2 Asia's 1997 Crash: its Character, Causes and Consequences

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INTRODUCTION

Most of East Asia's high-growth economies shuddered to a dramatic, unforecast halt after 2 July 1997. I remember that day very well. I was in Dublin to address MBA graduates from across Europe on market opportunities in the 'booming, high performance, economies of the Far East'. On the way I had glanced at my newspaper. A headline announced that the Bank of Thailand had floated the baht. By the time my session was over, during which I had spoken much of Asian commercial dynamism and big annual increases in expenditures, the baht had lost 15 per cent of its value, other regional currencies were coming under pressure, and a decade-old mindset of regional stability had begun to be superseded by one of regional fragility. Although few then clearly realised what was happening, there was early recognition, at least among the business community, that it was something important.

This chapter offers a summary overview of these events and of their still-unfolding consequences; not just for East Asia but for the global economy as a whole.

THE BEGINNING: THAILAND – EPICENTRE OF A CRASH

It probably was no accident that the crisis broke in Thailand. In October 1996 *Asia Week* had already labelled Thailand the region's worst performer – despite over 6 per cent GDP growth in that year. But the health of Thailand's financial sector had been a cause of concern for some time. The Bangkok Bank of Commerce had sunk in a sea of scandal even before 1997. A real estate company, Somprasong Land, had defaulted on a Eurobond loan in February 1997 and the country's largest finance company, Finance One, had been effectively closed down on account of bad debts by the Ministry of Finance (Lauridsen, 1998, p. 147).

At the same time, Thailand was experiencing a worrying balance of payments deficit. During 1996, economic and export growth had fallen to their lowest rates in a decade and domestic interest rates were already relatively high to protect the baht, which was pegged to a dollar-dominant basket of major currencies. As the current account deficit exceeded 8 per cent of GDP, a number which had become symbolic in financial circles as a result of the Mexican crisis of 1994, markets became uneasy and there were several speculative moves against the Thai currency. One came in December 1996, another in March 1997, then on 16 May the Bank of Thailand spent nearly $10 billion defending the baht's peg (Jumbala, 1998, p. 279). Nevertheless it is worth noting that Thailand had experienced a balance of payments deficit in excess of 8 per cent in 1990 without precipitating a crisis.

What occurred has been fully documented. A detailed chronology of events, compiled by New York academic Roubini, is freely available to all (www.stern.nyu.edu/-nroubini/asia); a remarkable public service. Much of the financial detail is to be found in a book published by a bank analyst based in Hong Kong (Delhaise, 1998, pp. 84–95). Essentially, appreciation of the baht against the yen and weaknesses in the Thai financial system made it difficult to maintain the established parity of the baht. Nonetheless the Bank of Thailand, for whatever reasons, steadily squandered the country's reserves trying to maintain it. Worse, it hid its actions from public view by failing fully to disclose swap transactions. By June 1997 these off-balance-sheet trades were almost equal to Thailand's national reserves. Consequently the time had arrived when another speculative challenge would force the Thai authorities to face reality. This occurred and on 2 July 1997 the Bank of Thailand announced a managed float of the baht. They also sought assistance from the International Monetary Fund (IMF). The baht fell 15–20 per cent and triggered the East Asian crisis.

With the benefit of hindsight it is very easy indeed to recognise both financial and economic weaknesses in the Thailand of 1997. Indeed if we were to look more closely at the detail of the country's political, economic and financial affairs at that time, we might even question why some kind of crisis had not occurred earlier. This is in fact a revealing perspective, for any attempt to explain the timing of Thailand's crisis offers the first clue to any reasonable understanding of these events. This is because the onset of the crisis in July 1997 cannot be explained by examining Thailand alone. Any full explanation must also to take Thailand's creditors fully into account, and other foreign financial interests also. The latter include overseas currency traders, fund managers, financial institutions such as hedge funds and, most importantly, foreign banks.

Some nine months afterwards, at a media briefing in Washington on 16 April 1998, representatives of the IMF spoke publicly about these events. The following is what Barry Eichengreen, a senior policy adviser at the IMF, is reported to have said (Hughes, 1998):

> 'Hedge funds triggered Thailand's financial crisis, building up large positions against the Thai baht and contributing to a devaluation that sparked Asia's devastating financial turmoil. However there is no concrete evidence that the hedge funds had built up large positions against other Southeast Asian currencies.'

In examining the Asian crisis, what we are really seeking to understand is more than an isolated event in a single country. Rather it is a regional event embracing many countries that turned out to have major global repercussions. What occurred in Thailand was just the start. The crisis quickly spread to embrace almost all of Southeast Asia and South Korea as well. Within just a few months Thailand's 'currency crisis' had become Asia's 'financial crisis', and later Asia's 'economic meltdown'. The rapid spread of crisis across the region is a most noteworthy and worrying feature of these events; it was essentially a phenomenon of fast and effective global financial markets. Financial markets provided the conducting mechanism by which the crisis in Thailand spread with such speed to other countries. The efficiency of this market mechanism reflected both modern communications technology and the characteristics of modern fund management.

The 'Asian crisis' was financial panic on a grand scale. The leap from country to country became known as 'the contagion effect'. Very soon there was a region-wide crisis of confidence, which, given lack of understanding and institutional rigidities, quickly spread from financial markets to the 'real' economies of the region with disastrous economic and social effects. The latter were and still are momentous and are bound to be of lasting impact; but they are not the focus of this chapter.

THE CRISIS SPREADS: 'CONTAGION'

Floating the baht precipitated 'capital flight' from the entire region. There was a rush by Thai banks and businesses with dollar-denominated debt, of which there were very many, to buy dollars and otherwise hedge their currency exposures. There was an even greater rush by outside interests to liquidate their baht exposures as speedily as possible. However these responses were not limited to Thailand or the baht; they quickly spread to nearly every nearby country, other than those which still blocked the free movement of capital. Within a few weeks the Philippine peso, Malaysian ringgit and Indonesian rupiah were all well down in value. Then on 24 October, speculators even attacked the Hong Kong dollar. Hong Kong, unlike the others, possessed huge foreign currency reserves and could fight back successfully. Yet all across the region previously respected currencies lost 20–40 per cent of their dollar value and at the same time regional stock market capitalisations were halved. After Hong Kong, the contagion spread to South Korea. Within the Association of Southeast Asian Nations (ASEAN), only Brunei and Singapore escaped major losses. By the end of 1997 Thailand, Indonesia, the Philippines and South Korea had been forced to seek, or renew in the case of the Philippines, IMF loans and support to remain solvent. Malaysia did not go to the IMF but was similarly afflicted. What had begun as a currency crisis in one country had within six months become a regional economic crisis of very considerable proportions. Currencies had tumbled, foreign reserves fallen alarmingly, economic growth suddenly halted, and the powerful foreign capital inflows of the earlier 1990s, including the first half of 1997, moved into rapid reverse.

In fact, in the days following Thailand's devaluation, investors sold off Brazilian real and Polish zloty as well as regional currencies (Hale, 1997). Inevitably, in such turmoil there were political repercussions too (Crone, 1998, p. 13). Indeed by the time Japan's famed Yamaichi Securities stockbroking firm collapsed on 23 November, some voices claimed that the Asian crisis had become a global crisis. However such voices did not yet include US President Clinton's, who at the APEC summit in Vancouver described the Asian financial turmoil as just 'a few glitches on the road'. Nonetheless there was already little doubt that the crisis was the most serious economic event in East Asia since the end of the Second World War (Noordin, 1998).

This was confirmed by information subsequently released by the Bank for International Settlements (Brenchley, 1998), which stated that in the second half of 1997, global markets had already been stretched to breaking point by the unfolding crisis in Asia and that the crisis had already sparked such a sharp international credit squeeze that the world financial system was on the brink of collapse. Japan's 'Mr Yen', vice-minister at the Ministry of Finance, Eisuke Sakakibara, reached a somewhat similar conclusion. In an interview with *The South China Morning Post* (Fulford, 1998) he said: 'I do not think it is an Asian crisis so much as a crisis of global capitalism. It was caused by large volumes of capital pouring into Asia.' Later, in September 1998, when calling for joint action on the crisis by the 'Group of Seven' (G7) industrialised countries, President Clinton asked the richer countries of the world to address 'the biggest financial challenge facing the world in half a century' (Gray, 1998a).

