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by

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I. Introduction

As the East Asian economic crisis has unfolded over the last six months, it has become common place for informed Western commentators to suggest that the crisis has essentially been caused by the specific model of capitalism -- the so-called "Asian model"-- that these countries had been following. It is admitted that this model had been quite successful in delivering fast economic growth for some time, but it is suggested that it was ultimately doomed to failure because of its incompatibility with free markets. These points are made stridently by Richard Hornik in an article in the popular *Time* magazine.

> "NEWS FLASH -- THE LAW OF GRAVITY DOES APPLY IN ASIA. For the past decade or two, Japan and then a succession of its East Asian neighbours had us convinced that they were exempt from conventional economic constraints. The proof: year after year of high growth with minimal inflation. Contravening all known wisdom of economic management, they did it with lots of direction from government bureaucrats -- who regularly outguessed the markets in developing efficient industries. The dawn of an Asian Century was upon us, and pundits struggled to explain this miracle.
>
> …. For it is the top-down nature of the Asian model itself that is the real cause of the crisis. This model bred complacency, cronyism and corruption. Isolated from public opinion, just as they insulated bankers and businessmen from market forces, the technocrats ignored the deafening clamour of alarm bells that market forces have been ringing for years….. The financial crisis facing Asia today is merely a symptom of a much deeper problem. The social and political assumptions on which the Asian model was founded are terribly outdated. The global economy is far too complex and fast paced for any bureaucrats to control. The only miracle in Asia is that this approach worked as long as it did."[1]

[1] *Time* magazine, December 8, 1997.

The distinguished *Financial Times* journalist Sir Samuel Brittan adopts basically the same position, only a little less stridently: "I am not arguing that the growth of east Asian countries is over. On the contrary, growth is likely to resume after the present adjustments. What is over is the so-called 'Asian model' as a system of organisation that western countries should either fear, or attempt to emulate."[2]

This causal linking of the financial crisis in the South-East and East Asian countries to the 'Asian model' of capitalism is not just confined to distinguished financial journalists and popular commentators, but is a view endorsed by leading policy-makers. Thus, Mr. Greenspan, the cautious chairman of the US Federal Reserve, in his recent testimony before the Senate Foreign Relations Committee suggested that, in the last decade or so, the world has observed "a consensus towards, for want of a better term, the Western form of free-market capitalism as the model which should govern how each individual country should run its economy…We saw the breakdown of the Berlin wall in 1989 and the massive shift away from central planning towards free market capitalist types of structures. Concurrent to that was the really quite dramatic, very strong growth in what appeared to be a competing capitalist-type system in Asia. And as a consequence of that, you had developments of types of structures which I believe at the end of the day were faulty, but you could not demonstrate that so long as growth was going at 10 percent a year."[3] Mr. Larry Summers, the U.S Treasury Under Secretary puts the matter in slightly different terms. *The Financial Times* (February 20, 1998) reports him as arguing that the roots of the Asian financial crisis lie not in bad policy management but in the nature of the economies themselves. Summers states: "(this crisis) is profoundly different because it has its roots not in improvidence but in economic structures. The problems that must be fixed are much more microeconomic than macroeconomic, and involve the private sector more and the public sector less." Similar views have been expressed perhaps in more measured terms by the Managing Director of the IMF, Mr. Michel Camdessus.[4]

In view of these widely held and influential criticisms of the Asian model by those who favour that of the Anglo Saxon one, a central aim of this paper will be to systematically assess the validity of this thesis, i.e., the paper will explore to what extent, if any, the so-called 'Asian model' is responsible for the present crisis in countries like Thailand, Indonesia, Malaysia and Korea. This question is important in part because in economic terms until very recently this model seems to have been exceptionally successful. It is no exaggeration to say that the industrialisation and economic development of the Asian newly industrialising countries (NICs), as well as Japan in the post-World War II period, has been the most successful example of fast economic growth in history. Further, and very importantly in the context of this paper, the 'Asian model', in addition to its economic merits, has also had a number of attractive qualities from a social point of view, e.g. poverty reduction, lifetime employment and relatively equal income distribution. In contrast, the alternative Western or American model has acquired some unappealing social characteristics as

[2] *Financial Times*, December 4, 1997.

[3] Quoted in the *International Herald Tribune*, February 13, 1998.

[4] See, for example, Mr. Camdessus' speech to Transparency International reported in the *IMF Survey*, February 9, 1998.

it is increasingly based on the doctrine of promoting labour market flexibility. Social protection which hitherto workers enjoyed is being greatly diminished and a growing number of jobs are being "informalised."[5]

In view of the economic and social merits of the Asian model, it is important to ask whether the model also entailed some long run hidden costs. Was it, for example likely to lead to the kind of crisis which descended suddenly and almost simultaneously on several of the hitherto highly successful economies. Such an analysis will obviously involve, *inter alia*, an assessment of other factors which may have been responsible for the crisis.

The paper is organised as follows. Section II reports on the economic and social achievements of the leading East Asian NICs and of the Asian model over the last three to four decades. As we shall see, Joseph Stiglitz, former Chairman of the US Council of Economic Advisers and now Chief Economist at the World Bank, is quite right to observe that "no other economic model has delivered so much, to so many, in so short a span of time." Section III outlines the essential characteristics of the Asian model. These have been the subject of an intense debate in the past, but as will be shown below, current events appear to be leading to a consensus on the broad contours of the system. Sections IV examines alternative theories of the current financial crisis, paying particular attention to the idea that the Asian economic system itself is the main cause of the financial turmoil. Section V reviews the evidence bearing on these issues. Section VI analyses the IMF policy programmes in East Asia including, *inter alia*, the extent, if any, to which these may have contributed to the crisis. Section VII considers the economic and social consequences of the adjustment efforts and also draws lessons from the Latin American experience, and that of Mexico in particular, regarding the duration of the crisis and the effects of adjustment. Section VIII sums up the analytical conclusions of the paper and comments on their policy implications.

II. Industrialisation and Catch-up in Asia, 1955-1995

The Asian model of "guided" capitalist development originated in and is epitomised by the post World War II experience of Japan, especially in the high growth period between 1950 and 1973. In the early 1950s, after the economy had recovered from the war and at the end of the period of U.S. occupation, the Japanese economic situation was not much different from that of a developing country. The total value of Japanese exports in 1952 was less than that of India's (Krueger, 1995); exports consisted mainly of textiles and other labour intensive products. In 1955, Japan produced only 5 million tons of steel and 30,000 automobiles. U.S. production at that time was 90 million tons of steel and nearly 7 million cars. Japan possessed few natural resources for producing steel or other heavy industrial products, and indeed the Japanese costs

[5] The Nobel laureate Paul A. Samuelson (1997) has emphasised the following characteristics of the U.S. model: "One, in America we now operate what we call the Ruthless Economy. Two, in America we now have a Cowed Labour Force."

of producing steel were at that time considerably greater than the prevailing world prices. Nevertheless, disregarding short term comparative advantage and against almost all economic advice, the Ministry of International Trade and Industry (MITI) deliberately encouraged and orchestrated the development of heavy industry in Japan. The rest is history. By the mid-1960s, Japan emerged as the lowest cost steel producer in the world and was outselling the U.S. steel industry in the U.S. itself. By early 1970, it was producing as much steel as the U.S. By 1975, Japan had overtaken Germany as the largest exporter of automobiles in the world. By 1980, Japan produced more automobiles than the US. Looking back on this phenomenal growth, it is that this incredible catch-up occurred over the relatively short span of 30 years.

