

The Main Lesson from the Asian Crisis: "Dragons" Should Not Fundamentally Change Their Policies

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Introduction

About ten years ago, the so-called Washington Consensus received a first and severe blow in Asia. The way the Crisis was handled met wide-spread criticism and stopped the IMF's attempts to amend its statutes to do legally what it had done in violation of its own statutes so far. IMF-interventions enforced a strong neoliberal opening, and brought about "fire sales" of Asian firms. Soon, however, the Dragons started to prevent or undo change. Meanwhile, they are frequently criticised for no longer pursuing the policies forced upon them by International Financial Institutions (IFIs) seizing the Crisis as an opportunity to push their ideological predilections on Asia. Instead of clearing the market from constraints imposed by the developmental state during the "miracle" period, the Dragons keep or adapt them. A full resurrection of successful "Dragon policies" may nowadays be circumscribed by new parameters set by, for instance, the WTO. This paper argues that liberating oneself from the IFI-dictates seems to be the optimal policy response, because the "reforms" demanded by IFIs did not treat the problem triggering the crisis but tried to enforce an unfeasible set of neoliberal policies, as well as to take economic advantage of the crisis.

The clear intention to use a crisis, which IFIs must have foreseen well in advance, to impose their ideological predilection on unwilling countries is officially documented in the case of Indonesia: "Internal documents show that both staff and management perceived the crisis as an opportunity to assist the reformist economic team in carrying out financial sector reform and deregulation, both areas that were earlier emphasized in IMF surveillance." (IMF, 2003: 13) This desire to push the Washington Consensus might also explain why staff "never explored comprehensively what that alternative would imply" although it had been recognised "that, if one questioned this basic assumption [that the crisis was a moderate case of contagion in which the exchange rate had overshot, KR], an entirely different approach would be necessary". Why should they? Leverage to enforce neoliberal policies was obviously what counted. The Asian case is a good illustration of Rodrik's (1996) thesis that chances "to wipe the slate clean" are immediately seized, with scant attention to what the reasons of a crisis had really been. The lending spree of the private sector tamed the "Dragons". The failure of the

government was allowing this to happen, or as Akyüz (1998: 5) put it "failing to prevent market failure - an approach that underpinned successful policy intervention in post-war East Asia." These economies had to open for foreign investment and reduce public spending, although the latter did not create the problem. Nor, as the IMF meanwhile contends does FDI encourage growth. Quite on the contrary, research by Prasad *et al* (2007: 18) showed that countries with "high investment ratios *and* lower reliance on foreign capital ... grew faster -on average, by about 1 percent a year - than countries that had high investment but also a greater degree of reliance on foreign capital."

The main argument of this paper is that Asian "tigers" did not fall into a "modernisation trap" but into a "BWI-trap" in the 1990s, and that they are in another BWI-trap right now. They followed the advice of the Bretton Woods Institutions (BWIs), the IMF and the International Bank for Reconstruction and Development (IBRD). Clearly, this does not mean that everything had necessarily been fine within the Dragons and that there was no need at all to adjust policies. Successful policies always adapt to changing reality. It just states that the Crisis would not have happened without destabilisation from without. Egged on by the BWIs -in the case of Korea also by the OECD - successful Asian economies started to embark on the very policies that were officially known to trigger catastrophe, as had been proved in other parts of the world. IFIs *knew* what the likely results of capital account liberalisation under the specific conditions of East Asia would be, but encouraged their members to produce a foreseeable crash. Turning away from such advice in favour of meaningful policies is a good decision. Present economic indicators corroborate this conclusion. Regional growth rates above world averages do not suggest extremely bad policies.

After briefly discussing reactions to the Crisis, this paper draws attention to inexplicable differences in the evaluation of Dragon economies before and after the Crash. Such quick u-turns cast grave doubts on the quality of BWI-advice as well as on whether it should be heeded. The paper shows that while egging "Dragons" on, IFIs knew their members were heading for catastrophe. Finally, it discusses East Asia's large reserves, established in reaction to the Crisis, which involve substantial risks of losing money once the dollar's value falls.

The Asian Crisis is also a tale of double standards: IFIs have routinely infringed on the membership rights of developing countries. They gravely breached their statutes to the detriment of Asian members. This would be unthinkable when and if big shareholders

exercised the same statutory rights. Talked again into not using their membership rights to control capital flows, Asian countries have attempted to shield themselves against a recurrence of the Crisis by following once again IMF-advice, accumulating large foreign exchange reserves. This paper argues that this one clearly visible change brought about by the Crisis should be undone. Much smaller reserves would suffice if countries decided to use the membership right of any IMF-member if and when necessary: controlling capital flows.

Reacting to the Crisis

Although the IMF predicted stagnant growth for at least 3-4 years following the crisis (a U-shaped recovery, cf. Jomo, 2003: 10), first signs of recovery were quickly noted. In July 1998 governments started to follow expansionary policies representing a considerable change of direction (Wade, 1998c: 701). Krause (2000: 1) noted that the "resolution of the crisis is being done in a very Korean way" with the government centrally involved. Seeing more talk and planning about reforms in Korea than reforms actually accomplished, he concluded: "Fortunately, the continuation of economic recovery does not depend on the completion of reforms." (*ibid.*: 19) Malaysia, the one country introducing capital controls against all neoliberal pressure, did not fare badly.

