V-shaped” recovery from the last quarter of 1998.

IMPLICATIONS OF THE CRISIS FOR ECONOMIC DEVELOPMENT

Developing countries had been weakened by the debt crises of the 1980s, which began to reverse the gains of the 1970s associated with the New International Economic Order and related initiatives. The conditionalities imposed in the aftermath of the 1980s debt crises, the broad range of reforms associated with the World Trade Organization (WTO), and changing international economic and political circumstances helped advance economic liberalization. Developments following the end of the Cold War as well as new constraints on state initiatives further undermined the capacity for effective intervention by the governments of developing countries.

There is still considerable debate over the implications of the crises for economic development, particularly over whether the Asian experiences of the last three decades offer different lessons and prescriptions for development from those advocated by the “Washington Consensus.” Economists at

the U.S. Treasury, the IMF, the World Bank and elsewhere cite the Asian financial crisis to criticize the preceding “East Asian Miracle” as flawed.

The crisis started not long after Paul Krugman claimed that Asian growth was not sustainable because it was based primarily on factor accumulation—eventually subject to diminishing returns—rather than productivity growth (“perspiration rather than inspiration”).⁴ Many initially saw the Asian currency and financial crises as vindication of Krugman’s argument. Often, there was more than a touch of Western triumphalism in pronouncements of “the end of the Asian miracle.”

In the first year after the Asian crises began in mid-1997, there was limited interest in the West to growing calls from Asia for reforms to the international monetary and financial system. However, the situation changed dramatically a year later as the Asian crisis seemed to be spreading west, with the Russian and Brazilian crises in 1998. The second half of 1998 saw much greater western concern about the international financial system, and the possible damage its vulnerability might cause. Some misgivings focused on the apparently new characteristics of the Asian crisis often described as the first capital account crisis.

RECOVERY AND REFORMS

It is now clear with hindsight that countercyclical, reflationary (as opposed to deflationary) Keynesian policies contributed crucially to macroeconomic recovery from 1999. The institutional reforms—such as the ostensible need for corporate governance reform—argued, by the new conventional wisdom, to be necessary to protect economies from future crises and to return crisis-affected economies to their previous high-growth paths, proved to be largely misleading. Although there is little talk now of reforming the international financial architecture, such systemic reforms are badly needed, not only to avoid and manage future crises, but also to ensure a much more stable and thus countercyclical, inclusive and developmental international financial system.

Macroeconomic Recovery

Before the Asian crisis, there were no clear macroeconomic warnings of imminent crisis. The countries of the region had achieved high growth

with low inflation. Their public finances were sound, and both external debts and current account deficits seemed manageable. Thus, Asian government officials reiterated their “healthy fundamentals,” even after the outbreak of the crisis. The “self-fulfilling” nature of the crisis suggests that little else could have been done with open capital accounts in the face of such capital flight.

With the exception of Indonesia—largely owing to its complicated political circumstances—the other three Asian economies recovered from the financial crisis in 1999 and 2000, far quicker than anticipated by most forecasts, including those by the IMF. Initial IMF predictions were that economic growth would be stagnant for at least three to four years following the crisis (a U-shaped recovery). Instead, the economies of South Korea, Malaysia and Thailand had quick V-shaped recoveries after the sharp recessions in 1998.

The turnaround in economic performance can be attributed to Keynesian counter-cyclical fiscal measures. Both the Malaysian and South Korean economies recovered due to such reflationary macroeconomic policies and the pre-Y2K electronics boom. Sharply increased interest rates caused corporate failures to soar, making voluntary corporate reforms even more difficult. Interest rates peaked in Thailand in September 1997, in South Korea in January 1998, in Malaysia in April 1998, and in Indonesia in August 1998. Of the four East Asian crisis countries, interest rates rose least in Malaysia, by less than three percentage points. And although capital controls introduced in September 1998 succeeded in consolidating the downward trend in interest rates, Thai rates soon fell below Malaysia’s from their much higher earlier levels after the U.S. Federal Reserve lowered interest rates in September 1998.

The currency depreciations compensated for declining export prices due to global price deflation of both primary and manufactured commodities associated with international trade liberalization. Then the Malaysian ringgit was fixed to the U.S. dollar from early September 1998 in an effort originally intended to strengthen its value. Fortuitously, lower U.S. interest rates in the aftermath of the Russian, Brazilian, LTCM and Wall Street crises of August - September 1998 served to strengthen the other Asian crisis currencies, instead causing the ringgit to be undervalued from late 1998. In South Korea, the authorities intervened in the foreign exchange market to ensure exchange rate competitiveness by

slowing down the pace of won appreciation from late 1998.

The depreciation of the region's currencies caused by the crisis helped export—and growth—recovery, and contributed to improved trade balances as well as foreign reserves among the four economies. Exchange rate volatility declined significantly after mid-1998, except in Indonesia, due to political instability there. Interest rates were highest when exchange rates were lowest, suggesting that all four governments responded similarly by raising interest rates in response to the contagion of spreading currency crises and falling foreign exchange rates.

Budget deficits substantially increased in 1998, especially in the second half of the year.⁵ Ironically, despite its bold capital controls from September 1998, and not being under IMF program conditionalities, Malaysia was the only crisis economy to maintain a budgetary surplus in 1998, and a large one at that. While government revenues were adversely affected by the economic slowdown, government expenditure rose, with fiscal efforts to inflate the economy from mid-1998, i.e. before the currency controls.

Re-capitalization of financial institutions was crucial for recovery. This involved taking out “inherited” systemic risk from the banking system, thus restoring liquidity. The modest budget surpluses during the early and mid-1990s, before the 1997–98 crisis were thus replaced by significant budgetary deficits to finance counter-cyclical measures. Thus, balancing budgets over the business cycle—rather than annually—was crucial to helping overcome the crisis. Such Keynesian policies were not part of the original IMF programs, but were tolerated from the third quarter of 1998, perhaps because of growing international fears of global financial collapse.

Reform of Corporate Governance

Several institutional arrangements in the crisis economies criticized after the crises began had contributed significantly to “catching up,” or accelerated “late development.” For example, conglomeration, informal agreements, and other stereotypes of Asian corporate mismanagement have been recognized as optimal in the face of underdeveloped legal systems, powerful political decision makers, and other features of some developing economies. While such features may no longer be desirable or appropriate, corporate reform advocates usually fail to acknowledge that

they may at least once have been conducive to rapid accumulation and growth. This is largely due to ideological presumptions about what constitutes good corporate governance, usually inspired by what has been termed the Anglo-American model of capitalism. From this perspective, pre-crisis East Asian economic institutions were undesirable for various reasons, especially insofar as they departed from such a model.

Worse still, with minimal evidence and faulty reasoning, the 1997–98 crises in the region have been blamed on these institutions, as if the crises were just waiting to happen. The IMF and World Bank pushed for radical microeconomic reforms, claiming that corporate governance was at the root of the crisis, with some reform-minded Asian governments agreeing.

However, it is doubtful that corporate governance was the sole major cause of the crisis, although there were some symptoms of corporate distress, namely deteriorating profitability and investment efficiency, in all the crisis-affected economies before the crisis. Corporate governance problems became especially significant owing to the changed economic environment resulting from financial, especially capital account, liberalization promoted by the Bretton Woods and other international financial institutions, financial market interests, and the OECD. Blaming the crisis on corporate governance was led from 1998 by the new “neo-liberal” economic orthodoxy often summarily labeled as the “Washington consensus.”

South Korea and Thailand especially began to experience corporate failures from early 1997. After Thailand, South Korea, and Indonesia went to the IMF for emergency credit facilities, the Fund kept emphasizing microeconomic reform as central to its recovery program.⁶ These reforms generally sought to transform existing corporate structures—regarded as having caused over-investment and other ills—along Anglo-American lines.

It is now clear that it would have been better to first improve the macroeconomic environment and to later address systemic risks in the financial system. There is no evidence whatsoever that the simultaneous attempts at radical corporate reforms decisively helped recovery. Most economies accommodate a diversity of corporate structures. While some may become dysfunctional owing to changing circumstances, there is no universally optimum corporate structure. Ironically, the IMF programs were generally not conducive to corporate reforms as they exacerbated

corporate failures sharply and made corporate as well as financial adjustments more difficult. The Asian experiences, particularly those of Malaysia and South Korea, suggest that improvements in macroeconomic conditions, especially interest rate reductions, appropriate increases in government spending and government bail-out facilities, were necessary to facilitate adjustments and reforms.

Corporate reform efforts in Asia thus far have hardly succeeded in achieving their stated objective of correcting the structure of high debt and low profitability, but have instead imposed huge new costs on the economy. Limited access to emergency finance threatened the survival of firms in affected countries that often faced insolvency or take-over at “bargain basement” or “fire sale” prices, usually by foreign interests unaffected by the crisis. As Krugman has noted, for a variety of microeconomic reasons, such takeovers are unlikely to result in superior management.⁷ Such elimination of otherwise viable enterprises has undermined the capacity and capability-building essential for catch-up development.

Undoubtedly, there were considerable abuses of the pre-crisis systems by politically powerful rentiers in the region that should, of course, be eliminated.⁸ South Korea needs a new catch-up system instead of IMF and other proposed transformations along Anglo-American lines.⁹ Other crisis-affected Southeast Asian economies still need reforms to ensure more appropriate capacity and capabilities to face new circumstances and challenges. There are also grave doubts as to whether recent reforms have improved corporate resilience in the long run.

REGIONAL INITIATIVES FOR FINANCIAL STABILITY

Following the crisis, regional financial cooperation has grown in East and Southeast Asia. However, the so-called Chiang Mai arrangements are inadequate as they currently stand, particularly due to the modest quantum available, the clumsiness of existing bilateral arrangements and the financing facility’s requirement of a country-level IMF program. However, in May 2007, the finance ministers of Japan, China, and Korea agreed to multilateralize the Chiang Mai arrangements and increasing the reserve financing facility involved. This multilateralization may no longer be conditional on an IMF program being in place.

There have also been efforts to develop the Asian Bond Market Initiative. For at least six economies in the region, there has been a significant trend towards massive “self-insurance.” This term may be a misnomer, as it essentially involves the accumulation of huge amounts of reserves. These reserves are typically held in ways that generate low incomes, and are not available, for the most part, for productive investments. However, the recent expansion of sovereign equity funds may significantly change this status quo.

Over the last few years, there has been talk regionally of establishing an Asian Investment Bank, comparable to the European Investment Bank or the Andean Fund. The Asian Investment Bank could make available significantly greater private sector resources for investment purposes across the region at more affordable rates. The Japan Bank for International Cooperation and others have estimated investment requirements for the region in the range of about \$200–\$300 billion annually. Currently, the Asian Development Bank offers less than 15 percent of that. Thus, the potential for such a facility is considerable.

A NEW INTERNATIONAL FINANCIAL ARCHITECTURE

Recent trends in the IMF and the WTO after the Asian crises are unlikely to improve prevention measures to avoid future crises. IMF policies—namely international financial liberalization or financial globalization—have not prevented, but rather have contributed to major financial turmoil. All the emerging market crises of the past two decades have been associated with large changes in the exchange rates of the major industrial economies.¹⁰ Developing countries cannot be expected to maintain exchange rate stability and simply adjust when the major currencies experience huge exchange rate swings of up to 20 percent in a week.

Much discussion of international financial reform to prevent future crises since the Asian crises has emphasized greater transparency and supply of information. However, there is no evidence that such information will prevent crises. New systems of prudential controls should recognize the existing diversity of national conditions as well as regional arrangements. The currently favored approach to prudential regulation is to formulate international standards for countries to implement and

enforce. Recently, such standards have usually been set by the Bank of International Settlements, which serves the central banks of the OECD countries. While there is still agreement that the IMF should not set financial standards, it is likely to be more involved in enforcing such standards, which raises similar concerns.

Developing countries are still being told to either fix—through a currency board or even dollarization—or freely float their currencies, also known as “corner solutions.” Meanwhile, developing country governments are discouraged from considering intermediate alternatives although studies show that a free floating currency is associated with the same degree of volatility as a pegged currency,¹¹ with the principal difference being in the impacts of external shocks.

Countries should be allowed to choose their own exchange rate regime, which should not be imposed as an IMF conditionality. There seemed to be agreement after the Asian crises that short-term capital flows required regulation but nothing much has happened since. While developing countries still have the right to control short-term capital flows, the lack of international regulatory support for such measures serves as a major deterrent.

The Asian experiences highlight the crucial importance of ensuring international liquidity during crises by quickly providing funds to such economies. Such provision of international liquidity is being frustrated by the lack of readily available funds, onerous conditionalities attached to such emergency credit, and the requirement that available funds be used to pay off creditors, rather than to support currencies against speculation and provide desperately needed liquidity.

Facilitating fair and orderly debt workouts to restructure debt payments due will be crucially important. Existing arrangements tend to treat debtor countries as if they are bankrupt companies without providing the protection, liquidity and other facilities of normal bankruptcy procedures. While the IMF’s Articles of Agreement allow for temporary standstills on debt, this has rarely occurred in practice. Widespread rejection of Anne Krueger’s 2002 debt workout proposal should not be misunderstood as rejecting the need for more desirable alternatives to the status quo.¹²

LESSONS LEARNED

It is important to point out the lessons that *have* been learned from the Asian financial crisis, the lessons that *have not* been learned, as well as those that *should be* learned. The international community has been paying more attention to proactive policies for crisis prevention and crisis management. However, the fundamental problems have not yet been adequately addressed; despite the publication of relevant papers by senior IMF economists, there is still no institutional recognition of the policy implications that financial globalization has fundamentally exacerbated the problem of pro-cyclical crises. There is also a need to prioritize developing new ways to contain and manage financial contagions in the event of such crises.

Regional financial cooperation is progressing slowly in Asia, and recent experiences suggest that it seems unlikely that regional financial initiatives will become an adequate alternative to global financial institutions. The region's leaders need to explore ways in which they can establish more effective regional financial cooperation, as well as inter-regional cooperation, as there is a real need to broaden the scope and deepen the reach of such cooperation.

The promise of financial flows from the North to the South through capital-account liberalization has not materialized. With the exception of brief episodes in the early and mid-1990s when the flow of funds was considerable, the net flow of funds with regards to East Asia has been from the South to the North, especially in the last decade. Ironically, in recent years, the global flow of funds involves U.S. Treasury bonds, with many developing countries buying U.S. Treasury bonds and thus essentially lending to the United States at low interest rates—causing Kenneth Rogoff to quip that the purchase of U.S. Treasury bonds is now the single largest foreign aid program.

More generally, the cost of funds has not significantly declined due to financial liberalization. Undoubtedly, the recent period has witnessed much lower interest rates, but this has been due to a variety of factors, including the efforts of the U.S. Federal Reserve to respond to the 2001 US slow down. Furthermore, financial deepening has not necessarily contributed to a decline in volatility and instability. In fact, due to the advent of hedge funds and a number of other recent investment strategies

in the last decade, it has become apparent that financial deepening can actually exacerbate overall volatility and instability in financial markets.

Several key lessons should be recognized by now. First, macroeconomic and financial policies should be counter-cyclical, rather than pro-cyclical. Second, developing countries should have policy space for expansionary macroeconomic policies. Existing policy conditionalities and other circumstances conspire against that. The last few years has undoubtedly been good for developing countries, but this has been exceptional due to low international interest rates and high commodity prices. Third, there is a need to re-develop development finance institutions at both national and regional levels, as many of these institutions have contracted and changed significantly, or become less useful for development finance purposes due to new constraints.

Finally, genuinely inclusive financial systems are urgently needed. The 2006 Nobel Peace Prize was awarded to Mohammed Yunus for his micro-credit initiatives. The challenge is to think about developing inclusive domestic financial systems, where the credit needs of all classes in society are adequately met. Currently, most financial systems are structured so that large corporations are easily financed, and sometimes, the poorest members of society might have access to preferential credit, such as Yunus's micro-credit initiative. However, the vast majority of people and enterprises between the large corporations and the poorest continue to experience considerable difficulty in serving credit necessary for and conducive to economic development.

PERSISTING CONSTRAINTS

Ironically, the absence of another crisis of a similar nature and scale to the Asian crisis has probably contributed to the lack of momentum for reform of the international financial system. Instead, complacency has set in, and there is little likelihood of thoroughgoing reform in the foreseeable future. The difficulties of achieving fundamental systemic reform cannot be overstated. A decade and a half elapsed and a world war occurred between the Great Depression from 1929 and the Bretton Woods conference in 1944.

The problem has been compounded by the refusal to institutionally recognize the pivotal role played by international financial liberalisa-

tion or financial globalisation in creating the conditions that led to the crisis, which the IMF contributed to exacerbating, instead of stemming. Analytically, the IMF and others focused on different generations of currency crisis theories though it has become abundantly clear that they were not relevant to the situation in Asia. From early 1998, the focus shifted to blaming alleged corporate governance failures, with no explanation provided for the timing of the crises.

Acknowledgment of problems with the international financial architecture from mid-1998 briefly drew attention to the nature and severity of the crises, but ironically, the rapid V-shaped recovery from late 1998 in most countries except for Indonesia has probably contributed to the subsequent apathy and lack of political will to reform the international financial system.

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TEN YEARS AFTER THE ASIAN CRISIS: AN INDONESIAN INSIDER'S VIEW

J. SOEDRADJAD DJIWANDONO

The Asian financial crisis of 1997–1998 generated a plethora of publications and conferences which seek to discuss and explain what occurred in Asia a decade ago. Scholars, analysts, policy-makers, and practitioners from across the board ruminate on the causes and effects of the Asian financial crisis, concluding on what lessons have been learned or have not been learned, together with attempts to theorize what is generally labeled a financial crisis.

Curiously, however, there is no standard interpretation yet on the causes of the Asian financial crisis, except for a general consensus on a few things, such as the fact that the crisis was triggered by a rapid depreciation of the Thai baht on July 2, 1997. This may explain why—aside from the obvious reason of the tenth anniversary of the crisis—there still remains tremendous interest in revisiting the discussions on the subject of the Asian financial crisis, especially in examining the various roles of governments, business communities, and regional as well as multilateral institutions. The experiences of these vital stakeholders could enable the global policy community to learn, or unlearn, from the past in order to avoid a repeat of a financial crisis in the future, or if one were to arise, to better cope with it.

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However, generalizing on the complex issues that comprise financial and economic crises is not an easy endeavor. For Indonesia, the challenge is even greater because the crisis was extremely complex, and in many ways, unique, as I shall explain below. In addition, I would conjecture that as a nation, Indonesia has looming difficulties to face, and a yet unfinished journey in the process of coming to peace with its own past. Writing about the Indonesian crisis—which is nothing less than a historical event—is therefore a pressing challenge.

It is precisely because of this challenge that after ten years it is still relevant to talk about the Asian financial crisis, analyzing how it happened and speculating on what had been the root causes. Since these discussions have already been extensively discussed in the past ten years, I will highlight only the areas that in my view need corrections or re-explanations.

This paper is an Indonesian insider's view of the Asian crisis. It will start with a descriptive analysis of what happened, looking at the similarities and differences of what seem to have been the causes of the crisis in different countries, with a focus on Indonesia. The description of the Asian crisis will also include the initial policy responses by the government, through regional cooperation and support from the International Monetary Fund (IMF). It concludes with some speculation on whether the Asian, and global, community is now facing a repeat of a financial crisis, and whether the lessons from the crisis have been learned.

HOME GROWN BUT NOT HOME ALONE

It is instructive to examine the similarities of how the financial and economic crisis of 1997-98 developed in the different Asian economies, as well as comparing them with countries outside of Asia both before and after the 1997-98 crisis. However, it may be even more important to recognize the differences among countries, in terms of the policy responses of the stakeholders, the variance in the effects of the crisis, and in the lessons learned and not learned by the countries. Let me mention some of the findings that other scholars have made regarding these issues, in particular those findings that either add to or correct the past studies,

which in a way become the standard interpretation of the crisis. I have learned from these studies that the differences from one crisis to another seem to be more prominent than the similarities. In other words, the financial crisis seems to be more country specific, although we can find certain characteristics that are similar among many countries.

In terms of its sequence, the Asian crisis started with rapid Thai baht depreciation on July 2, 1997. This was followed with a contagion that spread to other currencies in the region. However, a characteristic only recently shown by Takatoshi Ito in his 2007 article is that the speed of the currency depreciation the Asian contagion was much slower in comparison to that of the Mexican crisis in December 1994.¹ Additionally, Ito illustrated that the leading country in terms of currency depreciation—what he calls the “epicenter of the crisis”—moved from the Thai baht, between July and September, 1997, to the Indonesian rupiah and the South Korean won between September 1997 and January 1998. After January 1998, the rupiah was at the epicenter of the crisis. After the Asian contagion, the crisis erupted in Russia (1998), Brazil (1998–1999), Turkey (2000–2001) and Argentina (2000–2001).

Despite the international consensus that the Asian contagion affected most economies in Asia, after several months had passed, the level of development in the currency depreciation was different between countries. By September of 1997, there were four groups of countries based on the depth of the currency depreciations. Ito demonstrates that there were four classes in terms of the intensity of the currency depreciation. The Thai baht suffered the most, followed by Malaysia, Indonesia and the Philippines, followed later by Singapore and Taiwan who experienced only a mild depreciation. Meanwhile, the Chinese renminbi and the Hong Kong dollar were not suffering depreciation, the former due to China's capital controls, and latter due to its pegged system supported by a currency board.