One might argue that Japan was a special case because it had been undergoing industrialisation since the Meiji Restoration in 1870. However, S.Korea, which consciously followed the Japanese economic strategy was unequivocally backward in industrial development in the 1950s. In 1955 Korea's per capita manufacturing output was only $US 8 compared with $US 7 in India and $US 60 in Mexico.[6] Less than four decades later, Korea has become an industrially developed economy. It competes with advanced economies in a wide range of industrial products. Next to the U.S., it is the second most important country in the world in electronic memory chip technology (DRAM). By the year 2000, Korea was expected to become the fourth largest producer of automobiles in the world.

The Japanese and S.Korean development models have been followed to varying degrees in Taiwan Province of China and Singapore but, more significantly, also in Malaysia, Indonesia, and Thailand. There are important differences in aspects of industrial strategy followed by these five countries compared with that of Japan and Korea. The second group of countries have, for example, relied much more on FDI compared with the first group. Nevertheless, all these countries have followed the basic model of guided capitalist development rather than relying on free competitive markets.

The outstanding economic success of this group of East and South East Asian countries, together with Hong Kong, is widely acknowledged. These countries have been able to industrialise quickly and grow very fast over the last three decades (see Tables 1 & 2). Indeed, since 1980, this part of the world has emerged as the most dynamic region in the world economy (Table 1). Between 1980 - 1995, developing East Asia was growing at three times the rate of growth of the international economy.

Significantly, fast growth was accompanied by low inflation as is indicated by the data for the affected Asian countries in Tables 3. Moreover, World Bank (1993) notes "… For the eight HPAEs (high performing Asian economies), rapid growth and declining inequality (in income distribution) have been shared virtues, as comparisons over time of equality and growth using Gini coefficients illustrate."[7] In addition, as Stiglitz rightly emphasises, one of the most important achievements of Asian

[6] The source of these figures is Maizels (1963). Quoted in Amsden and Hikino (1993).

[7] The World Bank's conclusion of declining income inequality in East Asian economies is, however, subject to important qualifications. See further, Singh (1995a, 1997a) and UNCTAD (1997).

countries during this period was an enormous reduction in poverty. Stiglitz (1998a) observes: "In 1975, six out of 10 Asians lived on less than $1 a day. In Indonesia, the absolute poverty rate was even higher. Today, 2 out of 10 East Asians are living in absolute poverty. Korea, Thailand and Malaysia have eliminated poverty and Indonesia is within striking distance of that goal. The USA and other western countries, which have also seen solid growth over the last 20 years but with little reduction in their poverty rates, could well learn from the East Asian experience."[8] Indonesia's success in reducing poverty is particularly remarkable. In 1970, 60% of the population was living below the official poverty line. By 1996, the proportion had fallen to 12%, while during this period the population had increased from 117 to 200 million. (*IMF Survey* 16 August 1997.) Table 5 shows changes in social indicators of development for selected ASEAN countries between 1970 and 1994.

There is still further evidence which suggests that these high performing economies, most of which were working under some versions of the Asian model, not only achieved fast growth for the last three decades but that this growth was widely shared. Between 1980 and 1992, real wages in the fast growing Asian NICs rose at a rate of 5 per cent a year, whilst at the same time employment in manufacturing increased by 6 per cent a year. Some of these hitherto labour surplus economies began to experience a labour shortage and imported labour from neighbouring countries. Overall, in South East and East Asia, there was a vast improvement in the standards of living of literally hundreds of millions of people, especially if China is also included in this group of countries.[9]

The above highly positive East Asian record stands in striking contrast to that of large parts of the developing world in the recent period. In relation to Latin America, for example, ILO (1995) reports that during the 1980 and the early 1990s there was a steady fall in modern sector employment, with paid employment falling at a rate of 0.1 per cent a year. This reversed the trend of the previous three decades, when steady economic growth had led to a significant expansion of modern-sector employment. As will be seen later, there has been a huge "informalisation" of the labour force in Latin America since the debt crisis of the early 1980s, that is, most new jobs that have been created during the last fifteen years are low quality, informal jobs paying low wages. The average real wage in manufacturing in 1995 was still below its pre-debt crisis level, (See section VII, below).

III. The East Asian Model

Before any causal connection can be established between the Asian model of capitalism and the current financial crisis in the South East and the East Asian countries, it is important to be clear about the precise nature of this model of development. In this connection it is interesting to observe that, in the 1990s, the international financial institutions' (IFIs) theses -- specifically the World Bank's --

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8 "Restoring the Asian Miracle", *Wall Street Journal*, Europe (February 3, 1998, p. 4).

9 Although China has a different political system, there is evidence that during the last two decades of the relative liberalisation and marketisation of the economy, the country has attempted to emulate the East Asian model. See further, Nolan (1995) and Singh (1996a).

concerning (a) the basic characteristics and (b) the effectiveness of the Asian model have undergone a number of distinct changes.

At the first stage, in a seminal contribution,[10] World Bank (1991) claimed the East Asian countries were successful because they followed a "market-friendly" strategy of development and integrated their economies closely with that of the world economy. In order for the term not to be a mere tautology, the Bank's economists to their credit defined "market-friendly" in a fairly precise way as follows: (1) "intervene reluctantly", i.e. the government should intervene in economic activity only if the private sector is unable to do the tasks required; (2) interventions should be subject to checks and balances, and (3) interventions should be transparent. This characterisation essentially suggested a "night watchman" state, the main task of which was to provide the legal framework and the infrastructure necessary for private enterprise to flourish.

These propositions concerning the East Asian economies could not however be sustained as they were greatly at variance with facts. Critics pointed out that all the evidence suggested that the governments in countries like Japan and Korea did not "intervene reluctantly". Rather they pursued a vigorous industrial policy, the basic purpose of which was to change the matrix of prices and incentives facing private enterprise in the direction preferred by the planners. Similarly students of the subject pointed out that neither Japan or Korea for instance closely integrated their economies with the rest of the world. Although both countries were export-oriented, both of them made extensive use of selected import controls to protect specific industries.[11] Moreover both countries discouraged rather than promoted inward foreign investment.

At the second stage, in response to these criticisms, in another seminal publication in 1993 (*The East Asian Miracle*), World Bank economists significantly changed their characterisation of the East Asian model. The fact of enormous government interventions in these economies was now fully acknowledged. The World Bank (1993) stated:

> Policy interventions took many forms - targeted and subsidised credit to selected industries, low deposit rates and ceilings on borrowing rates to increase profits and retained earnings, protection of domestic import industries, the establishment and financial support of government banks, public investment in applied research, firm- and industry-specific export targets, development of export marketing institutions, and wide sharing of information between public and private sectors. Some industries were promoted while others were not.

[10] The significance of this contribution is discussed in Singh (1995a).

[11] As late as 1978, long after Japan had become a member of the OECD and had greatly reduced or abolished most formal import restrictions of the earlier era, its manufactured imports were only two percent of GDP. The comparable figures for countries like France, Germany and Britain were at that time five to six times as large. See Singh (1994).

Nevertheless, the Bank argued that, although the government intervened heavily, these interventions were neither necessary nor sufficient for the extraordinary success of the East Asian countries. The World Bank (1993)concludes:

> What are the main factors that contributed to the HPAE's superior allocation of physical and human capital to high yielding investments and their ability to catch up technologically? Mainly, the answer lies in fundamentally sound, market-oriented policies. Labour markets were allowed to work. Financial markets … generally had low distortions and limited subsidies compared with other developing economies. Import substitution was … quickly accompanied by the promotion of exports. … the result was limited differences between international relative prices and domestic relative prices in the HPAE's. Market forces and competitive pressures guided resources into activities that were consistent with comparative advantage …

In other words it was suggested that, notwithstanding the facts of heavy government intervention in East Asian economies, the Bank's traditional policy conclusions - that countries should seek their comparative advantage, get the prices right, have free markets as far as possible - are still valid.