Although she got most publicity by far, Malaysia was not the only country not relying on neoliberal recipes. "Hong Kong resorted to explicitly non-neoliberal measures to prevent crisis" (Grabel, 2002). China, Taiwan Province of China, and India retained substantial state control over their domestic and international financial systems. They suffered no "contagion". The WTO (1998: 26) had to acknowledge that "China... with a non-convertible currency largely isolated from speculative attack" was doing fine. Nevertheless, the WTO lauded the landmark agreement on financial services also signed by Asian countries hit by the crisis. It reported "most countries in Asia have accepted, either unilaterally, as part of IMF-sponsored adjustment programmes, or as a result of recent sectoral negotiations in the WTO and in APEC, substantial liberalization - and commitments to further liberalization - of their trade and investment policies." (*ibid.*: 27)

A paper based on material initially prepared for discussing Malaysia in the IMF's Executive Board in September 1999 (Ariyoshi *et al.*, 2000: 54; 104) concluded that "preliminary evidence suggests that the controls have been effective". But it is also seen as important to resist temptation to draw firm conclusions from Malaysia's experience with the use of controls

on capital outflows, not least because of the difficulty in separating the impact of the controls from that of the accompanying macroeconomic and financial sector reforms, as well as from the broader international and regional developments. By contrast, the BWIs have never seen problems in identifying causality between successful development and liberalisation.

The language recalls the IBRD's Asian miracle study's reluctance to admit that state intervention was successful. However, this paper also found that "The effectiveness of the controls was also evident" (*ibid.*: 99). According to this study the overall balance of payments continued to strengthen, net portfolio outflows were contained, foreign exchange reserves continued to increase, the reduction of interest rates that accompanied controls helped contain increases in non performing loans. "In its most recent upgrading of Malaysia's credit outlook, Standard & Poor's indicated that if interest rates had not been cut sharply ... nonperforming loans could have risen to above 30 percent of total loans, computed on a three-month basis" (*ibid.*: 100) One should recall that the IMF uniformly demanded higher interest rates to gain investor confidence. In economies with high debt/equity ratios such increases are likely to push quite a few firms into bankruptcy.

Jomo (2003: 10) explains the quick and sharp recovery of

"the economies of South Korea, Malaysia and, arguably, Thailand ... after sharp recessions in 1998 (a V-shaped recovery). The turnaround in economic performance can mainly be attributed to Keynesian counter-cyclical fiscal measures. Both the Malaysian and South Korean economies recovered as a result of such reflationary macro-economic policies. In contrast, the IMF's initial macroeconomic policy emphasis involved retrenchment."

Clearly, this ran counter the IMF's recipe. The IMF had demanded higher interest rates - domestic policy reduced them drastically "almost in defiance of IMF prescriptions - to boost corporate recovery" (Jomo, 2001: 28). Jomo's graph shows a steep and quick fall in interest rates - with Indonesia perceptibly lagging behind. Discarding IMF-advice early on might obviously have been a benefit.

Government interventions continue to be important (*ibid.*: 38), although the new international framework - notably the WTO's TRIMs treaty - precludes some policies applied successfully by the Dragons during their period of internationally acclaimed success. For post-crisis Korea Shin (2000: 22) even concludes that the "degree of government intervention ... was actually increased ... contrary to the IMF prescription and the Korean government's rhetoric". The policies optimal before 1995 may no longer be so. The Dragons had, in fact started to change their policy mix well before the Crisis. Indonesian, Malaysian, Philippine and Thai governments began to liberalise investment gradually during the decade-long boom preceding the collapse of 1997-98. Korea started to liberalise, not least under pressure of the OECD to show herself worthy of membership.

An Independent Evaluation Office's Report (IMF, 2003) clearly addresses the problem of ownership in the two Asian countries whose IMF programmes were evaluated. Its conclusion in the Indonesian case might well be more generally valid:

"the IMF misjudged the extent of ownership at the highest political level and underestimated the resistance to reform likely to be posed by vested interests. This underestimation of political constraints was perhaps a reflection of the earlier failure of surveillance in recognizing the changing nature of corruption and cronyism."

Not only in the three countries evaluated "the visible presence of major country officials close to the IMF negotiating teams sometimes created a misperception of the motives behind IMF involvement, thus weakening the sense of country ownership." (*ibid.*: 6) Nor did incidents such as a former member of the IMF-mission having been given all information by the central bank, returning two weeks later as the representative of a commercial US bank convince Asians that helping them was the Fund's one and only priority.

The passage on failing to recognise cronyism demands comment. One has to ask how reliable advice by institutions is likely to be if and as they apparently misunderstood the whole Asian development model over years , not noticing flagrant development barriers such as cronyism.