After the crisis, most Asian currencies have been able to economically strengthen themselves, but only to levels that remain below their pre-crisis gross domestic product (GDP) levels. The appreciation of currencies has not been similar for all currencies. Ten years after the crisis, the Korean won and the Singapore dollar have recovered 90–95 percent of their respective rates. The Thai baht and the Malaysian ringgit recovered 70 percent of their pre-crisis levels, the Philippines peso 50 percent,

while the Indonesian rupiah has recovered merely 25 percent of its pre-crisis currency rate. All Asian economies, except China, have also recovered their economic growth rates, however their average GDP growth rate, at 4–6 percent is lower than the pre crisis level of 7–9 percent, and associated with this are the investments rates which have also been lower than the pre-crisis levels.

The immediate issue associated with the above has been the question of undervalued currencies—which ones are undervalued, by how much, and what is to be done about them? Furthermore, there has also been the issue of whether the pre-crisis growth (and investment rates) are the normal pattern, or if the decreased rates post-crisis are the normal pattern. The implication of this question is reflected in the debate on whether it is the savings glut and investment deficit or rather, the excessive spending and lack of saving, that presents the correct explanation for the world's current global imbalance.²

With regard to the large number of discussions and theories regarding the causes of the Asian financial crisis, in this paper I contend that the Indonesian financial crisis was triggered by an external financial contagion, namely, the rapid depreciation of the Thai baht in early July 1997, almost immediately after it was floated. When the contagion hit Indonesia's financial system, it ushered in a different type of crisis. From a foreign exchange market crisis to a national banking sector in distress, the Indonesian experience turned into a full-blown economic crisis, and ultimately, a socio-political crisis, which culminated in the fall of 32 years of reign by President Suharto in May 1998.

There are two critical elements that ultimately transformed a financial shock into a contagion for Indonesia. First, Indonesia's financial crisis was activated by a contagious external currency depreciation. The implication here is that the Thai baht's rapid depreciation was contagious, and thus served as the trigger for the ensuing crisis. It is my belief that the trigger must be contagious. However, such a contagious trigger does not have to result in a financial shock such as sudden and rapid currency depreciation. It is also my belief that the trigger could come from other factors, either a shock in the economics, finance or socio-political arenas of a country. However, if the shock is not contagious, a crisis does not develop. In January 1995, Indonesia experienced a currency shock originating from the Mexican crisis. The Indonesian rupiah depreciated

quickly, but was stabilized by a Bank Indonesia intervention of close to U.S. \$600 million, supported by monetary tightening and the widening of intervention bands in a managed floating framework. This was a financial shock which did not develop into a contagion, and thus, a crisis did not occur.

The second element that propelled Indonesia toward a crisis was the institutionally weak national economy which the contagion attacked, and which resulted in a national economic crisis. Indonesia's institutions were embedded with structural weaknesses, such as in the banking sector, the corporate sector, and in the socio-political governance of these sectors. In such an environment, the trigger from the financial sector exposed the domestic structural weaknesses to destructive currency attacks. In July 1996, Indonesia had also suffered a currency shock, when social unrest followed the ransacking of Megawati's party headquarters. The rupiah took a beating, however, Bank Indonesia successfully stabilized the currency before it developed into a contagion through a market intervention that cost Bank Indonesia U.S. \$700 million.³

The basic differences in the arguments and theories about the Asian crisis are hinged to the central question of whether the causes of the crisis originated domestically, through weak fundamentals, cronyism, and faulty policies; or, whether it originated externally, through an abrupt perception change that triggered the reversal of capital flows, exacerbated by the herding of private sector investors and financial market actors. It is my conviction that the Indonesian crisis was caused by an indivisible combination of an external shock and domestic institutional weaknesses, further complicated by the inconsistencies of responses from the stakeholders, ranging from the government, to the private sector, and the International Monetary Fund (IMF or the Fund) after its involvement. I like to use the phrase "home grown, but not home alone" to describe the causes and the process of the Indonesian crisis of 1997-98.

A UNIQUE CRISIS?

In spite of the fact that the Asian crisis was distinctly marked by a contagion, I argue that over time, and with more careful assessments, one would find more differences between each country's experience of the

Asian crisis, such that the crisis could be considered on a country-specific level. I would even go further to say that despite the fact that Indonesia's crisis is certainly a part of the Asian contagion, it is also unique.

Academics are still debating how to explain the phenomenon of the Asian crisis being both a regional and a country-specific experience. It is also interesting to note that recently, the debate has turned to a different direction. Amidst rampant domestic dissatisfaction about the slow process of reform and recovery, some in the international policy community have expressed pleasant surprise to note that Indonesia actually experienced a negative growth rate only in 1998. Since then the country has been steadily growing, achieving the present growth rate of close to 6 percent. This has been achieved together with the democratic process in politics, which runs well. As some argued, even though all crisis countries have experienced political changes, Indonesia's experience has been the most tremendous of political transformations.⁴

Both the similarities of Indonesia's initial conditions with other crisis countries as well as its desperate position immediately after the crisis can be seen from the two tables below. Similar indicators between the crisis-affected countries are the ratio of short-term debts to GDPs, the non-performing loans in banking, and the current account deficits. In some indicators, like current account deficits, that of Indonesia's fares well. Perhaps the indicator of company ownership as a proxy of cronyism is the only sign which clearly shows that Indonesia had a more dense concentration of ownership in comparison to other countries. The second table illustrates that Indonesia suffers the worst in terms of the immediate impacts of the crisis, as shown from the figures of the negative GDP growth, the currency depreciation, and the performance of the capital market.

The Indonesian crisis is unique because despite exhibiting similar initial conditions and vulnerabilities with other crisis countries such as Thailand, Korea, Malaysia and the Philippines, and despite being generally acknowledged for formulating prudent policy responses to the crisis, at least initially, Indonesia ultimately suffered the worst economic meltdown and took the longest amount of time to recover. While Indonesia's economic health is now improving on a continual basis, it still has the lowest level of economic performance among the former crisis countries in terms of growth and investment rates and currency value.

Table 1. Vulnerability Indicators of Crisis-Affected Countries

	Indonesia	Korea	Thailand	Malaysia
Domestic Debt-to-GDP Ratios (1992-1996)	50	50	87	82
Corporate Debt-to-Equity Ratios (1991-1996)	190 200	480 640	170 340	90 200
Family-Owned Companies (1991-1995)	67.3	24.9	51.9	42.6
State-Owned Companies (1991-1995)	15.2	19.9	24.1	34.8
Bank Credits (1992-1996)	12	15	37	38
Property Loans (late 1997)	25-30	15-25	30-40	30-40
Non-Performing Loans (1996)	8.8	0.8	7.7	3.9
Non-Performing Loans (1998)	40	20	34	19
Short-Term Debt-to-Reserve Ratios (1996-1997)	188.9	217	121.5	45.3
Exports (1996)	9.1	-2.8	-4.5	0.9
Current Account (1991-1995)	-2.4	-1.8	-7.7	-7.6
Current Account (1996)	-3.2	-4.4	-8.9	-4.4

Source: rearrangement of Table 2, "Asian Crisis Countries: Vulnerability Indicators" in Andrew Berg, "The Asian Crisis: Causes, Policy Responses, Outcomes," *IMF Working Paper*, WP/99/138, (Washington: International Monetary Fund, 1999), <http://www.imf.org/external/pubs/ft/wp/1999/wp99138.pdf>; and Table 5, "Assets of Corporate Relations with Banks and States" in Qaizar Hussain and Clas Wihlborg, "Corporate Insolvency Procedures and Bank Behavior: A Study of Selected Asian Countries," *IMF Working Paper*, WP/99/135, (Washington: International Monetary Fund, 1999), <http://www.imf.org/external/pubs/ft/wp/1999/wp99135.pdf>.

Many analysts argued that Indonesia fared the worst in the crisis due to the faulty policies of its government and central bank, Bank Indonesia (BI). This argument is either unfair or incorrect. Many policies and steps were adopted by BI that averted potential financial crises at earlier points, both as part of and independent from the Government of Indonesia's efforts to address the crisis.

Some of the prominent policies to address the crisis include the decision to free float the rupiah in mid-August 1997, the policy to provide liquidity supports to all banks suffering from liquidity mismatches, the closure of 16 banks in early November 1997, and the debate on the possible introduction of a rupiah peg with a currency board—popularly known as the currency board system in January 1998.

The government decision to free float the national currency on August 14, 1997, caught the Indonesian business community off-guard. It was hailed by many as pre-emptive when it was issued, but it was also blamed by others as unwarranted. The currency started to depreciate immediately after the rupiah was floated, partly due to business and public responses to the government policies to address the crisis, which included the move by the domestic private sector to buy dollars in order to cut their losses, or to deposit their financial assets in overseas locations. The government and Bank Indonesia's policy to tighten the domestic fiscal and monetary situation catapulted the domestic contagion. And thus a currency shock rippled into a banking sector crisis, which then propelled a national economic crisis, as banks and corporate firms collapsed through the balance sheet effects.

POLICY FAILURES AND POLICY CONTROVERSIES IN INDONESIA

With the benefit of hindsight, it is now increasingly clear that the monetary and banking policies of both the Government of Indonesia and BI were indeed too restrictive when the domestic banks were already in a crisis situation. These policies included the doubling of interest rates by the central bank on its certificates (Sertifikat Bank Indonesia), the government's directive for state banks to transfer their deposits to central bank certificates, and the curtailment of budgetary routine expenditures that were meant to strengthen the exchange rate.

Table 2. Impacts of the Crisis (June 1997-March 1998, percent changes)

	Indonesia	South Korea	Thailand	Malaysia
Nominal Exchange Rate	-75	-41	-38	-33
Real Exchange Rate	-63	-33	-27	-23
Nominal Interest Rate	32	12	8	3.5
GDP growth	-13.7	-5.8	-9.4	-6.7
Stock Market (in U.S. dollars)	-50	-46	-58	-79
Stock Market (in Indonesian rupiah)	-27	-38	-18	-38

Source: Adapted from Table 5, Andrew Berg, "The Asian Crisis: Causes, Policy Responses, Outcomes," *IMF Working Paper*, WP/99/138, (Washington: International Monetary Fund, 1999), <http://www.imf.org/external/pubs/ft/wp/1999/wp99138.pdf>.

The decision to invite the IMF in early September 1997 was made with the aim of reinvigorating market and public confidence in the Indonesian management of the national economy. This is in recognition of the fact that the presence of multilateral financial institutions in Indonesia was expected to help revive market confidence. One of the key IMF recommendations for Indonesia was for the government to implement a comprehensive bank restructuring process, which included the closures of insolvent banks. In fact, the bank closure became a prior action program, which served as a precondition for the IMF to agree on providing a stand-by loan.

Unfortunately for Indonesia, the bank closures did not just fail to bring back market confidence, they actually instigated bank runs and brought the entire banking sector near total dissolution. The bank closures in conjunction with tightened monetary and fiscal policies turned

out to be tantamount to pushing the distressed banks into a full-fledged banking crisis.

There have been many discussions on the merits and demerits of the Indonesian bank closures, including regarding who exactly is to blame. In the debate of why the bank closures did not succeed, different arguments have been raised. Many, such as Steven Radelet and Jeffrey Sachs in their 1998 paper, argue that the bank closures failed because Indonesia did not have deposit insurance when the closure was made.⁵ Others, such as Morris Goldstein, argue that more banks should have been liquidated.⁶ I do not agree with the argument that the absence of a deposit insurance scheme was the culprit. Most deposit guarantee schemes only cover small depositors, which Indonesia provided at the time of the closures. The problem arose from the big depositors, whom a regular deposit guarantee scheme would not cover. It seems plausible that, if only Indonesia introduced an overall guarantee like the one introduced in late January 1998 (i.e. a blanket guarantee), the bank closures of November 1997 might not have caused bank runs. I should also add that if the owners of the liquidated banks were behaving well, instead of waging public campaigns criticizing the bank closures policy and prosecuting the Minister of Finance and BI Governor in court, bank runs might also have been avoided.

Controversy over Bank Indonesia Policy

The most controversial policy in Indonesia was BI's liquidity supports (also known as the BLBI policy) to domestic banks experiencing liquidity mismatches during the crisis. It was controversial in several aspects. The cost of the policy was estimated to be close to 50 percent of the nation's GDP. This was a great loss of finance to the domestic public sector, while also being the highest amount spent on bank restructuring among the crisis-affected countries. Furthermore, the policy was associated with corruption cases involving both BI officials and bank owners. To this day, the public perception is that BI's policy on liquidity supports for banks were a profound mistake, particularly because the policy's financial burden was unjustly placed on Indonesia's taxpayers while it is BI should have taken responsibility for the financial burdens.

The corruption cases were real. Three of my colleagues—all former Bank Indonesia managing directors—were jailed, curiously not for the

embezzlement of funds but for violating internal rules and for acting imprudently in the decision to provide the BLBI bank supports. The story has not come to a close yet, as there are still current accusations against BI officials and former officials on these issues. In essence, the BLBI bank supports have become a “scarlet letter” for BI and its officials.

However, despite this controversy, a solid defense can be made on behalf of the BLBI bank supports.⁷ I will only put down some notes here. First, the findings of the supreme audit board demonstrated that the total amount of BI liquidity supports to Indonesian banks up to January 1999 had been 144 trillion rupiah (close to U.S. \$70 billion at the current exchange rate). Some analysts considered this expenditure to have caused a massive loss to state finance, without any consideration to the amount of repayments made by some of the banks and the revenues from the sales of assets of the recipient banks, or even the sales of these banks themselves by the Indonesian Bank Restructuring Agency (BPPN). Second, the public generally perceived that the number of banks receiving the liquidity supports were equivalent to the number of banks managed by the BPPN, that is, 54 banks. However, the actual number of banks receiving the liquidity supports during the crisis is over 130—but not all recipient banks became problem banks that had to be managed by the BPPN.

There have been strong arguments stating that the total amount of the liquidity supports, as mentioned before, was equivalent to the total amount of loss to the state budget. However, only a few analysts go back to an alternative cost concept in economics, asking what would have been the cost to the economy had there been no liquidity supports provided to banks during the crisis. Would the government (BPPN) still have any right to sell privately-owned banks after the crisis if there were no liquidity supports? In terms of policy, the liquidity supports for banks provided by BI were completely acknowledged by the recipient banks, and it became the government's claim to these banks. Would there still be 136 banks currently in operation, which are in relatively good condition, had there been no liquidity supports during the crisis? Isn't there any difference between cost and loss? Certainly, a thorough analysis would have to make this distinction to be able to come up with the actual figure of the economic and financial loss of the policy.

The BI liquidity supports for the banks certainly were expensive, in that they incurred losses to the Indonesian economy. However, it is

interesting to note that there were almost no discussions on the cost of bank recapitalization, which would have cost more than four times the amount of the liquidity supports. Out of the total cost of bank recapitalization the biggest amount would have been the recapitalization of state-owned banks. It is my view that the liquidity supports that the Indonesian central bank provided during the crisis and the bank recapitalization in 1999 are similar in character. The former entails liquidity supports to help banks facing liquidity mismatches, while the latter, bank recapitalization, assists banks facing “capital mismatches” closely associated with a solvency problem.

The debate about the rumor of President Suharto’s intention, in January 1998, to return to a pegged exchange rate system through the creation of a currency board, and the rumor that my disagreement with his intention was the reason for my dismissal as central bank governor should also be explained here. Indeed, in January 1998, I did not support the idea of a pegged exchange rate system through the use of a currency board. I was concerned because I did not feel confident that the currency board would be implemented adequately, given the domestic conditions at that time. It was difficult to feel confident that President Suharto and his family—given their high propensity to intervene or tinker with economic policy—would let the currency board system (CBS) operate on its own course. A CBS is often called an “auto-piloted system,” in that it should not be tinkered with. Furthermore, I was also concerned that Indonesia’s reserves were not sufficient to back a currency board. Ultimately, the CBS idea was discarded, due to mounting pressures from the leaders of many western countries who were against the plan, in addition to a BI memorandum to the President which stated that the adoption of a currency board was not feasible at that time.

IS INDONESIA FACING A REPEAT OF THE 1997–98 CRISIS?

Have we, the international policy community, learned our lessons from the Asian financial crisis? I will answer this question by commenting on the emerging concerns that another financial crisis seems very possible in Indonesia. The recent phenomenon of high-volume, short-term capital inflows has raised concerns for some government officials, in-

cluding the Indonesian minister of finance, because the patterns seem eerily similar to the events leading up to the Asian crisis in 1997. Even the proliferation of property development is the same. However, despite the similarities, I believe that another financial crisis is not highly likely at the moment since both the conditions of the regional Asian economies as well as the Indonesian economy are faring well. There is no strong motivation for market players in Indonesia to make moves that would trigger a financial shock capable of developing into a contagion like that of 1997-98.

The Asian economies have significantly decreased their vulnerabilities to a financial crises in the last decade. The most important factor in this process has been the accumulation of foreign reserves by almost all economies in Asia. The total reserves of East Asian economies currently stand at approximately U.S. \$3.5 trillion, with China alone holding U.S. \$1.2 trillion. Even Indonesia holds more than U.S. \$50 billion in reserves. Additionally, the current accounts of most East Asian economies have also been in good shape. Despite no standard pattern or well established cooperation among Asian economies, the regional exchange rate regime is more flexible compared to the past, and generally closer to a floating system than a fixed one. With these two favorable factors empowering most East Asian economies, there are not enough incentives for market players to make the kind of move toward profit-taking that would instigate a contagion.

Furthermore, the domestic Indonesian conditions—in terms of the banking sector and other institutional structures—are also less prone to a contagion in comparison to Indonesia's pre-1997 conditions. The banking sector is much stronger. The average capital adequacy ratio of Indonesian banks is currently around 20, while just before the crisis in 1997 it was substantially less than the required 8. The average loan-to-deposit ratio of banks in Indonesia is currently around 60 percent, while in 1996 it was over 80 percent. At present foreign short-term exposures in both the public and the private sectors are much smaller than in the past. Bank Indonesia's prudential monetary policy measures, compliance levels, and capacity to serve as a lender-of-last-resort have also been meaningfully improved in the ten years since the Indonesian crisis. In addition, both social and political infrastructures are more robust now than in the past. I do not foresee a financial shock that could strike

Indonesia today and that could cause a contagion resulting in a full-fledged financial crisis.

Thus, judging from both the regional and domestic economic environments, another Asian financial crisis is not imminent, despite the fact that the Indonesian financial sector still faces a variety of risks. However, this should not make Indonesia, as well as other Asian economies, complacent. The world economy is now facing a new and different challenge—that of an unsustainable global imbalance, which, no matter how one assigns its causes, implies the presence of an enormous risk inherent in the implications of the unwinding of the global imbalance, to name only one of the obvious dangers.

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A CENTURY AFTER THE UNPARALLELED INVASION: EAST ASIA AFTER THE CRISIS

MEREDITH JUNG-EN WOO

This year marks the tenth anniversary of the Asian financial crisis of 1997. But there will always be some debate about when this crisis actually began. Most South Koreans will trace the beginning to the stream of bad economic news that cast a pall over the otherwise crisp days of autumn. The Thais will likely push the onset of the crisis back a few months to the early summer of 1997, when the currency traders could not trade away the Thai *baht* fast enough, putting unbearable pressure on it. For Indonesians, the full brunt of a crisis that eventually rolled back the economic gains of the past three decades proved overwhelming well into the start of 1998. But one really sensed that something big and dreadful was afoot in July 1997 when the prime minister of Malaysia, Dr. Mahathir bin Mohammad, blamed the freefall of the Southeast Asian currencies to a “worldwide Jewish conspiracy,” headed by George Soros.

The Asian financial crisis was spectacular both for the ravages it caused—in a region of the world that was deemed immune from ravages of this kind—and for the speed of the recovery. By the last quarter of 1998 the East and Southeast Asian contagion was over, and the

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countries that had been affected most severely—South Korea, Malaysia, Thailand and Indonesia—were more or less back on their feet. Those who had quarreled over the causes of the financial crisis—such as the sister institutions, the World Bank and the International Monetary Fund (IMF, or the Fund), as well as policymakers and economists—who failed to see eye to eye on the cause of the crisis, could now agree, happily, on one thing: the recovery was fast, and the recovery was “V-shaped.”¹ Not only that, the crisis seems to have served a useful purpose. Today, the central bank coffers of East and Southeast Asian economies overflow with foreign exchange reserves, which can be used to defend their currencies—and through swap agreements, the reserves of the regional economies can be used to defend each other’s currencies when they are under stress.

The financial crisis being remembered after a decade this year, in 2007, was a classic liquidity crisis, exacerbated by idiosyncratic institutional practices in the affected countries. The crisis had all the requisite *dramatis personae*. There were the global herds of institutional fund managers who behaved as if to confirm to the adage that there is nothing more sordid than panicky capitalists, officials of the U.S. Treasury Department who were determined to exploit the occasion to open up once and for all the East Asian economies—especially the South Korean one—regardless of the causes of the crisis, and the officials of the IMF doing what they were expected to do, pressuring the distressed Asian economies to put in place high interest rate policies, so that they can retreat turtle-like inside their carapace, suffering the verbal beatings spewed out by outraged people around the world.