Now, in the wake of the current financial crisis in South-East Asia, the IMF in particular is suggesting that important characteristics of the East Asian model are dysfunctional.[12] Especially singled out for criticism are: (a) the close relationship between government and business, and (b) various distortions to competitive markets. The relationships under (a) are regarded as creating crony-capitalism, leading to corruption and a myriad inefficiencies in resource allocation. The inference is that these countries should go back to the World Bank (1991) prescription of a "night watchman" state and an economy which is closely integrated with the world economy.

The Bank's critics vigorously dispute its theses on the lack of effectiveness of interventions in the East Asian economies.[12] There is, however, now much greater agreement between the two sides on the broad description of the model as outlined in the first of the two quotations from World Bank (1993) above. Based on my own previous research and that of other scholars, there would be more or less agreement on the following characteristics of the East Asian model in its "ideal form": [14]

1. The close relationship between the government and business where the government does not do anything without consulting business and vice versa.

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[12] As indicated earlier, the World Bank's Chief Economist, Professor Stiglitz, takes a rather different view of the crisis than that of the Fund. However, as Wade & Veneroso (1998) suggest the position of the relevant operational departments of the Bank is closer to that of the IMF than to that of Professor Stiglitz.

[13] For comprehensive critical analyses of the World Bank (1993) theses, see the contributions in Amsden (1994); see also Singh (1995a).

[14] See Singh (1995a, 1997a, 1997b); see also Okimoto (1989), Tsuru (1993), Amsden (1989), Wade (1990) and Amsden and Singh (1994).

2. Many interventions are carried out through a system of "administrative guidance" rather than through formal legislation.

3. The relationship between the corporation and the financial system in countries like Japan and Korea has also been very different from that of the US and the UK. The former countries have followed, for example, the so-called main bank system which involves long-term relationships between the corporations and the main banks. This enables Japanese or Korean managers to take a long-term view in their investment decisions. The managers are not constrained by the threat of hostile take-overs on stock markets as is the case in the Anglo-Saxon countries.

4. There are differences in the internal organisation of East Asian corporations compared with those of the US and the UK. The former involve co-operative relationships between management and labour, epitomised by the system of lifetime employment. This implies considerable imperfections in the labour market.

5. As for the competition in product markets, such competition is not regarded by the East Asian authorities as an unalloyed good. Unlike in countries like the US, economic philosophy in the East Asian countries does not accept the dictum that "the more competition the better." The governments in these countries have taken the view that, from the perspective of promoting investment and technical change, the optimal degree of competition is not perfect or maximum competition. The governments have therefore purposefully managed and guided competition: it has been encouraged but also restricted in a number of ways.[15]

6. Following this basic economic philosophy outlined above, the East Asian governments have sought not "close" but what might be called "strategic" integration with the world economy i.e. they have integrated up to the point where it has been useful for them to do so. Thus during their high-growth, developmental phases, Japan (between 1950 - 1973) and Korea (1970s and 1980s) integrated with the world economy in relation to exports but not imports; with respect to science and technology but not finance and multinational investment.

As noted above, this is a characterisation of the East Asian model as an ideal type. Not all countries, or even Japan and Korea have followed the model exactly at all times in the post-war period. As far as the government-business relationships are concerned there is a continuum with the closest relationship to be found in Korea, and the least close in Thailand. Malaysia and Indonesia fall in between. Similarly, the main bank system worked differently in Korea compared with Japan. Unlike Japan, where the "main banks" were by and large private entities, in Korea for much of the period these were directly state-controlled. Only in the recent period have they been privatised. Nevertheless, there is considerable truth in the view that the Asian way of doing business and the institutional structures it has generated are considerably different from those of countries like the U.S. and the U.K.

IV Causes of the Crisis

Table 6 outlines the salient financial facts concerning the crisis in the East and South East Asian countries during the last six months. In the worst affected country, Indonesia, the stock market has fallen by more than 80 per cent and the exchange rate of the rupiah against the dollar by almost 75 per cent. This implies that a foreign investor who invested $100 in a company quoted on the Indonesian stock market would have seen the value of his/her investment fall by 96 per cent during the half year. By the same token, it also means that if a foreign corporation had to pay $100 to acquire an Indonesian company in July 1997, it could in principle purchase it now for only $4. This is of course not just a theoretical possibility, but as Krugman (1998) notes, there is evidence of a "fire sale" of East Asian assets currently in progress in the wake of the financial crisis.[16] The twin crises of the stock and currency markets have also resulted in corporate and financial sector bankruptcies with huge losses of production and jobs.

Those who attribute the crisis to the failings of the Asian model suggest that, while there may have been various immediate triggers -- a property price bubble, macroeconomic mistakes (for example, supporting for far too long a nominally fixed exchange rate), a fall in the rate of growth of exports, or a regional contagion effect -- the underlying causes were structural and an integral part of the Asian model of capitalism. The crisis manifested itself in the form of "overinvestment" (see further below), misallocation of foreign capital inflows, and severe problems in the financial sector. The financial structure of the corporations and the banks, as well as other deficiencies of the state-guided or state-directed financial systems in Asian countries, made these economies very fragile. IMF (1997, p.14) points to the following specific structural weaknesses of the most affected economies.

- In Korea, the industrial structure has been heavily influenced by government intervention, including, as well as directed credits, regulations and explicit or implicit subsidies. The resulting lack of market discipline has contributed to the problem of unproductive or excessive investment that has played a role in the build-up of the recent crisis.

- In Indonesia, trade restrictions, import monopolies, and regulations have impeded economic efficiency and competitiveness, and reduced the quality and productivity of investment.

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[15] For a fuller discussion, see Amsden and Singh (1994).

[16] Krugman reports that in the case of South Korea, the price of its corporations to foreign buyers essentially fell by 70 percent during 1997. Thus, the stock market value of Korean Air Lines with a fleet of more than 100 aircraft at the end of 1997 was only $240 million. This is approximately the price of two Boeing 747s. However, any acquirer would also have to take on the Korean Air Lines debt of $5 billion.

- In Thailand, political disarray at various times during 1996-97, including in the wake of the November 1996 general election, delayed the implementation of necessary policy measures. In these and other cases, the power of special interests has often appeared to have had considerable influence on the allocation of budgetary resources and other public policy actions.

- In a number of countries, uncertainty has been increased and confidence adversely affected by inadequate disclosure of information and data deficiencies, particularly with regard to extra- budgetary fiscal transactions, the quasi-fiscal activities of the central bank, directed lending, the problem loans of financial institutions, official foreign exchange reserves and their management (including reserve-related liabilities), and private sector short-term debt. There has also often been a lack of transparency in policy implementation, such as with the decisions regarding public infrastructure projects and ad hoc tax exemptions.

The failure of the Asian model thesis has powerful proponents including Mr. Greenspan, Mr. Summers and the IFIs. But it is by no means the only significant available theory with respect to the financial crisis. Many Asian political leaders have put forward an entirely different perspective. They are prone to blame the whole of the crisis on the activities of foreign speculators and reject the view that the crisis was essentially "home grown" (to use the phrase of the I.M.F Deputy Managing Director, Mr. Stanley Fischer).

A more sophisticated version of this "external factors" view is contained in the recent academic literature spawned by the Mexican crisis of 1994.[17] These contributions, based on careful theoretical and empirical analyses, show that it is entirely possible for a financial crisis to occur even when a country's fundamentals are totally sound. It may arise because of changes in investor sentiment or perceptions which may be triggered off entirely by external events such as changes in interest rates or equity prices in advanced countries. Some of these theories suggest that such crises of confidence can be self-fulfilling prophecies. Other models use the analogy of the classic panic-induced run on the banks to describe the present financial crisis in East Asian countries.