So what exactly was happening? The sequence of events in the second half of 1997 was as follows. After the floating of the Thai baht on 2 July, the Malaysian ringgit required central bank support on 8 July and on 24 July there was what seemed like a currency meltdown with the baht, rupiah, ringgit and peso all slumping. In August the IMF offered Thailand a $17.2 billion rescue loan package; and the Malaysian ringgit plunged again. In September, Indonesia sought to keep control of events by going to the IMF for support before being forced to do so; the rupiah plunged thereafter. In October, world currency and stockmarkets were in chaos, the Hong Kong dollar was attacked by speculators and Indonesia was offered a $23 billion rescue package – the first of three. In November, 16 Indonesian banks were closed on IMF advice, some Japanese financial institutions failed, the won plunged and Seoul sought an IMF bailout. The extreme urgency of the Korean situation, coupled with the size of Korea's economy, the world's eleventh largest, was sufficiently alarming to US monetary authorities for the USA to start giving the Asian crisis priority attention. As a result, by the time of the APEC summit in Vancouver the USA, Japan and the IMF were all prepared to give South Korea the generous financial support that was required. With active US Treasury involvement, the IMF approved a $21 billion loan to South Korea on 4 December; with record speed. The year-on-year effect on regional currencies and stock market indices, both of which very clearly demonstrate the severity of the crisis, are shown in Tables 2.1 and 2.2.

By the end of 1997 many Western 'experts' were quietly optimistic, believing the worst to be over and the crisis contained. In reality, as Table 2.2 shows, dramatic currency depreciation continued into 1998. However, neither Russia nor Brazil was yet causing widespread concern and the sick economies of Asia had been prescribed what the IMF thought the right medicine. It then became increasingly apparent that some patients, notably Indonesia, did not want to take their medicine – worse, some thought it the wrong medicine anyway. From almost the outset, respected voices were

Table 2.1 Currency depreciation in the worst affected countries

	$ value 31 Dec. 96	*$ value 19 Dec. 97*	*% change*
Thailand	25.63 baht	44.85 baht	– 42.9
Malaysia	2.5264 ringgit	3.815 ringgit	– 33.8
Indonesia	2362.25 rupiah	5100.00 rupiah	– 53.7
Philippines	26.30 peso	39.65 peso	– 33.7
South Korea	844.5 won	1557.0 won	– 45.8

Source: (1997) *Business Times*, Singapore, 20 December, p. 3.

Table 2.2 Asian currency and stock index changes, 1 July 1997 to 16 January 1998 (per cent)

	Currency	*Stock*
Thailand	−52	−33
Malaysia	−41	−50
Indonesia	−71	−46
South Korea	−45	−36
Hong Kong	−2	−41
China	−1	−45
Japan	−12	−20

Source: (1998) *Nihon Keizai Shimbun*, Tokyo, 17 January, p. 5.

heard to oppose both the IMF diagnosis of the problem and its recommended cure. In particular, critics argued that the IMF was wrongly imposing credit squeeze policies on Asian countries. These were similar to those which had been successfully adopted by Mexico in 1995, but in Asia's different circumstances they were arguably inappropriate; instead, many thought the priority should have been the maintenance of commercial confidence. Most strikingly, there was public disagreement about the whole nature of the crisis between Stanley Fischer, first deputy managing director of the IMF (Fischer, 1998) and Joseph Stiglitz, senior vice president and chief economist of the World Bank (Stiglitz, 1998). The tenor of this public spat can be gauged by the following paragraph from the financial press (Gray, 1998b): 'The World Bank has publicly parted company with its sister agency, the International Monetary Fund, and the US Treasury, arguing that hard-line rescue strategies for crisis-hit countries have failed because of the disastrous social consequences.'

In fact an increasingly vigorous intellectual debate took off among those trying to understand the crisis, and naturally enough, those who came to different conclusions about causation prescribed different remedies. It was noticeable that on all sides of this debate American commentators and economists, despite the tardiness of their government's official response, took the lead. There were important voices in several other parts of the world as well, but this observer noted with regret that Europe conspicuously failed to pull its intellectual weight in the debate.

In the course of 1998 the fallout from the crisis continued. Within Southeast Asia, economic conditions deteriorated through the first quarter of the year. However, except in Indonesia, where political uncertainties

dominated attention, and Hong Kong, where the currency remained pegged to the dollar, the region as a whole appeared to have 'bottomed-out' by mid-year (Kranenberg, 1998). However, it was also in 1998 that the impact of Asia's crisis was strongly felt outside the region; notably in the other 'emerging markets' of Eastern Europe and Latin America and also, very importantly, on Wall Street. Since these more distant repercussions powerfully influenced 'expert' thinking about the nature of the crisis, they cannot be overlooked.

The most important consequences outside Asia were as follows. In early June, came renewed turmoil on currency markets. Stabilisation followed after 17 June as a result of combined US Treasury – Bank of Japan intervention in the market to lift the value of the Yen but then there was major loan default by the Russian government on $40 billion of rouble bonds. This occurred just over one year after the crisis began in Asia, in August 1998. The default came despite Russia receiving IMF support and during a period of near panic among foreign investors. It is estimated that American banks and hedge funds lost at least $8 billion as a result (Deans, 1998). This default, in turn, led to the technical bankruptcy of one of the world's most prominent hedge funds, Long Term Capital Management (LTCM). This event marked a new phase of the crisis. The strength of its impact can be gauged from the words of a leading article in the *Financial Times* of 3 October 1998: ' … the folly of bankers, who punted such huge sums on an over-borrowed hedge fund, that the whole US financial system was put in danger.' Even the quasi-official salvaging of LTCM rattled Wall Street and American banks began to tighten lending requirements to other investment funds (Morgenson, 1998).

It seemed there could no longer be any doubt that the Asian crisis had gone global. Through the last part of the year and into 1999, there followed a long-anticipated debt management and currency crisis in Brazil. Both Russian and Brazilian crises were partly due to 'contagion' from Asia. Western investment institutions, which had become frightened of exposure to Asia, quickly became nervous of exposure to other emerging markets and promptly withdrew their funds, weakening stockmarkets and putting downward pressure on exchange rates as a result. In the case of Brazil, the US government feared currency collapse might quickly snowball to other Latin American countries. For this reason the US itself offered $5 billion and mobilised support from 20 nations for Brazil, in addition to an $18 billion IMF loan. This was in November 1998 but it proved insufficient to prevent a currency devaluation of some 38 per cent on 13 January 1999. At the time of writing (June 1999) this Latin American currency crisis had not spread beyond Brazil; but it may be too soon to be confident that it will not. A leading article in the *Financial Times* of 10 October 1998 put it this way: 'Since the Russian debacle (August) and the derailment of the LTCM hedge fund (September) ... contagion has spread the Asian disease to the developed world. *The difficulty is that the global economy is increasingly hostage to the world of finance*' (emphasis added).

Taken together, these 'global' events critically influenced the climate of intellectual opinion about Asia's crisis. First, Russian default, more than Asian rescheduling, really hurt foreign investors, who collectively lost at least $33 billion (Coggan *et al.*, 1998) and the event caused many to look again at the quality of their risk assessment. It also underlined more than ever the increased global interdependence of the world's money markets. Second, the effective collapse of LTCM starkly highlighted the systemic risk to the global financial system resulting from the extremely high levels of leverage enjoyed by hedge funds and others; further, LTCM's rescue, which was orchestrated by the Federal Reserve and involved many of the world's most prominent financial institutions, alerted everybody to the wide and legitimate public interest in the internal affairs of highly leveraged institutions. The near-collapse of LTCM proved a decisive event in terms of moulding informed opinion. In particular it alerted the US authorities to the fact that the threat posed by highly leveraged institutions was dangerous not just to individual economies but also to the stability of the global financial system as a whole (Sikri, 1998). Third, crisis in Brazil, by far the largest economy of South America, focused concern about contagion in Washington and boosted support for developing mechanisms to limit it. On 2 October 1998, unlike at the APEC meeting in November 1997, President Clinton announced a US proposal to provide countries threatened by economic crisis with new emergency lines of credit (Blustein, 1998).

Meanwhile, within the region speculative activity remained a factor in currency markets. As a consequence there were a number of important restrictive moves. The Central Bank of China in Taipei banned dealing in three types of derivative used in foreign exchange transactions from 25 May 1998 (Hsu, 1998). Renewed speculation against the Hong Kong dollar gave rise to an unprecedented $3 billion purchase of local shares by the Hong Kong Monetary Authority on 14 August 1998 (Oldfield, 1998). The government said this had been necessary to prevent speculators from profiting by 'shorting' these equities. Revealingly, this effective initiative was criticised by the international investment community (Jacob, 1999). More interestingly, one fund manager offered a more informed and balanced view in the *Far Eastern Economic Review* (Bhala, 1998). Anyway, the outcome was that attacks on the currency dwindled, interest rates fell and share prices rose (Granitsas, 1998). As in the previous year, competent officials backed by huge foreign currency reserves saw off the speculative attack. Bigger non-financial problems remained, but calm returned to Hong Kong's financial markets. Then on 1 September Malaysia became the first country in the region to reintroduce comprehensive capital controls and a fixed exchange rate. When announcing these measures Dr Mahatir said that 'People can no longer stay with the free-market system.' Arguably, however, by the time these moves were made the crisis had peaked and to date it seems as though little difference was made. Either way, no other country in the region chose to follow Malaysia's example.