Inexplicable, Sudden U-Turns

The crash of 1997 brought about a very abrupt change of mainstream opinion. To judge the efficiency, reliability and advisability of following IFI advice, it is important to comment briefly on inexplicable U-turns.

Both BWIs had paraded Asian economies as their model pupils, successful because of following BWI-advice. While the "Asian miracle" was proclaimed, orthodoxy claimed that the Dragons' success was the result of applying orthodox policies. Orthodoxy had usually presented the Asian "Tigers" as empirical "proof" that their policies worked. The fact that these countries - with the possible exception of the harbour-state Hong Kong - did demonstrably not follow the Washington Consensus was downplayed at best, but mostly denied before 1997 (cf. Raffer and Singer, 2001). The IBRD (1993: 9, stress in original) stated that "adherents of the *neoclassical view* stress ... an absence of price controls and other distortionary measures." In the text some few short passages can be found, contending for example that East Asia did not wholly conform with the neoclassical model. However, the IBRD's president, Lewis T. Preston, summarised the authors' conclusions more briefly: "rapid growth in each economy was primarily due to the application a set of common, market friendly economic policies" (*ibid.*: vi). This conclusion reinforced other research. Thus, the "market-oriented aspects of East Asia's policies can be recommended with few reservations". Whereas the IBRD had problems in concluding whether "interventions contributed to the rapid growth ... or detracted from it" (*ibid.*: 24; cf. also 354), it found it apparently less difficult to demonstrate the beneficial effects of liberalisation. The array of government incentives and interventions was particularly impressive in South Korea as Rhee *et. al* (1984) documented. This detailed IBRD study is not even mentioned in the "miracle" study. As one of the former's authors, Bruce Ross-Larson, was also a member of the latter's research team, unawareness can hardly account for that omission. Apparently, strong but inconvenient evidence was simply "forgotten" whenever convenient.

The fact that Dragons did demonstrably not follow the Washington consensus (cf. Rodrik, 1996; Raffer and Singer, 2001) was downplayed at best, but mostly disregarded. Even though "many of the discredited policies had long been in use in South Korea, Taiwan, and Singapore, and apparently to good effect" (Rodrik, 1996: 17), the view developed soon among "professional economists" that Asian success "could be attributed to market-oriented policies and the reduced role of government intervention" (*ibid.*: 13). Ironically, neoliberal reforms in

the 1980s were "inspired at least in part by the East Asian experience" (*ibid.*: 11). Facts had to be ignored to be able to use the "tigers" to justify neoliberal policies.

Warnings were ignored or silenced. IBRD staff trying to ring the alarm bell were overruled. During a visit to Indonesia in the autumn of 1997 IBRD-president Wolfensohn himself removed a passage by the resident mission that warned of serious problems, "substituting it by even more fulsome endorsement of Indonesia as an Asian miracle." (Wade, 1998b) According to Wade one typically did not want to hear news that went against one's ideological preferences, in this case for free private capital markets that had to be proved right by the Asian example.

A 1992 World Bank report "cited Indonesia as 'one of the Bank's greatest success stories overall in the 1980s', and [claimed] that '[t]he impressive growth of Indonesian industry was a testimony, among other things, to the Bank's sound analysis, advice and influence'" (quoted from Pincus and Ramli, 1998: 724). As late as June 1997 Indonesia was praised by the IMF for prudent macroeconomic policies, high investment and savings rates, and reforms to liberalise markets (*ibid.*: 725).

Looking at facts shows that all "Tigers" were successful precisely because they did not apply orthodox advice. Selectively they picked those policies they considered most appropriate. Therefore the range of policies is very wide - from extremely protectionist South Korea to non-interventionist Hong Kong. Naturally, optimal policies of harbours and city states such as Hong Kong and Singapore must differ from the options of larger, "normal" countries. Even in the case of the harbour Singapore, obviously quite open to foreign trade, an IBRD study found selective protectionism (Rhee *et al.*, 1984: 6). This eclectic choice of policies is precisely what was recommended as "selective dissociation" by Raúl Prebisch and the *dependentistas* in lieu of blind faith in the world market.

"Tiger" governments governed the market efficiently and pragmatically. Conservative fiscal policies and competitive exchange rates can be singled out as the areas "where Korea and Taiwan followed the orthodox path most closely" (Rodrik, 1996: 18). Not anyone doubting the applicability of the orthodox model is by necessity pursuing policies of unsustainable spending and reckless overvaluation. Pragmatic choices are typical for eclectic approaches likely to adopt those policies considered useful whether recommended by orthodoxy or not. The

Korean payments crisis of 1979/80 and its quick fix show that the country experimented which amount of debt would be sustainable. None of the Asian success economies could be egged on by the BWIs' applause to borrow as heavily as other developing countries before 1982. Consequently none became a problem debtor in the 1980s.