A third important theory ascribes the crisis to liberalisation of the global financial markets, and particularly to the deregulation of the capital account which many Asian countries had undertaken in the preceding period. It is suggested that the latter was the main cause of the crisis rather than any structural factors connected with the Asian development model. Indeed, it is argued that if these countries had continued to follow the Asian model of state-guided investment and state direction of the financial system, there would not have been a crisis at all in the first place. The crisis occurred directly as a result of deregulation and liberalisation when the governments relinquished controls over the financial sector as well as corporate

[17] See for example Calvo and Mendoza (1996), Sachs, Tornell and Velasco (1996), Cole and Kehoe (1996), Krugman (1998).

investment activities. This led to misallocation (towards, for example, the property sector) of investment as well as overinvestment.

As these theories are central in determining the choice of remedies for the crisis, it is clearly important to know which of them is more congruous with the facts. The events are too close to be able to provide anywhere near a definitive explanation of the crisis, but the following section will review the evidence.

V. Evidence on the Theories Concerning the Crisis

The survey below of available evidence bearing on the alternative theories of the present financial crisis in South East and East Asian countries is organised around the following themes:

(a) the role of fundamentals;
(b) the proximate cause of the crisis – the capital supply shock;
(c) the role of structural factors; and
(d) financial liberalisation

V.1. Fundamentals

The most important point to note here is that all the affected countries prior to the crisis had for a long time enjoyed strong "fundamentals." This is evident from our earlier discussion in Section II and from the more detailed data presented in Tables 1-3. Thailand, Indonesia, Malaysia, and Korea had all recorded extraordinarily strong economic growth for many years; their inflation rates were usually in single figures and much below the developing country average. These countries also had high domestic savings rates, indeed considerably greater than those of other developing countries including Brazil, Mexico, and India (the three countries for which data is provided in Table 4 for comparative purposes.)

Moreover, the crisis countries had healthy fiscal positions. The public sector finances were either in surplus or had small sustainable deficits. The fiscal position of these countries compared very favourably with the average of developing countries as well as with that of Brazil, Mexico, and India.

A potentially significant blemish on this generally positive pre-crisis long-term economic record was the position of the current account balance in the some of the affected countries. Thailand and Malaysia have experienced huge current account deficits, which in the 1990s amounted to nearly 6.9 percent of GDP in the case of Thailand, and 6 percent of GDP for Malaysia. In 1996 the Thai current account deficit was almost 8 percent of GDP while that of Malaysia had fallen to 4.9 percent. Nevertheless, it is also the case that both those countries had a relatively low debt service to exports ratios throughout the 1990s -- 4.5 percent for Thailand, and 6 percent for Malaysia. Furthermore, in the case of Malaysia, as Table 7 on external capital flows indicates, the high current account deficit was to a considerable extent financed by a strong net inflow of foreign direct investment.

The Korean current account deficit in 1996 was 4.9 percent of GDP, an unusually high figure for Korea. Korea was not however a persistent offender - its average deficit during the 1990s was less than 2 percent of GDP. The larger 1996 deficit was caused by special circumstances, notably the collapse of prices of semi-conductors of which Korea was a major exporter. However, this sharp increase in the current account deficit was a temporary phenomena, as one would expect from a highly diversified export-oriented economy. Indeed, in the last quarter of 1997 the Korean economy recorded a huge current account surplus of $3 billion. Indonesia's current account deficit during the 1990s averaged 2.6 percent of GDP; in 1996 it was 3.3 percent, an entirely sustainable figure on the past record of the economy. The only country where the current account deficit could be regarded as a real problem was Thailand. This is mainly because the deficit was being financed by bank borrowings (see Table 7).

It is also relevant to observe that, as late as September 1997, the Korean debt had a high rating from western rating agencies. Similarly, until almost the eve of the financial crisis in August 1997, the IMF was praising the Indonesian government for its successful management of the economy as well as for its achievements in reducing poverty. [18]

To sum up, all the affected Asian countries had strong "fundamentals" in the sense of a proven record of being able to sustain fast economic growth. In view of their export orientation, they also had the ability to service their debts in the long term. They did, however, suffer to varying degrees from short term imbalances such as overvalued exchange rates, as well as short term liabilities of the financial sector which exceeded the value of the central bank's reserves. This required some macroeconomic adjustments and restructuring of debts. In other words, these countries had problems of liquidity rather than solvency. In this context Wolf's (1998) observations concerning Indonesia are pertinent:

> Dwell for a moment, on Indonesia: its current account deficit was less than 4 percent of GDP throughout the 1990's; its budget was in balance; inflation was below 10 percent; at the end of 1996 the real exchange rate (as estimated by J.P. Morgan) was just 4 percent higher than at the end of 1994; and the ratio to GDP of domestic bank credit to the private sector had risen merely from 50 percent in 1990 to 55 percent in 1996. True, the banking system had mountains of bad debt, but foreign lending to Indonesian companies had largely bypassed it.
>
> Is anyone prepared to assert that this is a country whose exchange rate one might expect to depreciate by about 75 percent? Some exchange-rate adjustment was certainly necessary; what happened beggars belief.

V.2. The Capital Supply Shock

[18] See *IMF Survey*, Vol.26, No.16, August 18, 1997.

It is generally agreed that the proximate cause of the crisis in all the four affected countries was the capital supply shock – the sudden interruption and reversal of normal capital inflows into these economies. Table 8, which provides aggregate financing figures for these countries plus the Philippines, indicates that their net external capital inflows more than doubled between 1994 and 1996 -- from a little over $40 billion to more than $90 billion. The latter figure greatly exceeded the combined current account deficits of these countries, allowing them to build sizeable reserves. In 1997, however, there was a huge capital supply shock: the net inflow of $93 billion in 1996 turned into a net outflow of $12 billion in 1997, a turnaround of $105 billion. The latter figure is equivalent of 10 per cent of the pre-crisis GDP of these countries (Wolf (1997). The decomposition of the capital inflows in Table 8 suggests that the most volatile item was commercial bank lending which turned from a positive figure of over $50 billion in 1996 to a negative figure of $21 billion in 1997.

What the above evidence on the "fundamentals", as well as the analysis of section II on the long-term supply-side capabilities of these economies suggests is that, whatever the trigger for the crisis (whether external macroeconomic imbalances or the liabilities of the financial institutions) the foreign commercial banks grossly over reacted, giving rise to a classic panic induced bank--run - with the difference that it is the external creditors who were withdrawing their funds (from, say, Thailand) before the country defaulted. Such behaviour on the part of the banks makes default or a major IMF bail-out a self-fulfilling prophecy.

V.3. Structural Factors

Turning to the "structural factors" connected with the Asian model, which the IMF and others implicate in the crisis, we first consider the issue of "transparency." It is suggested that, because of the nature of the Asian corporations (involving extensive cross-subsidisation of subsidiaries) and their close, non-arm's length relationship with banks, and similar relationships between banks and governments, the markets did not have enough information about the true financial status of the corporations and the banks. This is regarded as being one important reason for the overreaction by the markets.[19]

However, in relation to this proposition, the following observations are relevant. First, as Stiglitz (1998a) notes, following financial liberalisation there have been similar banking crises in the early 1990s even in the Scandinavian countries. These countries would be regarded by many as being at the top of any international transparency league: the availability of reliable information was evidently not adequate by itself to prevent financial panics. Secondly, it is specifically claimed that international banks did not have accurate and timely information on the shortening maturity of bank claims on Asian countries. This complaint is also controversial. As

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[19] Thus Mr. Camdessus (1998): "In Korea, for example, opacity had become systemic. The lack of transparency about government, corporate and financial sector operations concealed the extent of Korea's problems – so much so that corrective action came too late and ultimately could not prevent the collapse of market confidence, with the IMF finally being authorised to intervene just days before potential bankruptcy."