A credible, global perspective of the time is nicely encapsulated in the following: 'The contagion of the Asian crisis, within Asia, spreading through Russia and Latin America, and now threatening a global recession next year, has laid bare the substantial weaknesses of our international and regional institutions to handle the crisis' (*The Australian Financial Review*, 25 September 1998).

At the end of 1998, with the future of the Brazilian currency still hanging in the balance, informed voices were more cautious than twelve months before. Yet within a few months it would be seen that the Brazilian float did not destabilise other Latin American currencies, most of the afflicted Asian economies seemed to bottom out and begin to recover, and the international financial atmosphere was more relaxed. So much so that US Treasury Secretary Rubin could announce his departure without causing jitters. By the middle of 1999, whatever official or institutional energy had earlier existed to tackle the inadequacies of the 'international financial architecture' appeared to be fast ebbing away.

Yet by this time it had become quite clear that the mechanism of contagion was the international financial market; in particular those elements dealing in derivatives purchased on margin. During 1998 this had been publicly recognised by both the IMF and the World Bank. John Williamson of the World Bank said so explicitly during a panel discussion organised by the American Economic Association of New York in January 1999. Jack Boorman, director of the IMF's Policy Department, put it this way 'These countries opened themselves to great vulnerability by accepting short-term capital flows in a way that ultimately proved destabilising' (IMF, 1999).

CAUSES

Perspective

In examining causes, it should be stressed at the outset that opinions on the balance of causation of Asia's crisis do differ; it is still difficult to speak with confidence of a majority view. So while what follows refers to the judgements of some well-known and well-placed individuals, it is just a practical attempt to make sense out of the disagreement among economists and the inherent complexity of events. It is only personal opinion.

A good number of factors have been put forward to explain the crisis. In the months after July 1997 most commentators sought explanation within the afflicted economies themselves. Some pointed to specific economic factors, such as balance of payments deficits; some to institutional factors, such as inadequate prudential supervision of banks; and yet others to more cultural factors, such as cronyism and a predilection for sweetheart deals. Some blamed all of these and suggested that until the Asian economies cleaned up their act and adopted business practices more like those of the West, market forces would continue to exact a high price.

If the author believed that any of these factors did cause the Asian crisis he would investigate them in detail. However common sense suggests an obvious flaw in these arguments; namely that most or all of these factors had characterised the East Asian economies for years and they had not suddenly appeared in the run-up to 1997. Indeed many of these factors had been characteristic of East Asian economies for the preceding 30 years, during which they had achieved the fastest, most dramatic rise in economic activity and living standards the world had ever witnessed (World Bank, 1993, p. 4). So while these factors might indeed be negatives for the East Asian economies, they could not have caused the crisis of 1997.

Macroeconomic

A more convincing explanation might be found in the policy of fixed exchange rates that was followed by the countries of the region prior to the crisis. This policy operated in a way that effectively tied regional currencies to the American dollar. This provided exchange rate stability with the currency in which most international trade is denominated and might therefore be seen as an advantage. More significant, however, was the direct impact of this quasi-dollar peg on competitiveness. Typically, the countries of the region relied on buying intermediate goods from Japan in yen and exporting to the USA and EU in dollar prices. As it happened, between 1989 and 1995 the yen appreciated strongly against the dollar and Japanese manufacturers moved into the other Asian countries to establish local, lower-cost production. The recipient economies benefited from this inward direct investment and at the same time were able to continue to develop their dollar-priced exports. Then from 1995 the currency trends reversed. The dollar began to appreciate strongly against the yen and the output of most

East Asian economies became less internationally competitive as a result. So the Asian economies began to suffer slower export growth. Naturally other factors were affecting regional export growth as well, notably the 1996 slump in demand for consumer electronics in the USA. Yet the dollar peg must have eroded their ability to compete, especially against rival Chinese products.

At first sight, an appealing reason for rejecting exchange rate relativities as a cause of the crisis is that adverse balance of payments figures are country specific, whereas what has to be explained is a region-wide phenomenon. However there were important similarities among many of the economies of the region, not least the 1996 export slowdown and their dollar-pegged currencies. So it makes sense to examine the argument further by looking at some of the figures (Tables 2.3 and 2.4). These summary figures suggest a deteriorating situation in at least two of these countries, with Thailand clearly the hardest hit by the export slowdown. Such evidence is at least consistent with the view that adverse currency movements caused the crisis. But is such evidence sufficient and convincing? Some are largely convinced (for example Warr, 1998, p. 55) but certainly not everybody (for example Hale, 1998, p. 269). In particular, it can be shown that Thailand's balance of payments in 1997 was no worse than

Table 2.3 Annual export growth (percentage of US$ values)

	1994	*1995*	*1996*
Thailand	23	25	−1
Malaysia	25	26	6
Indonesia	9	13	10

Source: World Trade Organisation.

Table 2.4 Current account balance as percentage of GDP

	1994	*1995*	*1996*
Thailand	−5.9	−8.0	−8.0
Malaysia	−5.9	−8.5	−5.3
Indonesia	−1.6	−3.4	−3.4

Source: Asian Development Bank.

it had been in 1990. Furthermore, countries in other parts of the world had worse balance of payments at the time, and anyway it does not make a lot of sense to look at balance of payments figures in isolation.

There are, however, theoretical reasons for considering the argument that a major change in currency relativities caused the Asian crisis. Paul Krugman (1979), in what IMF staff have called a seminal paper (Kaminsky *et al.*, 1997), attempted to identify the causes of financial crises. He concluded that under fixed exchange rates, appreciating currencies and worsening trade balances generally precede the speculative attacks that trigger financial crises. In other words, his theoretically derived statement seems consistent with the situation of Thailand in 1997. Indeed it may be that without the underlying conditions that Krugman's early work on financial crises focused upon, the Asian crisis could not or would not have occurred.

The potential of changing currency relativities comes across with particular clarity in the following statement from a London financial adviser:

> In 1995, when the yen soared to nearly 80 to the greenback, dollar-linked Asia enjoyed its highest rate of export growth in a decade. After Tokyo authorities cut rates and took other measures to weaken the yen in late 1995, export growth in Malaysia, Singapore, South Korea and Thailand went into free fall (Michael Howell of *Cross-border Capital*, quoted in *Business Week*, 22 September 1997, p. 23).

The primacy of this factor was also accepted by the editors of *The Nikkei Weekly*, which in a leading article on 15 June 1998 simply stated that 'The Asian crisis was triggered by the yen's depreciation due to the lengthy slump in Japan.' There remains nonetheless the awkward question of whether currency changes by themselves offer an adequate and sufficient explanation of events. The answer is almost certainly no.

The basic weakness of the currency and balance of payments argument, as a suggested cause of the crisis, is that it cannot explain the timing of the crisis. Payments data show that worrying current account deficits emerged in Southeast Asia at least a couple of years before the crisis broke; as is crystal clear in the case of Malaysia from Table 2.4 above. Moreover this is acknowledged by Stanley Fischer of the IMF (Jomo, 1998, p. 10). What the argument fails to consider and what Krugman failed to consider until many years later (1998), a very prominent feature of the Asian crisis of 1997 was the very large-scale movement of international capital. It is the role of these global capital flows that we now need to consider.

Financial markets

First, even if seldom remembered it is worth noting that in 1996 the IMF formally warned Asia of the risks it faced in this regard (*World Economic Outlook*, September 1996). Interestingly, this warning referred both to the crisis-warning signals identified by Krugman and to the potential effects of heavy foreign capital inflow. This warning was given front page status, under the headline 'IMF's warning to Asia – financial crisis looms as economies overheat', in *The Australian Financial Review* of 26 September 1996, which spoke in the following terms:

> the IMF highlights one of the key economic dilemmas confronting the developing countries of Asia ... how to prevent *large-scale foreign capital inflows* overheating their economies, fuelling speculative inflation, blowing out their balance of payments and producing a repeat of Mexico's financial market crunch.
>
> It particularly names Malaysia, which last year ran a current account deficit equal to more than 8 per cent of its gross domestic product ...
>
> The Mexican financial crisis provided a strong reminder of the potential for sudden changes in financial markets' assessments of a country's economic policies and prospects (emphasis added).