Not only the first tier, but also the so-called next-generation "tigers" had interventionist governments. They overcame the problems of the "lost decade". "In short, in striking contrast to elsewhere, public investment in 1980-87 in these East Asian economies was countercyclical to the reduction of private investment." (IBRD, 1993: 43)

Even privatisation differed strongly between Asia and Latin America before 1997. Between 1988 and 1992 privatisation proceeds amounted to slightly more than \$40 billion in Latin America and to \$7.5 billion in East Asia (IBRD, 1994: 105). The share of foreigners was 56 percent and 2 percent respectively - in East Asia 98 percent of assets remained under domestic control. The lack of strong domestic firms and the resulting strong dependence on Northern transnationals has always been standard criticism of Latin American policies by *dependentistas*.

Economic success bred self-reliant ideas, such as an Asian Monetary Fund to deal with crises in the region. Although this was precisely what would have been needed to defuse the crisis, any form of regional funds would have reduced the IMF's clout and US influence with it. The Asian crisis put an end to such attempts.

After the crash, official statements changed abruptly and fundamentally. In contrast to its "Asian Miracle" study the IBRD (1999) unexpectedly asserted that East Asia had not followed the Washington Consensus. The economic systems and the very same policies that had led to the "economic miracle" were now described as deplorably inefficient and flawed, mostly by the same people who had marvelled about the Asian success story shortly before, claiming success to be the result of applying their policy advice. This new interpretation makes one wonder how and why success could be achieved in the past. One may wonder even more about the quick change of opinion happening virtually overnight. Ignoring one's own recent views actually appears to be bliss. In comparison, Harry Potter's wand produces slow changes.

Suddenly, the IBRD (1999) stated that Mexico had fulfilled most of the Consensus conditions, but East Asia had not. Suddenly, "market economy superstars" turned into corrupt cronies in need of being taught market discipline. The pertinent question, how incompetent cronies could have managed East Asia's steep and successful development was not asked. Jomo (2003) points out that "[P]reviously identified and acclaimed as central to the East Asian success story, business-government relations became perhaps the most obvious example of this rapid shift in opinion." Suddenly, these relations were "denounced as 'crony capitalism', now alleged to be responsible for the onset as well as severity of the crisis".

In its Asian Miracle Study the IBRD (1993: 359, stress added) had stated that high performance could only be achieved due to "high government institutional capability ... because their civil services and public institutions *were largely staffed by competent and honest civil servants*". Lacking such able and integer civil service, other countries should and could not emulate government interventions. Export was the single yardstick for performance. Directed credit programmes "were designed to achieve policy objectives", but as the IBRD (1993: 20) assured at that time "nevertheless included strict performance criteria ... These performance-based directed-credit mechanisms appear to have improved credit allocation, especially during the early stages of rapid growth (see Chapter 6 [of the World Bank's publication])." Without a "clear link to economic performance" (*ibid.*: 367) similar interventions "have failed" elsewhere.

After 1997 all these objective, competent, and honest institutions/individuals that had served as an argument why the East Asian experience could not be duplicated elsewhere, had suddenly and surreptitiously turned into corrupt crony-capitalists that could only be expected to go bust, although, miraculously, no one had expected it. Reading post-1997 publications one wonders why the BWIs did obviously not expect it, let alone why they ever claimed East Asia as their success, praising Korea's and Thailand's economic performances on the very eve of the crash.

U-turns of official opinion is nothing new in the case of this region. East Asia (in particular South Korea and Taiwan Province of China) has a curious history. In the 1950s its economies were considered hopeless basket cases, particularly so the two largest "Tiger" or "Dragon" countries of the "first generation". "Non-economic factors" were cited in the 1950s to corroborate the basket case view. The "Chinese factor", Buddhism, or Confucian tradition, briefly: Asian mentality,

were routinely quoted as reasons for stagnation and a hindrance to economic development. Asian mentality proved a useful "argument" later on as well, "explaining" the success of the miracle, the crash, and the quick recovery.

After 1997 the IBRD (1999: 2) stated that "decisionmakers overlooked the failure of the Asian countries to comply with the basic tenets of the much abused Washington consensus." Arguably, the Bank's own Asian miracle study is the most perfect corroborating example. To support the thesis that the Washington Consensus is not to blame, the IBRD (1999) used and expanded Rodrik's (1996) Table 3, produced to show that Taiwan Province of China and Korea did—in contrast to what the BWIs postulated at that time—not follow the Washington Consensus. Indonesia, Korea, Taiwan Province of China and Thailand complied only with six or seven of the Washington Consensus's ten tenets. Privatisation and deregulation in particular were insufficient, and barriers to foreign direct investment were found (*ibid.*: 3). Property rights were - except in Taiwan Province of China - seen as not secure enough. In the case of Korea the IBRD's Table 1.2 quotes Rodrik's information that leading businessmen were imprisoned and threatened with confiscation in 1961. There is a subtle change in emphasis, though: while Rodrik (1996) mentioned this before the crash to show that the BWIs were wrong, writing the same in 1999 the IBRD tried to use it to show that their new view was right, conveying the impression that this was one reason for the crash the IBRD had foreseen. The Bank's method might be refined to explain a future crash in China by recalling some of Djingis Chan's atrocities against shopkeepers.