Professor Alexandre Lamfalussy, the former chief economist at the Bank of International Settlements noted in a recent letter to the *Financial Times* (February 13, 1998):

> …the Bank for International Settlement is encouraged to speed up the publication of its statistics on international bank lending…The suggested improvement will surely do no harm but it will not do much good either as long as market participants and other concerned parties fail to read publicly available information or to draw practical conclusions from it.
>
> In the summer of 1996 the BIS reported in its half yearly statistics that by end-1995 the total of consolidated bank claims on South Korea, Thailand, Indonesia, and Malaysia reached \$201.6bn. It reported in January 1997 that by mid-1996 the figure rose to \$226.5bn and six months later, that by end-1996 it reached \$247.8bn – an increase of 23 per cent in one year. For each of these dates the maturity breakdown was available. It was therefore known by mid-summer 1996 that bank claims maturing within one year made up 70 per cent of the total for South Korea, 69.4 per cent for Thailand, 61.9 per cent for Indonesia, but "only" 47.2 per cent for Malaysia.

Professor Lamfalussy goes on to add:

> Moreover, in its Annual Report published on June 10 1996, the BIS did not hesitate to use strong words describing developments that had taken place already in 1995: '…By year end, Thailand had become the largest bank debtor in the developing world….

Thirdly, in relation to this argument about transparency and information, it is also pertinent to note that international banks lent huge sums of money to merchant banks in South Korea. Most of the latter did not have a long enough track record, being less than two years old (Chang 1998). Many would regard such lending practices to be highly imprudent, if not reckless.

Turning to other structural features of the Asian model which it has become customary to blame for the crisis, we consider first the questions of overinvestment and misallocation of investment in countries like Thailand to the non-productive property sector. Here it is important to observe that if in the process of financial liberalisation, the governments of countries like Korea and Thailand had not eschewed control over their financial sector and corporate investment activity, such overinvestment and misallocation would not have occurred. It was therefore not the Asian model but the abandonment of one of its essential features which was directly responsible for the observed weaknesses that came to the fore.

Another structural characteristic of the Asian model which is the subject of much adverse comment in orthodox analysis of the current crisis pertains to corporate finance. As is well known, the typical corporation particularly in Japan, Korea, or Thailand is heavily geared, i.e. has a high ratio of debt to the equity capital of the shareholders. The Korean *chaebol* enterprises which spear-headed that country's extraordinarily successful industrialisation drive and the continuous technological upgrading of its exports over the last three decades are typically family owned. They are however very big – 11 South Korean companies are included in *Fortune* magazine's top 500 in the world. To put this figure into perspective, it may be useful to note that Switzerland, a far more developed economy, also has only 11 companies in the world's top 500. [20] In order for the families to be able to own such huge corporations, the equity component of the total invested corporate capital tends to be small relative to debt. Table 9 shows the debt-equity ratios of leading Korean corporations. Table 10 provides a comparative analysis of the debt equity ratios of the largest quoted companies in nine emerging markets in the 1980s and 1990s. It clearly indicates that the Korean companies are relatively very heavily geared with a median value of the debt to equity ratio of 4.3 between 1980 and 1994. However the bottom two parts of the Table indicate that between the early 1980's and the early 1990's, this fell from 5.48 to 3.96 . The Table also reveals that the Asian corporations, including those from India, have considerably higher debt-equity ratios than those of the Latin American corporations.

However, the important point to note is that such corporate financial arrangements have been functional within the traditional Asian economic system. This is in part due to the continuous monitoring of the corporations by "main banks" with whom they have long term relationships, as well as to the close oversight by the government over the banks. These arrangements were particularly useful during Korea's industrialisation drive, as the corporations were induced by the government to enter into new technological areas involving huge risks. Left to themselves, the corporations may not have been able to undertake such risks, but with the government becoming in effect a co-partner through the banking system, such technological risks were "socialised". Following the work of Williamson (1976), Lee (1992) has characterised this system as essentially constituting an internal capital market. In view of the well known weaknesses of free capital markets (e.g., a tendency towards short termism and quick profits) such an internal capital market may in fact be more efficient than the former.[21]

However, such a corporate system became dysfunctional when, for example, in Korea the government undertook during the last few years a process of financial liberalisation (under pressure from the U.S. government and the IFI's, but see the discussion in Section VIII). Korea resisted allowing non-residents to buy majority stakes in its corporations. However, its mistake was to implement other components of capital account liberalisation by permitting Korean companies and banks to raise money abroad without the traditional supervision and control. So, in that sense, it was again financial de-regulation (i.e. the dismantling of a fundamental aspect of the previous system) which rendered the system dysfunctional and fragile.

It is interesting in the above context to consider the case of India. As Table 10 indicates, the Indian corporations are also very highly geared. Moreover India's

[20] See further Amsden and Hikino (1994), Singh (1995).
[21] There is a large literature on these issues. For a fuller discussion, see further Aoki and Patrick (1996); Singh (1996b); Singh and Weisse (1998).

fundamentals, as Tables 3 and 4 (discussed earlier) suggest, were much weaker than those of the East Asian countries. Nevertheless, India has not had a financial crisis. At a time of deep turbulence in the currency markets of its South East and East Asian neighbours, the Indian currency market has been a model of stability. Why? Most observers would agree that the main reason for this is that India has rather limited capital account liberalisation. It does not allow its corporations or banks to borrow or lend capital abroad without government approval. It has carried out some liberalisation by allowing non-residents to purchase shares directly on the Indian stock markets, but they cannot become majority shareholders. This limited, cautious openness, the relatively small size of foreign portfolio inflows as well as that of the stock market itself has been helpful to the Indian economy. The Indian currency is consequently much less vulnerable to changes in investor sentiment or speculative attacks from outside.

VI. The IMF Policy Programme and the East Asian Crisis

As the financial crisis deepened in East Asia during the last six months and more and more countries became involved, the IMF assembled large financial packages to bail out the affected countries. However this aid was available only in return for strict conditionality. Apart from their usual policies of demand restraint (cuts in money supply, high interest rates, fiscal retrenchment, etc.) the Fund went further. It recommended far-reaching changes in the economic and social systems of these countries. These changes included further liberalisation of the financial sector (including permitting hostile take-overs of domestic firms by non-residents); changes in the system of corporate governance, in labour laws, in government business relations, and in competition policy. Such measures were insisted on because it was believed (erroneously as we have seen above) that the root cause of the crisis was the "dirigiste" institutional structures and policies of these countries.

Following the important work of the Chief Economist at the World Bank, Stiglitz (1998a, b), as well as that of leading independent economists, Sachs (1997), Feldstein (1998a, b), Wade and Veneroso (1998), Amsden and Euh (1997), Akyuz (1997), the difficulties with the IMF policy programmes may be summarised as follows :

1. The institution's traditional policy programme of demand restraint etc. is typically designed to deal with countries with persistent current account disequilibria, fiscal deficits, and over-heated economies. For the Asian economies, however, except perhaps to some extent for Thailand, the problem has been one of capital account disequilibrium rather than that of current account imbalances. Moreover, as we have seen earlier, the public sector finances in these countries (including Thailand) have been by and large in equilibrium and it is the private sector which is in severe disequilibrium. In these circumstances, the large fiscal austerity required by the IMF's original programmes for these countries would have made matters worse rather than better, pushing the countries deeper into recession, and thereby exacerbating the private sector financial disequilibria.

2. The high real interest rates entailed by the programmes are likely to greatly impede the private sector's viability. Such rates may indeed lead to the bankruptcy

of a large part of the sector, deepening the depression of the real economy. In response to this criticism, the IMF has argued that higher interest rates are required for restoring international confidence in the countries' policies. Stiglitz's (1998) counter argument is that there is little empirical evidence to support the view that high interest rates improve confidence. He goes on to add that one could perhaps make a case for an increase in interest rates for a brief spell, but countries like Indonesia and Thailand have had real interest rates of 20 per cent or more now for nearly nine months.

