CONTAGION AND CONVALESCENCE: CAPITAL LIBERALIZATION, CAPITAL CONTROLS, AND THE EAST ASIAN FINANCIAL CRISIS CASE STUDY: THAILAND & MALAYSIA

BY

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ABBREVIATIONS AND ACRONYMS

AFTA	ASEAN Free Trade Agreement
APEC	Asia-Pacific Economic Co-operation
ASEAN	Association of East Asian Nations
BIBF	Bangkok International Banking Facility
BIS	Bank of International Settlements
CEPT	Common Effective Preferential Tariff
FDI	Foreign Direct Investment
GAO	Government Accountability Office
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GSP	Generalized System of Preferences
IMF	International Monetary Fund
NAFTA	North American Free Trade Agreement
NBFI	nonblank financial institution
OECD	Organization for Economic Co-operation and Development
TFP	Total Factor Productivity
WEO	World Economic Outlook Report
WTO	World Trade Organization

MAP: EAST ASIA

Source: www.lib.utexas.edu/maps/asia.html

ABSTRACT

The East Asian Financial crisis highlighted the disastrous consequences of fast-tracked capital account liberalization in emerging market economies lacking the macroeconomic and regulatory infrastructures to manage such changes. The removal of impediments to free capital mobility did not necessarily cause the crisis. However without a strong and systematic sequencing methodology and a strong underlying macroeconomic foundation, the implementation of capital account liberalization left East Asian economies vulnerable to the volatility of the global economy. Finally, the crisis illustrated the consequences of the uncontrolled expansion of credit, coupled with rampant real estate speculation and inflated asset values.

The dichotomy between capital account liberalization and capital controls is illustrated in the divergent strategies utilized by Thailand and Malaysia in responding to the crisis. Thailand, implemented an IMF program, which drove its economy into deep recession. Additionally, the Fund pressured Thailand to maintain open capital account transactions while hemorrhaging capital. Malaysia implemented a reflationary strategy independent of the IMF. Controversially, Malaysia employed short-term capital controls to shield the country from rampant speculation and destabilizing capital outflows, while implementing reforms. Malaysia was able to recover far more quickly than Thailand due to the complimentary use of capital controls and a Keynesian macroeconomic plan. Furthermore, Malaysia did not experience the level of contraction that Thailand did. The benefit of hindsight has not offered compelling evidence that Malaysia should have pursued an alternative strategy or that such a strategy would have been more successful or prudential.

This paper does not attempt to resolve long-standing debate regarding the risks of capital account liberalization, the merits of capital controls, or the sources of Asia's remarkable growth. Analysis of these controversial subjects is merely suggestive rather than resolutive. However, the paper has drawn reasonable conclusions based on data, available scholarly work, and the author's own analyses of tested hypotheses.

CHAPTER 1

CAPITAL LIBERALIZATION, CAPITAL CONTROLS, & GLOBALIZATION

1.1 INTRODUCTION

The East Asian Financial Crisis that first struck Thailand during the summer of 1997 with the collapse and devaluation of the Baht was the third major currency crisis of the 1990's. One prominent World Bank economist described the catastrophe as "the worst financial and economic crisis since the great depression"[1]. What was characterized by then-President Bill Clinton, as "a few glitches in the road"[2] soon heralded the age of contagion. The crisis soon spread like a virus, infecting the ASEAN-5[3] region of Thailand, Malaysia, Indonesia, South Korea, and the Philippines. It soon infected Latin America, Russia, and finally reached the continental United States, devastating the Long-Term Capital Management hedge fund.

Joseph Stiglitz, the former Chief Economist of the World Bank described the crisis, stating, "What many expected to be no more than a slight blip has instead become the largest threat to the stability of the world's market economy since the Great Depression".[4] The financial crisis in East Asia is not unique from the standpoint of a region facing an economic downturn; there have literally been hundreds of economic disturbances and recessions in the last few decades. However, what is inimitable in this crisis is the region's consistent history of high investment and savings rates, its reputation for strong growth, and fiscal stability; nations with such strengths typically do not experience economic downturns of the magnitude of the East Asian crisis. What also is

[1] Stiglitz, Stanford University Pg. 1
[2] Goldstein Pg. 1
[3] Association of Southeast Asian Nations
[4] http://web.worldbank.org

disconcerting is that the crisis took the international financial community by surprise. The brightest minds did not foresee the crisis looming despite conspicuous signs of weakness. This was partly due to the strong economic performance of the region and also owing to its high investment and savings rates.