Watching Catastrophe Happening

It is most important to recall that the Asian Crisis did not come unexpectedly. In fact, the BWIs knew well in advance what would happen, but egged their Asian members on to produce catastrophe. The IBRD acknowledged in an official document that it had known that Asia was heading towards a crash. The "the relevant institutional lessons" (IBRD, 1999: 2) had been known well before East Asian Dragons embarked on capital account liberalisation, but instead of warning member countries, they were encouraged to liberalise with undue hurry.

An audit report by the IBRD's Operations Evaluation Department (OED) "on Chile's structural adjustment loans highlighted the lack of prudential supervision of financial institutions in increasing the economy's vulnerability to the point of collapse." (sic!, *ibid.*) The OED's "key lesson" that "prudential rules and surveillance are necessary safeguards for the operation of domestic financial markets, rather than unnecessary restrictions" (*ibid.*) did not make "policy

makers and international financial institutions give these weaknesses appropriate weight". In spite of what was already known they encouraged the same policies in Asia. According to the Bank they were "guided" by "the lessons of the general debt crisis" (whatever that might mean), not by the "more relevant" cases of Chile and Mexico 1994-5. The neglect of proper sequencing and institution building "featured prominently in the Chile and Mexico crises." (*ibid.*)

In the early 1980s, when Chile's fascist and corrupt military junta became the favourite of IFIs and orthodox economists in general, neoliberal policies - liberalising and opening the Chilean economy - produced a financial crash, well comparable to Asia in 1997. The military dictatorship provided an ideal precondition to realise neoliberal ideas. Price controls were eliminated, public expenditure was reduced, state enterprises privatised, and the economy opened up. As the market knows best, banking supervision was cut down. Moral backing came from the BWIs. Voluntary financial transactions between private agents were believed to be their own business only, and presumably Pareto-optimal. The IMF's Director of the Western Hemisphere, E. Walter Robichek, even assured Chileans that private borrowers - as opposed to governments - were very unlikely to overborrow, even with official guarantees (Diaz-Alejandro, 1985: 9). This view is sometimes called the Robichek doctrine. The bulk of booming credit expansion went into speculation (as later in Asia). After bailing-out the Banco Osorno, authorities realised that "practically no inspection or supervision of bank portfolios existed." (*ibid.*: 8) Reserve requirements had been steadily reduced, and "apparently little effort was spent on investigating the banking credentials of new entrants" when banks were privatised (*ibid.*) The "Chilean miracle" of 1981 turned into catastrophe in 1982, when GDP fell by more than 14 percent. The government was forced to socialise private losses (as later in Asia), although the one point the junta had clarified early on was that both profits and losses would be private. No bail-out should be expected. Quick, "unsequenced" liberalisation had shown what results should be expected. This was repeated in Asia.

Based on what had already been known and analysed years earlier, the unfolding of the Asian Crisis could be watched like a movie whose script is known. The Argentine crisis of 1995 goes unmentioned by IBRD (1999), although it was of a similar variety, namely triggered by private sector debts. Before 1994-5 IMF and IBRD had applauded and encouraged inflows to Mexico, presenting them as a proof that the debt crisis was over, although their own data showed this not to be true (for details v. Raffer, 1996). Why did the BWIs (both not normally

known for their restraint in giving advice) not warn Asian countries to proceed more slowly with cautious sequencing - as they do presently - pointing at already available evidence, instead of once again applauding too quick liberalisation and those inflows of volatile capital? Like in the case of Asia, official euphoria must certainly have fuelled inflows further. In the case of any consultant courts would look into the matter to decide whether the consultancy firm had obeyed professional duties by not making essential knowledge they had available to their client, with fairly foreseeable results. The same market discipline of connecting actions and risk must be brought to IFIs.

It must not be forgotten that Northern regulatory measures fostered crises by increasing speed and volatility. The risk weight given by the Basle Committee to short run flows, or regulatory changes necessary to allow institutional investors to invest in Mexican tesobonos before 1994-5 are examples. Northern regulatory decisions thus contributed to the Asian crash 1997. The costs of these ill-advised decisions had to be borne mainly by the poor in the South.

Basle I focused on risk weighted capital adequacy, unduly disregarding the stabilising potential of proper provisioning rules. It explicitly demanded lower capital weights for short term exposure in the South, thus positively encouraging shifts to shorter maturities. The basic idea, to give lower weights to less risky claims, is theoretically correct. In practice, however, those risky short term flows were encouraged that brought about the Asian crash of 1997. The Basle system accorded a low risk weight of 20 percent to claims *vis-à-vis* private banks in non-OECD countries with maturities up to, and a weight of 100 percent with maturities exceeding one year. Andrew Crockett, General Manager of the BIS and Chairman of the Financial Stability Forum, explained at a hearing at the German *Bundestag* (2001: 66) that this problematic decision may be seen a micro-macro problem. For any individual loan a shorter maturity means *ceteris paribus* less risk than a longer one. But if "all loans to Thailand are with three-months maturity" there is a problem, their effect becomes highly destabilising. This is a correct observation. But as rules and norms are made for all lenders rather than for the odd out loan, this macro-effect was foreseeable. In contrast to Asian governments, the Basle Committee was hardly criticised.