A HISTORICAL MARKER

The impact of the crisis was very severe. Big and small firms alike went belly-up, unable to meet the (now high) interest rates and unable to attain leniency from the (suddenly tough) bankruptcy courts. Legislation that protected workers’ employment rights were dismantled in Korea, leading to a multitude of workers being laid off. In Indonesia, workers migrated back to the rural areas where they had come from, and faced with the sudden interruption in subsidies for food and oil—the pillars of

the three decades of the *New Order* regime under President Suharto—they now vented their anger and frustration on the victims who had just as little to do with the crisis as the angry mob: the store keepers and small merchants who happened to be ethnic Chinese. Thus, 1998 might be remembered as the year of riots and pogroms, the likes of which had not been seen in Indonesia since 1965.

It is possible, then, to construe the Asian financial crisis of 1997-1998 as the local paroxysm of familiar crises made indelible in our memory by Charles Kindleberger as “mania, panic and crash,” and which was the harbinger for what eventually followed: the crises in Brazil and Russia in 1998, and Argentina from 1999 to 2003. But it is also entirely possible to think of the events of 1997-1998 as something unique, if not in substance then in historical significance. I will suggest that the Asian financial crisis is a *historical marker*. With this crisis, the old political and economic order in East and Southeast Asia went up in flames—a metaphor that I shall return to—and was replaced by a new order that was no less climactic when it finally did arrive.

THE “NEW” ORDER

The “new” order that arrived in the aftermath of the Asian financial crisis was actually a very old order—one in which China played a centripetal role, if not a full-fledged Middle Kingdom role. In that regard it is worth remembering that for some, the Asian financial crisis had its real start not in 1997 but in 1994, when China abandoned the official exchange rate for its currency. This Chinese depreciation, which boosted its exports, put enormous pressures on Thailand. Unable to compete effectively, the Thais experienced significant difficulty in exporting their manufactured commodities and servicing their debt. As their currency was effectively fixed to the U.S. dollar, the Thais were hamstrung from engaging in competitive devaluation. International investors like George Soros saw opportunities here, and with the short-selling of the baht, the chickens came home to roost.

What actually *causes* a financial crisis is a complex matter, however. There is likely to be not one but many causes, and how these multiple causes conspire with existing conditions to produce a catastrophe may be

beyond our Cartesian instincts to connect dots as efficiently as possible. In this paper, I shall explore instead the meaning of the changing order in East Asia that, at the minimum, *coincided* with what we have come to call the Asian financial crisis. The history that the Asian crisis *marked* was, as I suggested earlier, a significant reorientation of East Asia toward the Chinese fold, which is as time-honored as it was suddenly imminent. The V-shaped recovery that followed on the heels of the crisis may be understood, then, in the context of the East Asian economies scrambling to accommodate themselves to a new regional order. So, what does this brave new world look like?

THE CHINESE WORLD ORDER

This is the like the question American writer Jack London pondered one hundred years ago to this year. He had spent time in Korea covering the Russo-Japanese War for the Hearst papers, and three years later in 1907, he published a short story. It is a science fiction that takes place nearly a century later, in a world where China has become an important world power. In the first half of the 20th century, London imagines, China learns the art of manufacturing at the feet of Japan and eventually surpasses its one time master. Japan for its part loses its appetite for manufacturing, focusing on its comparative advantage—that of aesthetics. As Japan diddles around, pleasing the world with tea ceremonies and the masterfully cultivated bonsai, China catapults into the world stage as an industrial powerhouse, to the bemusement of all. But China lacked interest in the usual corollaries of economic power. She showed no interest in building a truly modern and mighty army, nor in the blue water navy that could guard its globe-girdling commercial interest. She showed little interest at all in conquest, in the usual and familiar terms through which all empires rose and fell. In time, the world realized the truth that China is no ordinary empire. Demography was in China's favor. Soon the world saw the Chinese spilling across China's borders, to the west, to the east, and to the south, commingling with others, in what London dubbed "The Unparalleled Invasion."²

This invasion, by the most unparalleled of all empires, required an equally unparalleled response—an invasion. If China's might rested in

its fecundity, the western powers reasoned that there was only one way to deal with the root cause of the problem. In the event, the western nations conspire to unleash a bacteriological warfare, raining all manners of germs—small pox, scarlet fever, cholera, bubonic plague—on China until the Chinese were no more. When the genocide is completed, all complicit nations of the civilized world get together in Copenhagen, to solemnly pledge against another genocide. In one sense, Jack London's science fiction is a period piece: an imagination run wild in an era of the "yellow peril," when all questions of civilization were captured through the prism of race. But in another sense it also speaks to fears that are not time-bound but rather, that reflect the genuine bafflement of all those who can count—namely, the problem of accommodating the spectacular commercial genius and energy of a people who account for one out of every six members of humanity. The same arithmetic of China's population would point to the source of its self-confidence, which augurs well for world peace—if only the rest of the world could live with it.

According to London:

China had no Napoleonic dream, and was content to devote herself to the arts of peace. After a time of disquiet, the idea was accepted that China was to be feared, not in war, but in commerce. . . . China went on consummating her machine-civilization. Instead of a large standing army, she developed an immensely larger and splendid efficient militia. Her navy was so small that it was the laughing stock of the world; nor did she attempt to strengthen the navy. The treaty ports of the world were never entered by her visiting battleships.³

The unparalleled nature of the Chinese world order, interested as it is in commerce but not in big power politics, was as true of the early 15th century as it is today. Nearly six centuries ago, Admiral Zheng He, a eunuch from Ming China whose fleet girdled the globe—including North and Southeast Asia, South Asia, the Middle East and finally East Africa—engaging in a bountiful trade that the West could only dream of, with nary a thought of using the vast fleet at his disposal for military conquest. Today, the nature of the Chinese world order would seem in some fundamental way similar to that of Admiral Zheng He—China

remains far more interested in trade and making money than it is in military expansionism.

THE PREREQUISITES OF THE “EAST ASIAN MIRACLE”

If the *new* Chinese regional order of commercial dynamism that knits East Asia together is in reality a *very old* order, what did the *recent old* order that was swept aside with the Asian financial crisis look like? In a remarkably pithy article written in 1998, Benedict Anderson summarized the confluence of fortuitous events that made possible the manufacturing miracles of Southeast Asia—the pre-requisites, one might say, of Southeast Asian growth. The first aspect of this was political, the American support for political stability in the area, including three decades of Suharto’s *New Order* which produced “capitalism in one family.” One might also add here the four decades of Western support for the tough-as-nails anti-communists in power in South Korea, as well. The second aspect was economic, involving investment capital that flowed in from Japan in the 1980s with the rising value of the yen, reaching its peak with the Plaza Accord. So much money flowed in, such that Japan was able to see Southeast Asia as its own backyard, much as Latin America is America’s, prompting a suggestion willy-nilly by the Japanese Vice Minister for International Finance in 1997 for the creation of an Asian Monetary Fund—until the United States Treasury officials slapped his wrist.

The presence of overseas Chinese entrepreneurs in Southeast Asia was the third aspect, and the true locomotive of the region’s spectacular rise. Once they were the *comprador* capitalists, the indispensable outsiders who connected the world market with Thailand, Indonesia, the Philippines and the Malays—today the ethnic Chinese preside over the vast wealth of the region in a kind of ethnic division of labor, most pronounced in places like Indonesia, where political power is strictly the purview of the natives. Finally, Anderson highlighted the fourth aspect of the prerequisites of the Southeast Asian manufacturing miracle, which was that it occurred in the extraordinary context of the sequestration of China since 1949. In other words, Southeast Asian growth was on borrowed time until China would roar back into the world market.⁴

This was the postwar order that was destroyed in the Asian financial crisis of 1997–1998, according to Anderson. Or, as I said earlier, it went up in flames. The financial crisis was just one of the many problems that beset Southeast Asia, which was in the grips of an ecological catastrophe. In the three hundred years of recorded history of the El Niño Southern Oscillation (ENSO), one of the worst was in 1997–1998, and it had an extremely long reach, stretching from Syria, Mongolia, China, North Korea, to Southeast Asia, devastating in its wake several developing countries that were hapless before its elementary power. ENSO-related aberrations were responsible for the severe winter in Tibet that threatened 20 percent of all its livestock, plus three million livestock in Mongolia, and it portended massive food shortage in Tajikistan. In North Korea, the severe drought of 1997–1998 further destroyed what slim prospect for food production there was after the floods that preceded it, and wrought a holocaust that claimed hundreds of thousands of lives. In Indonesia, the drought aided the devastating fire that ripped through its tinder-dry forests, damaging 18,000 square miles of forest and enveloping Southeast Asia in smoke and haze, for months on end. When the smoke cleared, East Asia was a different place.

SHIFTS OF POWER

The “Miracle” that the World Bank liked to highlight was market-friendly Southeast Asia, not the intervention-prone Northeast Asia, and it was predicated on sustained economic growth since the mid-1980s, hovering around 7–9 percent.⁵ After 1997–1998, Southeast Asia would never regain that momentum—in the best of times the growth rate would not exceed 4–6 percent.

Politically, the authoritarian governments that presided over rapid economic growth fell by the wayside. In Indonesia, the *New Order* was replaced by a series of feckless democratic leaders, replacing capitalism in one family with capitalism by a few more families, and perpetuating corruption that was now far more decentralized than before. In Malaysia, Prime Minister Mahathir had the presence of mind to impose capital controls in the midst of the global financial panic and thus helped avert

a bigger crisis for Malaysia. Nonetheless he found it difficult to sustain his power base in the face of massive hostility from the global financial community. This, combined with a series of political misjudgments, finally forced him to step down.

As there is no necessary relationship between authoritarian politics and economic growth, the end of authoritarianism did not spell the end of economic growth. What it did signal was the disappearance of the kind of developmental patterns and ambitions that invoked the state as an essential agent of growth, and also the disappearance of governments, like Indonesia's, that tried overtly to maintain an ethnic division of labor, where the Chinese were allowed to make money in return of political protection, as occurred under Suharto.

With the Japanese economy in the doldrums in the 1990s, it is no longer the Japanese who march through Southeast Asia in search of investment in natural resources and manufacturing, and for tourism. Now, it is the South Koreans who do so, and most importantly, the Chinese, who are increasingly replacing the Japanese as the main source of foreign investment in the Asia Pacific region. Today the Chinese diaspora stitches East Asia into a coherent regional order, but they do so in utterly unprecedented ways. The long sequestration of China now over, the Chinese diaspora in Southeast Asia is now reconnecting to its homeland. Long intermediaries between western capitalism and the local economy, this diaspora now often works on behalf of Chinese capitalism, which is replacing the one the west dominated. While this diaspora provides renewed rigor to Southeast Asia's economies, proving once again that they are the "indispensable strangers," the massive insertion of China into the world economy does portend an end to Southeast Asia's "*manufacturing*" miracle.

South Korea's Anxiety

Nobody frets more about China's emergence in the world system than South Korea. Since the early 1980s, the South Koreans have worried about China's emerging power, wringing their hands about losing their competitive edge to the Chinese, and trying to figure out how to keep the Chinese juggernaut from steamrolling over South Korea. In the ten years since the Asian financial crisis, the South Koreans have dealt with the dilemma of the new Sino-centric regional order in two different

ways. One was to intensify economic interaction with China, to the point where China is today South Korea's biggest export market, followed by the United States. China and South Korea are each other's second most important country of origin for imports. (And North Korea is a ward of China's, depending on the latter for practically all of its imported energy and manufactured goods.) And none of this is perhaps too surprising. Korea, like Vietnam, was long a tributary state to China, and is culturally at ease with it. There are today more South Koreans studying in China than any other nationality.

What is more surprising and interesting is South Korea's second response to the emerging Chinese regional order. Koreans are reaching out to the United States to counteract Chinese influence, and the best example of this policy is the Free Trade Agreement (FTA) between Korea and the United States. On the face of it, this FTA constitutes a radical disavowal of Korea's past interventionism, as the world's most famous "developmental state" transmogrifies itself into a modal free trading nation. In another sense, it is also the boldest industrial policy initiative on the Korean part. The Korean government has decided that the country cannot compete with the Chinese head-on without a massive revamping of its economy and society—by basically merging its economy with that of the United States.

Every country in East and Southeast Asia will have to find its own response to the emergent regional order. South Korea's response resonates with its history—intimate coexistence with the Chinese—while deeply implicating the United States in its balancing act. The Koreans may have a great deal to lose by dismantling all trade barriers with the United States, but they have decided the short-term loss is worth the long-term gain in upgrading the technological capability of the country.

NOTES

1. Shahid Yusuf and Joseph Stiglitz, *Rethinking the East Asian Miracle* (New York: Oxford University Press, 2001).

2. Jack London, "The Unparalleled Invasion," in *The Complete Stories of Jack London, Volume II*, eds. Earle Labor, Robert C. Leitz III, and I. Milo Shepard (Stanford: Stanford University Press, 1993), 1238.

3. *Ibid.*
4. Benedict Anderson, “From Miracle to Crash,” *London Review of Books*, 20 (1998): 8.
5. World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (New York: Oxford University Press, 1993).

ASIA AND THE INTERNATIONAL MONETARY FUND: TEN YEARS AFTER THE ASIAN CRISIS

DAVID BURTON

Both Asia and the International Monetary Fund (IMF, or the Fund) have changed in many important ways in response to the Asian financial crisis and its aftermath. A decade later, Asia has made considerable progress in strengthening its economic foundations, and is once again the most dynamic region in the world economy. For its part, the IMF has retooled itself to better help its membership cope with increasing economic and financial globalization. However, before considering the changes in Asia and at the IMF, it is important to briefly review the crisis itself.

REVIEWING THE CRISIS

The Asian financial crisis was unprecedented in its nature and virility. With the exception of Thailand, traditional macroeconomic imbalances were not evident beforehand, and did not play a major role. Instead, financial and corporate sector weaknesses, not fully apparent at the time,

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were at the root of the crisis. Other ingredients that contributed to the crisis included pegged exchange rates that encouraged excessive unhedged foreign borrowing, inadequate reserve levels, and a lack of transparency—particularly about the true level of usable foreign exchange reserves. Indeed, lack of information was a major impediment to understanding what was happening as the crisis unfolded and to formulating appropriate policy recommendations.

This mixture set the stage for the sudden reversal of investor sentiment and international capital that took place and exacerbated its effects. Doubts about the soundness of financial institutions and corporate firms spread quickly across national borders. This set off a vicious circle of capital outflows, plummeting exchange rates, and crippling balance sheet effects. Private demand collapsed and output in the most affected countries declined sharply. And the underdevelopment of social safety nets exacerbated the social and economic impact of the slumps.

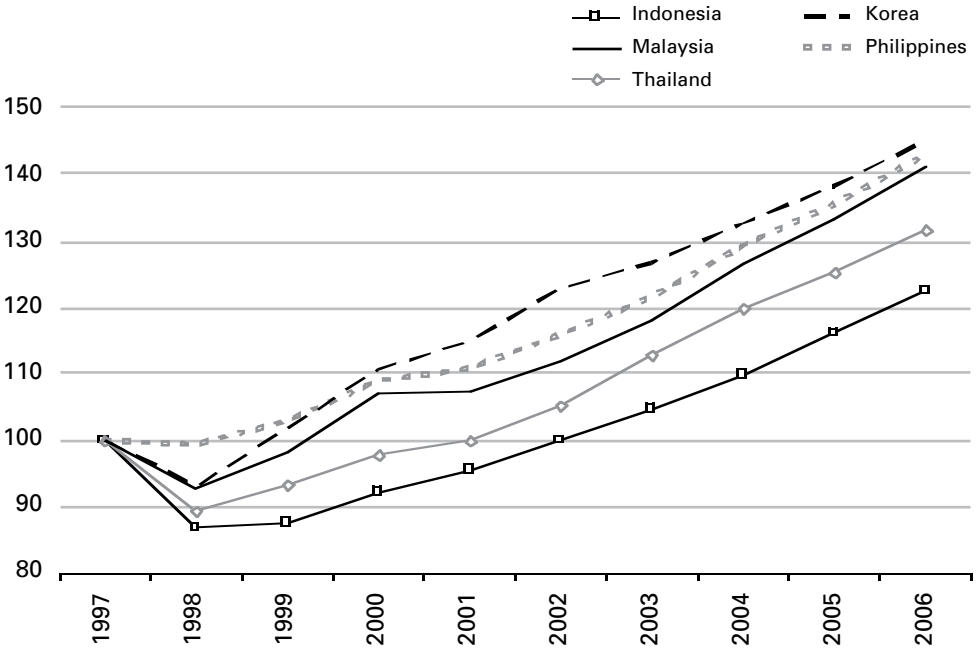
As private creditors were stampeding for the exit, the international community, working through the Fund, provided substantial financing to the affected countries. At the same time, governments in the region adjusted policies, increasingly taking strong and appropriate actions. Also, steps were taken to involve the private sector in providing financing. After some initial adjustments, the approach eventually turned the tide, as confidence began to recover and capital to return, though not before substantial damage had been done by the crisis. As can be seen in Figure 1, output recovered quickly, with the most determined reformers—notably Korea and Malaysia—performing the strongest.

LESSONS FROM THE CRISIS

What were the lessons learned from the crisis, and what progress has been made in applying them? Here I will focus on questions related to financial liberalization and openness.

First, it is crucial to highlight one wrong lesson that fortunately was not drawn—namely that it was safest for Asian countries to withdraw from globalization. Despite the crisis, Asia has continued to embrace globalization, and today the region plays an even bigger role in the world economy than in the mid-1990s. Instead, the reforms undertaken in the

Figure 1. Recovery Rates Based on Real GDP Rates



Source: International Monetary Fund, *World Economic Outlook: Spillovers and Cycles in the Global Economy* (Washington: International Monetary Fund, 2007), available from <http://www.imf.org/Pubs/FT/weo/2007/01/index.htm>.

region over the past decade have been geared to equip it to benefit more from globalization and to cope with globalization’s attendant risks, especially those associated with mobile international capital.

In this connection, an important lesson we have learned, supported by work done at the IMF and elsewhere, is that to reap the potential gains that financial globalization offers and to avoid the attendant risk of higher volatility, macroeconomic frameworks and financial sectors must be robust. This means meeting certain standards of institutional quality, governance and transparency—preconditions that were not adequately met in Asia prior to the crisis.

Much more has also been learned about the inter-linkages between

the balance sheets of the financial, corporate, government, and household sectors, and about how disturbances in one sector can quickly spread to the others. This has helped to improve the ability of country authorities and the Fund to identify weaknesses and vulnerabilities that previously might have gone undetected.

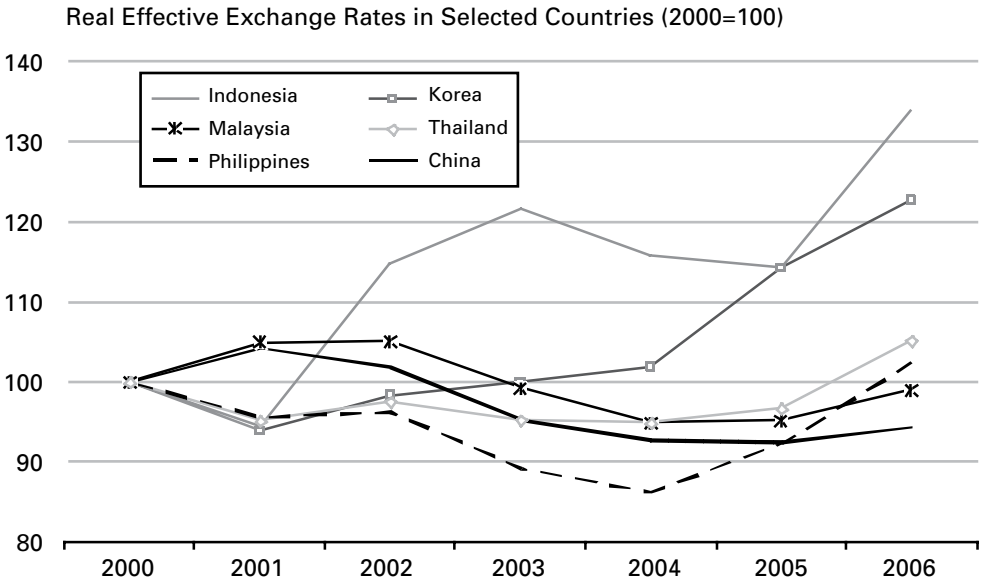
CHANGES IN ASIA

Over the past decade, countries in Asia have made considerable progress in applying these lessons. They have strengthened their policy and institutional frameworks to an impressive extent, reducing vulnerabilities. In particular, there are three key areas where improvements have been made at the national level.