There is some truth in both these contentions. Evidence from the financial crisis in the various parts of the world suggests that higher interest rates help before a crisis has occurred (i.e. they may forestall the crisis) but once the crisis has taken place, increasing interest rates is often regarded by the market as a sign of weakness and is therefore counter productive.

3. The international financial institutions (IFIs) are quite right to stress the importance of prudential regulation and supervision of the financial sector. Certainly, financial liberalisation by the affected countries without such regulations was a serious mistake. However, to forestall the crisis, the IFIs should have discouraged financial liberalisation by these countries until the appropriate regulatory regime was in place. This the institution did not do, presumably because of its own strong commitment to external account liberalisation. Further, it is a moot point whether under a regime of free capital flows, prudential regulation of the domestic financial sector, without that of international banks as well, would have been enough to prevent a financial crisis. [Akyuz (1997); Stiglitz (1998)].

4. The misdiagnosis of the crisis by the IFIs (that it has been due to the *dirigiste* model of Asian capitalism rather than being caused by internal and external financial liberalisation) has had serious adverse consequences for the affected countries. It is certainly arguable that the IFIs' emphasis on what was perceived to be the fundamental structural difficulties of the Asian model (crony capitalism, corruption etc.), panicked foreign investors still further, and thereby worsened the crisis [Feldstein, 1998 a, b].

5. As the evidence outlined earlier (the strong fundamentals, the large inflows of private capital from abroad and IFIs' approval of economic management of these countries until the eve of the crisis), suggests the East Asian crisis was originally one of liquidity rather than solvency. In these circumstances, it would have been preferable for the institutions to have acted as an intermediary to help bridge the gap between lenders and borrowers over the time profile of repayment. Instead, huge sums of money were raised for bail-outs and imposed far-reaching conditionalities on the crisis countries which could be interpreted as signalling a deeper crisis of insolvency rather than one simply of liquidity.

6. Professor Feldstein [1998 a, b] makes an important point of political economy concerning the IMF programmes which deserves serious consideration by the international community. He notes that the IMF is an international agency whose purpose ought to be to provide technical advice and, as appropriate, the financial

> assistance necessary to help countries overcome a balance of payments crisis with as little loss of output and employment as possible. It may also wish to ensure that the country continues to follow the right economic policies so that, as far as possible, the situation does not re-occur. However, he suggests that the IMF "should not use the opportunity to impose other economic changes that, however helpful they maybe, are not necessary to deal with the balance-of-payments problem and are the proper responsibility of the country's own political system."

Professor Feldstein proposes the following three-point test for the structural aspects of the IMF conditionalities:

> In deciding whether to insist on any particular reform, the IMF should ask three questions: Is this reform really needed to restore the country's access to international capital markets? Is this a technical matter that does not interfere unnecessarily with the proper jurisdiction of a sovereign government? If the policies to be changed are also practised in the major industrial countries of Europe, would the IMF think it appropriate to force similar changes in those countries if they were subject to a fund program? The IMF is justified in requiring a change in a client country's national policy only if the answer to all three questions is yes. (Feldstein, 1998b)

Unfortunately, Professor Feldstein suggests that the answers to none of the three questions above for S.Korea, for example, is in the affirmative. The structural conditions imposed on S.Korea include fundamental changes in labour regulations, corporate governance, the relationship between government and business. These clearly involve deeply political matters. Moreover, few governments can deliver such reforms in a short space of time and this unnerves the markets, making the resolution of the crisis more difficult.

VII. Economic and Social Consequences of the Adjustment Programmes.

The adjustment programmes agreed with the IMF by the affected countries are likely to have serious economic and social consequences not only in the short term but also perhaps in the medium to long term. The IMF economists own estimates of the impact of the programmes would appear to be rather optimistic.

VII.1 Short to Medium-Term Impact on Employment, Poverty and Ethnic Relations

The IMF's original projections (in December 1997) for GDP growth for 1998 for selected Asian countries are shown in Table 11. These indicate that, apart from Thailand for which no growth is projected, the expected growth in affected countries will be 2 to 2.5 percent per annum. Although for Indonesia, Malaysia and Korea this represents a sharp slow down from their long-term growth trajectory, there is still a positive growth rate. Table 12, however provides the composite average forecasts for GDP growth for 1998 by independent analysts - the investment banks Credit Lyonnais, HBSC James Capel and J. P. Morgan. These suggest a deep depression for

Thailand and Indonesia, and severe recession for Korea. The previous record of the Fund's programmes in other countries (see further the discussion on Latin American countries below) suggest that the composite projections are more likely to be near the mark. [22]

What will be the social consequences for the crisis countries of the negative growth rates for 1998 as suggested by independent organisations? Further, how long will it take for economic growth in these countries to reach the previous long-term levels?

In relation to the first question, theoretical analysis and international evidence indicate that there would be significant effects in the following areas:

- unemployment, underemployment and quality of jobs;
- poverty and income distribution;
- ethnic relations (in the case of some of the affected countries, there are special aspects relating to ethnic composition of the population and distribution of assets among ethnic groups which could have serious social and economic ramifications.)

Moreover, in addition to reduced growth, adjustment will entail in the short term at least much higher inflation, as a consequence of currency depreciations. Also the fiscal restraint introduced as part of the adjustment package is likely to entail cuts in social expenditures such as health and education. To the extent that the World Bank's countermeasure to contain the social effects of the crisis are not fully effective, the impact of reduced growth on poverty and income distribution is likely to be compounded. Unemployment, poverty, worsening income distribution and rising prices could in turn all generate ethnic tensions.

As it is still an unfolding crisis, hard evidence on the full social dimensions will not be available for some time. The *Financial Times* reported at the end of last year (December 10, 1997, p. 4) enormous job losses throughout Asia, and even in countries that just months earlier were experiencing labour shortages. The Thai government estimates job losses will total about 1.5 million by the end of 1998; in Korea these are expected to be nearly a million. Similarly, labour unions in Indonesia expect unemployment in that country to rise by one million by the end of 1998 (ILO 1998).

These could well turn out to be optimistic numbers in view of the expected decline in economic growth and of the uncertainty as to how long slow growth will continue. The main determinants of aggregate employment and poverty in developing countries are the trend rate of economic growth and of inflation. As we saw earlier, with high growth rates and low inflation, the Asian economies during the 1980s and 1990s were able to achieve not only fast growth of employment but also rapidly growing real wages. In Latin America and Africa, on the other hand, despite falling or

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[22] Subsequently, both the IMF and independent economists have revised their projections for GDP growth in the affected countries in a downward direction. The Financial Times in its editorial of 1 July, 1998 reported as follows : ' The latest consensus is Indonesian GDP will shrink 13% this year, Thailand's 6%, South Korea's 4% and Malaysia's 2%. The forecast for the next year is for further sluggishness. The outcome will probably be worse'.

stagnant real wages, modern sector employment fell. As there are no adequate social security systems in most developing countries, those who become unemployed in the formal sector are obliged to seek work in the informal sector regardless of how poorly remunerated or productive such work may be. In other words, what we find in poor countries is that reduced economic growth and reduced demand for jobs leads less to a rise in open employment but rather to a growth of disguised or informal sector employment. (This point is discussed further below.)

Islam (1998) has made some admittedly rough estimates of the likely effects of reduced growth on unemployment in Indonesia in 1998. His calculations are based on two alternative assumptions: (a) that the GDP growth rate in 1998 will be zero and (b) that the GDP growth rate will be minus 5 per cent. On the basis of desegregated sectoral data, unemployment is expected to increase to approximately 7 million in 1998 under assumption (a). This is 7.4 per cent of the labour force compared to less than five per cent in 1996. Under assumption (b), Islam projects an unemployment rate in 1998 of 8.8 per cent. It will be noticed that these estimates of increased unemployment in 1998 are considerably higher than the estimates of the Indonesian trade unions quoted earlier. However, Islam suggests that the open unemployment will turn out to be less than his estimates as a significant proportion of those losing their jobs will enter the informal sector for lack of alternative means of subsistence.