The IBRD (1999: 3) rightly concluded that a system that "seemed adequate as long as the boom lasted" (a more correct wording would have been "as long as capital movements were controlled") proved fatally flawed once external conditions deteriorated. Inexplicably, it fails

to point out the role of authorities in OECD-countries. The "unprecedented volume and reversibility of short-term capital flows, weak banking institutions and ineffective regulation systems proved a lethal combination." As it had proved before. If Asian countries had not liberalised their economies so quickly and strongly, the crisis could not have happened. Those countries that had liberalised less, had no crisis. Money that cannot enter a country can hardly leave it. Sticking to the old Asian model would have prevented the crisis, as it prevented the debt crisis of the 1980s or controlled debt problems as in the Korean case. High debt/equity ratios - Wade (1998b: 1544) quotes for instance 5:1 for Daewoo - which posed no problem under government protection in the Asian system make an enterprise extremely vulnerable in a Western-type financial system, even without the additional risk of volatile short term inflows. These ratios alone were enough reason not to liberalise so speedily, exposing actors to an environment for which they were extremely ill equipped.

Nevertheless, more liberalisation of capital flows was demanded and enforced as the solution. If one agrees with the IBRD (1999: 3) that building institutional capacity is expensive, slow and complex, even more liberalisation before one has the needed regulatory structures in place does not seem good advice. One wonders why it was given.

Raffer and Singer (2001: 151) assert that one should, "of course, not assume that attempts to establish an Asian Monetary Fund had anything to do with the fact that the BWIs did not warn Asian countries. Nor do we comment on conspiracy theories that emerged due to the crisis, also fuelled by cheap sales of Asian assets to Euro-American foreigners. But it should be recalled that as distinguished an economist as Jagdish Bhagwati spoke of a "Wall-Street-Treasury complex" dictating the agenda. The fact that the IMF even identified two foreign buyers for Korean banks (Krause, 2000: 6) did certainly not counteract such perceptions. Expanding that expression to the "Wall Street-Treasury-IMF complex" Wade (1998a: 1545) asked why the IMF insisted on further capital account opening in countries "awash with domestic savings", and why it did "so little to organize debt *rescheduling* negotiations". Short term debts were finally renegotiated after two rescue packages "and the foreign exchange crisis ended." (Krause, 2000: 4).

What may be most surprising is that there was no need to liberalise so quickly. In contrast to debtor countries in the South the BWIs could not force Dragons to do so. It seems largely a "victory" of ideology and persuasion. In the case of Korea OECD-membership was certainly a

factor. The country had traditionally maintained strict capital controls, which enabled authorities "to prevent excessive speculative foreign exchange trading" (Park, 1996: 216). These were liberalised in preparation of OECD-membership, in McKinnon's (1999, p.97) words, a "premature removal of the controls as a condition for Korea's joining the OECD three years before" had occurred. Although Korea had fared quite well under the old system Park (1996: 193) justified liberalisation of the capital account with "the inefficiency of these regulations and ... the worldwide trend towards economic liberalization". In 1997 Korea repeated the experience of efficient liberalisation Mexico had had in 1994, and Chile in the early 1980s.

Years before 1997, Wade (1990: 367; 1998a: 1552) had warned that control of international financial flows must be maintained to avoid exchange rate movements "with damaging consequences for the real economy." Wade warned of "speculative inflows", "[U]ncontrolled outflows", and vulnerability to an "investment collapse". Both his warnings and the IBRD's (1999: 2) acknowledgement of knowing "the relevant institutional lessons" at least since the early 1990s prove that the crisis was foreseen. The Dragons were trapped.

"Global Imbalances" and IMF Membership Rights

Under the trauma of the Crash, Asian countries have meanwhile amassed huge reserves to shield their economies against a future crisis. Arguably, this is the most important and visible change brought about. It also may be interpreted as falling into another BWI-trap, believing the IMF's new mantra about open capital accounts cum huge reserves as preferable to appropriate reserves plus using the right to capital controls.

According to the BIS (2007: 89), East Asia and India (ten countries) held over 44 per cent of the world's official foreign exchange reserves in December 2006, of which China held nearly half. Korea (\$238.4 billion) and Taiwan Province of China (\$266.1 billion) held more reserves than the whole Euro area, 1.3 and 1.45 times as much respectively. At the end of 2005, Korea's reserves amounted to about 28 percent of GDP, up from some 9 percent at the start of the 1990s (Ra, 2007: 150). Ra compares this to the US, Germany and Britain, all with a ratio below 2.5 percent, citing criticisms that Korea shoulders unnecessarily high costs for these reserves. Pointing out that "some reserves have been accumulated through government bond sales" he states the financial problem succinctly: "reserves earn a current market rate of 2-3%, but the government bonds carry an interest rate of 9%." Ra (*ibid.*: 148) also points out that the yield of

US Treasuries (the usual form of holding reserves) are much below "the expected return on local investments". Substantial opportunity costs are suffered just to keep capital accounts open.