First, many countries have strengthened macroeconomic policy frameworks in several respects. In particular, substantial reserve cushions have been built up as an important line of defense against possible future market volatility. Up to a point boosting foreign exchange reserves is good, although too large a buffer of this type can be costly to maintain. Also, continued reserve buildups can come at the expense of an unbalanced and unsustainable pattern of growth. Many countries have adopted more flexible exchange rate systems. This has allowed for more effective absorption of shocks, including shifts in investor sentiment. Flexible exchange rates also allow interest rates to be set more in response to domestic conditions, and help to avoid an under assessment of exchange risks by banks and corporations. The move toward exchange rate flexibility, however, has not been uniform in Asia, with some countries moving faster than others—as is evident from Figure 2. In particular, the limited flexibility so far in China makes it more difficult for other countries to allow their exchange rates to strengthen. And this has been reflected in continued reserve buildups in some cases

A second area of change in Asia is the marked improvement of transparency of policies and availability of information. Asian authorities, with the help of the IMF under its transparency initiatives, now routinely publish more high frequency information, including about their external debt and reserves. With many of the region's central banks having moved to inflation targeting frameworks, statements about monetary

Figure 2. Exchange Rate Flexibility Has Increased Over Time



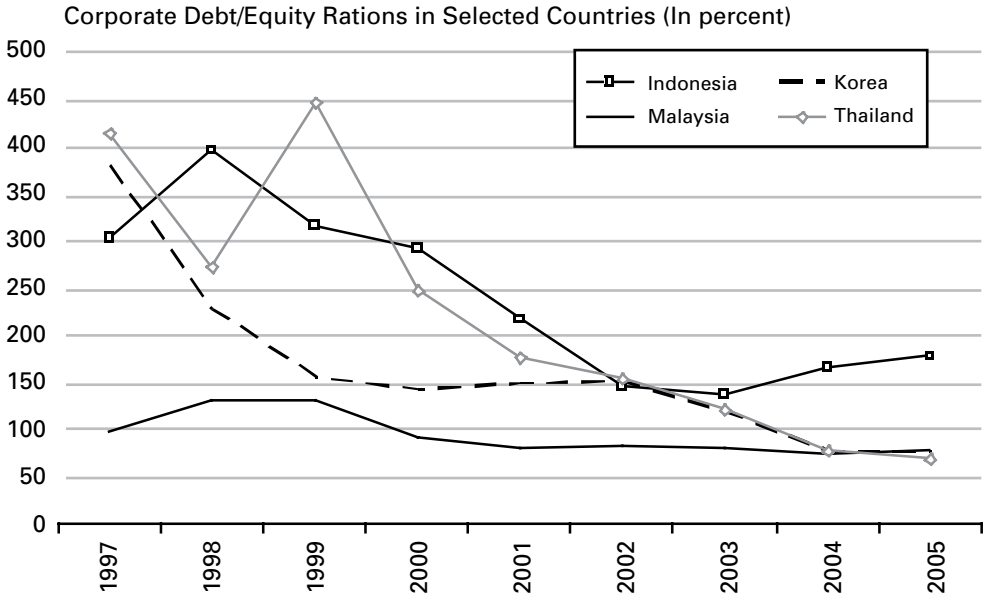
Source: International Monetary Fund, *International Financial Statistics* (various monthly volumes), available from <http://www.imfstatistics.org/imf/logon.aspx>.

conditions and policy developments are also now regularly published.

Third, Asian countries have undertaken important efforts to reform financial sectors and improve corporate governance. These reforms include overhauling regulatory and supervisory systems, raising accounting standards, and strengthening shareholder rights. In the banking system, this has been reflected in a marked reduction in non-performing loans—this is true for all the countries most affected by the crisis.

At the same time, overgeared corporations have substantially reduced their debt levels, with debt equity ratios sharply reduced across the board (see Figure 3). The lessons of the crisis have also spawned a number of regional initiatives aimed at increasing the financial integration and resilience of the region through increased policy dialogue, reserve sharing arrangements and capital market development.

Figure 3. Overgeared Companies Have Reduced Debt/Equity Ratios Over Time



Sources: International Monetary Fund staff estimates; and Thomson Analytics Database.

Information exchange and policy dialogue have been stepped up since the crisis through various fora including the Association of Southeast Asian Nations (ASEAN) and ASEAN+3 (ASEAN plus China, Japan, and South Korea), with the crisis perhaps creating a stronger sense of regional identity. Under the ASEAN+3 framework, a system of bilateral swap arrangements (the Chiang Mai Initiative) was set up after the crisis. In May 2007, a plan was announced to strengthen this mechanism by turning it into a reserve pooling arrangement. The IMF supports this initiative, seeing it as a useful complement to its own financing.

In order to broaden and deepen regional capital markets, efforts are underway to promote local bond markets, with a view to developing and diversifying sources of funding in Asia. Government initiatives in this area, including under the Asian Bond Market Initiative and the two Asian Bond Funds, are facilitating a bottom up process of integration.

As a result of these changes at both the national and regional level, the strength and resilience of Asia's financial sectors have been enhanced, making the region better placed to benefit from the globalization of finance. Indeed, over the past year or so emerging Asia has been able to weather successfully two moderate bouts of global financial market turbulence, recovering quickly from each episode. However, the regional economy remains to be tested by a major disturbance to global financial markets.

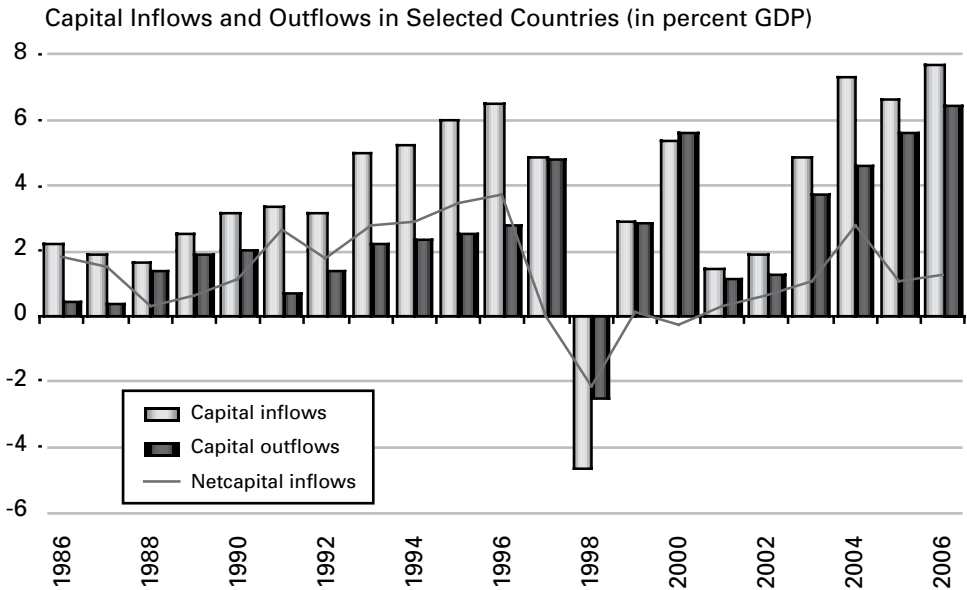
CONTINUING CHALLENGES FROM CAPITAL FLOWS

Nevertheless, Asia continues to face challenges from its increasing financial integration at the global and regional levels. One issue that officials in many countries are currently grappling with is how to deal with surges in capital inflows. While net inflows have been relatively constant in recent years, gross inflows and outflows have both risen sharply (see Figure 4). The increase in outflows is particularly noteworthy. It reflects a growing desire of Asians to invest outside their home countries. This is a natural and healthy result of Asia's growing financial integration with the global economy.

In addition to increasing in scale, gross capital flows in the region have also become more volatile. A particular concern here is that surges in inflows can put strong upward pressure on currencies and can provide additional—sometimes unwanted—loanable funds in the financial sector, potentially contributing to asset price bubbles and, perhaps most importantly, creating a risk that funds might flow out more quickly than they came in.

A temptation may be to address these concerns by imposing some form of capital controls to discourage speculative inflows. While the use of capital controls cannot be entirely ruled out, they can be very difficult to implement in practice and are often counterproductive. There is evidence to suggest that capital controls tend to be particularly easily circumvented when they are imposed on previously liberalized financial systems. Also, in those circumstances controls can create doubts about the future direction of economic policy, potentially discouraging foreign direct investment.

Figure 4. Gross Capital Inflows and Outflows Have Increased Over Time



Sources: International Monetary Fund staff estimates; and CEIC Data Company, Ltd

Surges in capital inflows seem for the time being to be a feature of financial globalization (see Figure 5). And there is no “magic bullet” for dealing with them. The best short-run policy response appears to be a combination of exchange rate flexibility, and limited intervention to smooth volatile exchange rate movements. Over the longer term, further steps to develop and deepen financial markets, including in the context of regional financial integration, can also help economies cope with shifts in capital flows. Further liberalization of restrictions on outflows, as warranted by the pace of financial market reform, can also support deeper integration and potentially offset swings in capital inflows.

CHANGES AT THE INTERNATIONAL MONETARY FUND

Over the past decade, the IMF too has changed in response to the Asian

financial crisis. Here I will focus on a few key areas.

First, we have substantially raised the importance of financial sector surveillance, and of integrating this work more closely with our traditional macroeconomic analysis. The focus is on identifying potential vulnerabilities in the financial sector, and appropriate policy responses. This is now a central part of our dialogue with member countries. We have done a lot of work over the last decade to better understand how vulnerabilities in the financial sector can be transmitted to other sectors of the economy, and vice versa. We also follow developments in capital markets more closely than before, and analyze their potential implications for economic and financial stability.

Second, we now do more analysis at multilateral and regional levels, to complement our country-level work. The goal is to better capture common trends and actual and potential spillovers, especially from financial market developments.

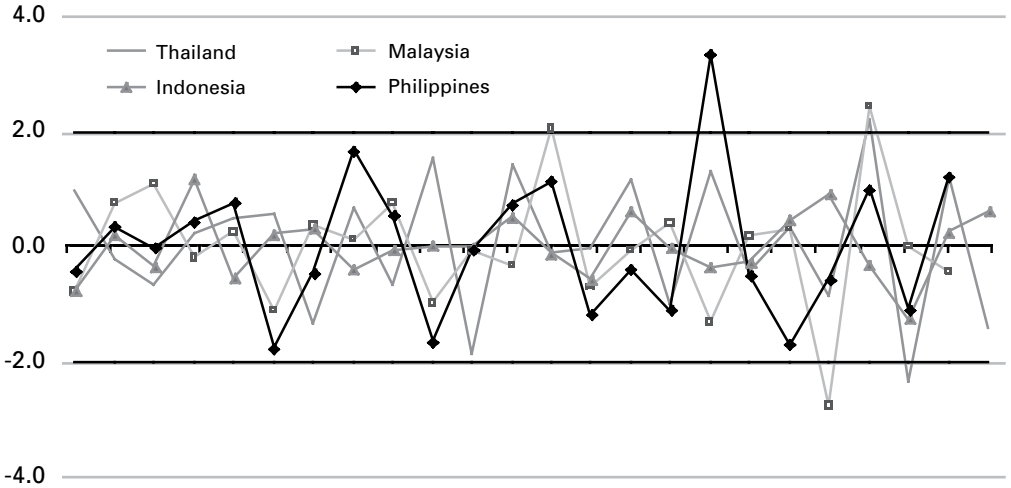
Third, we are also assessing whether our financing tools for crisis prevention can be improved, and whether the membership can agree on a new liquidity instrument that would be both useful to, and used by, emerging market countries.

Fourth, we have learned better the importance of country ownership. We give prominence to the government's own priorities in program design. And we have streamlined the conditions attached to our lending so that they cover only issues critical to macroeconomic stability and growth.

Fifth, we are moving ahead with governance reform. The objective is to ensure that voice and representation in the Fund better reflect the realities of today's global economy. We took an important step at our annual meeting in Singapore in September 2006, where the Fund's Governors agreed to a two-year program of change, starting with increases in quotas for China, Mexico, Korea, and Turkey. The Governors also agreed that the next stage should involve further increases in quotas for the Fund's most dynamic members, while making sure that the voice of low income countries is enhanced. The second stage is to be completed no later than September 2008. Dynamic emerging market countries, including those in Asia, must feel that they have an adequate voice in the Fund—that the Fund is their institution.

Figure 5. Surges in Capital Flows Have Become a Concern

Change in Portfolio and Other Investment Flows in Selected Countries:
Deviation from Trend



Sources: International Monetary Fund staff estimates; and CEIC Data Company, Ltd.

CONCLUDING THOUGHTS

Finally, the Fund's role in Asia has changed a lot since the Asian crisis. We no longer have programs with the emerging market countries in Asia. But this is in fact a normal and desirable state of affairs—it was the Asian financial crisis and its aftermath that were the aberrations. However, the Fund continues to be closely engaged with our members in Asia, both at a national level and in regional fora. This engagement is based very much on two-way dialogue, in which the Fund can bring global economic perspectives and the experience of the membership at large to bear on national and regional economic issues, and in which the Asian perspective can be brought to global economic questions. We also provide considerable technical assistance and training to members in the region.

The primary objective in all of this is to ensure financial stability both in the region, but also at the global level, where Asia is an increasingly important player.

THE AFTERMATH OF THE ASIAN FINANCIAL CRISIS: FROM “LIBERALIZE THE MARKET” TO “STANDARDIZE THE MARKET” AND CREATE A “LEVEL PLAYING FIELD”

ROBERT H. WADE¹

The international financial system has no enforcement mechanism analogous to the state’s authority in national financial systems, even as international financial flows have grown to dwarf international real-economy flows. It lacks institutions and organizations that are normal at the national level, such as a central bank, a financial regulator, a bankruptcy court, deposit insurance, and the like. Yet the financial services industry is built on confidence, and a lack of confidence in international transactions can be extremely contagious. Thus, international institutions to provide the public good of confidence in the international financial system are highly desirable. This means prudential rules, such that all international banks reach an acceptable standard of prudence, and transparency rules, such that all governments, banks, and other financial organizations reach an acceptable standard of transparency in their financial accounts.

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After the several major financial crises of the 1990s, the authorities of the international financial system—meaning the International Monetary Fund (IMF, or the Fund), the Bank for International Settlements, the World Bank, the U.S. Treasury, the U.S. Federal Reserve, and agencies of the Group of Seven (G7) states which oversee the international organizations and steer international economic policy—determined that the system for providing these international public goods was in urgent need of strengthening. Accordingly, these institutions reinvigorated the development of comprehensive and universal standards of good practice in such areas as bank supervision, financial accounting, data dissemination, and corporate governance.

Organizations like the IMF, the Basel Committee on Banking Supervision, the Financial Stability Forum (FSF), and a gamut of non-official bodies have been used to formulate and enforce these standards of good financial practice. The theory was that countries, banks and firms which comply more with the standards would gain better access to finance than those which comply less, and that this would induce them to comply, boosting international financial stability as a result. I call this the standards-surveillance-compliance (SSC) system.

In the 1980s and 1990s, the authorities of global finance had agreed on a single broad economic policy recipe for all countries (and developing countries in particular). This recipe was known as the Washington Consensus, summarized in the commandment, “liberalize the market.” The commandment expressed the classical liberal belief that market freedom and government are opposed to each other, and that the expansion of freedom consists of reducing government “intervention” in the natural functioning of markets.

After the shock of the Asian and other financial crises of the 1990s, the consensus shifted from “liberalize the market” to “standardize the market” on a global scale, implying the standardization of market institutions around a particular set of political economy models, thereby creating a “level playing field” in line with the spirit of “globalization.” The shift from “liberalize” to “standardize” is not the small step beyond the Washington Consensus that it seems at first glance. Turning classical liberalism on its head, it entails a significant *increase* in government and supranational “intervention” in order to secure the desired level playing field and homogenization of market institutions. It could appropriately

be called the Post-Washington Consensus.

Private international financial firms from developed countries have been intensively involved in this process. The resulting standards reflect their collective preferences, for they maximize their freedom of geographical and sectoral maneuver while setting collective constraints on their competitive strategies. On the other hand, the more radical proposals for strengthening the international financial system put forward after the Asian crisis—including an array of new international financial organizations—would have curtailed the freedom of private financial participants, and consequently have not left the drawing board.

AN ASSESSMENT OF THE SSC SYSTEM

The SSC system has strengths and weaknesses. This paper concentrates on the weaknesses. In ascending order, there exist six central weaknesses in the SSC system. First, the SSC system tends to treat each national economy as a unit and does not give enough attention to the world economy as a whole and to policy spillovers from “systemically important” economies onto others. Second, the SSC system may raise the propensity of financial market participants to “herd,” and thereby increase the volatility and pro-cyclicality of developing country access to finance. Third, the SSC system tends to give a structural advantage to developed country banks and other financial organizations and a structural disadvantage to those based in developing countries, especially through the dramatic effect on the cost of their capital adequacy requirements.

Fourth, the SSC system tends to further shrink developing country “policy space” as compared to the Washington Consensus by increasing the constraints on policy and institutional arrangements. Fifth, the SSC system tends to narrowly equate the national interest with promoting economic growth and increasing personal economic welfare, and to marginalize important developmentalist objectives such as constructing national unity, deepening national economic integration, diversifying into higher growth potential industries, and protecting national culture. And sixth, the SSC system imparts to national economies a gravitational pull towards an Anglo-American type of capitalism, and away from other types of advanced capitalism, such as Scandinavian, continental

European or pre-crisis East Asian. This pull is consistent with the preference of western investors for developing countries to adopt a regime of full openness and arms-length, short-term relations between banks, firms, and government, and banks operating solely to maximize profits for their shareholders (with no government guarantees and no mix of public and private purposes).

The SSC system is therefore deeply problematic from a liberal perspective. In the name of economic freedom, the SSC system expands market participants' freedom to move their capital where they wish and use it as they may. But it curbs the liberal value of the national ability to choose policy frameworks, by injecting a single policy model from above. And by nearly excluding developing countries from the standards-setting fora, the SSC system curbs the liberal value of democratic participation, such that those who are subject to a decision should have some role in making it, or at least be able to hold accountable those who make the decisions. In this paper I amplify these arguments, and make three modest proposals for reforms at the end.

THE NEW INTERNATIONAL FINANCIAL ARCHITECTURE

In the wake of the Asian crisis, leading policy economists tripped over themselves to offer plans for a “new international financial architecture” (NIFA)—not merely new interior decoration, or even plumbing, but new architecture, meaning a change on the order of the one initiated at the Bretton Woods conference of 1944 and toward creating a much stronger supranational authority in financial markets. The NIFA proposals included ambitious new global organizations—including a much larger IMF, a global financial regulator, a sovereign bankruptcy court, an international deposit insurance corporation, and a global central bank. They included, more modestly, the proposal for the Fund to be given greater authority to support standstills—postponement of foreign debt repayments and even controls on capital outflows. This amounted to “bailing in” countries' private creditors, so as to give countries protection from creditor panics, analogous to the kind of protection companies get from bankruptcy laws.

At first sight it seems, looking back from 2007, that not much has changed. The IMF has not been super-sized, as some analysts had de-

sired on grounds that the giant size of global financial markets required a big increase in the Fund's resources and staff so that when crises implode, the IMF can provide enough hard currency to deter financial investors from panicking about a shortage of liquidity. On the other hand, the IMF has also not been abolished, as prominent conservatives like former Secretary of State George Shultz had wanted, and nor has it been substantially cut, as called for by the majority on a congressionally appointed panel led by economist Allan Meltzer. One of the more radical proposals to originate from the official sector, the Sovereign Debt Restructuring Mechanism (SDRM) proposed by Ann Krueger of the Fund—which contained elements of a global bankruptcy procedure—was defeated by a combination of developing and developed member states alike at the IMF meetings of March 2003. The SDRM would have involved full debt restructuring including changes in interest rates, reductions in amounts owed, and influence over private investments and contracts. It would have entailed a big jump in the authority of an international organization over private financial markets.

The proposal for Contingent Credit Lines (CCL) was implemented, in that the IMF did create a facility which enables the institution for the first time to lend pre-emptively to help prevent a crisis. However, countries had to volunteer to join the facility, and the IMF had to certify that the country had strong enough economic policies. From the country-level perspective, signing up to a CCL looked like a confession of national economic fragility. From the IMF perspective, expelling a country which acquired a new government not to the Fund's liking would send a negative signal to the markets, possibility precipitating a financial crisis.²

In short, in the aftermath of the Asian financial crisis there has been little movement on any of the more radical NIFA proposals. The central reason is the unwillingness of participants in private financial markets to accept more international authority over the markets. Financial market participants prefer to operate in a world where authority lies mainly with nation states, which gives them greater freedom to do what they want than in a regime with stronger supranational authority.

Progress on Transparency, Standards, and Surveillance

Despite the lack of momentum for the NIFA proposals, there has been real movement in the area of global economic standardization, such as

the standards for good quality financial data (“transparency”), standards of good practice (including the Basel II capital requirements for international banks), and surveillance of national financial systems by multinational authorities, aimed especially at developing countries.