Stiglitz (1998a) provides some estimates of the increase in the incidence of absolute poverty as growth slows down in the affected countries. On the basis of zero growth and unchanging income distribution, he calculates that the poverty rates in Indonesia, Malaysia, Philippines and Thailand will worsen by the year 2000 but only by a few percentage points. He suggests that this will not reverse the gains made during the last five years. However, still assuming a zero growth rate but a worsening distribution of income, the worst case assumption of past experience indicates a substantial increase in poverty. But this increase in poverty will still not be sufficient to reverse the reduction in poverty of the last decade. It should be noted, however, that the Stiglitz estimates do not take into account the effects of any rise in the inflation rate which may follow from the crisis.

Very importantly, a major cause for concern in several East and South East Asian countries today is the prospect of ethnic violence. The minority Chinese community, which is often wealthy and the backbone of business in many of these countries, could become the victim of such violence as economic conditions deteriorate. Apart from its political consequences, such ethnic strife could destroy the entire fabric of economic development in the region. One important reason for East Asia's economic success has precisely been the capacity of the political system in these countries to be able to harness the wealth and the expertise of the Chinese community for economic development. The task of political leaders in the affected countries to maintain ethnic peace would become much more difficult as a consequence of economic decline.

VII.2 Duration and Long-Term Affects of the Crisis: Lessons from Latin America

The foregoing analysis, particularly of unemployment and poverty, has been based on the assumption that after a short period of reduced growth the economies of the affected countries will return to their previous long-term trend rates. This assumption may not, however, be realistic. Turning, therefore, to the crucial question of how long it might take to recover from the crisis, and what would be the social consequences if the crisis is a prolonged one, it is useful to examine in more detail the Latin American experience. In the last 15 years countries in the region experienced a major debt crisis and more recently many were faced by a huge financial crisis. Following the onset of the debt crisis in Mexico in 1982, and its spread by contagion to other Latin American economies, most countries adopted IMF programmes at some point. These programmes - as is also presently envisaged in the case of Asian countries - were intended to administer a short sharp shock which would lead to a speedy resumption of economic growth. This, however, did not happen. Nor did the heterodox policies followed by some governments succeed in achieving sustained economic growth with low inflation. Throughout much of the 1980s the Latin American countries were severely credit rationed by the international banks, and the result was a decade in which they experienced no growth and often hyper-inflation.

Following the introduction of Brady bonds and the implementation of neo-liberal "Washington consensus" policies, international capital flows to the region resumed towards the end of the 1980s. This led to a resumption of economic growth in the 1990s. But it is important to note that these countries have still not reached the previous trend rates of economic growth experienced before the debt crisis.

With regard to the social impact of the crisis, Tokman (1997) has systematically analysed the effects of changes in the pattern of economic growth and inflation in Latin America since the beginning of the debt crisis in the early 1980s to the mid 1990s on unemployment, income distribution and poverty. His main conclusions can be summarised as follows:

1. Economic growth, rather than labour market conditions, is the main determinant of changes in employment levels, particularly in the formal sector. The overall elasticity of employment with respect to output was found to be of the order of 0.8. (In other words, a 1 per cent increase in production leads to a 0.8 per cent increase in employment.) However, between 1980 and the early 1990s, eight of each ten new jobs occurred in the informal sector. Informal sector employment in the non-agricultural sector as a percentage of total non-agricultural employment rose from 40 per cent in 1980 to a massive 55 per cent by 1995.

2. As a consequence of this "informalisation" of the economy, the increase in open unemployment rates was not large. Nevertheless, open unemployment among youth reached 20 per cent.

3. Real wages in manufacturing fell by 14 per cent between 1980 and 1990, and even by 1995 were still 4 per cent below their 1980 level. In 1995, the minimum real wage was still 30 per cent below its 1980 level.

4. The percentage of households living below the poverty line rose from 35 per cent to 39 per cent between 1980 and 1990, whereas prior to the crisis poverty had been declining.

5. Income distribution is not only very unequal in Latin America, inequalities greatly increased during the period of adjustment.[23]

Returning to the question of how long the crisis may last, which is critical to an analysis of its social consequences, a discussion of the experience of Mexico in some detail is helpful. This is for two reasons. First, Mexico has been the Fund's star pupil in the region since the onset of the debt crisis in 1982, in the sense that it has most faithfully followed the Fund's policy advice. Secondly, Mexico's experience in overcoming the more recent "tequila" crisis of 1994/5 is often held up as a model for affected Asian countries to follow.

As in the case of Latin America as a whole, Mexico's record over the long period 1982-1997 does not provide much encouragement for Asian countries. In 1997, for the first time in 15 years, Mexico recorded a rate of growth of 7 per cent which is broadly in the region of its long-term growth rate of 6 per cent a year prior to the debt crisis. Even if this higher growth rate were to persist in the future, the country would have taken 15 years to recover its long-term growth trajectory (Singh 1997a; Ros 1997). However, various projections for the Mexican economy show its growth rate falling to 5 per cent in 1998 and to 4 per cent in 1999, whilst the current account deficit is projected to increase to US$ 7.3 billion from 1997 to US$ 13.4 billion in 1998, to US$ 16.4 billion in 1999. (The Financial Times, 12 March 1998)

Following the debt crisis, between 1982 and 1990, the Mexican economy did not grow at all. With the resumption of capital inflows, growth started again but the average growth rate between 1990 and 1996 was only 2 per cent. This is despite the fact that Mexico attracted huge net capital inflows amounting to US$ 91 billion in the period 1990 to 1993 -- one fifth of all such inflows to developing countries. From 1992 to 1994, annual capital inflows to Mexico averaged 8 per cent of GDP, compared with 5 per cent of GDP in the previous peak period 1977 to 1981. As argued in detail in Singh and Weiss (1998), these massive capital inflows were not based on the performance of Mexico's fundamentals but on the euphoria generated by Mexico's membership of the North American Free Trade Area (NAFTA).

The steep devaluation of the Mexican peso in December 1994 which triggered the "tequila" crisis caused the country to suffer a sharp but, fortunately in this case, brief economic reversal. In 1995, Mexico experienced a 15 per cent fall in aggregate demand, 26 per cent fall in investment and 7 per cent in GDP. However, following the interruption in international capital flows in 1995, capital flows resumed in 1996. In 1997, the country received a record US$ 12.1 billion in foreign direct investment. The *Financial Times*, in its recent review *Latin American Finance (*12 March 1998, p. 5*)* sums up Mexico's central economic problem as follows: "The economy needs to grow at 6 per cent a year to keep its young expanding population employed. The country lacks sufficient internal savings to finance such internal growth. So it

[23] On this subject there are important contributions by Fishlow (1997) and Morley (1995).

borrows capital from abroad, which creates a balance of payments shortfall, which in turn exposes Mexico to periodic financial crises when foreign investors pull the plug."

It is generally agreed that an important underlying cause of the huge balance of payments deficits in Mexico prior to the 1994 "tequila" crisis was overconsumption. In the wake of financial liberalisation, consumers went on a spending spree, with the result that Mexico's private savings fell from 15 per cent of GDP in 1990 to 5 per cent in 1994.

In contrast to the Mexican financial crisis of 1994, the present financial crisis in Asia has not been caused by a shortage or fall in domestic savings. All the affected countries have, as seen earlier, very high domestic savings rates. The large current account deficit in Thailand, for example, was not due to low savings. In 1996 Thailand's domestic saving rate was a huge 33 per cent of GDP, but its investment rate was even higher a little over 40 per cent of GDP (see Table 3). To the extent that a significant part of this investment is thought to have been allocated to "unproductive" uses such as real estate, the Thai crisis may be regarded as one of overinvestment.