The notable thing is that to accept that global capital flows could have played an important part in the Asian crisis, is to accept that we have to look *outside* the afflicted countries to explain events. In the post-crisis months of 1997, few in the West were willing to do this. Since that time, in contrast, especially since the LTCM affair, this has become the preferred approach. Indeed by May 1999 the Japanese press were publicly warning Asian markets against accepting 'hot money' for a second time (TNW, 1999). So let us now examine the size and nature of these external capital flows. While the data are neither exact nor complete, in the context of the crisis two factors are of particular interest:

- The *magnitude* of the external capital flows relative to GDP.
- The institutional *mechanism* driving and changing these flows.

According to figures issued by the Institute of International Finance (IIF, 1998), in the five Asian countries most affected by the crisis – Thailand, Malaysia, Indonesia, Philippines and South Korea – the net capital flow changed from an *in*flow of $93 billion in 1996 to an *out*flow of $12 billion in 1997. There was a dramatic turnaround of $105 billion within six months. This is the equivalent of more than 10 per cent of these countries' combined

GDP. Quite obviously, such a turnaround could have been destabilising. On top of this, according to the Bank for International Settlements, international bank lending to Asia fell by $51.7 billion, or 14 per cent, in the first half of 1998. This was the biggest recorded decline in a decade.

In the case of both Thailand and Malaysia, the average annual net private capital inflow over the period 1992–96 was about 10 per cent of GDP; in the case of the former this was predominantly loans and portfolio investment rather than direct investment. It is obvious that sudden reversals in volumes of this magnitude could well destabilise a country's domestic credit availability, currency value and/or foreign currency reserves. In the case of Thailand the foreign liabilities of banks and financial institutions rose from 5 per cent of GDP in 1990 to 28 per cent of GDP in 1995 (Radelet and Sachs, 1999). It is undeniable that more foreign funds were made available than were actually needed or could safely be swallowed (Delhaise, 1998, p. 85). Not only did international banks rush to invest in East Asia but so too did pension funds, investment houses and others. The implications of these free, unregulated, cross-border capital flows are several and not necessarily obvious. For clarity, it is worth making some general observations.

First, where cross-border capital movement is scarcely regulated, as in Southeast Asia in 1997, financial transfers can be made at will. They can also be made cheaply and instantaneously, even automatically, by computer. With such speed comes an inescapable risk of volatility. Second, investors need not invest in a particular economy in order to earn a return from the 'real' economy. Rather they have the option of making a purely speculative play on financial markets. Offering scope for speculation attracts funds into an economy that might otherwise stay away, further increasing the risk of volatility. Third, the financial instruments available to contemporary speculators are increasingly sophisticated and include many that can be purchased with just a small deposit. Speculators who act in this way can leverage their investments; often highly, as indicated below. This institutional facility to leverage speculative plays adds further to the potential volatility of open capital markets. It comes about because those who buy on margin are generally obliged to sell very quickly indeed when prices move against them, if they wish to avoid crippling losses.

At this point it is worth noting a couple of facts. These were established beyond any doubt by the 28 April 1999 report by President Clinton's working group on financial markets, led by Treasury Secretary Rubin and Federal Reserve Chairman Greenspan; their report is as authoritative as any document on this subject can be. It describes the increasing tendency of financial companies to leverage their bets on financial markets with

borrowed money: 'leading securities firms use even more borrowed money relative to capital than LTCM did the ratios of borrowed money to capital at the top five investment banks average 27 to 1'.

Boyd (1999), writing at about the same time, stated that 'LTCM had a leverage of 50 because banks were falling over each other to lend to it'. Anyway, partly as a consequence of the working party report, the US government is considering direct regulation of both hedge funds and derivatives dealers, which are now largely free of supervision (Kahn, 1999). Derivatives are known to have been an important mechanism of contagion in the crisis. In this context it is interesting to note remarks made by Jan Kregel of the Jerome Levy Economics Institute in New York, as quoted in *The New York Times* of 17 February 1999: 'Western banks made incomparably more money selling derivatives than making loans and that in any case much of the lending was linked to derivatives as well. Most major American banks – Bankers Trust, Chase and JP Morgan – were actively selling derivatives in Asia'. In addition, Kregel is quoted as stating that 'South Korea in particular invested in high risk securities tied to Thailand, Russia, Indonesia and Latin America, including 40% of one Russian bond issue and almost 100% of a Colombian bond issue.'

So against this background let us now return to the basic issue of the magnitude of the capital flows into and out of the East Asian economies in 1997. There can be no doubt that following the steady capital market liberalisations of the 1990s, those Asian economies which received major flows of funds from overseas exposed themselves to risk of a sudden destabilising, withdrawal of funds (Delhaise, 1998, p. 30). Of course there may well have been benefits too, but that is not the issue here. In a 1998 paper, a senior World Bank official (Severino, 1998) recommended that governments should 'think carefully about the regime that integrates their domestic financial sectors with foreign capital flows'. In other words, short-term capital inflows can be a very mixed blessing. Another World Bank official (Stiglitz, 1998, p. 8) has gone further: 'A consensus is beginning to form that governments, *and possibly the international system*, need to do more to restrain the movement of capital, especially of short-term hot money' (emphasis added).

It is also worth noting, as Federal Reserve Chairman Alan Greenspan often does, that modern communications and computerised trading have greatly reduced the cost of global financial dealing. These facts, together with the wide availability of leveraged instruments such as derivatives, have enabled the trading departments of banks and specialised intermediaries such as hedge funds to develop a profitable business in moving large concentrations of funds quickly between markets in order to exploit perceived arbitrage opportunities (Hale, 1998, p. 271). Indeed the chairman of the Federal Reserve Board said earlier this year (Greenspan, 1999a) that

> By far the most significant event in finance during the past decade has been the extraordinary development and expansion of financial derivatives. ... At year-end, US commercial banks, the leading players in global derivatives markets, reported outstanding derivatives contracts with a notional value of $33 trillion, a measure that has been growing at a compound annual rate of around 20 percent since 1990.

In addition, looking at currency markets, it is estimated that by 1995 foreign exchange spot transactions amounted to 67 times the value of international trade in goods, or some 40 times the total value of trade in goods and services (Jomo, 1998, p. 10). Obviously there is a sense in which the market for foreign exchange is largely divorced from the real economy. In a typical day it is said that $1.5 trillion changes hands on the world's foreign exchange markets – an eightfold increase since 1986 and equivalent to total world trade for four months (Kristoff and Wyatt, 1999).

So it is easy to see that when the huge investment capacities of the world's major financial institutions are focused on an emerging economy, a relatively small shift in fund allocation by a major investment house might overwhelm the capital market of a relatively small economy. As Delhaise (1998, p. 88) put it in the context of Thailand in 1997: 'A seemingly innocuous decision to reallocate funds, taken in a NY boardroom, could move markets in Asia.' The same point is put more generally, more forcefully and with total clarity by a highly respected columnist of the *Financial Times* (Wolf, *Financial Times*, 20 January 1999, p. 5):

> Yet without the banks there would have been no crisis: for the five most affected Asian economies, three-quarters of the net swing in private external finance, between 1996 and 1998, was accounted for by the commercial banks alone. The banks, in particular, and debt-creating inflows, in general, have therefore been behind all the volatility.

Such moves need not relate to the economic fundamentals of the country at all. If it is assumed that institutions that are big enough to move emerging markets are aware of their power, and this is a completely realistic assumption, it follows that they may well choose to move markets for their own private gain. In such cases, when international market plays give rise to destabilising local consequences, these consequences are caused by outside interests and, in a proximate sense at least, not by forces within the country itself. So despite the sometimes gross imperfections of economic management in the afflicted Asian economies, we need to recognise that the Asian crisis may not be Asia's fault. Put rather differently, Malaysian Prime Minister Mahatir, warts and all, probably has much better reason to feel aggrieved than has been publicly recognised.

One commentator (Weinstein, 1998) wrote as follows: 'Fickle investors, controlling trillions of dollars, can drive currency values up and down in huge swings for seemingly no valid economic reason. Sudden currency swings play havoc with people's lives.'