The financial crisis in the Asian-Pacific region was as much about macroeconomic and regulatory fundamentals as it was a crisis of the neo-liberal economic philosophy utilized to assist with the transition of emerging economies. Market liberalization policies had long been supported by the U.S. Treasury, World Bank, and the International Monetary Fund (IMF). Such policies were a means of not only liberalizing previously controlled emerging economies, but were also implemented to allow greater access of Western business interests to such lucrative new markets. The crisis highlighted the disastrous consequences of capital account liberalization in emerging market economies lacking the macroeconomic, regulatory, and financial infrastructures to manage such monumental changes.

The crisis also challenged the "Washington Consensus", which had supported an age of globalization. The philosophy advocated the liberalization of interest rates, trade, and capital, along with privatization and deregulation of industry. The "Washington Consensus" was controversial with developing nations who felt the West forced them to follow a path that furthered the West's interests at the expense of developing nations' economies. John Williamson who coined the phrase, tried to distance himself from the strategy used by Washington, stating, "I…never intended my term to imply policies like

capital account liberalization...monetarism, supply-side economics, or a minimal state, which I think of as the quintessentially neoliberal ideas."[5]

Aside from an analysis of East Asia's remarkable growth and the corresponding crisis, this paper will utilize Thailand and Malaysia as case studies to examine two wholly divergent strategies in responding to the economic contraction. The countries' differing tactics to contain and ameliorate the crisis offer inimitable insight not only to what was then accepted economic practice. These countries were chosen for their similarities to assist with a comparative analysis of their policy responses and to analyze viable alternative strategies. Both countries developed economies around export-oriented manufacturing. As the economies developed and modernized, there was a massive demographic shift in the Thai and Malay populations from rural agrarianism to urban industrialization. This shift was in response to the industrialized-centers' demand for inexpensive labor and also by the prospect of abundant jobs in prospering and growing cities. Finally, Thailand and Malaysia grew exponentially during the 1980's and 1990's due to vast amounts of foreign direct investment. FDI flows were assisted by the removal of capital controls and also by fast tracked capital liberalization (see Section 1.2) policies to exploit foreign direct investment.

However, Thailand and Malaysia were also chosen for comparison due to their response differences to the crisis. Thailand received an IMF loan and following an austerity program, implemented a contractionary economic plan. Malaysia chose a strategy independent of the Fund, implementing a reflationary and Keynesian strategy. Furthermore, Thailand followed the IMF's advice on maintaining capital liberalization policies to maintain FDI inflows. Malaysia ignored orthodox economic theory and

[5] Williamson, John Pg. 3

implemented capital controls. Utilizing capital controls as a tool in an overall economic plan in response to a major contractionary had a very limited track record and was extremely controversial.

As a result of Malaysia's expansionary response in conjunction with the capital controls, the Malay economy was only moderately affected in comparison to Thailand's. The Malaysian contraction was not as deep and the recovery was more rapid. Finally, in a comparative analysis of the two disparate strategies utilized by Thailand and Malaysia, the evidence supports the conclusion that Malaysia would not have been better off had the country pursued either an IMF rescue package or implemented an alternative strategy other than the one the country ultimately pursued.

1.2 CAPITAL ACCOUNT LIBERALIZATION

Debate over the merits and risks of capital account liberalization ignited during the Asian crisis. Many blamed the crisis solely on the lack of restraints on capital transactions, while moderates understood capital liberalization not as a direct cause of the crisis, but certainly a contributor. The ability to move capital freely started a chain reaction in 1997. It was not, however, the catalyst that started the contraction. The weaknesses in East Asia were amplified by capital account liberalization. Without a strong and systematic sequencing methodology and a strong underlying macroeconomic foundation, the implementation of capital account liberalization leaves economies open to increasing risks in the forms of market asymmetries, currency and market volatility, moral hazards, investor herd behavior, and finally large swings in both capital inflows and outflows. The result is that an economy's ability and preparedness to adequately

manage the swings in both inflows and outflows without economic upheaval is jeopardized.