While domestic debt has grown in developing countries over the last ten years, and domestic debt markets have been developed, the switch from foreign to domestic debt was especially pronounced in Asia. A rebalancing of debt occurred after the Crisis. The ratio of domestic to external debt in that region rose from 1.0 in 1997 to almost 3.0 in 2002. This, too, is a promising strategy of preventing crises such as in 1997-8, particularly in countries with extremely high saving rates.

While Asians appear to start thinking about the usefulness of large reserves, coincidence has it that the BIS (2007: 46) warns: "Some similarities to pre-1997 crisis conditions are apparent" in Emerging Market Economies (EMEs). Fortunately, the BIS identifies "also important differences compared with the earlier period", mainly "foreign exchange reserves" at "record levels, exceeding conventional thresholds of reserve adequacy in most EMEs."

The IMF (2000: 6) supports and advises this choice, defining the ratio of reserves to short-term external debt (R/STD) as the "Single most important indicator of reserve adequacy in countries with significant but uncertain access to capital markets." Positing that "conditions to ensure private sector access to international capital markets reduces the need" (*ibid.*) for reserves, the IMF continues to pursue its liberalisation agenda. Especially with regard to Asia this assertion sounds courageous and definitely not in tune with historical facts. The IMF (2000: 16) goes on "A smaller reserves to short-term debt ratio is associated with a greater incidence and depth of crises", which is only valid if and as long as capital accounts are kept open. Under such conditions, the suggestion "that the weaker a country's liquidity position prior to the onset of the crisis, the stronger the exchange market pressure and thus potential for a crisis during the crisis period" (*ibid.*: 16) is to be expected. Capital controls are a better alternative *and* a membership right of any IMF-member. The IMF does not like this option, though.

It is all the more important to point out that such reserves are not necessary, especially so as the IMF meanwhile started to see "global imbalances" as the new problem. Of course, not the

biggest deficit country is the focus of IMF concern. In contrast to business as usual, surplus countries are now the target of criticism.

In contrast to high interest rates and keeping capital accounts open, as foisted onto members in distress and recommended to Asian countries right now, the IMF's Articles of Agreement do not only stipulate the right to capital controls, but even explicitly restrict the use of Fund resources to finance outflows. Art.VI(3) establishes the right of members to "exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions". Art.XXX(d) defines these as "not for the purpose of transferring capital", including "Payments of *moderate* (emph. KR) amount of amortization of loans or for depreciation of direct investments", or "*moderate* remittances for family living expenses". Although this definition is somewhat opaque, even restricting such flows is a member's right. In plain English, Dragons have always had the right to stop amortisations. There was no obligation to finance outflows fully, nor is there an economic need to keep extremely high reserves against capital account crises.

Not only has any member the right to control capital flows, but the IMF is not allowed to finance outflows as it did in Asia pursuant to Art.VI(1)(a). A "member may not use the Fund's general resources to meet a large and sustained outflow of capital except as provided in Section 2 of this Article [this refers exclusively to reserve tranche purchases] and the Fund may request a member to exercise controls to prevent such use of the general resources of the Fund. If, after receiving such a request, a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the general resources of the Fund." Financing the large and sustained outflow in Asia, the IMF clearly and openly violated its own Articles of Agreement, inflicting considerable damage on its Asian member countries. Although the IMF may but is not obliged to request controls and declare members ineligible, its statutes clearly show that it is not supposed to press for liberalisation of capital movements in the way it has actually done. Clearly, Asian countries had not only the right to control capital outflows in 1997, as the IMF had to admit when Malaysia exercised it (Raffer and Singer, 2001: 157). The Fund's forcing members to finance large and sustained outflows by speculators is definitely a violation of the IMF's own constitution.

The intentions of its statutes are clear. Rather than forcing or even encouraging members to keep capital accounts open, the Fund is meant to request controls from members not imposing such controls by themselves, and may even sanction them. However, when it comes to protecting the rights of developing members, legal regulations and obligations are apparently insignificant. Art.VI(1)(b)(ii) allows members to meet outflows "out of a member's own resources, but members undertake that such capital movements will be in accordance with the purposes of the Fund." Members are even encouraged not to finance large and sustained outflows. Current transfers can be restricted with the Fund's approval.

Forgoing the right to capital controls makes increased stocks of international reserves necessary. These practically sterilised reserves could alternatively be used either for anti-poverty measures, debt service or Keynesian policies. Reserves are costly, because interest revenues (often from US Treasury bonds) they earn are a fraction of what countries have to pay for borrowing. Developing Countries face substantial annual costs that could be avoided by exercising statutory rights. Adding insult to injury IFIs made these reserves one of the widely-used targets of poverty reduction strategies in Africa. The IMF has blocked ODA-inflows destined to finance the MDGs in order to stock up reserves in poor countries. This money is lost for poverty eradication or financing the MDGs.