The detail of the Asian crisis gives fully adequate reason for believing that short-term foreign currency debt can be a major liability in a world of unregulated capital flows. This does not necessarily mean that short-term capital movements were the sole cause; but it does mean they were the most important cause. This observer does judge that money market moves directly triggered the collapse of the Thai baht and by this means set off the Asian crisis. The judgement rests on the following evidence. First and most obviously, hedge funds accounted for the timing of the floating of the baht, as later acknowledged by the IMF and already noted above. It had very probably been desirable to devalue the baht for some time but it was hedge-fund currency speculation that forced the issue. Second, the speed and magnitude of the well documented reversal of foreign capital into and out of the afflicted countries, before and after the baht was floated, could reasonably explain the speed and magnitude of the currency and stockmarket falls the region experienced. These are shown in Table 2.2 above. In contrast the economic fundamentals of the countries concerned cannot explain changes of this speed and magnitude. In addition, the financial market responses were disproportionately violent in relation to the relatively minor economic imbalances in the Southeast Asian economies in 1997. Third, given the record of contagion, it is hard to identify any mechanism in the real economy that could respond with such speed across different economies: apparently ignoring some diverse economic fundamentals. Last but not least, it can be observed that the market forces that created the Asian crisis did not bring about market corrections, but gave rise to such severe 'overshooting' that they left the afflicted economies enfeebled rather than invigorated.

CONSEQUENCES

Perspective

The Asian crisis has had powerful national, regional and global consequences. Moreover these are still unfolding. Many are likely to have long-term significance. Even cursory familiarity with these events, as offered above, makes clear that the full impact embraces financial, economic, political, social and institutional consequences. The latter, which will eventually include improvements to the 'global financial architecture', which the crisis has shown to be necessary, still lie in the future.

One short chapter cannot deal with such matters comprehensively. As indicated earlier, most of the intellectual energy invested in understanding these events has been American and, not surprisingly, most of this has focused on the global consequences of the crisis. The purpose here is different. It is to focus on just one particular set of consequences: the likely impact of the crisis on Asian business. For simplicity, this set of consequences may be categorised as follows:

- Impact on the financial sector of East Asian economies.
- Impact on the corporate sector of these economies.
- Impact on business–government relations in these economies.
- Impact on industry policy in the East Asian economies.

Following this, it is interesting to speculate on the impact of the crisis on the so-called Asian model of development.

All these consequences are already being felt throughout the afflicted region. Yet what we see, so far, is probably just the start of a fairly long adjustment process. Even if the worst of the crisis is already over, as many believe, the full adjustment may still come to embrace more fundamental political and social change than is yet evident, in which case the impact will prove profound and will be felt for many years to come. Moreover, as was said of the Great Depression of the 1930s, the most profound consequence of all is its impact on the mind of a generation.

The Financial Sector

Given that the crisis originated as a currency and stockmarket crash, it is appropriate to begin with financial sector changes. Far and away the most obvious and most important has been the unpegging and floating of regional currencies.

Prior to 1997, as noted at the outset, pegged exchange rates were the region's norm. The peg provided apparent stability but allowed regional currencies to rise to unsustainable levels against the dollar. This proved not to be in the interest of regional economies. In addition the pegged rates encouraged local borrowers to raise dollar-denominated loans and risk leaving these unhedged. This was not in their interest either: in fact it proved an unmitigated disaster. Today, with the exception of the regulated ringgit and still-pegged Hong Kong dollar, the freely convertible currencies of the region all float. Nearly everyone looks upon this change positively.

The crisis also highlighted the risk of holding too much short-term debt. So it may safely be assumed that regional administrations are now giving renewed thought, some under IMF tutelage, to the associated issues of financial system regulation and disclosure. In 1997 most regional governments and central banks had little idea of the volume of short-term, foreign currency debts held by their banks or their corporate sectors. The need to improve on this state of affairs is now recognised everywhere. Regulatory changes and new disclosure requirements will probably make such ignorance a thing of the past. The crisis has also shown that central banks do need to be able to exercise effective authority in difficult times. Events have shown that prudence requires domestic financial systems to be liberalised, internationalised and made competitive before they are fully opened up to global capital. If not, small, emerging money markets will be at the mercy of more powerful foreign interests. A related lesson of the crisis is that financial liberalisation requires strict, impartial regulation and close prudential supervision at the national level if it is to work well. Emerging markets now know that if they are to inspire confidence and work satisfactorily they must achieve this. At the same time it is noteworthy that all the Southeast Asian countries possessed elaborate prudential controls before the crisis. It was implementation and enforcement that was lacking.

The conventional tools of prudential regulation had mostly been phased in during the early 1990s. These related to capital adequacy, lending to associated borrowers, percentage limits on individual foreign currency and interest exposures, and so on. However there tended to be very lax rules governing provisioning for non-performing loans. (Fane, 1998, pp. 293–5). This was a major weakness and after the crisis all the countries of the region announced plans for much stricter provisioning requirements. Both Thailand and Malaysia are now adopting US-style conventions for classifying loans and providing for losses. Malaysia has gone further and in 1998 began quarterly public disclosure of prudential information on individual banks. In addition the central bank now demands that banks under its supervision include a monthly 'stress test' to supplement their internal controls. In Indonesia, prudential supervision of the 240 banks that existed prior to the crisis showed itself to be totally ineffective due to complete lack of enforcement. In this particular case, however, state-owned banks were in practice often required to grant loans to members of the president's family (*Time*, 1999, p. 45) and these were not necessarily serviced or repaid. Nevertheless, since the crisis even Indonesia has raised minimum capital requirements and necessarily moved towards fewer, stronger banks.

So it can safely be said that a further consequence of the 1997 crash is region-wide recognition of the need for much higher quality prudential regulation of the financial sector with a much clearer focus on essentials than in the past. This means higher capital adequacy ratios – Hong Kong had an average ratio of 17.7 per cent in 1996, twice the Basle minimum of 8 per cent – plus tight rules on the classification of loans, continuously, impartially and rigorously implemented. Unlike before, circumvention needs to be actively countered. Looking back at the precrisis situation, Delhaise (1998, p. 299) described the situation in the following terms: 'It turned out that there had been a chasm between the controls that existed on paper and those that were actually implemented, as the widespread flouting of the prudential regulations had demonstrated even before the crisis occurred.'

In Korea, the banking system has been well characterised as a 'disaster' and merchant banks as 'an interesting case of uncontrollable madness' (Delhaise, 1998, pp. 105–15). Although Korean banks have the advantage of being less exposed to speculative real estate investment than banks elsewhere in Asia, their Japanese-style practices render their accounting procedures largely worthless for prudential purposes. Delhaise suggests that, in aggregate, Korean banks were already bankrupt in 1996, even before the major bankruptcies of Hanbo Steel and the Kia group, and that Thomson Bank Watch had shown that Korean banks lacked positive net worth several years before the Asian crisis broke. In fact, as Alan Greenspan (1999b) later said: 'South Korea's short-term debts, including those owed by South Korean banks, were more than three times the level of the country's foreign exchange reserves in December 1996, the year before the Asian currency crisis struck that nation.' Indeed, when Kia collapsed in 1997 three merchant banks were found to have lent the equivalent of over 120 per cent of their own capitalisation to the group. Given the major equity investments of Korean banks, they were in a very much worse situation after the crisis.

In any case, as in the other afflicted economies of the region, the classification rules governing non-performing loans in Korea have long been extremely loose. Nonetheless, loans so classified rose from 4.1 per cent at the end of 1996 to 6.8 per cent in September 1997 on the eve of the crisis in Korea (Chang, 1998, p. 223). Furthermore the merchant banks were highly exposed to foreign currency loans in the absence of any prudential regulations governing them in this regard (Smith, 1998, p. 74). Moreover the central bank had an established practice of compensating banks for some of their losses. On the credit side, the government is now opening up its banking sector to foreign competition. Bankrupt Seoul Bank and Korea First Bank were both (Veale, 1999, p. 26) sold to foreign interests, and on 17 April 1999 Goldman Sachs bought a 17 per cent stake in Kookmin Bank. Yet Korea, more than any of the other afflicted economies, faces cultural and institutional problems as well as technical problems in bringing its financial system up to an internationally acceptable standard. Even with the best will in the world, this will take time.

In the region as a whole, financial institutions require fundamental upgrading to reach internationally acceptable standards. Whilst this remains a major challenge there is at least an understanding of why it is important. Before the crisis there was complacency. Since the crisis, spurred by events, we have begun to see an improvement.

The Corporate Sector

All five of the most afflicted economies experienced a severe credit crunch after the currency collapses of 1997. Consequently business firms, especially those which had borrowed in foreign currency, faced steep increases in debt servicing costs. As a result many businesses collapsed. In Asia, unlike the West, that did not necessarily mean they stopped trading. Some did, many others did not. Typically, firms defaulted on their loans, stopped providing or supporting normal trade credit and cut back sharply on operations, but remained in business at a more modest level. Although technically bankrupt, the absence of modern bankruptcy laws or lack of established procedures for dealing with insolvency on a large scale, as in Thailand and Indonesia, enabled enterprises to remain in existence and continue trading.