International financial transactions have exponentially expanded during the last two decades (see Figure 1.1). This growth was driven by a variety of advances in technology, communication, and global trade. In the information age, real-time information is available to investors across the world, which facilitates the ease of international financial transactions in both volume and velocity. As such, capital is far more mobile today than ever before. This increased mobility and technology has made it "increasingly more difficult for governments to control either inward or outward international capital flows when they wish to do so…the liberalization of capital markets and…increases in the volume and the volatility of international capital flows is an ongoing and…irreversible process"[6].

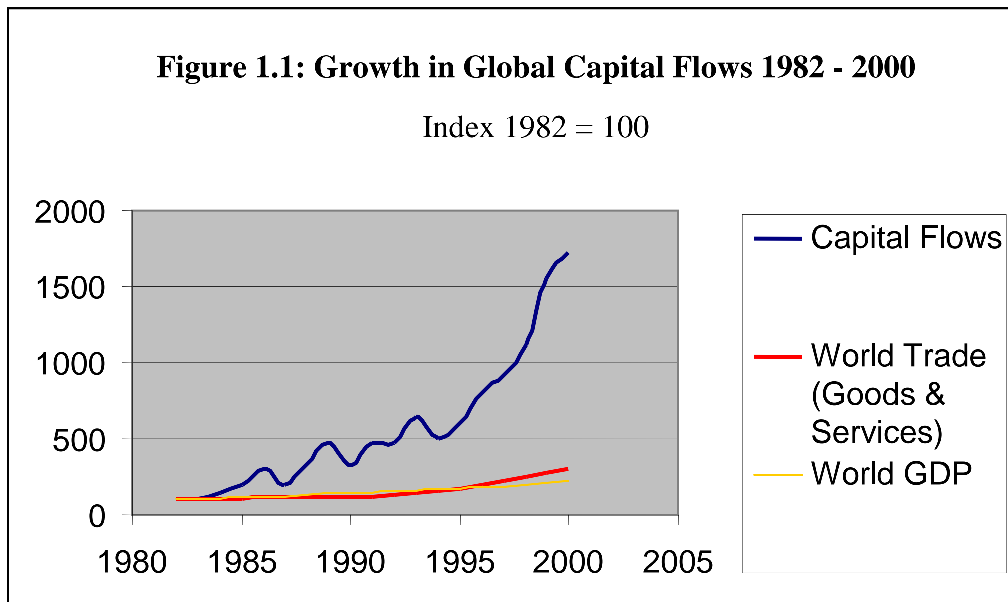

Figure 1.1: Growth in Global Capital Flows 1982 - 2000

Index 1982 = 100

Source: International Monetary Fund

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[6] Eichengreen, Mussa, Dell'Ariccia, Detragiache, MilesiFerretti, & Tweedie Pg. 1

The sum of the capital account and current account equals the balance of the payments and measures the payments between a given country and other countries. The capital account is the net result of both private and public investment flows into and out of a given country. Such capital flows include debt, foreign direct investment, market investments including currencies, stocks and bonds, real estate investment, and finally portfolio equity. The full or partial emancipation of restrictions on such transactions is capital account liberalization.

The fundamental argument for capital liberalization is similar to that for free trade. Free trade lifts barriers, such as tariffs, import and export quotas, duties, and subsidies to trade, between nations in goods and services. Theoretically, it allows nations to benefit from their comparative advantage and efficiently allocate resources. This allows for market expansions and prosperity. Similarly, capital account liberalization, like other advanced-economy policies, can lead to greater market and resource allocation efficiency. It has many derived benefits; as barriers to capital mobility are lifted, investment increases and growth quickens.

None of the member countries of the Organisation for Economic Co-operation and Development (OECD) maintains capital controls. The organization estimates that "annual gains arising from the mobility of international capital are on average…1 percentage point of GDP"[7]. Countries with surplus savings seek out attractive investment opportunities, which offer stronger yields. Thus foreign direct investment and higher yields can become self-fulfilling prophecies. Beneficiaries of capital investment enjoy higher standards of living and market expansions. These benefits trickle down as transportation, communication, and healthcare infrastructures improve.