In October 1998, as the Asian crisis was still unfolding, the G7 finance ministers and Central Bank governors declared an agreement on “the need for greater transparency” (repeating their declaration after the Mexican crisis). Greater transparency implied the provision of “accurate and timely” macroeconomic and financial supervisory data, including the reserve positions of central banks and levels of national public *and* private indebtedness.³ World Bank economists supported this line of crisis prevention with the argument that the Asian crisis was due in large measure to “lack of transparency” in financial data. In the words of a World Bank paper published in 2001:

The findings suggest that these [crisis-affected] countries did not follow International Accounting Standards and that this likely triggered the financial crisis. Users of the accounting information were misled and were not able to take precautions in a timely fashion.⁴

The IMF argued in 2003 that the global “adoption of internationally recognized standards of good practices [would help] foster financial market stability and better risk assessment.” Compliance with standards would help a country “mitigate the impact of an external crisis by supporting continued access to external borrowing,” and “help prevent crises” by reducing the cost of foreign capital and thereby help a government “remain solvent in cases it otherwise might not have remained solvent.”⁵

The initial concern to improve “transparency” grew into a broader concern to reorganize and re-regulate economic activity around the world. The re-regulation had four main components. First, the standards of good information, and second, the standards of good practices (including banking supervision and payments systems). The third component was the systematic surveillance of economies in order to judge compliance with the standards, and the fourth component outlined mechanisms for encouraging governments to comply with the standards.⁶

The IMF was charged with developing Special Data Dissemination Standards (SDDS), and was also to be the primary enforcer of many of

the standards, through the formal mechanisms of structural conditionality, contingent credit lines, and Article IV consultations.

However, these formal enforcement mechanisms were never developed. Instead, the IMF—and the “transparency” thrust more generally—relied on indirect enforcement through the response of “financial markets” (i.e. the “Electronic Herd”). The Fund would directly, or indirectly via the government, make public the results of the surveillance. Even if the government restricted the public information, the network of experts who conducted the surveillance leaked enough to ensure that anyone who wanted to see the results could see them. Financial markets would respond to the high quality information appropriately, being willing to lend more funds at cheaper rates to governments that complied more fully with the standards, and less to governments that complied less. In the context of a market-driven reward and punishment system, governments would strive for more compliance, and the international financial system would become more stable.

This was the theory. In line with this theory the IMF, supplemented by the World Bank, produced Reports on the Observance of Standards and Codes (ROSCs), and initiated a Financial Sector Assessment Program (FSAP). Between 1999 and 2006, the Fund produced 502 ROSCs and the World Bank 92; where 130 countries had at least one ROSC.

The ROSCs fed into the larger exercise of the FSAP, which had three main assessment components. The first component was compliance with standards based on the ROSC, the second was the stability of the financial system, and the third was reforms necessary for the financial sector. Operationally, the FSAP exercise may entail, for a large country, a sizable team of personnel from the IMF, the World Bank, and outside consultants, coming to a given country and carrying out sustained dialogue with financial authorities on critical matters such as, for example, payments systems, and feeding the results of this dialogue back to the authorities.

At the same time, on a separate but parallel track, the Basel Committee on Banking Supervision, under the umbrella of the Bank for International Settlements (BIS), which is the association of G8 countries’ central banks, was developing a new set of standards for the capital adequacy of banks and for banking supervision. The impetus came from bank regulators feeling overwhelmed by financial innovations in the 1990s, and from the development of new kinds of risk assessment models

in central banks, coupled with the prevailing norm that “markets know best.” The process of formulating the new set of standards came to be known as the Basel II process, the successor of Basel I, whose standards had by then come to be seen as out of date. The initial statement of the Basel II proposals from the Basel Committee was published in 1999, the Asian crisis having given the project added urgency.

A whole gamut of unofficial bodies has also been formulating standards that have global impact. They include the International Association of Insurance Supervisors, the International Accounting Standards Board, the International Organization of Securities Commissioners, the International Organization for Standardization, and the International Federation of Stock Exchanges.

Effects of the Drive for Transparency, Standards and Surveillance

At first glance transparency, standards and surveillance are as desirable as motherhood and apple pie. To go beyond the first glance we have to ask whether national regulatory authorities have complied with the standards, and whether their compliance makes a difference to the behaviour of private market participants; and whether such changes as are observed are a “good thing.”

On the positive side, the FSAP exercise has produced useful results, according to insiders on the country end. The IMF’s FSAP team typically concentrates on “supervising the national supervisors”—in other words, on examining how the national financial supervisory system is working and making suggestions for improvement. Often its political role is to strengthen the hand of regulators against the government. The regulators can say to the government, “The IMF says X and Y must be done. If we don’t comply, we will be subject to international criticism and market discipline.” Indeed, quite a few governments have overhauled their financial regulatory system ahead of an FSAP exercise, especially when the government has made a commitment to publish the findings of the FSAP in advance. The UK Financial Services Authority, for example, has often been asked to provide technical help to other governments in advance of an FSAP exercise. Even where the findings of the exercise are kept internal to government and not released to markets, market participants can find out readily enough if they wish to.

On the other hand, the negative results are substantial. First, the FSAP and the ROSCs have tended to amount to a checklist. They tend to lack focus, and to include much detail on so-called “structural” issues which are not closely related to external stability, which is what should be the focus.⁷ Second, as Rachel Lomax, deputy governor of the Bank of England, said recently:

The IMF does not devote enough time and effort to overseeing the system as a whole, through assessing global economic prospects and analysing international economic linkages and policy spillovers (so-called multilateral surveillance)...The IMF needs to be better focussed on the big global issues, including financial issues and on the interactions between different regions and countries.⁸

Moreover, the report on multilateral surveillance from the IMF Independent Evaluation Office states that the Fund’s operational staff tend to not read the IMF global stability reports, let alone integrate the reports’ findings into their bilateral work. Only 14 percent of senior staff said that the IMF’s findings from its “multilateral surveillance” were discussed with national authorities.⁹

Conversely, bilateral surveillance reports show little discussion of policy spillovers even from systemically important countries like Germany, Russia, and even the United States. These findings confirm the view that the IMF, and equally the World Bank, are not properly “world” organizations.

Third, it seems that on the whole, financial market participants pay rather little attention to the data provided through “transparency” exercises—even though they would presumably no longer be “misled” by the data (as they supposedly were before the Asian crisis). A recent independent evaluation of the IMF’s FSAP concluded that:

while many authorities identified the ‘signalling role’ to markets as one of their motivations for participating in the FSAP exercise, the impact of FSSAs [Financial Sector Stability Assessments] on the views of financial market participants appears modest.¹⁰

Financial markets pay more attention to “traditional” macroeconomic indicators like inflation than to compliance with standards of

good financial practice. Studies of the link between compliance with standards and cost of foreign capital have found no significant impact of the former on the latter. Yet as noted, the IMF's approach to enforcement of compliance with standards of good practice relies on indirect enforcement through financial markets rewarding countries with good policies and punishing those with non-compliant policies. If financial markets do not pay much attention to the data released from surveillance exercises, the enforcement mechanism is hobbled.

Fourth, to the extent that markets do pay attention to the information made available through transparency exercises the impact may be to make financial markets *less* stable and *more* prone to crisis. By homogenizing the data about economies and reducing the diversity of opinion on economic forecasts, transparency exercises may accentuate the tendency to *pro-cyclical* herding behaviour, as bankers and investors buy what others are buying, sell what others are selling, and own what others are owning.

In short, the Fund's attempt to remedy what the powers of the international financial system took to be a major cause of the Asian financial crisis—lack of transparency—by providing more transparency so that users of accounting information would not again be “misled,” may have helped to strengthen financial standards through the FSAP process. On the other hand, the strengthening of financial standards has probably had little effect on the behavior of financial market participants because they do not pay attention to the resulting information. Moreover, to the extent that the behavior of financial market participants has been affected by the provision of increased transparency, it may be in a more *pro-cyclical* and destabilizing direction rather than the opposite.

There is a broadly similar argument to be made about the impact of the Basel II—as distinct from IMF—standards. Avinash Persaud, former head of research at State Street Bank, argues that the Basel II move towards more quantitative, market sensitive risk management practices reinforces herding behaviour and market volatility in a vicious circle.¹¹ Two other analysts make the same point in the following terms:

[T]he application of model-based risk management may result in the creation of second-order dangers, which raises questions

about the recent move of financial regulators worldwide toward an integration of mathematical risk assessment tools in the regulatory framework.¹²

One reason is that the standards encourage the more sophisticated banks—those based in developed countries—to adopt a single type of internal ratings-based (IRB) model. The IRB model relies on current asset prices, which tend to be pro-cyclical, raising the capital requirements at times of downturns when banks are less able to meet the requirements. A second reason is that banks will tend to react similarly to common signals—because they are using the same type of risk assessment model, which leads them to downgrade or upgrade clients *en masse*.¹³

Thus, Basle II standards, like IMF standards, may well make market participants behave in ways that increase rather than decrease market volatility. However, to judge the impact of standards of good practice and their diffusion through regular bilateral—and even multilateral—surveillance only by their effect on the behaviour of market participants is too narrow.

Effects on Developing Countries' Access to Finance and Competitiveness of Developing Country Banks

Standards of good practice are rarely distributionally neutral. Standards usually benefit some participants more than others. The standards coming out from the Basel Committee, the IMF, the FSF, and the like—and the surveillance coming out in line with the standards—may be having at least two far-reaching impacts, which are disadvantageous for developing countries and advantageous for developed countries.

The first of these far-reaching impacts is that Basle II, as compared to Basle I (or as compared to a “first best” solution), will shift competitive advantage even further towards developed country banks and against developing country banks, by raising the cost of finance to developing countries. The rise in the cost of finance will likely hurt development prospects more broadly by making developing country access to finance more pro-cyclical.

Basle II requires banks with less sophisticated risk management systems—which tend to be based in developing countries—to carry

relatively more supervisory capital than banks with more sophisticated systems. Therefore it raises their costs of lending relative to those with more sophisticated risk management systems, which tend to be based in developed countries. The latter are allowed to establish their credit risks and capital adequacy themselves (“self-supervise”), subject to the financial supervisor approving their model. Also, Basel II requires greater differential risk weighting to lower-rated borrowers than Basel I, who are disproportionately in developing countries. And, Basel II’s standards insufficiently recognize risk diversification benefits of lending to clients in developing countries.

The Basel Committee’s recent quantitative impact study reveals a large variance in the amount of capital required for banks using the different Basel II-based risk assessment methodologies. For example, some banks using the advanced IRB approach—coming predominantly from developed countries—are expected to have large *reductions* of their capital requirements of the order of 30 percent. Banks using the simpler “foundational” approach—predominantly from developing countries—are expected to experience an *increase* in their capital requirements of over 38 percent.¹⁴ The Basel II standards thus present a structural advantage to large developed country banks, and a structural disadvantage to developing country banks, as well as to the regional, national, and local economies they are nested within.

The consequence is that developing countries under Basel II could face a higher cost of capital and a lower volume of lending than under Basel I, with greater financial pro-cyclical volatility and with their banks having fewer chances of establishing international operations and more likely to be taken over by developed country banks.¹⁵ No country should let its banking system be taken over by foreign banks—even though in developing countries western banks are likely to be more “efficient” than domestic ones—for at times of crisis banks rely heavily on their home state and are likely to sacrifice operations in developing countries in order to protect their home base.

The Pull Towards the Norms of Anglo-American Capitalism

The second far-reaching impact is that the new standards and surveillance mechanisms may be shifting norms about the “normal” or “proper” kind of capitalism in the direction of the Anglo-American type.¹⁶ The

Anglo-American type of capitalism typically refers to short-term and arms-length relations between non-financial companies, banks, and the state, and banks oriented to profit maximizing.

A contrasting type of capitalism is that of the East Asian type, which is based on longer-term and more “multiplex” relations between companies, financiers, and the state, where some banks have mandates to invest in social purposes that go beyond profit maximizing. I have argued elsewhere that this system was an important factor in the very high rates of investment and diversification in capitalist East Asia from the 1950s to the 1980s, particularly because it enabled large firms to carry very high ratios of debt to equity in comparison to counterparts operating in an Anglo-American type of capitalism. The high debt to equity ratios supported high rates of investment and enabled the East Asian states to steer the direction of investment through industrial policy.¹⁷ As long as the East Asian system operates on the basis of long term relationships, patient capital, and government guarantees, Anglo-American firms are at a disadvantage in East Asian markets. On the other hand, financial firms in the United States and in the United Kingdom know that they have an advantage over others in an institutional context of arms-length relations, unsubsidized banks oriented solely to maximizing profits, stock markets, open capital accounts, and new financial instruments. Therefore they invoke the metaphor of “level playing field” in order to justify the claim that the East Asian financial system must be changed towards that of the Anglo-American financial system.¹⁸

“Level playing field” translates into “you conform to us.” When an East Asian economy adopts the standards of good practice established by the powers of the global financial system, its banks have to operate under much tighter prudential standards and cannot support debt to equity ratios anywhere close to those they supported earlier. The adoption of standards also disables East Asian banks from supporting the mix of public and private purposes common to East Asian banking. Further, this change in the national financial system tends to spill over into changes in related institutional areas, including corporate governance, product markets, labour markets, as well as the welfare state and education. The national economy moves in the direction of a “liberal market economy,” as distinct from a “coordinated market economy,” in the language of Peter Hall and David Soskice.¹⁹

So to the extent to which the international financial system uses Anglo-American standards of good financial practices as “normal,” such that non-compliance is “deviant,” it imparts a “global warming” type of change in the international political economy, away from coordinated market economies of the East Asian type and toward the Anglo-American liberal market type.

Therefore the financial system’s efforts at surveillance should not be understood as just an add-on to previous efforts at market liberalization. The drive for “transparency” involves not so much “removing the veil” as a massive program of standardization and reporting, using standards derived from good practices in the liberal market economies rather than from good practice in more coordinated economies. The drive for transparency thereby reinforces and legitimizes the injection of the power of dominant states (i.e. the G7 states) and multilateral organizations in order to intensify and stabilize financial liberalization. As suggested earlier, the change is significant enough to justify the label “Post-Washington Consensus.”²⁰

The question is whether this shift in the political economy of developing countries towards the liberal or Anglo-American type of capitalism can be justified in terms of improving developing countries’ prospects for developing countries to catch up to the growth levels of developed countries. The answer is, broadly, no, although defending the answer is well beyond the scope of this paper. Suffice it to quote here the conclusion of Dani Rodrik, that the “new focus on institutions” is not warranted by the evidence, because “our ability to disentangle the web of causality between prosperity and institutions is seriously limited. [But it is clear that countries do not need] an extensive set of institutional reforms” to spur economic growth.²¹

So how did this agenda of transparency, standards, and surveillance crystallize? The key point is that representatives of developing countries and their financial organizations had virtually no place in formulating the agenda or the implementation of this agenda. The G7 finance ministers led the debate. Of the bodies which conducted additional decision-making and implementation, the Financial Stability Forum, the Basel Committee, and the OECD include virtually no developing country members. Meanwhile, the IMF and the World Bank are dominated by the G7 states, exemplified by the particular fact that 64 developing coun-

tries are in constituencies whose executive directors are always from developed countries (like Belgium, the Netherlands, Spain, and Italy). The G7 states are highly responsive to the preferences of private financial organizations based in their states. The large array of international standard-setting unofficial bodies of the kind mentioned earlier have almost no representation from developing countries.

The big international developed country banks have an especially effective spokesperson for the industry in the Institute for International Finance (IIF), based in Washington, D.C., which does research and lobbying on their behalf. When the Basel Committee on Banking Supervision came under pressure from its member states (all of which are developed countries) to consult with “the industry” about improving the working of Basel I in the mid-1990s, the Basel Committee turned to the IIF as its principal interlocutor. In formulating Basel II, the Basel Committee relied even more on the IIF. But the IIF has the reputation of being the voice of the international—and mostly developed country—banks, and of taking little notice of the preferences of less international banks, which include most developing country banks. The process of formulating how to strengthen the global financial system after the Asian crisis was disproportionately shaped by the preferences of the developed country states and developed country private financial actors, to the effect of marginalizing the preferences of developing country states and their private financial actors.²²

CONCLUSION

Post-Asian financial crisis, the international financial system continues to place the onus on developing countries to prevent crises, without much reform at the international level to mitigate the intensity of pressures from global financial liberalization. For example, such mechanisms for reducing the severity of crisis as the Sovereign Debt Restructuring Mechanism, and standstills more broadly, have been dismissed. The fact that the world economy in the past five years has not experienced frequent financial crises as it did between the 1980s and the early 2000s is due less to institutional changes than to generally benign world macroeconomic conditions.

The fundamental reason for the lack of institutional movement is disagreement about how much control should be conferred on supranational bodies, and on what kinds of supranational bodies—for example, global or regional, and public or private. Private financial market participants in the West remain hostile to measures which go beyond standardization on a western, particularly Anglo–American model of arms-length, short-term capital markets.

Here are three more or less feasible proposals for incremental improvement in the world financial system, where “improvement” includes not only financial stability but also national autonomy.

WHAT SHOULD BE DONE?

A Greater Degree of Surveillance of the World Economy

A greater degree of surveillance of the world economy—as distinct from the surveillance of individual countries—should be conducted, and bilateral surveillance should be focused on issues closely linked to external stability. Both the IMF and the World Bank are, surprisingly, not meaningful “world” organizations, in the sense that they pay primary attention to national economies considered as separate units and only secondary attention to the world economy. In the case of standards and surveillance, the IMF should shift the emphasis towards multilateral surveillance, and in its bilateral surveillance, the IMF should focus its analysis on policy spillovers. This means that the IMF should be ruthlessly selective in its bilateral surveillance of “structural” issues, and only deal with those which closely affect external stability and policy spillovers to the rest of the world. Partly to fortify its credibility as a multilateral organization and not an arm of the G7 or the G1, the IMF should, in deputy governor of the Bank of England Rachel Lomax’s words:

explicitly recognize members’ undoubted right to choose their own policy frameworks, providing that they are consistent with their commitments under the Articles.

Lomax’s distinction between members choosing their own policy framework, in line with the spirit of national sovereignty, and members

pressed to adopt a homogeneous institutional framework, in line with the spirit of the Group of Eight (G8)-led world financial system, is parallel to the distinction between “national treatment” and “deep integration” in trade policy. Under the national treatment principle, governments are free to set tariffs as they will, but cannot discriminate between countries—if they lower tariffs on imports from one country they must lower import tariffs for all countries. Under deep integration, governments must change institutions deep within their borders, in order to be consistent with the models ratified in multilateral fora. The distinction is also analogous to the one between an organization where user departments choose their own software systems, with the *facilitation* of a central information department (and within broad limits of intercommunication), and one where a central data processing department makes top-down decisions about software for the whole organization and does the processing itself.

Retreating from the structural issues would allow the Fund to make the business of forming standards and monitoring compliance less of a Trojan horse for the insertion of Anglo-American political economy models into the rest of the world.

A Democratic Revision of the Basel Standards

The Basel standards should be revised in a process less dominated by developed country states and developed country banks. The Basel II standards are currently being implemented around the world. Yet the Basel Committee has indicated that the process of standardizing capital adequacy and supervisory standards must evolve in a way that responds to innovation in international financial markets. This calls for changes in the way the Basel Committee structures its interaction with outside groups. The consultation process with both non-Basel Committee banking supervisory agencies and with the private sector should be more transparent. The Basel Committee has initiated a semi-transparent consultative process, where it posts openly solicited comments received on design proposals. While this is a step in the right direction, the Basel Committee’s manner of handling these comments is completely opaque. The use of independent external auditors to assess comments received and interactions between the Basel Committee and outside groups would improve the transparency and accountability of the Committee.

Such a formalization of procedure could also give leverage to developing countries when new proposals are being made.

Currently, developing country banking regulators and banks are experiencing great difficulties in implementing Basel II. In particular, the few developing country regulators and banks trying to implement the more advanced risk assessment methodologies are encountering severe problems.²³ At a minimum there should be in place better provision of technical assistance to developing countries to implement these standards, while still providing autonomy to developing countries to decide for themselves on the extent to which they will implement Basel II standards given competing national priorities.

Discussions for a Basel III—which are expected to begin over the next few years—should involve developing countries more than in the previous rounds. Regional organizations, such as the Association of Supervisors of Banks of the Americas and the Latin American Bank Federation, have a potentially important role to play. For example, the new standards should give higher weighting to the risk-reducing effects of international diversification of borrowing and lending—including to and among developing countries.²⁴ Furthermore, efforts should be directed to formulating a less uniform and “cookie cutter” approach to standards. Instead, standards should be regionally differentiated, with surveillance conducted by regional organizations, and attention should be paid to the distinction between the capital requirements of internationally active banks versus national development banks, as more countries begin to revive their development bank system.

Basel III should also grapple with the fundamental question of whether regulating levels of capital adequacy is the best way to promote greater bank stability, and expand the scope for bank stability options outside of an intensive application of the Basel II standards.²⁵ The options should include a range of legitimate ways to achieve adequate levels of prudence to protect the international financial system against a loss of confidence. For example, such a range of protection mechanisms could include not only prescribed levels of core capital but also government guarantees. Furthermore, the options should include alternative ways of providing liquidity during a crisis, because contrary to the thrust of Basel II, the problem for banks during a financial crisis (especially for banks in developing countries) is liquidity, not capital.

Distinguishing between “functions” and alternative institutional arrangements for fulfilling given functions is a first step towards expanding the scope for national autonomy.