Businesses in all five meltdown economies, on a devastating scale, faced the same core problem of unmanageable indebtedness. Despite differences between countries, this core problem was everywhere the same. This section offers a summary of what has been happening as a result. In each of the countries we can find instances of nationalisation, especially of banks, enforced mergers of both public and private enterprises, asset sales, the raising of new equity finance and the introduction of new business partners, often foreign partners for the first time. We may fairly say that the crisis is changing the face of Asian business.

An example or two, taken from the respected monthly *Asian Business* (April 1999, pp. 22–9), indicate the character of this broad picture. In Thailand, the introduction of Western style bankruptcy legislation proved one of the most delicate and time-consuming institutional adjustments made. As a result, corporate restructuring proceeded very slowly indeed. Thai Petrochemical Industry, for example, one of Thailand's biggest defaulters with \$4.2 billion of overdue debts, has been haggling with creditors without conclusion for more than two years. On the other hand Siam Cement, which has managed to avoid default, is voluntarily restructuring to reduce debt and better cope with the crisis conditions. The company president calls it 'business restructuring' rather than 'debt restructuring' (Mertens, 1999, p. 24). In Indonesia, the worst hit economy, where unresolved political problems compound the crisis, an estimated 70 per cent of businesses are insolvent. Nevertheless few companies have been declared bankrupt because the new IMF-backed bankruptcy law lacks teeth. Some giant conglomerate groups, for example Salim and Gadjah Tunggal, are nonetheless having changes forced upon them by the official Indonesian Bank Reconstruction Agency. Unlike Chinese conglomerates, the ethnic Indonesian or *pribumi* Bakrie group has apparently successfully split itself into a good half and a bad half and offered its many hundreds of creditors a debt-equity swap option that has drawn an encouraging response. The company is being advised by Chase Manhattan Bank and Salomon Smith Barney. At the same time, however, *Asian Business* (April 1999, p. 29) tells us Aburizal Bakrie, head of the Indonesian Chamber of Commerce, is lobbying for corporate debt relief from government. South Korea is a somewhat different case. As a rule, Korean businesses are more globally exposed, their sophistication is greater and their debts are bigger too. Yet in common with companies in Southeast Asian countries, Korean businesses are accustomed to close government involvement and support. The difference is that in Korea, half of the top thirty conglomerates, or *chaebol*, are formally bankrupt or have been placed under court receivership. The giant 'top five', in contrast, have considered themselves too big to be leaned on by government and have up to the last possible moment resisted change. The government's policy for these biggest conglomerates is twofold. First, they are to reduce their extraordinarily high gearing levels of around 500 per cent to 200 per cent by the end of 1999. Second, they must rationalise their business activities so that they are not all participating in the same industries; and are subsequently able to focus on their remaining core businesses. From end of 1997 to mid 1999, however, this restructuring process was half hearted at best. Some limited swapping of subsidiaries has occurred, but not without a deal of bickering among the contestants. In addition some new equity has been gained, but not necessarily as the government wished; they have raised money through rights issues and so avoided dilution of ownership. The underlying problem is that most of the *chaebol* are still family controlled and their owners do not want to share power. While they would now welcome an injection of foreign funds, they would not welcome foreigners on their boards. The surviving smaller *chaebol*, with their debts pressing, have responded more actively. The star performer is possibly Hanwha, the eighth largest. It escaped collapse only through half a billion dollars worth of 'cooperative loans' from its

creditor banks in a government-directed rescue. It then sold off whole or partial stakes in nine affiliates and lowered its debt ratio from 1200 per cent in 1997 to 255 per cent by mid 1999 (Lee, 1999, p. 42). The remaining businesses are now being grouped into three areas of activity in which future investment will be determined by cash flow and value creation rather than growth potential as in the past. The company claims it now 'operates on an entirely different paradigm'.

Whilst Singapore is definitely not one of the meltdown economies, it is notable that Singapore, too, is in a phase of active corporate restructuring. Driven by competitive ambition rather than necessity, Singapore is forcing mergers and higher standards on both its corporate sector and its financial institutions. The objective is to enhance national competitive strength and to help local players survive and prosper when the local market is fully open to global competition.

A process of massive corporate restructuring on a region-wide scale is well underway. It is forcing centralisation and attention to profit on Asia's sprawling conglomerates. It is forcing asset sales in the drive towards debt reduction. It is making short-term profitability the priority, at least for now, for large and small businesses alike. At the same time it is putting greater pressure than ever on management and a premium on strategic business thinking.

Business–Government Relations

In a magazine article written shortly after the crisis began, Paul Krugman (1997, p. 13) stated that 'The biggest lesson from Asia's troubles isn't about economics, it's about governments.' Krugman went on to suggest, as he had before the crisis began (1994), that the contribution of Asian governments to economic development had not been truly significant. The accuracy or inaccuracy of this assertion is the big question that lies behind most assessments of day-to-day Asian government involvement in business. The underlying economic and ideological question of whether it is primarily governments or markets that have 'managed' the Asian economic development success until 1997 will not be explored here; the question is too hotly debated and too far from resolution. The following comments relate more narrowly, and perhaps more superficially, to the *character* of day-to-day Asian government involvement in business and to the question of how the crisis may be changing this involvement.

When discussing post-crisis changes in government–business relations it is important to recognise that these changes are as likely to relate to non-controversial issues as to controversial ones. For example, improvement in the handling of bankruptcy and insolvency, which is widely desirable across Asia, requires legislation by governments and implementation by the courts, free of favour. The same holds for improvements in corporate auditing, accounting and reporting procedures. It follows that the very process of reform, the need for which has been highlighted and made urgent by the crisis, itself requires the active involvement of political leaders, legislatures and bureaucracies. Only in the much narrower sense of a government's direct, developmental role in 'industry policy' as a so-called 'developmental state', may it be useful to separate governmental responses from corporate responses to the crisis. Otherwise the responsibilities and needs of each are closely interrelated and to a degree symbiotic.

Perhaps the most urgent post-crisis task facing the region has been the resuscitation of sick banks and the nationalisation or sale of those beyond repair. While what has been done varies somewhat between countries, whatever has been done has required public money and directly involved government. In Thailand, for example, the government has given capital support to some banks in the form of ten-year bonds in return for preference shares. In return the banks are required to boost their core capital. Similarly the Malaysian government has established an asset management company, Danaharta, to take over non-performing loans and a second institution, Danamodal, to recapitalise ailing banks (Yeoh, 1998). Both agencies are funded through the issue of government bonds. In addition the governments of the region are facilitating bank mergers and even sales to foreigners. For example GE Capital has taken control of Korea First Bank in Seoul and Standard Chartered has taken over Nakornthon Bank in Bangkok. In both countries, foreign control of domestic banks is new; it would not have been acceptable to either government before the crisis.

Government influence on the conventional non-financial corporate sector represents a more delicate side of government–business relations. In all of the afflicted economies, government and business have long been closely intertwined. In Indonesia this came about through the commercial dominance of former President Suharto's family and friends. In Korea it came about through the government's control of credit and provision of 'policy loans'. The Asian crisis mercilessly exposed such intimate but not necessarily competitive government–business relations. The consequence so far is that these particular kinds of government influence over business have been permanently weakened, and are perhaps in the process of ending altogether.

On the other side of the balance sheet, in Indonesia as in China, the military arm of government has long engaged in business. The Indonesian military's business operations range from plantations and mining to real estate and protection. Among the many office buildings owned by the military is the Jakarta Stock Exchange (Thoenes, 1998). In Indonesia, unlike China, there is as yet no sign that this particular involvement will cease.

In all the afflicted countries, one response to the crisis has been to open up hitherto protected sectors of the economy to foreign investment and competition. Indonesia claims to have opened 26 sectors and lifted its ban on investment by large firms, domestic or foreign, in sectors that were previously the sole preserve of small enterprises. The latter include, notably, distribution and retail. Similarly Thailand is revising its restrictive Alien Business Law and will remove a 49 per cent limit on foreign ownership in the hotel, tourism and advertising sectors. All such moves represent a further step in the integration of local economies with the emerging global marketplace. At the time of writing it looks as though all the crisis-affected economies – even Malaysia, which has reintroduced capital and exchange controls – will emerge from the experience with a more liberal foreign direct investment regime, greater privatisation of monopolies and increased integration of local business with the outside world through ownership and trade. Of course the dramatic currency devaluations that triggered the crisis have increased the international competitiveness of these local businesses.