There are good reasons to believe that Thailand's crisis of overinvestment may be more difficult and take longer to unravel than would a crisis of overconsumption[24]. This is due to the massive indebtedness of both the non-financial corporate sector and of the financial institutions. Technically, by western accounting standards, many of these corporations and banks may be bankrupt as a result of the enormous currency depreciation, the huge rise in real interest rates and the collapse in property prices. The experience of banking crises in other countries suggests that the restructuring of the balance sheets of banks and corporations is usually a protracted process even in the best of circumstances.[25]

VIII. Analytical Conclusions and Policy Implications

VIII. 1 Analytical conclusions

The main analytical arguments of this paper may be summarised as follows. Firstly, the current widely held and highly influential thesis that the root cause of the present financial crisis in South East and East Asian countries lies in the *dirigiste* model of Asian capitalism pursued by these countries is seriously mistaken. The analysis of the paper suggests that the fundamental reason for the crisis is to be found not in too much, but rather in too little government control over the financial liberalisation process which these countries implemented in the recent period.

Secondly, in view of the rather different circumstances of the Asian countries (compared with the kinds of countries that usually face financial difficulties), the IFIs appear to have misdiagnosed the crisis. They have therefore proposed inappropriate

[24] See also IMF (1997) on this point.

[25] What is generally regarded as a successful case - the resolution of the savings and loan crisis in the U.S - took a number of years to achieve in the 1980s.

remedies (for example, further financial liberalisation, large fiscal austerity, a steep rise in real interest rates) which are likely to deepen the crisis. Moreover, market confidence, which was of critical importance in the evolution of the crisis, is unlikely to have been helped by these institutions' emphasis on the ostensible fundamental structural weaknesses of these countries and requirement that they should implement far-reaching reforms in their economic and social systems. All these factors contributed to turning what was essentially a liquidity problem into one of solvency.

Thirdly, as explained in the previous sections, the governments of the affected countries made serious errors by not controlling the financial liberalisation process. Although it is true that the IMF as well as the U.S. government have been urging capital account liberalisation for these countries, it is also the case that a growing domestic constituency also supported such liberalisation. Thus, for example, prior to the crisis, Thailand and Malaysia were vying with one another as well as with Hong Kong and Singapore to assume the role of regional financial centre. This necessarily entailed considerable financial liberalisation. In the euphoria accompanying the large inflows of capital during the 1980s and 1990s, the benefits of becoming a regional financial centre were readily seen, (the development of the financial services industry, skilled employment etc.). However, the governments seemed oblivious to the potential costs.[26]

In addition to the pursuit of financial liberalisation without proper institutional controls, the governments of some of the crisis countries (particularly Thailand) might also have made some macroeconomic mistakes, for example, not adjusting the exchange rate, relying on short-term capital to finance a large current account deficit. Nevertheless, a central argument of this paper is that, although these government policy errors may have initiated the crisis, this was compounded by other factors: the lack of co-ordination between banks and the desire of each bank not to renew its short-term loans following the crisis of confidence; the herd behaviour of international investors which was partly responsible for the "contagion" throughout the region; and, as suggested above, the inappropriate policy response from the IFIs to the confidence crisis.

VIII.2 Policy implications

What are the policy implications of these conclusions? The basic policy issues which are closely interlinked are as follows:

1) How to restore investor confidence so that normal capital flows in the region are resumed;

2) How to ensure that long-term growth in the real economy is restored as quickly as possible; and

[26] Chang (1998) notes that a major ambition of the previous South Korean government was for the country to become an OECD member during its own term of office. In pursuit of that ambition the government was willing to forsake important parts of the Asian model, particularly control over investment activity and the financial transactions of large firms and banks.

3) How to provide immediate assistance to the millions of people who are likely to become unemployed or pushed back into poverty once again.

The importance of the last issue cannot be exaggerated. This is not just for humanitarian reasons but, as indicated in the previous section, it is also necessary for maintaining social peace. To provide such assistance effectively and on an adequate scale will require not only considerable imagination but also a large expansion in government activity and often direct intervention in the market processes. Such emergency safety net programmes may include selective subsidies, food for work schemes and public works projects, including the kind of labour intensive infrastructural projects which the ILO has pioneered in developing countries of Asia and Africa.[27] How to pay for these measures within the limits of fiscal prudence, let alone within the IMF fiscal austerity programmes, will be a major issue of political economy for these countries.

Turning to the first policy issue, the most important requirement for achieving a resumption of normal capital flows to the affected countries are economic policies which are credible and have wide domestic political support. Such credibility is much more likely to be achieved if there is political unity in the country and if there is close co-operation not only between government and business but also labour and civil society organisations in a national programme to resolve the economic situation. This would inevitably mean that the burden of adjustment would need to be equitably shared by all sections of society. Thus, the traditional Asian model of capitalism essentially based on corporatism becomes all the more essential if the present acute economic crisis is to be overcome.

The first best approach to resolving the present crisis of confidence is for the IMF and the affected countries to co-operate closely on the essential and immediate narrow task of restoring their access to the international capital markets. For this purpose, the IMF should act as an intermediary between the international banks and other major creditors on the one side and the private sector debtors on the other, in order to achieve a rapid restructuring of the debt. In this role, the institution needs to reiterate to investors and creditors the healthy fundamentals of these countries, their proven strong supply-side potential, their export orientation and therefore their ability in the medium to long term to service their debts. It is significant and most encouraging that in response to the criticism of its policy programmes, the IMF has already made some important changes such as softening the strong demand restraint measures required of Thailand and Korea. Although somewhat late in the day (rather than before the crisis began) the Fund has also been participating in discussions to facilitate the re-scheduling of the debts.

VIII.3 Policy implications for the ILO

The analysis of this paper has important policy implications for the ILO. The ILO’s traditional policy concerns relate, among other things, to employment, wages and conditions of work of employees, and poverty reduction. For these objectives to be

[27] For a fuller discussion of these short-term measures see Islam (1998).

met on a sustained basis requires a country to have steady and fast long-term economic growth.[28] If there is an interruption to the process, for whatever reason, it should be as brief as possible with as little loss of output and employment as possible in the adjustment period. The ILO has a difficult task in the present crisis in the affected countries. The first important point is that it should act independently, and be seen to be doing so in pursuit of its own objectives. For this purpose, it is essential for the organisation to develop its own analysis of the crisis rather than simply accepting others' view of it.

Secondly, the ILO needs to make a clear distinction between policies which would be helpful in the short-term and those which might be required in the long-term. The kind of policies which would be appropriate in the short-term have been indicated above. Although these policies would involve considerable government intervention in the market processes they are relatively uncontroversial. There is a growing international consensus concerning the need for swift public measures to cope with the effects of fluctuations in economic activity in the context of a globalized liberal international economy.

However, there are more difficult issues for the ILO to consider with respect to safety net policies for the long-term. Does the organisation support, for example, the traditional Asian model of lifetime employment or does it think that, even if feasible, such a model is not appropriate and should be replaced by flexible labour markets on the U.S.-U.K. pattern. Similarly, the organisation would need to define its approach to pension systems and social security in these countries. Thus, taking into account economic as well as social factors (economic efficiency, savings and growth potential, social solidarity and poverty avoidance), should these counties institute the traditional European type of pay-as-you-go state pension system, or a privatised pension system, as increasingly advocated by the World Bank and IMF? If it were the latter should it be, for example, the Singapore model or the Chilean model? The ILO will be expected to advise on these questions as the affected countries, sooner or later, return to their normal long-term growth trajectory.

[28] There is a large literature on this subject, much of it originating in the ILO itself. These contributions show that fast long-term economic growth is necessary to reduce unemployment and poverty on a sustained basis. The recent historical record of the East Asian countries confirms the positive association between these variables. See further, the classic work ILO (1976). See also Singh (1979, 1995a).