A Greater Scope for Capital Controls

Since the dominant developed country states continue to place the onus on developing countries for avoiding financial crises (rather than change the international system to make financial crises less likely), developing countries should draw the implied lesson. They have to protect themselves. Some Asian countries have managed to accumulate large foreign exchange reserves, as a means of self-insurance. However, large reserves have big costs. A partial alternative is to make more use of capital controls to curb the flow of capital surges in and out of national borders. At the international level, standards of good practice should permit states to impose restrictions—as well as regulations—on portfolio capital mobility. As free trade champion Jagdish Bhagwati declared:

In my judgement it is a lot of ideological humbug to say that without free portfolio capital mobility, somehow the world cannot function and growth rates will collapse.²⁶

The international community now knows from the East Asian experience that capital inflow surges can generate pressure for exchange rate appreciation, a domestic credit boom, and loss of export competitiveness. Thus, capital surges raise the risk of a sudden “bust” triggered by panicked capital withdrawal. Controls on inflows and outflows can dampen these surges. We know, too, that capital controls on inflows can also be effective as a macroeconomic management tool, to curtail demand at times of boom, when tax increases for the same purpose are too slow or precluded for political reasons. Restrictions on inflows allow domestic interest rates to be raised to curb aggregate demand, in a way not possible in the absence of the controls. Without the controls raising the cost of short-term foreign loans domestic borrowers would simply switch from domestic to foreign loans, undermining monetary tightening.

For reasons both of national sovereignty—“members’ undoubted right to choose their own policy frameworks,” in Lomax’s words—and of effectiveness in preventing financial crises and maintaining macroeconomic

stability, multilateral rules should explicitly recognize countries' right to use capital controls. There should be no revival of the G7 push to insert the goal of promoting free capital mobility in the Articles of Agreement of the IMF in the 1990s, or to give the IMF jurisdiction over the capital account of a sovereign government.

My policy suggestions, then, are to focus IMF surveillance more on “multilateral” and less on “structural” features of national economies distant from the economy's external stability, to provide more voice to developing countries in the Basel II process, to give scope for countries to use capital controls, and more generally to distinguish between the functions that have to be met by institutional arrangements and alternative institutional forms for meeting those functions. The world financial system needs to reflect a wider concern to blunt the momentum towards “deep integration” or “standardization” of national economies around the liberal market economy of the Anglo-American countries. Conversely its rules need to reflect a concern to expand national and regional “policy space.”²⁷

NOTES

1. In addition to the cited references I have drawn on discussions with Jane D'Arista (Financial Markets Center, www.fmcenter.org), Jakob Vestergaard (visiting fellow, Centre for the Analysis of Risk and Regulation (CARR), London School of Economics (LSE), Kevin Young (PhD candidate, Government Department, LSE), Charles Goodhart (Financial Markets Group, LSE), and Howard Davies (former head of the UK Financial Services Authority and current director of LSE).

2. See International Monetary Fund (IMF), “Progress in Strengthening the Architecture of the International Financial System,” IMF Fact Sheet, July 2, 2000, <http://www.imf.org/external/np/exr/facts/arcguide.htm>, which gives a link to 2001 updates of the Fact Sheet. See also 2003 IMF *Review of Contingent Credit Lines* (Washington: International Monetary Fund, 2003).

3. “G7 Leaders Statement on the world economy” and “Declaration of G7 Finance Ministers and Central Bank Governors,” Finance Ministers' Meetings, London, October 30, 1998.

4. Tara Vishwanath and Daniel Kaufman, “Towards transparency: new approaches and their application to financial markets,” *The World Bank Research Observer* 16 (2001): 1, 44.

5. IMF, "The link between adherence to international standards of good practice, foreign exchange spreads, and ratings," IMF *Working paper*, No. 03/74 (Washington: International Monetary Fund, 2003), 26.
6. My argument on transparency and surveillance is indebted to Jakob Vestergaard, "Risk, transparency, and market discipline: IMF and the Post-Washington Consensus," typescript, Centre for the Analysis of Risk and Regulation, London School of Economics, London, April 2007; and Jakob Vestergaard, *Discipline in the Global Economy: Panopticism and the Post-Washington Consensus*, (Ph. D. dissertation, Copenhagen Business School, 2007).
7. Structural issues refer to institutional domains, such as social security systems or the energy sector, as distinct from macroeconomic policy issues having to do with international reserves, external borrowing, and fiscal balances.
8. Rachel Lomax, "International monetary stability – can the IMF make a difference?" (Lecture, Somerset House, London, November 1, 2006).
9. IMF, Independent Evaluation Office (IEO), *Evaluation Report: Multilateral Surveillance*, 2006,
www.imf.org/external/np/ieo/2006/ms/eng/pdf/report.pdf.
10. *Ibid.*
11. Avinash Persaud, "The Disturbing Interactions Between the Madness of Crowds and the Risk Management of Banks in Developing Countries and the Global Financial System," in *Developing Countries and the Global Financial System*, ed. Stephany Griffith-Jones and Amar Bhattacharya (London: Commonwealth Secretariat, 2001), 61.
12. Boris Holzer and Yuval Millo, "From Risks to Second-Order Dangers in Financial Markets," Centre for the Analysis of Risk and Regulation Discussion Paper, London School of Economics (2004), 17.
13. Stijn Claessens, Geoffrey Underhill, and Xiaoke Zhang, "Basel II Capital Requirements and Developing Countries: A Political Economy Perspective," (paper presented at the workshop on "Quantifying the Impact of Rich Countries' Policies on Poor Countries" organized by the Center for Global Development and the Global Development Network, Washington, D.C., October 23–24, 2003).
14. Basel Committee on Banking Supervision, *Results of the Fifth Quantitative Impact Study* (Basel: Bank for International Settlements, June 16, 2006), 2.
15. Stijn Claessens et al., 17.
16. Jakob Vestergaard, "Risk, transparency, and market discipline."
17. Robert H. Wade, "Governing the Market; The Asian Debt and Development Crisis of 1997-?: Causes and Consequences," *World Development* 26, no.8 (1998); Robert H. Wade, "From 'Miracle' to 'Cronyism': Explaining the Great Asian Slump," *Cambridge J. Economics* 22, no. 6 (1998). See also John Zysman, *Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change* (Ithaca, N.Y.: Cornell University Press, 1983).
18. As an example, the United States Senate passed a Foreign Operations Appropriations Bill in September 1998 stating that U.S. funds were not available

to the IMF until the U.S. Department of the Treasury certified that all the G7 governments publicly agreed that they would require the IMF to require of its borrowers: (a) liberalization of trade and investment, and (b) elimination of “government directed lending on non-commercial terms or provision of market distorting subsidies to favored industries, enterprises, parties or institutions” (i.e. elimination of sectoral industrial policy).

19. Peter Hall and David Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001).

20. This is a central point of Jakob Vestergaard, “Risk, transparency, and market discipline.”

21. Dani Rodrik, “Getting the Institutions Right,” Working paper, Kennedy School of Government, Harvard University, 2002, http://ksghome.harvard.edu/~drodrik/ifo-institutions%20article%20_April%202004_.pdf.

22. This point is central to Claessens, Underhill, and Zhang, “Basel II Capital Requirements and Developing Countries: A Political Economy Perspective.”

23. See Financial Stability Institute, “Implementation of the New Capital Adequacy Framework in Non-Basel Committee Member Countries,” Occasional Paper no. 6 (September 2006): 11. See also Andrew Fight, “Emerging Markets Struggle with Basel II,” *The Financial Regulator* 11, no.3 (December 2006): 31-34. My thanks to Kevin Young for discussions of these points.

24. See Stephany Griffith-Jones, Miguel Segoviano, and Stephen Spratt, “CAD3 and Developing Countries: The Potential Impact of Diversification Effects on International Lending Patterns and Pro-Cyclicality,” Institute of Development Studies, Sussex University, *mimeo*, August 2004.

25. See, for example, Jan Kregel, “From Monterrey to Basel: Who Rules the Banks?” *Social Watch* (2006), <http://www.socialwatch.org/en/informesTematicos/102.html>.

26. “Interview with Jagdish Bhagwati,” *Times of India*, December 31, 1997.

27. Robert H. Wade, “What Strategies Are Viable for Developing Countries Today? The World Trade Organization and the Shrinking of ‘Development Space,’” *Review of International Political Economy* 10, no. 4 (2003): 621-44. See also Robert H. Wade, “Choking the South,” *New Left Review* 38 (Mar/Apr 2006): 115-27.

ONE STEP FORWARD, TWO STEPS BACK: POLICY (IN)COHERENCE AND FINANCIAL CRISES

ILENE GRABEL¹

The tenth anniversary of the East Asian financial crisis is a propitious time to reflect on the lessons of that watershed event. However, it is important to acknowledge that in many important respects the Asian crisis was a repeat of events in Mexico just a few years prior. Former International Monetary Fund (IMF) managing director Michel Camdessus had it right when he dubbed the Mexican debacle of 1994-95 the “first financial crisis of the twenty-first century.”² The Asian crisis was more serious and surprising than events in Mexico insofar as the Asian economies were hailed as miracles right up until their implosion.

The Asian crisis was followed by crises in Turkey, Brazil, Poland, Russia, and Argentina. Although each of these crises had a slightly different etiology, it is nonetheless true that they all occurred in the financially fragile environments fueled by speculative booms made possible by misguided programs of internal and external financial liberalization.³

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LEARNING FROM CRISES

It is interesting that, faced with cumulative evidence of policy failure and the human misery associated with these crises, economists in the academic and policy community ultimately seem to have learned something, particularly from the events in Asia. Granted, some were slow learners. The slow learners did quite well for a while in the various cottage industries that sprung up after each crisis. They shared with wide audiences the serious problems that they came to see as deeply rooted and pervasive, albeit somehow also undetected by international investors and policymakers who extolled the virtues of the model economies. Here I refer to those that gave crisis post-mortems that focused on the role of corruption, cronyism and malfeasance, on misguided programs of government intervention, on nostalgic attachments to pegged exchange rates, and on inadequate information about the true conditions of firms and governments in crisis-afflicted countries.

The informational inadequacy crowd had perhaps the biggest reach in the policy world. Their views dominated the agenda at the Group of Seven's (G7) Halifax Summit of 1995 and the Rey Committee that was later formed. The informational inadequacy constituency was influential in other practical ways as well. They promoted a variety of early warning systems, such as the one developed by Goldstein, Kaminsky and Reinhart in 2000.⁴ They were also the prime movers behind the IMF's creation of a Special Data Dissemination Standard, the Reports on the Observance of Standards and Codes, and the Financial Sector Assessment Program. They drove efforts to incorporate assessments by private bond rating agencies in the global financial architecture.⁵

But ultimately, even the slow learners came to acknowledge—at least to an extent—that there was something to be learned from countries like India, China, Chile, Colombia and Malaysia, all of which were able to weather this period of turbulence successfully.⁶ Among these experiences, the most important drivers of a change in conventional wisdom were Malaysia's deployment of temporary, stringent capital controls, Chile's use of market-friendly capital controls that were adjusted in response to changing market conditions and identified channels of evasion, and China and India's gradualist approach to financial integration and liberalization⁷

With a few exceptions—notably, prominent academics Sebastian Edwards and Ronald McKinnon with Huw Pill⁸—the new conventional wisdom can be inelegantly stated in the following way: Unrestrained financial liberalization, especially concerning international private capital flows, can aggravate or induce macroeconomic vulnerabilities that often culminate in crisis. Therefore, subject to “numerous and customary caveats,” temporary, market-friendly controls over international capital movements can play an important role in mitigating the risk of financial crises in developing countries.

Notably, a widely cited report by an IMF team issued in 2003 received a great deal of attention for reaching these startling findings.⁹ There have been other studies by neoclassical or otherwise high profile economists that have reached complementary conclusions.¹⁰

Thus, perhaps the most lasting and important effect of this decade of crises is that the center of gravity has largely shifted away from an unequivocal, fundamentalist opposition to any interference with the free flow of capital to a kind of tepid, conditional support for some types of capital controls. This shift certainly moves policy discussions in the right direction, but the new, weak consensus is not adequate to the task of preventing an Asian crisis redux.

WHY WE SHOULD NOT GET TOO EXCITED

There are several reasons why the new consensus has not taken the international community more than one step forward in the task of preventing the next Asian crisis. First, there is an inconsistency between the policy lessons of these crises and the content of recent bi- and multilateral trade and investment agreements. These agreements codify what is referred to these days with the new buzzword of “policy coherence”—a term that on the face of it seems innocuous and sensible since incoherent policy regimes hardly have much to recommend them. The intuition behind the concept of policy coherence is simple. Any individual economic policy—such as free trade—will only yield beneficial outcomes if it is nested in a broader policy environment that is conducive, that is consistent or coherent, with its objectives. From this perspective, the justification for expanding the scope of trade reform and agreements to

new areas over the last decade is that previous efforts to liberalize trade have failed to promote growth because of inconsistencies between trade and other economic and social policies.¹¹

But there is a problem here. Recent trade and investment agreements have become a new Trojan horse for bringing developing countries in line with fundamentalist and outdated ideals about internal and external financial liberalization.¹² Indeed, the bi- and multilateral trade and investment agreements go much further in instituting neoliberal financial reform and an expansive notion of investor rights than have even international financial institutions such as the IMF in the recent past or at present. These agreements—such as the U.S.-Chile and the U.S.-Singapore Free Trade Agreements, the North American Free Trade Agreement, the Central American-Dominican Free Trade Agreement and all of the bilateral investment treaties that the United States has signed of late—establish mechanisms that punish developing countries for taking entirely reasonable actions to prevent or respond to financial crises.¹³

Punishment takes the form of legal actions by foreign investors in international dispute settlement bodies against signatories that deploy temporary capital controls of any sort. Examples of prohibited measures would include steps to make foreign capital sticky during times of crisis, temporary suspension of currency convertibility, adjustment in the exchange rate, and a variety of commonplace macroeconomic and social policies that can now be interpreted as being tantamount to expropriation of foreign investment.

These same trade and investment agreements preclude many important types of developmental financial policies, they limit the opportunity for institutional and policy heterogeneity, and they frustrate the right of countries to engage in policy experimentation. All of these are critical components of successful development experiences as much recent work in the field of development economics has shown.¹⁴

For these reasons, these agreements introduce a new kind of dangerous policy incoherence. Financial crises are increasingly likely as a consequence of the outdated ideologies and financial interests that are driving trade and investment agreements. These two steps back come just as IMF researchers and the international community, including development economists, seem to have absorbed key lessons about crisis prevention and defensive policies from a decade of financial crises across the world.

A second dimension of policy incoherence is the strange disconnect between IMF research since the East and Southeast Asian crisis of 1997–98 and its own practice when it comes to Article IV negotiations with its member countries. The latter seem to be moving on a track that is orthogonal to the institution’s own research.

The third and final reason why the international community should not be satisfied with the new post-crisis policy consensus is that, even if the new consensus was to be operationalized on the level of policy, it does not go far enough. The new consensus does not endorse the case for substantially increasing the “policy space” of developing countries when it comes to promoting financial stability. Moreover, it does not place policies that promote financial stability squarely at the center of a policy agenda that harnesses the resources of domestic and international capital markets in the service of economic and human development.

Policies that reduce the likelihood of financial crises or enable countries to respond to crises are necessary co-requisites to other developmental financial policies because they protect “policy space” and the achievements of developmental policies. Here, it is important to note that several development economists have expanded on the many types of developmental financial policies, such as programs of credit allocation, tax incentives or quotas aimed at promoting lending to priority projects or groups, development banks, credit guarantee schemes or subsidies that reduce risk premia on medium- and long-term lending, partnerships between informal and formal financial institutions, new institutions to channel credit to underserved populations and regions, asset-based reserve requirements, and employment targeting for central banks.¹⁵

WHERE DO WE GO FROM HERE?

Where does all of this leave academics, policymakers and civil society groups that are interested in learning from the decade of financial crises to prevent recurrences? There are a couple of directions for future discussion.

Developing countries need to rethink seriously their participation in trade and investment agreements that constrain their ability to protect themselves from and respond to financial crisis. The costs of these

agreements are clear, and the benefits are, at best, negligible insofar as there is no empirical evidence that they actually enhance trade or investment flows to the developing world.¹⁶

There are good reasons for policymakers in rich, developed countries to take seriously the reasons why policymakers in Asia and South America are pursuing the development of new institutional frameworks for promoting regional financial stability, cooperation, and policy dialogue, and for protecting policy space. For instance, the Chiang Mai Initiative agreed to by the Association of Southeast Asian Nations+3 (ASEAN and China, South Korea, and Japan) created a mechanism for swap lines and credits. Other innovations within the region include a reserve pooling arrangement and the Asian Bond Market Initiative.¹⁷ It is an open question as to whether the Asian Monetary Fund initiative that was first proposed in 1997 by a Japanese official as the regional crisis unfolded will resurface in some modified form in the near future.

Within the Americas, it is clear that some countries have begun to turn away from the IMF—countries such as Bolivia, Ecuador, Nicaragua, Argentina, and Venezuela.¹⁸ And Argentina for instance, repaid the last of its U.S. \$9.6 billion in debt to the IMF ahead of schedule, following Venezuela's purchase of about \$1.5 billion in Argentine bonds. In the spring of 2007, Venezuela withdrew from the World Bank and the IMF (though it should be noted that the country had no outstanding debts to either institution). Ecuador's President Rafael Correa recently asked the World Bank's representative there to leave, and Nicaraguan President Daniel Ortega announced that he, too, is pursuing the possibility of exiting the International Monetary Fund. At least some countries may well bolt from the IMF in favor of the Bank of the South, a regional financing facility that has recently been proposed by the Venezuelan President.

However before debating the real or hypothetical costs and benefits of the Asian or the Venezuelan initiatives, we must recognize that their currency stems quite directly from the serious inadequacies of the IMF's policy programs with countries during the decade of economic and financial crises in developing countries globally. In addition, the currency of these regional initiatives stems from the stunning loss of legitimacy and credibility of the Bretton Woods Institutions, and from the failure of

their leadership to promote fundamental reforms that enhance country ownership, and governance structures that enhance institutional transparency and the voice of Southern members.

What else can be said about a policy agenda that builds directly on lessons from the decade of crisis? It is essential that financial policies in developing countries must focus on generating, mobilizing and allocating capital to the kinds of projects that have the greatest developmental payoff and that ameliorate important social ills.¹⁹ Moreover, the time is ripe to take seriously the fact that controls over international capital movements are a critical supporting player in this broader financial landscape. Capital controls also reduce the risk of investor flight, financial crises, and consequent involvement with the IMF. In so doing, capital controls create space for policy experimentation and policy and institutional diversity.²⁰

To illustrate one possible framework for capital controls, I describe the following proposal, which I term “trip wires” and “speed bumps.”²¹ By trip wires I refer to an indicator of a looming financial difficulty, such as the reversal of portfolio investment or foreign bank lending, the vulnerability to a financial contagion that originates elsewhere in the world, or the vulnerability to debt distress caused by a locational or maturity mismatch. In this approach, policymakers would design trip wires that target their own country’s financial and macroeconomic vulnerabilities. Once a trip wire identifies a particular vulnerability, a graduated speed bump would be activated. For example, in the case of a trip wire that reveals a vulnerability to the reversal of portfolio investment, the appropriate speed bump would slow the entrance of new inflows until more investment was financed domestically.

Note that the early warning systems that were initially developed after the Asian financial crisis did not incorporate any institutional response to a crisis that would constrain the behavior of financial actors, that is, what I term speed bumps. That is because the early warning models were motivated by the idea that crises were significantly driven by informational inadequacies. Therefore, they rested on the idea that the mere provision of information could induce market-correcting behaviors by financial actors.

CONCLUSION

A decade has now passed since the Asian financial crisis. The concern raised in this paper is that the global policy community has not used this time wisely. The global community has the understanding, and the means necessary to prevent a recurrence of another crisis on the scale of events in East Asia in 1997–1998. And thus, it is terribly disappointing that the political will that could have been mobilized in the wake of the Asian crisis may have by now dissipated, without any substantial crisis-preventing reform. Instead of meaningful reform, the global community today faces increasing efforts to lock in financial liberalism, leaving the world financial order perhaps even more precarious than it was a decade ago. One step forward, two steps back—unfortunately, it is difficult to make sense of the past ten years of international financial *mismanagement* in any other way.

NOTES

1. I am grateful to Kirsten Benites, Keith Gehring, and Ania Jankowski for superb research assistance.

2. James Boughton, “Michel Camdessus at the IMF: A Retrospective,” *Finance and Development* 37 (2000): 1.

3. See the following literature by Ilene Grabel for discussions of these various crises and the contribution of internal and external financial liberalization thereto: Ilene Grabel, “Averting Crisis: Assessing Measures to Manage Financial Integration in Emerging Economies,” *Cambridge Journal of Economics* 27, no. 3 (2003): 317–336; Grabel “Neoliberal Finance and Crisis in the Developing World,” Special issue on “The New Face of Capitalism,” *Monthly Review* 53, no. 11 (2002): 34–46; Grabel “Rejecting Exceptionalism: Reinterpreting the Asian Financial Crises,” in *Global Instability: The Political Economy of World Economic Governance*, ed. Jonathan Michie and John Grieve Smith (London: Routledge, 1999): 37–67; Grabel, “Marketing the Third World: The Contradictions of Portfolio Investment in the Global Economy,” *World Development* 24, no. 11 (1996): 1761–1776.