Much government influence on business in the afflicted economies, as in Japan, has been non-transparent. This influence has been substantially weakened but not removed by the crisis. Where the crisis has either coincided with or accelerated political change, as in all three countries under IMF tutelage, old 'crony' relationships have been devalued. However this is not to say that new ones cannot arise. In the case of Indonesia, many of the indebted conglomerates whose leaders are closely associated with former President Suharto have recently found that the government is less willing than in the past to give them support. At the same time, long-term relationships do not disappear overnight. For example Soegianto, head of Indonesia's giant, state-owned oil company, Pertamina, was replaced without public explanation in December 1998 after less than one year in the job. With all probability this was due to the continuing influence of ex-President Suharto's family, whose business interests were being adversely affected by Soegianto's decisions (Praginanto, 1998). It is known that Pertamina wanted to terminate contracts awarded earlier to Suharto family firms, without competitive bidding, because Soegianto judged them 'unfair' to Pertamina. The sacked man had earlier claimed to have identified 159 such contracts and had already terminated some of them. Such events as his removal suggest that while political direction and crony connections are quite likely to diminish as business influences, old habits do tend to linger on.

Industry Policy

The most interesting dimension of East Asian government–business relations is the role of the government as midwife to industrialisation, or 'industry policy'. With the partial exception of the Philippines, the governments of all the crisis economies, like Japan before them, possess active industry policies to accelerate and direct their industrialisation and development. Indeed it was the conspicuous developmental success of these economies that largely accounted for the close interest of so many of the world's governments, global financial institutions and development economists in industry policy and associated business–government relations. The question here is what consequences, if any, the 1997 crash has had on such policies.

South Korea is the classic 'tiger' economy. There, more than elsewhere, we can point with confidence to a government that has played a decisive role as initiator, promoter and master of the industrialisation process (Amsden, 1989). The crisis-afflicted Southeast Asian countries are different; they are both behind Korea on the development ladder and have employed far less comprehensive and less prescriptive industry policy practices. Unlike Korea, they have courted foreign direct investment and to a greater or lesser extent welcomed other foreign involvement in their economies. Nevertheless the governments of these countries have played a central role in the establishment of new industries from scratch. The Malaysian national car, Proton, is but one example. Less obviously, Thailand's single most important regional industrial development project, the Eastern Seaboard Project, would not have been possible without government initiative (Jomo *et al.*, 1997, p. 76). Where government itself directly negotiates the establishment of new enterprises, it is reasonable to suppose that close business–government relations are established.

Our focus here is whether the crisis is changing the role of East Asian governments in economic development. After all, it could be that the practices and mechanisms of past industry policy are now no longer appropriate.

The first step in answering this question is to note that industry policy, as practiced in Asia over the past 40 years, was under challenge before the crisis began. First, it was under challenge from theoretical economists in the West who viewed close government involvement in business as unwarranted and efficiency-reducing interference, or 'intervention', in otherwise welfare-maximising markets. We agree with Takahashi (1997, p. 293) that 'industrial policy has been a dirty word among neoclassical theorists for many years'. Second, to the extent that industry policy was seen to embrace special advantages or favours to local producers, it was also under political and diplomatic threat from Western, especially

American, trade negotiators and regulators. Third, and closely related to the previous point, industry policy mechanisms that were seen as nationally discriminatory were under potential threat from action under the World Trade Organisation's rules on competition. So industry policy was already a controversial policy issue before the 1997 crisis struck. Many classic industry policy mechanisms – those which involved government fiat, centralised or preferential allocation of resources, or identifiable subsidies and preferences – were believed most unlikely to be WTO-compatible and were therefore doomed.

So against this background, what difference has the crisis made? Although many believe that the worst of the crisis is already over, it is too soon to be sure. The most certain feature is that the dominant commercial trends of the decade – liberalisation, deregulation, privatisation and globalisation – show every sign of continuing unabated. These four words, taken together, capture what is both an intellectual and a practical current of our time. The crisis has not changed that. Indeed the crisis itself is probably best regarded as a manifestation of these trends. Moreover, with just one notable exception, the impact of the crisis has been to strengthen these developments. The single exception is short-term capital movement; the 1997 crash has put global financial markets under very critical scrutiny and, as noted earlier, the volatility of short-term capital markets and their potential to destabilise economic activity suggests much closer prudential regulation in the future. Otherwise liberalisation, deregulation, privatisation and globalisation look set to progress further in the future.

There are those who would argue the crisis has accelerated these trends. Support for this view can be found by scrutinising government responses to the crisis. As already noted, Thailand, Korea and Indonesia, the three countries under IMF tutelage, have since 1997 opened up their economies to greater foreign investment, including foreign control of businesses in hitherto protected sectors. This particular move embraces both liberalisation and closer integration into the global economy. Importantly, these consequences will be felt in both financial and traded goods sectors and will enhance their international competitiveness across the board. Even in Malaysia, the one crisis-affected economy that has chosen to reverse the liberalisation trend, it is notable that the reintroduced capital controls exempt foreign direct investment and international trade. Furthermore, companies associated with the government's Multimedia Super Corridor project are also exempted (Mahbob, 1998); the latter, please note, is itself an example of government-inspired industry policy.

It is in the context of major global trends that the impact of the crisis on industry policy is best examined. This author is aware of no evidence that the crisis has caused any regional government to reduce its commitment to economic development. So, to the extent that industry policy is still seen to offer a path to development, it is likely to be retained and employed by regional governments. Despite growing and critical scrutiny of 'crony' relationships in some countries, and despite growing and critical scrutiny of corruption in most of them, and even despite criticism of some particular mechanisms of industry policy, notably in Korea, there is no clear evidence that industry policy, in principle, is under criticism. This is quite unlike the West. Rather the evidence of government actions across the region suggests that regional politicians and bureaucrats approach development issues with very great pragmatism. The priority of the day is recovery. To this end, bank bailouts, forcing big *chaebol* to rationalise, encouraging conglomerates to divest non-core assets, liberalising foreign investment regulations, and anything else that works, is all fine. Circumstances have changed and the objective is the reestablishment of fast growth. So where industry policy is still seen to offer advantage it will still be employed. The new problem in this context is not a consequence of the crisis; rather it is today's need to make any industry policy acceptable to trading partners and the world at large. The problem is the practical difficulty of ensuring that the mechanisms of industry policy are commercially effective at the domestic level and yet permissible at the global level. This may not be so easy. It is likely to require both sophistication and ingenuity. Still, if judged useful, it is likely to be done.

The Asian Model

Discussion of industry policy leads easily into the slightly broader topic of the so-called 'Asian model' of development; sometimes termed 'Asian capitalism'. The Asian model cries out for definition, but sadly there is no established and agreed definition available. The World Bank is not alone in acknowledging this (Jomo *et al.*, 1997, p. 157). Yet the label usefully encapsulates core aspects of the political economy of Japan and that small group of East Asian 'tiger' economies that have successfully achieved unprecedented and sustained economic growth over recent decades. This political economy amounts to more than just a close business–government relationship of the kind described above; after all, corporatist state–business partnerships have been evident in other societies. The key distinguishing feature of Asian capitalism, irrespective of private ownership of industrial property, is that the government has been firmly in the driving seat and has itself played a major and proactive part in the industrialisation process (Henderson and Applebaum, 1992, p. 2). The spirit of the Asian model of development, as perceived in the West, comes across in the widely used

epithets 'Japan Inc', 'Malaysia Inc' and so on. As such labels suggest, the concept really reflects a perception that the East Asian states have somehow managed to develop a collective national cohesion through which they have succeeded in making startling economic progress. This differs sharply from the Anglo-American experience. Moreover it is closely linked in the Western mind with notions of strong or authoritarian government. Perhaps not surprisingly, therefore, majority Western opinion finds it rather unappealing. This negative attitude may reflect political perceptions and preferences as much as simplistic, neoclassical economic ideology.

There is a further complication. Once we focus on the political dimension of the Asian model it is easy to drift into the much broader debate over so-called 'Asian values'. Proponents of the latter seek to account for Asia's economic success in terms of authoritarian political structures, which in turn are viewed as a reflection of widely shared, usually Confucian, Asian values. This chapter avoids such contentious issues, even though the line between a proactive government stance on industrialisation and the institutional character of policy implementation in general is not always a clear one.

There is a solid body of research findings that corroborate the effectiveness of East Asian approaches to development. Yet others have explained the Asian miracle, from the same evidence, in terms of the benefits gained from allowing market forces to hold sway. This debate is summarised elsewhere (Wade, 1992). The issue here is the narrower one of whether the events of 1997 are likely to have a lasting impact on what are commonly accepted as peculiarly Asian approaches to development. In mid 1999, the time of writing, any answer to this question must be speculative.