Corrective measures affecting the balance of payments should be done "without resorting to measures destructive of national or international prosperity" (Art.I(v)). This would have been easily possible in Asia if speculators would not have been bailed out by socialising their losses. Art. IV(1)(ii) requests the IMF to foster stability and a monetary system that does not produce "erratic disruptions". The policy of high real interest rates forced on clients did the opposite. Real interest rates sky-rocketing beyond 40 percent (as in Brazil) are no doubt erratic disruptions as bankruptcies of domestic firms prove. A price tag can be put to such policies. Given the ratio between equity and debts in Asia high interest rates were particularly suicidal.

Minds more critical than I might even perceive crises to be in the institutional self-interest of the BWIs. During the Asian Crisis the IMF's First Deputy Managing Director still argued - using Thailand and Mexico as supporting evidence - that the prospect of larger crises caused by capital account liberalisation would call for more resources for the IMF to cope with the very crises the IMF's proposal would create in the future (Fischer, 1997). This is easily explained by the present lack of financial accountability, which is at severe odds with any

market friendly incentive system. From the narrow point of view of institutional self-interest - which one of course hopes to be irrelevant - such crises are better than the use of contractual rights to capital controls, which would not require increased IMF resources. Thus, any of the Dragons - or any developing country in trouble - has had the right to introduce such controls, but IMF conditionality forbade it.

At appears that Asian countries are meanwhile reconsidering their policy of piling up low revenue reserves. The recent IMF's initiative to get surplus countries to support US deficits may be one reason for this. Strongly increasing US debts triggered an IMF-reaction unheard of so far. To fight this debt's driving engine, the current account deficit (IMF-code: "global imbalances"), the IMF exhorts developing countries, including oil exporters with balance of payments surpluses, to import more from the US. The prudent use of large current account surpluses by Arab countries after 2000, first lauded as an improvement over the 1970s is coming under attack (cf. Raffer, 2007) to support one deficit country.

Such demands on surplus countries differ markedly from the usual IMF strategy to adjust balance of payments deficits. One may wonder, whether this is the first sign of a fundamental re-orientation of the Fund's "adjustment" policies, whether we should expect the IMF soon to request higher imports of Namibian beef or African cotton by OECD-countries in order to correct imbalances, right in the way Keynes had wanted it.

The IMF's (2005a: 113f) *World Economic Outlook* demands a "5 percent of GDP permanently higher investment rate" of oil producers and East Asian economies to reduce the US current account deficit visibly, since oil price increases added to "global imbalances". The IMF (2005b, p. 10) points out that "these countries may need to increase spending on imported goods". However, not all imports are good. Imports from Asia are apparently not. An IMF-director sees necessary adjustment of global current account balances as "the bottom line" (Nsouli, 2006: 11), demanding higher government spending by oil exporters in order to reduce global imbalances by increasing imports. The fact that oil exporters import relatively little from the US, having "turned into large buyers of goods from Asia, a region where they also sell the bulk of their oil", which "has mitigated the improvement in the trade surplus of oil-exporting countries vis-à-vis Asian countries" (*ibid.*: 6) is of particular concern to this author, even though that could simply be a clear sign of Asia's revealed comparative advantage, in other words, an indication that the global market functions well.

There is one interesting difference between OPEC and Dragons, though. Petrodollar Recycling is demanded again: countries with low absorption capacity should recycle their petrodollars through capital outflows to the rest of the world, in other words, the same policy is now requested from OPEC, which has been used so far to blame the debt crisis on OPEC (cf. Raffer and Singer, 2001: 133ff). At the same time, though, new donors from Asia are condemned as granting "rogue aid".

Conclusion

One may fault Asian governments for not reining in the private sector as Akyüz (1998) did or for shedding their successful model too quickly rather than slowly adapting it to a changing environment. Hasty climbers have sudden falls, especially so if they act on the advice to climb even more hastily. In short, Asian countries should not have listened to the BWIs. The failure of the private sector was used to increase its role even more, to change policies that had nothing to do with the crisis, and to dismantle public control further. IMF conditionality went much further than usual, attempting to trigger fundamental systemic changes. Very quickly, though, Asian countries back-pedalled, re-gaining independence from the IMF. They should beware of not falling once again in a costly BWI-trap. By exercising their membership rights they could safeguard this independence at much lower costs. This would allow investing part of the money piled up as reserves in their own future.

The policy space offered by the IMF's statutes is in danger of being eroded, though. Grabel (2007: 4) calls trade and investment agreements "a new Trojan horse" used to bring developing countries in line with "fundamentalist and outdated ideals about internal and external financial liberalisation". Stipulating very strong investor's rights subsuming loans under investments these agreements usually go much beyond the obligations under the IMF's statutes. The further evolution of GATS and the WTO's agreement on financial services might need close scrutiny. In any case, Dragons are well advised to return to the type of policy they had embraced while being called a miracle: deliberate choice of policies that are in the country's interest. This does not exclude orthodox policies as such, but it certainly excludes policy-mixes consisting uniquely of orthodox measures, and it does not encourage heeding BWI-advice in the future.

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