4. Morris Goldstein, Graciela Kaminsky, and Carmen Reinhart, *Assessing Financial Vulnerability: An Early Warning System for Emerging Markets* (Washington: Institute for International Economics, 2000).

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6. A. Ariyoshi, K. Habermeier, B. Laurens, I. Otker-Robe, J. Canales-Kriljenko, and A. Kirilenko, *Country Experiences with the Use and Liberalization of Capital Controls* (Washington: International Monetary Fund, 2000).

7. See, e.g., Grabel, “Averting Crisis: Assessing Measures to Manage Financial Integration in Emerging Economies”; Epstein, I. Grabel and KS Jomo, “Capital Management Techniques in Developing Countries: An Assessment of Experiences from the 1990’s and Lessons for the Future,” (paper prepared for the XVI Technical Group Meeting of the Group of Twenty-four, Port of Spain, Trinidad and Tobago, February 13–14, 2004 and published as *G24 Discussion Paper* no. 27, United Nations, NY and Geneva, March 2004).

8. Sebastian Edwards, “How Effective are Capital Controls,” *Journal of Economic Perspectives* 13, no. 4 (1999): 65–84; Ronald McKinnon and Huw Pill, “International Overborrowing: A Decomposition of Credit and Currency Risks,” *World Development* 26, no. 7 (1998): 1267–82; and for a discussion of the unintended negative consequences of Chile’s capital controls for smaller firms during the 1990s, see Kristen Forbes, “One Cost of the Chilean Capital Controls: Increased Financial Constraints for Smaller Traded Firms,” *Journal of International Economics* 71 (2007): 294–323.

9. Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence*, <http://www.imf.org/external/np/res/docs/2003/031703.htm>.

10. In this connection, see Jagdish Bhagwati, “The Capital Myth: The Difference Between Trade in Widgets and Dollars,” *Foreign Affairs* 77, no. 3 (1998): 7–12; Barry Eichengreen, *Toward a New International Financial Architecture* (Washington: Institute for International Economics, 1999); Dani Rodrik, *The New Global Economy and Developing Countries: Making Openness Work*, Policy essay No. 24, Overseas Development Council, Washington, D.C., 1999; and Paul Krugman, “Open Letter to Mr. Mahathir,” *Fortune*, September 28, 1998.

11. This intuition is reminiscent of neoclassical theories of policy credibility and of Polanyi’s discussion of the rhetorical strategies employed by defenders of neo-liberalism. On both, see Grabel, “Ideology, Power, and the Rise of Independent Monetary Institutions in Emerging Economies,” in *Monetary Orders: Ambiguous Economics, Ubiquitous Politics*, ed. Jonathan Kirshner (Ithaca, N.Y.: Cornell University Press, 2003): 25–52.

12. See Ilene Grabel, "Policy Coherence or Conformance: The New IMF–World Bank–WTO Rhetoric on Trade and Investment in Developing Countries," *Review of Radical Political Economics*, forthcoming.

13. As of this writing, the US–South Korea Free Trade agreement has not been ratified (or even finalized) by either party. But the information available on this agreement at this time suggests that it will carry forward many of controversial provisions embodied in the other agreements listed above, particularly the NAFTA–style protections (embodied in Chapter 11 of the agreement) afforded to foreign investors. I thank Keith Gehring for this point.

14. e.g., Dani Rodrik, *In Search of Prosperity: Analytical Narratives on Economic Growth* (Princeton, N.J.: Princeton University Press, 2003); Ha-Joon Chang and Ilene Grabel, *Reclaiming Development: An Alternative Economic Policy Manual* (New York: Palgrave Macmillan, 2004); Epstein et al., "Capital Management Techniques in Developing Countries"; Gerald Epstein and Ilene Grabel, "Financial Policies for Pro-Poor Growth," prepared for the United Nations Development Program (UNDP), International Poverty Centre, Global Training Program on Economic Policies for Growth, Employment, and Poverty Reduction, <http://www.peri.umass.edu>.

15. e.g., Chang and Grabel, *Reclaiming Development: An Alternative Economic Policy Manual*; Epstein and Grabel, "Financial Policies for Pro-Poor Growth."

16. e.g., Mary Hallward-Driemeier, "Do Bilateral Investment Treaties Attract Foreign Direct Investment? Only a Bit...and They Could Bite," World Bank Policy Research Working Paper, No. 3121, 2003; Jennifer Tobin and Susan Rose-Ackerman, "Foreign Direct Investment and the Treaties," Department of Political Science and Law School, Yale University, Unpublished paper, 2005; and Kevin Gallagher and Melissa Birch, "Do Investment Agreements Attract Investment? Evidence from Latin America," *Journal of World Investment and Trade* 7 no. 6 (2006): 961–974. These studies find that bilateral investment treaties do not stimulate foreign direct investment flows into developing countries.

17. For discussion of these and other regional initiatives, see Worapot Manupipatpong, "Regional Initiatives for Financial Stability in ASEAN and East Asia" in this volume. See also B. Eichengreen, "What to Do With the Chiang Mai Initiative," *Asian Economic Papers* 2, no. 1 (2003): 65–84.

18. For details, see Kelly Hearn, "Venezuela Proposes 'Bank of the South,'" *Washington Times*, January 13, 2006.

19. See, e.g., Epstein and Grabel, "Financial Policies for Pro-Poor Growth"; Chang and Grabel, *Reclaiming Development: An Alternative Economic Policy Manual*.

20. Grabel, "Averting Crisis."

21. For details, see Ilene Grabel, "Trip Wires and Speed Bumps: Managing Financial Risks and Reducing the Potential for Financial Crises in Developing Economies" (paper prepared for the XVIII Technical Group Meeting of the G-24, Geneva, Switzerland, March 8–9, 2004, and published as G-24 Discussion Paper No. 33 (November 2004) United Nations and Geneva).

TEN YEARS AFTER: THE LASTING IMPACT OF THE ASIAN FINANCIAL CRISIS

MARK WEISBROT

The Asian financial crisis, which began ten years ago, was in many ways a formative event at the end of the 20th century. It brought to the forefront some pressing problems with the international financial system, such as the dangers of sudden reversals of capital flows (which precipitated the crisis), the problem of “contagion”—a new phenomenon as the crisis spread to Russia and then Brazil, for no clear reason other than the herd behavior of investors—and the pro-cyclical nature of international financial markets—that is, international capital flows tended to come in when economies were growing and even overheating, and exit during downturns, thus exacerbating the swings of business cycles.

This crisis changed some of the ways that economists and other observers think about the international financial system. For example, the idea that developing countries would necessarily gain from the increased opening of their economies to international capital flows then prevailed in the most important policy and media circles at that time. Today there is more skepticism.

As a result of the crisis and the subsequent heightened understanding of these problems, there were a whole series of proposals for reform of

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what was often called “the international financial architecture.”¹ These proposals included some very ambitious reforms, such as international currency, a world central bank, an international regulatory body for the world financial system, an international bankruptcy court, and proposals for sweeping reforms of the International Monetary Fund (IMF, or the Fund). Some of these ideas were sound and sensible.

Ten years later, none of these proposed reforms have come to fruition. But something just as important actually did happen—in fact, it is the biggest change in the international financial system since the breakdown of the Bretton Woods System of fixed exchange rates in 1973. The Asian crisis set in motion a process in which the IMF has lost most of its power over middle-income countries. This is a sea change in the developing world, and it is likely to be the most lasting impact of the crisis.

The reason that this is so important is because the IMF had vastly more power and influence over economic policy in developing countries than it would be able to exert on the basis of just its own lending. Of course, even this lending has been drastically reduced. The Fund’s loan portfolio has shrunk from U.S. \$96 billion as recently as four years ago to \$20 billion today, with about half of the current loans owed by Turkey. But the real power of the IMF came from its position as “gatekeeper” for official credit, which gave it control over a very influential “creditors’ cartel.” A borrowing country that did not meet IMF conditions would often not be eligible for loans from the much larger World Bank, regional banks such as the Inter-American Development Bank, high-income country governments—including those belonging to the Paris Club—and sometimes even the private sector. This often gave the Fund enormous influence over economic policy in developing countries. Since the U.S. Treasury Department holds not only a veto but an overwhelming policy influence within the IMF, other developed countries, including Europe and Japan, could outvote the United States. They have chosen not to do so in the last 63 years because the IMF was one of the most important avenues of influence for the United States in developing countries.

THE IMF’S FAILURE IN THE ASIAN CRISIS

The IMF’s failure in the Asian crisis was profound and publicized as

never before, which permanently damaged the institution's credibility and authority in much of the world. First, the IMF failed to act as a lender of last resort, when such a lender was most needed. In the Asian crisis, this would have been toward the beginning of the crisis, which began with the devaluation of the Thai baht in July 1997. At that time the economies of the region were not beset by the kinds of serious structural imbalances or weaknesses that would by themselves have warned of disaster.²

The regional current account deficit peaked at 5.9 percent of gross domestic product (GDP) in 1996, which is high but not overwhelming by historical standards, and it ranged from 3.5 percent for Indonesia to 8 percent for Thailand. But until the crisis, the countries were all taking in capital flows in excess of their current account deficits, and accumulating foreign exchange reserves. And all five countries were running domestic budget surpluses, or balanced budgets. So while some adjustment in the current account was due, there was no need for the depression that ensued.

The problem was caused by a sudden reversal of private international capital flows to the region, from a net inflow of \$92.8 billion in 1996 to a net outflow of \$12.1 billion in 1997. This \$105 billion turnaround represented, in one year, about 11 percent of the GDP of the five countries. To a large extent this speculative reversal was the result of policies that were strongly promoted by the IMF and the U.S. Treasury Department. This build-up of short-term international borrowing was a result of the financial liberalization that took place in the years preceding the crisis. In South Korea, for example, this included the removal of a number of restrictions on foreign ownership of domestic stocks and bonds, residents' ownership of foreign assets, and overseas borrowing by domestic financial and non-financial institutions.³ Korea's foreign debt nearly tripled from \$44 billion in 1993 to \$120 billion in September 1997. This was not a very large debt burden for an economy of Korea's size, but the short-term percentage was high at 67.9 percent by mid-1997.⁴ For comparison, the average ratio of short-term to total debt for less-developed countries (LDCs) not in the Organization for Petroleum Exporting Countries (OPEC) at the time of the 1980s debt crisis was 20 percent.⁵

Financial liberalization in the other countries led to similar vulnerabilities. Thailand created the Bangkok International Banking Facility

in 1992, which greatly expanded both the number and scope of financial institutions that could borrow and lend in international markets. Indonesian non-financial corporations borrowed directly from foreign capital markets, piling up \$39.7 billion of debt by mid 1997, 87 percent of which was short-term.⁶ On the eve of the crisis the five countries had a combined debt to foreign banks of \$274 billion, with about sixty-four percent in short-term obligations. The high percentage of short-term debt, especially relative to reserves, turned out to be deadly when investor panic set in.

Both the U.S. Treasury Department and the IMF pushed strongly for the legal changes that created the pre-crisis situation. The IMF went so far as to seriously consider changing its charter to make “capital account liberalization”—encouraging countries to remove restrictions on international borrowing and investing—a permanent part of its mandate.⁷

The Asian crisis was a direct result of this financial liberalization, and the logic was fairly straightforward. With a high level of short-term international debt, a depreciation of the domestic currency increases the cost of debt service. Everyone needs more domestic currency to get the same amount of dollars for debt service, and the selling of domestic currency to get those dollars or other “hard” currencies drives the domestic currency down further. It does not take much to set off a rush for the exits, especially if the central bank does not have a high level of foreign currency reserves relative to the short-term debt. These reserves shrink further as more and more investors convert their domestic currency and domestic assets into dollars. Foreign lenders refuse to renew the short-term loans, and the downward spiral continues.

If ever there was a situation in which a lender of last resort could have made all the difference in the world—simply by providing reserves so that investors did not believe they had to get out today or get few or zero dollars tomorrow—this seemed to be it. But the IMF and its supervisor, the U.S. Treasury Department, were not interested in this kind of a solution. In September 1997, when it was still early enough to prevent most of the disaster, Japan proposed at a meeting of regional finance ministers that an “Asian Monetary Fund” be created in order to provide liquidity to the faltering economies faster, and with fewer of the conditions imposed by the IMF. This fund was to have been endowed with as much as \$100 billion in emergency resources, which would come

not only from Japan, but from China, Taiwan, Hong Kong, Singapore, and other countries, all of whom supported the proposal. After strenuous opposition from the U.S. Treasury Department, which insisted that the IMF must determine the conditions of any bailout before any other funds were committed, the plan was dropped by November 1997. It is impossible to tell how things might have turned out differently, but it is certainly conceivable that not only the depression, but also even the worst of the currency collapses, might have been avoided if the Asian Monetary Fund had been assembled and deployed quickly at that time.⁸

After establishing itself as the broker for any international settlement, the IMF recommended a series of policies that evidently worsened the crisis. Most of these followed a pattern of misdiagnosis that was seen in Argentina and elsewhere, which included high interest rates and a tightening of domestic credit to slow economic growth, fiscal tightening—including cuts in food and energy subsidies in Indonesia, which were later rescinded after rioting broke out—and, amazingly, further liberalization of international capital flows. South Korea, for example, was required to abolish nearly all of its remaining restrictions on capital flows, including those relating to the domestic financial services market and foreign exchange controls. The IMF's inflation target for South Korea was 5.2 percent for 1998, as compared to 4.2 percent for the previous year. However, when the Korean won depreciated by 80 percent, this target was made nearly impossible to achieve without a severe recession or depression.

The IMF made other serious mistakes that worsened the crisis. One of these was later acknowledged as an error in an internal Fund memo that was leaked to the press. This was the closing of 16 Indonesian banks, a move that the IMF thought would help restore confidence in the banking system. Instead it led to panic withdrawals by depositors at remaining banks, further destabilizing the financial system.⁹

In the first few months of its intervention, the IMF also failed to arrange a roll-over of the short-term foreign debt owed by Indonesian non-financial firms. Indonesia was thus unable to stabilize its currency and economy, and firms could not obtain the necessary credits for essential imports and even exports. The Indonesian currency actually took its worst plunge just days after the second IMF agreement was signed in January of 1998. And the amounts of funds dispersed (much smaller

than those committed) were too little and too late to slow the damage: in Indonesia, for example, only \$3 billion had been disbursed by March 1998, as compared to a \$40 billion commitment.¹⁰ Even the IMF's own Independent Evaluation Office conceded that "[I]n Indonesia... the depth of the collapse makes it difficult to argue that things would have been worse without the IMF..."¹¹

In retrospect, it is not surprising that the IMF failed to restore market confidence in the region. The Fund was negotiating, first of all, for recessionary conditions with the affected countries. This is generally the wrong thing to do in a recession, however, the error was even less defensible in the Asian crisis than it had been in other similar IMF interventions. The Asian countries had high national savings rates, low inflation, and balanced budgets. The only "structural adjustment" that was arguably needed was, in some cases, a reduction of the current account deficit. This could be, and was, in fact, accomplished through increased exports and reduced imports due to currency depreciation. There was no reason to further shrink demand through monetary and fiscal austerity.

Structural Reforms

In the crucial first few months of the crisis (August–December 1997), the IMF concentrated on structural "reforms," and put forth the argument that the crisis was due to "fundamental structural weaknesses"¹² in these economies, rather than the much more easily resolvable liquidity problem that actually caused the crisis. The proposed structural reforms were in some cases politically unpalatable and economically unnecessary or even harmful. For example, mass layoffs in the Korean auto industry led to strikes and riots. Besides the demands for trade liberalization and privatization, the conditions placed on Indonesia were unusually far-reaching and numerous—at a cumulative of about 140. They included not only removal of some restrictions on foreign investment, reducing tariffs and closing some banks, but such details as "allowing cement producers to export with only a general exporters license."¹³

These demands for structural reforms seemed to people in the region to be irrelevant to the crisis, and excessive. Talk of "crony capitalism" and corruption in East Asia made good sound bites in the Western media, but in East Asia the image that stuck in people's minds was the

picture of IMF Managing Director Michel Camdessus standing over Indonesia's President Suharto as he signed the agreement. Nationalist sentiments were inflamed. Camdessus himself did not help matters when he proclaimed that the Asian crisis was a "blessing in disguise," at a time when tens of millions of people were being thrown into poverty, and press reports described Indonesians in the countryside subsisting on tree bark, leaves, and insects.

After several months of failed efforts to restore confidence to the region through structural reforms and contractionary monetary and fiscal policies, the IMF—together with the U.S. government—finally did help to arrange what was really needed: a roll-over of the short-term debt into longer-term loans. This was accomplished in Korea and Thailand in January 1998. Unfortunately for Indonesia it took until April, which greatly extended the economic damage in that country. Part of the deal was for the governments of Korea, Thailand, and Indonesia to guarantee the loans that foreign banks had made to the private sector. This is what would be expected from an arrangement brokered by an international creditors' cartel, although it turned out not to make that much difference in this case, as the guarantees were not drawn upon. In the end, the real damage was done by not arranging the roll-over when the crisis started, and by the recessionary and financially destabilizing policies promoted by the Fund. The economic and human costs of these mistakes were very large. Indonesia, the world's fourth most populous country, had still not reached its pre-crisis level of per capita GDP by the end of 2004.

CREDIBILITY UNDERMINED

The IMF's failures, and the conditions that it required for the loans that were eventually made, caused the governments of the region to want to avoid ever having to borrow from the Fund again. As a result they have chosen to "self-insure," or pile up an enormous amount of international reserves. This accumulation of reserves had other causes, especially the policy of these countries to prevent their currencies from rising. And it is a solution that has significant costs, since holding international reserves such as US Treasury securities brings a very low rate of return as compared with what could be obtained through investment in the domestic

economy.¹⁴ But this large accumulation of reserves—currently at U.S. \$461 billion for South Korea, Malaysia, Thailand, Indonesia, and the Philippines—does provide these countries with a form of insurance that, if they had possessed ten years ago, could have mitigated or prevented the crisis, and would have kept them away from the IMF consortium.

The IMF's reputation, authority, and legitimacy was also permanently damaged by its mishandling of the crisis. Prior to the crisis, the Fund was not very well known in the United States and developing countries; the crisis did not make it a household word, but it raised the IMF's profile considerably and in a very negative way. In 1998 there was a proposed 50 percent or \$90 billion increase in the Fund's capital, with \$18 billion coming from the United States. Legislation for the \$18 billion contribution from the United States failed on three votes in the Republican-controlled House of Representatives, passing only after the Senate approved it and attached it to a conference spending bill. As a condition of the funding, the U.S. Congress appointed a commission of economists to evaluate the IMF, World Bank, and other international financial institutions. The commission's report was highly critical of the IMF.¹⁵

Perhaps even more damaging were the unprecedented public criticisms that the Fund received from prominent economists. Joseph Stiglitz, who was then chief economist at the World Bank and was later to receive the Nobel Prize in economics, told the *Wall Street Journal*: "These are crises in confidence... You don't want to push these countries into severe recession. One ought to focus... on things that caused the crisis, not on things that make it more difficult to deal with."¹⁶ Jeffrey Sachs, then at the Harvard Institute of International Development, was even more blunt, calling the IMF "the Typhoid Mary of emerging markets, spreading recessions in country after country."¹⁷

The Cases of Argentina and Russia

The IMF's credibility was further undermined as a result of the Argentine crisis, where it was widely seen as an author of the policies that brought about and then worsened the steep 1998–2002 recession. Once again the Fund failed to act as a lender of last resort, and again when it was badly needed. After the currency and then the banking system collapsed at the end of 2002 and beginning of 2003, the IMF

provided no help. Instead, together with the World Bank, the Fund drained a net \$4 billion, or a sizeable 4 percent of GDP, out of the economy. As in the Asian crisis, the IMF tried to pressure the government to adopt a host of unpalatable measures, and—since Argentina had defaulted on its foreign public debt—to offer a more favorable settlement to these creditors. In this case, however, the government of Argentina stood down the IMF—and won. In September of 2003, Argentina even temporarily defaulted to the IMF. At the time, no one knew what the consequences would be, since it was possible that the Fund could force a cut-off of credit to the country. But politically this was not possible—instead Argentina’s default effectively forced the IMF to roll over its debt.

After three months of contraction following its default, Argentina began to grow rapidly and has now been the fastest growing economy in the Western hemisphere over the last five years, averaging about 8.6 percent annual GDP growth. Moreover, it achieved this growth by following policies that the IMF was against, including a central bank policy that targeted a stable and competitive real exchange rate, an export tax, a freeze on utility price increases, and a hard line on negotiations over the defaulted debt. Argentina’s success showed that it was possible for a developing country government to stand up to the IMF—and not only live to tell about it, but also achieve a rapid and robust economic recovery. This experience further undermined the Fund’s authority and legitimacy.

Russia has also experienced rapid growth since it lost the last remnant of its IMF program, the fixed exchange rate that collapsed in August of 1998. Rising oil prices have also allowed Russia, like the Asian countries, to accumulate enormous reserves and thus not to worry about having to borrow from the IMF again. The IMF-sponsored program in Russia, which began in 1992, was possibly the worst of all the Fund’s failures in its history, with the country losing more than a third of its GDP in the ensuing six years, and tens of millions falling into poverty. But unlike the IMF’s failure in the Asian crisis, this disaster had limited impact on the Fund’s reputation because it was not well known or reported in the Western media as an IMF policy failure.