In the West, the 1997 crisis has been widely seen as much more than 'the end of the Asian miracle'. It has, also been enthusiastically welcomed as a signal that the Japan-inspired development model, the Asian model, has now failed. Indeed some Western press comments along these lines have been labelled 'triumphalist'. So it is interesting to assess whether the crisis has really changed the mindset of the Asian elite. Prior to the crisis, as noted, the main debate centred on how the Asian model succeeded in achieving development, on whether this was primarily through government guidance or primarily by leaving market forces free to do their work. Since the crisis, attention has shifted to whether or not the Asian model will survive. This is quite a change; but it is largely a change in Western focus.

Given that the model originated in Japan and largely owes its regional appeal to Japan's global commercial success, it is sensible to look first at Japanese attitudes. Unlike those economies most affected in 1997, Japan's economy has been stagnating since 1991. The vice-minister at the Ministry of Finance, Dr Sakakibara, once a firm supporter of 'the Japanese way', now wants to change the model. He recently said that Japan's core problem was 'the rigidity of our organisations' and 'Japanese institutions need to have major restructuring to keep up with globalisation and technology'(Hartcher and Cornell, 1999). So although Japan is not one of the crisis economies, it is instructive to note such a dramatic change of view from one of the most prominent supporters of the model (Sakakibara, 1993) and someone who has been so directly involved in the crisis itself. Yet on the other side of the argument we might note the Japanese government remains intimately involved in public sector–private sector collaboration, for example in the development of a 300-seat, supersonic commercial aircraft (TNW, 1997).

Similarly Steve Parker, an economist with the Asian Development Bank Institute in Tokyo, has been reported as saying that 'Asian governments are entering new and uncharted territory. This time around, there's a new dynamism at work, You can't just invest and save your way out of this crisis' (Zielenziger, 1999). This comment goes to the heart of the high-saving, high-investment Asian model. Parker is emphasising that Asian economies cannot rely on export-led growth to the same extent as before; they must now save less and consume more. Such an adjustment would mean slower GDP growth and take a central piece out of both the input side and the output side of the Asian model. It implies a post-crisis future in which Asian growth is less rapid and in which the performance of the residual Asian model will be less distinctive. Yet this implies only macroeconomic and performance changes. It does not necessarily imply changes to policy priorities, the mindset of the administrative elite or political structures.

A more dispassionate view is offered by Garran (1998:4). He argues:

> The Asian model was only ever useful for countries behind the frontier of technology and industrialisation. Once Japan. Korea. Singapore, Hong Kong and Taiwan caught up with the rich world's level of technology the model had little to offer. And even if the 1997 crash shows that economic conditions have changed in fundamental ways, ... Asia's leaders, and their boosters in the West, ... applauded the strengths of the Asian model – and their success shows its virtues were considerable – without recognising its weaknesses.

Despite the measured tone of this evaluation, the present writer is less than convinced. For the time being the evidence on the ground still seems very mixed. For brevity, I shall comment on Korea alone, the country which looks like emerging first from the crisis. On one side of the argument,

President Kim Dae-jung has praised the role and policies of the IMF in putting his country on the road to economic recovery (Lee, 1999). So he apparently applauds the conventional 'Western', IMF, 'hands-off', perspective on business–government relations. It is certainly the case that he personally owes nothing to Korea's established politician–bureaucrat–bank–business networks. Yet the Korean economy cannot instantly escape its own past. This can be recognised from its own government's actions. On the other side of the argument, Kim's Minister of Commerce, Industry and Energy, Park Tae-young, recently announced government plans (Sohn, 1999) for Korea to enhance its position in the global footwear industry. The '*government*', he said 'will finalise plans to establish shoe manufacturing centers and other support facilities ... ' In addition, to promote research and development in footwear manufacturing: 'the *Ministry*, would reinvigorate research centers by sharply enhancing administrative support' (emphasis added).

He even said: 'the *Ministry* plans to improve the quality of Korean made footwear ... while devising differentiated export strategies' (emphasis added). Speaking more generally, rather than just about the footwear industry, he went on to refer to the government's target trade surplus. To achieve it, he said, 'the government will develop 200 export items for niche markets overseas'.

Even leaving on one side the fact that the government has a target trade surplus, itself a characteristic of the Asian developmental state, this all sounds like very intimate government involvement in industry. Actually, it sounds like pre-crisis Korea. Evidence like this suggests it may well be premature to assume that the crisis has really changed attitudes significantly. This is particularly the case if, as June 1999 suggests, the stricken economies are already on the mend and with the passage of time the crisis will come to appear short-lived.

Overall, it does not appear to this writer that the relationships which were the underpinning of the Asian model are dying quickly. The crisis has certainly jolted the Asian economies into greater openness and closer integration with the rest of the world. However this may still leave them a very long way from University of Chicago capitalism. Contemporary adjustments may be judged to represent some modest measure of convergence on the part of Asian economies towards Western norms but this is unlikely to be sufficient to leave the Asian model indistinguishable from the American model. As Jusuf Wanandi, chairman of the policy research centre in Jakarta has put it (Kristof, 1998):

> Everybody has been liberating markets to take advantage of globalization and the world economy. So we are all moving more to the American

model. But this does not mean that Asian countries will adopt the American model outright. Many Asians are still not on friendly terms with the market forces that over the last few months have demolished their currencies and stock markets.

A former Japanese trade official, Naohiro Amaya, regarded as a theorist of the Japanese model (Kristof, 1999), has been quoted as speaking similarly: 'When you go hunting you have to shoot at a target. But your neoclassical school of economics says you can fire in all directions at once and the "market" will insure you hit the target. Well, we don't accept that line of reasoning ...'

For the present, the jury judging the contemporary value of the Asian model is still out. Arguments for and against it, in whole and in part, can be heard within all the afflicted Asian economies. It is this debate within the region rather than Western comment, or even IMF pressure, that is likely to be decisive in the end. Judgement now is premature. The Asian crisis has most certainly given these economies a battering but, as spelt out earlier in this chapter, this crisis was not uniquely their fault. It follows that it was not necessarily the fault of their Asian model of development either. Yet the future value of the model is most certainly being reassessed. The outcome may be either its retention or its rejection, or, most likely, modification and a bit of both.

CONCLUSION

This chapter has addressed three broad questions and offered partial answers to each of them. In briefest possible summary, the answers in the opinion of this author are as follows. The *character* of the 1997 Asian crash was that of a sudden, deep and region-wide economic depression: the worst experienced by some countries of the region since their modern industrialisation began. The principal *cause* was the herd-like behaviour of fund managers[1] in an inherently unstable global financial system; one in which some highly leveraged participants have the ability to 'move' markets. The *consequences* have been profound and extend beyond the region to the world at large. The regional consequences are social and political as well as financial and economic. Among the consequences still working themselves out are massive corporate restructuring, changes in the regulatory frameworks governing business and finance, reassessment of business–government relations in general, and critical scrutiny of the so-called Asian model of economic development. This model and the business–government relations that lie at its heart are likely to be weakened, but will not disappear.

Note

1. Whom Paul Krugman (1997) has aptly characterised as 'an extremely dangerous flock of financial sheep'.

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3 The Institutional Basis of Asia's Economic Crisis

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The analysis of the Asian crisis offered in this chapter departs from an understanding of the nature of the interaction of economic and political institutions with market processes. A link is drawn between the underlying political culture and a set of institutional arrangements that it engenders. In turn, this institutional infrastructure defines a set of incentives within which economic decisions are made. Faulty institutions will send misguided signals such that decisions that appear to be rational when judged by internal criteria are proved to be irrational and inefficient when compared with external standards. A number of propositions or observations will be outlined and then explored.

First, the economic crisis afflicting East Asia after July 1997 can be considered as being self-inflicted in that it reflected a general failure of governance. In effect, the turmoil resulted from systematic politicisation of domestic financial markets. Policies of directed development were followed in most of the countries in the region. As such, investments for development were directed through banks while domestic capital markets were suppressed.

Second, it follows, then, that global capital flows were not the cause of the crisis. These footloose flows merely transmitted the message that the institutional framework of the East Asian economies would no longer be considered compatible with the demands of the international marketplace. Overall conditions of competition changed the rules of the game. Political and economic institutions that were once thought to help promote growth in the region began to serve as a drag. Judging from the resignation of former Indonesian President Suharto, global capital can now be seen as a liberating force that displaces dictators and inept rulers.

Third, East Asia's problems are deepseated and arise from elements of political culture and similar development policies that are evident throughout the region. As such, resolution of the crisis requires radical changes that must include the introduction of greater political accountability and increased financial transparency. Participation in the global marketplace will induce reluctant leaders to embrace modernisation of their political and economic institutions.