ALTERNATIVE SOURCES OF FINANCE

The final blow to the IMF's creditors' cartel in middle-income countries came when Latin America found an alternative source of credit a few years ago—the government of Venezuela. When Argentina decided to pay off its last remaining \$9.8 billion to the IMF in 2006, Venezuela committed \$2.5 billion—and more after that. Bolivia, which labored under IMF agreements for 20 consecutive years—with the exception of nine months—and whose per capita income last year was less than it was 28 years ago, allowed its last agreement with the Fund to expire in March of 2006. The government declined to negotiate for any new agreement with the Fund. This was especially significant because Bolivia is still a low-income country—one which last year had almost all of its IMF and World Bank debt cancelled under the Heavily Indebted Poor Countries (HIPC) Initiative.

Just a few years ago, an IMF agreement for Bolivia would have been a prerequisite for other loans and grants from developed countries, including Europe. But this is no longer true. The rules of the game for Latin America, and for middle income countries generally, have changed. Bolivia has re-nationalized its hydrocarbons industry and vastly increased royalties on foreign companies over the last two years, netting an additional \$670 million in government revenue, or 6.7 percent of GDP, in the process. These and other reforms by the new democracies in South America would have been difficult, if not impossible, just a few years ago when the IMF and the U.S. Treasury, together with the World Bank and the Inter-American Development Bank, had much more influence.

It is in Latin America that the collapse of the IMF's power has had the most significant impact. Venezuela's offers of credit, without policy conditions, to Argentina, Bolivia, Ecuador, Nicaragua, and other countries has changed the equation. Since the IMF was Washington's main avenue of influence in the region, U.S. influence has dropped precipitously, and most of the region is now more politically independent of the United States than Europe is. This comes at a time when the majority of the region now has left-of-center governments, including Argentina, Brazil, Venezuela, Ecuador, Bolivia, and Uruguay. These six, plus Paraguay, are currently meeting to form a new lending institution entitled "Bank of the South." Although many details remain to be worked out, the inten-

tion is clearly to form an alternative to the Washington-dominated IMF, World Bank, and IDB. The new Bank would focus on development lending and lending for regional economic integration, but the participating governments are also looking to set up a regional stabilization fund that would give countries an alternative to the IMF when they are in need of balance of payments support.

The Asian countries also took steps in the direction of a regional stabilization fund with the Chang Mai Initiative that began in 2000. This includes a collection of bilateral currency swap arrangements among the Association of Southeast Asian Nations plus China, Japan, and South Korea (ASEAN+3). Under these arrangements, the contracting countries would be able to access at least some foreign exchange reserves in the event of a liquidity or balance of payments crisis of the type that was experienced in Asia in 1997. But this initiative is still tied to the IMF in that for almost all of the swap arrangements, a country wanting to tap into more than 20 percent of the agreed upon reserves would need an IMF agreement. The limit was originally 10 percent, and it is possible that the Chiang Mai Initiative will further weaken its “IMF link.” More recently, in May of this year, thirteen Asian countries, including Japan, agreed in principle to pool part of their \$2.7 trillion of reserves for a stabilization fund, although it is not clear how long it might take for this to be realized.

CONCLUSION

These regional alternatives to the IMF offer the best chance at reform that can help prevent a repeat of the Asian financial crisis, and allow developing countries more policy space to pursue more effective macroeconomic and development policies. The ten years since the Asian financial crisis have produced a very important result—the collapse of the U.S. Treasury and IMF creditors’ cartel in middle-income countries. But they have also shown how far we are from any practical reforms at the international level that would involve the participation of the high-income countries—regardless of whether it is reform of existing institutions such as the IMF and World Bank, or the creation of new institutions.

This can be seen from the handling of the recent scandal at the World Bank, where Paul Wolfowitz was replaced as Bank president with another neo-conservative from the Bush administration, and the current selection process for a new IMF chief, who by tradition will be a European approved by Washington. Both of these processes have taken place without significant input outside of Europe and the United States, despite demands from the majority of member countries for a change in governance that would give other countries a voice. These events indicate that the high-income countries are not significantly closer to a genuine reform of the international financial system than they were a decade ago. For the foreseeable future, reform will therefore have to take place at the *national and regional level*.

The independence that middle-income countries have won from the Fund will also need to be extended to the low income countries, for whom the IMF-led creditors' cartel remains in full force. In April the IMF's Independent Evaluation Office (IEO) reported that since 1999, nearly three-quarters of official development aid to the poor countries of sub-Saharan Africa has not been spent. Rather, at the IMF's request, it has been used to pay off external debts and accumulate reserves. These are some of the poorest countries in the world, who desperately need to spend this money on such pressing needs as the HIV/AIDS pandemic. Freeing the low-income countries from the restrictions of an IMF-led creditors' cartel should be the next item on the agenda of international financial reform.

NOTES

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2. The IMF's subsequently much-criticized 1997 annual report, published after the crisis had already begun, was optimistic for the region: "Directors welcomed Korea's continued impressive macroeconomic performance [and] praised the authorities for their enviable fiscal record," *IMF Annual Report* (Washington: International Monetary Fund, 1997) 57. The directors also "strongly praised Thailand's remarkable economic performance and the authorities' consistent record of sound macroeconomic policies." Jeffrey Sachs, "IMF is a Power Unto Itself," *Financial Times*, December 11, 1997.

3. Ha-Joon Chang, Hong-Jae Park and Chul Gyue Yoo, "Interpreting the Korean Crisis—Financial Liberalisation, Industrial Policy, and Corporate Governance," *Cambridge Journal of Economics* 22 (1998): 4.
4. Steven Radelet and Jeffrey Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects," Harvard Institute for International Development, 1998, <http://www.ksg.harvard.edu/CID/hiidpapers/bpeasia.pdf>.
5. Chang et al, "Interpreting the Korean Crisis—Financial Liberalisation, Industrial Policy, and Corporate Governance."
6. Bank for International Settlements, *Annual Report* (Basle: Bank for International Settlements, 1997).
7. "It is time to add a new chapter to the Bretton Woods agreement," wrote the IMF's Interim Committee in 1997, as the Asian crisis was getting under way. "Private capital flows have become much more important to the international monetary system, and an increasingly open and liberal system has proved to be highly beneficial to the world economy." Quoted from the International Monetary Fund, The Interim Committee, "Statement of the Interim Committee on the Liberalization of Capital Movements Under an Amendment of the Articles," Hong Kong, September 21, 1997, available from <http://www.imf.org/external/pubs/ft/survey/pdf/100697.pdf>.
8. Felix has argued this point; David Felix, "IMF: Still Bungling in Asia," *Journal of Commerce* (July 9, 1998), <http://www.globalpolicy.org/socecon/bwi-wto/imf/1998/felix.htm>. For details on the politics of the proposal, see Eric Altbach, "The Asian Monetary Fund proposal: A Case Study of Japanese regional leadership," Japan Economic Institute Report no. 47A, December 19, 1997.
9. See David Sanger, "IMF reports plan backfired, worsening Indonesia woes," *New York Times*, January 14, 1998.
10. See Radelet and Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects" for some of these and other arguments regarding the failure of the IMF to restore market confidence.
11. IMF Independent Evaluation Office, *The IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil* (Washington: IMF Independent Evaluation Office, 2003) 38, <http://www.internationalmonetaryfund.com/external/np/ieo/2003/cac/pdf/main.pdf>.
12. Korea Memorandum, quoted in Radelet and Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects."
13. Morris Goldstein, "IMF Structural Conditionality: How Much Is Too Much?" (paper presented at the conference on "NBER Conference on Economic and Financial Crises in Emerging Market Economies," Woodstock, VT, October 19, 2000).
14. See Dean Baker and Karl Wallentin, "Money for Nothing: The Increasing Cost of Foreign Reserve Holdings to Developing Nations" (Washington: Center for Economic and Policy Research, November, 2001), <http://www.cepr.net/documents/publications/reserves.pdf>.

15. See “Report of the International Financial Institutions Advisory Commission,” U.S. House of Representatives, March, 2000, available from <http://www.house.gov/jec/imf/ifiac.htm>.

16. Bob Davis and David Wessel, “World Bank, IMF at Odds over Asian Austerity,” *Wall Street Journal*, January 8, 1998, A5.

17. Jeffrey Sachs, “With Friends Like IMF...,” *Cleveland Plain Dealer*, June 6, 1998, 10B.

REGIONAL INITIATIVES FOR FINANCIAL STABILITY IN ASEAN AND EAST ASIA

WORAPOT MANUPIPATPONG

In the ten years that have passed since the onset of the Asian financial crisis of 1997-1998, each of the crisis-affected countries in East Asia—Indonesia, South Korea, Thailand, Philippines, and Malaysia—have successfully implemented economic and financial reforms. Due to the various reforms these countries have carried out, they have emerged from the financial crisis stronger, more robust, and more concerted in their efforts to prevent and manage future crisis.

The Association of Southeast Asian Nations (ASEAN) and ASEAN+3 (ASEAN plus China, Japan, and South Korea) have been implementing reforms and maintaining sound macroeconomic policies at the national level. In addition, the ASEAN and ASEAN+3 countries have adopted four key regional initiatives that aim to strengthen the region's capability to prevent and manage future financial crisis. One of these regional initiatives is being carried out by ASEAN, while the other three are under the ASEAN+3 cooperation framework. Two of them involve macroeconomic surveillance. These are the ASEAN Surveillance Process and the ASEAN+3 Economic Review and Policy Dialogue. The Chiang Mai Initiative aims to enhance the region's capacity to deal with balance of payment difficulties while the Asian Bond Markets Initiative aims to deepen and widen local bond markets to address the currency and

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maturity mismatches that are believed to have contributed to the Asian financial crisis a decade ago.

THE ASEAN SURVEILLANCE PROCESS

Following the APEC initiative to establish the Manila Framework in November 1997 as a determined approach to restoring financial stability in the region, the ASEAN finance ministers decided at their meeting in February 1998 to establish their own surveillance mechanism. A Terms of Understanding (ToU) for the ASEAN Surveillance Process (ASP) was drafted and subsequently endorsed by the Special ASEAN Finance Ministers Meeting in Washington, D.C. on December 5, 1998.

In the ToU for the ASP, the ASEAN finance ministers intended that the ASP be informal and simple. It was to be based on a peer review process and it was to be complementary to the global surveillance exercise carried out by the International Monetary Fund (IMF). To promote closer economic review and policy dialogue, the Ministers agreed to share a set of baseline data, as provided to the IMF during the Article IV consultation mission. The Ministers also decided to include a regular agenda to discuss surveillance matters at their annual meeting.

To coordinate the ASP, a small unit was set up in the ASEAN Secretariat to monitor global and regional economic and financial developments, and to coordinate all surveillance related activities, including preparing the annual ASEAN Surveillance Reports (ASR). The ASR monitors and analyzes recent economic and financial developments, including the progress of economic and financial reforms, identifies any emerging or increasing vulnerabilities, and raises key policy issues for the peer review sessions of the ASEAN finance and central bank deputies and the ASEAN finance ministers.

The ASP, and in particular the peer review, have contributed to a more consistent and coherent set of macroeconomic policies in the region that enhance the robustness of their economies. It also enhances crisis prevention by identifying any emerging or potential risks or vulnerabilities in an early stage, and bringing them to the attention of the regional policymakers so that timely unitary or collective policy actions can be undertaken to address or mitigate them as required.

THE ECONOMIC REVIEW AND POLICY DIALOGUE

As the ASEAN+3 finance ministers recognized the importance of enhanced economic monitoring in the process of implementing the Bilateral Swap Arrangements under the Chiang Mai Initiative (CMI), they decided in 2002 to increase the level of their economic monitoring effectiveness by establishing the Economic Review and Policy Dialogue (ERPD). This existed alongside the ASEAN Surveillance Process that had been established a few years earlier.

Under the ERPD, the ASEAN+3 finance ministers meet once a year, and their deputies twice a year, to discuss economic and financial developments as well as any emerging policy issues in their countries. Participation is voluntary but all countries now participate in this regular dialogue.

The arrangement for the ERPD is different from the ASP in that each country prepares its own economic report based on a common template and presents it at the meeting. Question-and-answer sessions follow every country presentation in order to provide an opportunity for the exchange of views on policy issues. This interactive dialogue is complemented by presentations from both the IMF and the Asian Development Bank on regional economic outlooks and risks.

Since May 2006, a Group of Experts has been established to carry out in-depth studies on issues of economic and financial vulnerabilities and concerns for the region. At the same time, the Technical Working Group on Economic and Financial Monitoring has also been set up to enhance the national surveillance capacities of each member as well as to promote the development of Early Warning Systems. This system is being primarily developed through the early warning system software of the Asian Development Bank (ADB), which is called “Vulnerability Indicators and Early Warning Systems,” or VIEWS.

THE CHIANG MAI INITIATIVE

In May 2000, in Chiang Mai, the ASEAN+3 finance ministers discussed how to develop a regional financing arrangement that could be harnessed to promote and maintain financial stability in the East Asian

region. At that time, the ASEAN Swap Arrangement (ASA) was being expanded to include all ASEAN countries, and enlarged to the amount of U.S. \$1 billion. The ASEAN+3 finance ministers decided to combine the expanded ASA with a network of bilateral swap arrangements (BSAs) among their member countries in order to establish the very first regional financing arrangement, thereby called the Chiang Mai Initiative, after the location of the meeting in 2000.

With the combined powers of the ASA and the network of BSAs, the CMI acts as the region's self-help and support mechanism by having the ability to provide short-term liquidity support to member countries that may be experiencing balance of payment difficulties. While it is intended to be a quick disbursing facility for short-term liquidity support, as a first line of defense, the CMI is supplemental to international financing facilities, such as that of the IMF.

As of April 2007, the CMI comprised the \$2 billion-worth ASA and the network of 16 BSAs among eight ASEAN+3 countries with a combined monetary size of \$80 billion.¹ Most of the BSAs are now two-way swaps, with the first 20 percent of financing eligible for draw down without a linkage to a corresponding IMF program.

To enhance the effectiveness of the CMI, the ASEAN+3 finance ministers recently agreed to multilateralize the CMI through a self-managed reserve pooling arrangement governed by a single contractual agreement. Key elements of this arrangement are currently being worked out, including the size of the multilateral facility, the borrowing quota, activation mechanism, and the surveillance operations.

THE ASIAN BOND MARKETS INITIATIVE

Too much reliance on bank financing and easy access to U.S. dollar-financing—many of which were short-term—were often cited as key factors contributing to the Asian financial crisis. The region's over-reliance on external bank and credit financing prompted a number of regional initiatives aimed at further developing the bond markets. Some of these regional bond market initiatives include those under the rubric of the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP) and the Asia Pacific Economic Cooperation (APEC).

EMEAP's Asian Bond Fund focuses on the demand side through two initiatives, both of which invest in the government bonds of some of its country members. APEC's Regional Bond Market Development Initiative focuses on constructing a substantial regional bond market, including securitization and a credit guarantee mechanism.

Established by the ASEAN+3 body, the Asian Bond Markets Initiative (ABMI) aims at mitigating maturity and currency mismatches through the promotion of local currency denominated bonds. As a region with surplus savings, the ABMI is also expected to facilitate the channeling of regional savings in order to meet the region's investment needs, particularly in regional infrastructure development.

The implementation of the ABMI follows a two-pronged approach. The first is to widen the issuers base by promoting more local currency denominated bonds provided by a greater variety of issuers. With the goal of widening and deepening the local bond markets, the ABMI aims to initially promote local currency denominated bonds issued by foreign companies and international agencies that have presence in the country as well as by government financial institutions and agencies. It is also encouraging the issuance of more sophisticated or structured bonds, such as through securitization.

The ABMI implementation scheme's second approach entails creating an enabling environment that facilitates both the issuance of and the investment in bonds. To augment bond issuance, there is a need to create an environment that is attractive to both issuers and investors to the East Asian region. For example, credit guarantees allow a certain type of underlying asset, such as loans to small and medium enterprises (SMEs), which appeal to wider group of investors while also increasing the access to bond markets for SMEs. A well-functioning derivative market would also allow investors to hedge their exchange rate risk.

Information asymmetry is another factor that may deter investment in the region's bond markets, particularly by non-residents. It is therefore important to enhance information dissemination to promote greater transparency. Credible credit rating plays a significant role in contributing to greater transparency and disclosure. In the long term, closer collaboration among credit rating agencies in the region will pave the way toward harmonizing credit rating methods and scales that would facilitate cross-border issuance of bonds.

While the existing settlement systems are adequate for the purposes of investing and trading in local currency denominated bonds, linking them together would augment access to the region's bond markets and allow new products to tap a much wider investors' base. At the same time, efforts are also being made to reduce development gaps in bond market infrastructure through capacity building efforts.

The Progress of the Asian Bond Market Initiative

A number of local currency denominated bond issues have come into the market since the establishment of the ABMI. These bond issues include:

1. Collateralized bond obligations with small and medium enterprise loans and student loans as underlying assets in Korea, asset-backed securities issued by the China Development Bank and the China Construction Bank.
2. Residential mortgage-backed securities of 1.6 billion ringgit and Asian Development Bank bonds worth 400 million ringgit in Malaysia.
3. Panda bonds in China issued by the ADB and the International Finance Corporation.
4. Peso bonds in the Philippines issued by the ADB.
5. Asian bonds in Thai baht currency issued by the Thai government, non-listed state-owned enterprises and specialized financial institutions whose incomes are exempt from the withholding tax requirement.
6. Collateralized bond obligations and corporate bonds issued in Thailand, Malaysia and Indonesia and guaranteed by the Japan Bank for International Cooperation.
7. The ADB has developed a U.S. \$10 billion Asian Currency Note Program which will allow the Asian Development Bank to issue Asian currency bonds in their domestic markets under a single unified framework, and with a common set of documents governed by English law.

Progress made for the second prong of the ABMI, that of creating an enabling environment for the issuance of and investment in regional bonds, includes the withholding tax exemption for non-resident investors that is already effective in Malaysia and Thailand. In addition, to enhance the effectiveness of information dissemination and transparency, the ADB has launched an Asian Bonds Online website to act as a conduit for disseminating the relevant information and statistics on bond markets in ASEAN+3 countries, as well as the progress and outcome of the implementation of the ABMI. The website also includes Asian bond indicators and an Asian bond monitor.

Throughout the various activities of the ABMI, the private sector has been invited to participate where possible in order to solicit its views and support. This process has included a number of seminars and workshops on credit rating and local currency denominated bonds issued by the international financial institutions, namely the World Bank and the IMF, as well as multinational corporations.

A number of studies have also been conducted to explore the ways in which the development of regional bond markets could be stimulated. These include studies on credit guarantee and investment mechanisms, regional settlement linkages (called Asian Link), impediments to cross-border bond issuance and investment, minimization of foreign exchange settlement risk in the ASEAN+3 region, and regional basket currency bonds.

Further studies will be conducted on new debt instruments for infrastructure financing, securitization of loan credits and receivables, and the Asian Medium Term Note Program. At the same time, capacity building is being provided to less advanced countries to develop their bond markets. It is being implemented through a variety of technical assistance projects both bilaterally and multilaterally. Countries with more advanced systems are also providing assistance and sharing their experiences.

In the longer term, we may see bonds denominated in a basket of regional currencies offered to international as well as regional investors, as efforts to create an enabling environment and improve infrastructure continue. Such efforts may also include a common approach on withholding taxes, an establishment of regional credit guarantee, an investment facility, and linkages among the region's settlement systems.

CONCLUSION

These four initiatives—the ASP, the ERPDP, the CMI, and the ABMI—have fundamentally contributed to strengthening the region’s capability to prevent as well as manage a financial crisis, should one occur. The ASP and the ERPDP help ensure that macroeconomic policies are not only sound but also coherent and consistent across the region. They assert peer pressure and provide peer support for countries to develop and maintain a robust financial system with an appropriate regulatory and advisory regime and improved risk management.

The creation of the ABMI has led to the further development of a deep and liquid bond market that provides a viable alternative to bank financing and allows a greater variety of issuers to tap the bond market for funding, including the local SMEs which constitute the economic lifeline of most local economies in the East Asian region.

As a crisis management mechanism, the CMI, despite the recent accumulation of foreign exchange reserves in most East Asian countries, will continue to be enlarged and strengthened through a multilateralization process. This multilateralization will make the CMI more effective as a stand-by quick-disbursing financing facility that member countries can immediately draw upon in the event of a balance of payment crisis.

While no one can predict what a future crisis, or crises, will look like, these regional initiatives will continue to promote a concerted effort to ensure that the region’s economies are no longer as vulnerable as they were ten years ago. These regional initiatives have developed, and will continue to develop, robust local economies and sound macroeconomic policies and financial systems. They offer the peace of mind that any risks and vulnerabilities that do appear in the region’s economies will be addressed in a timely and effective manner.

NOTES

1. The current counter-parties to the Bilateral Swap Arrangements are China, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore and Thailand.

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