[7] OECD: Liberalising Capital Flows: Lessons from Asia Pg. 1

Moreover, investment risk may be spread and mitigated as investors diversify by placing capital abroad. Consumption may also be easily shifted from period to period. For instance, capital liberalization makes it easier for investors, borrowers, and lenders to find and transact with one another. This process shifts resources from period to period. Furthermore, integration into the global economy is possible as financial transactions are aided and access to new markets and investment opportunities are made possible. Finally, the composition of trade changes as the historical inputs of labor and capital are freed from the confines of space and time. Furthermore, "once any input has the choice of country location…the doctrine of comparative advantage, with its emphasis on the question of what a factor does within the country, needs to share pride of place with the doctrine of absolute advantage guiding the question of where an internationally mobile factor goes"[8].

Capital account liberalization has taken decades to implement in the industrialized world. The heritage of the Great Depression and World War II was strident capital controls. Many advanced countries did not dismantle their capital control regimes until the 1980's. Western countries and nongovernmental organizations have long advocated capital account liberalization. The OECD has supported capital liberalization among industrialized nations. Article I of the OECD's Code of Liberalisation of Capital Movements states that "Members shall progressively abolish between one another…restrictions on movements of capital to the extent necessary for effective co-operation"[9]. Furthermore, the IMF long promoted capital liberalization. The IMF's

[8] Wolf Pg. 83
[9] OECD June 2006 Pg. 11

articles were in the process of being amended to formally support capital liberalization as one of its goals when the Asian crisis struck and such attempts were forgotten[10].

Capital liberalization has been accompanied by other trade and financial policy adjustments to promote both trade and openness. The "relaxation of controls on the financial sector during the past quarter century has not proceeded in a vacuum; it as been accompanied both by a more general liberalization of the domestic economy and by an opening-up toward the outside world."[11]

However liberalizing impediments to free capital mobility is a double-edged sword. Such policy changes are accompanied by increasing risks in the forms of market asymmetries, especially in information, currency and market volatility, and moral hazards. When the capital flow abruptly reverses itself, crises often follow. With the flow of foreign direct investment, the economy should expand. If a beneficiary economy does not have the technology to fully utilize the increases in to FDI, there will not be increases in output and the level of investment will return to its pre-FDI levels. Furthermore, FDI can be additionally problematic in that with high levels of FDI, the domestic savings level may decrease because of high exogenous investment levels, a greater reliance on such investment may develop. A lower incentive for domestic savings may also develop.

Capital account liberalization may also precipitate crises, however the root cause is not capital liberalization per se, but poor macroeconomic policies, weak regulatory and financial infrastructure, and poor overall economic management and supervision. Such deficiencies are amplified by the free flow of capital. The root cause of concern is not

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[10] OECD "Balancing Globalisation". Pg. 2
[11] Caprio, Honohan, & Stiglitz Pg. 9

necessarily the free flow of capital, but an economy's ability and preparedness to manage liberalization, both swings in inflows and outflows. In cases where capital account liberalization is implemented prematurely, the absence of a strong supervisory infrastructure to manage such monumental changes can result in crisis. However, the OECD believes that "there is plenty of evidence to show that as markets and institutions mature, the efficiency and regulatory gains arising from the liberalisation of capital movements outweigh the risks"[12]. This holds true for advanced economies, however, for emerging market economies, the benefits have been tenuous and the risks enormous. However, it is apparent in this age of a globally integrated economy, it is not a matter of whether to liberalize capital and markets, but when, how quickly, and how broad to make such policy changes with the minimum of risk.

Some of the 21st century's most illustrious economists were cautious of capital liberalization. For instance, "both of the main architects of the Bretton-Woods Institutions, John Maynard Keynes and Harry Dexter White, argued that countries should be protected from the disruptive impact of speculative international capital movements and that a world of unrestricted capital movements was not compatible with either a stable exchange rate system or a liberal international trading system"[13]. Capital inflows are volatile and are susceptible to significant outflows (see Figure 1.2).

In East Asia, many of the countries historically implemented capital controls to promote stability and monetary independence. However, by the 1990's such policy regimes were dismantled to capture foreign direct investment needed to fuel the regions remarkable growth. The removal of capital controls to facilitate capital liberalization was

[12] OECD Liberalising Capital Flows: Lessons from Asia Pg. 1
[13] IMF: Report on the Evaluation of the IMF's Approach to Capital Liberalization Pg. 27

also what all developed nations undertook. To be in compliance of Article VIII of the Articles of Agreement of the IMF, all barriers to international transactions involving foreign exchange transactions had to be removed.

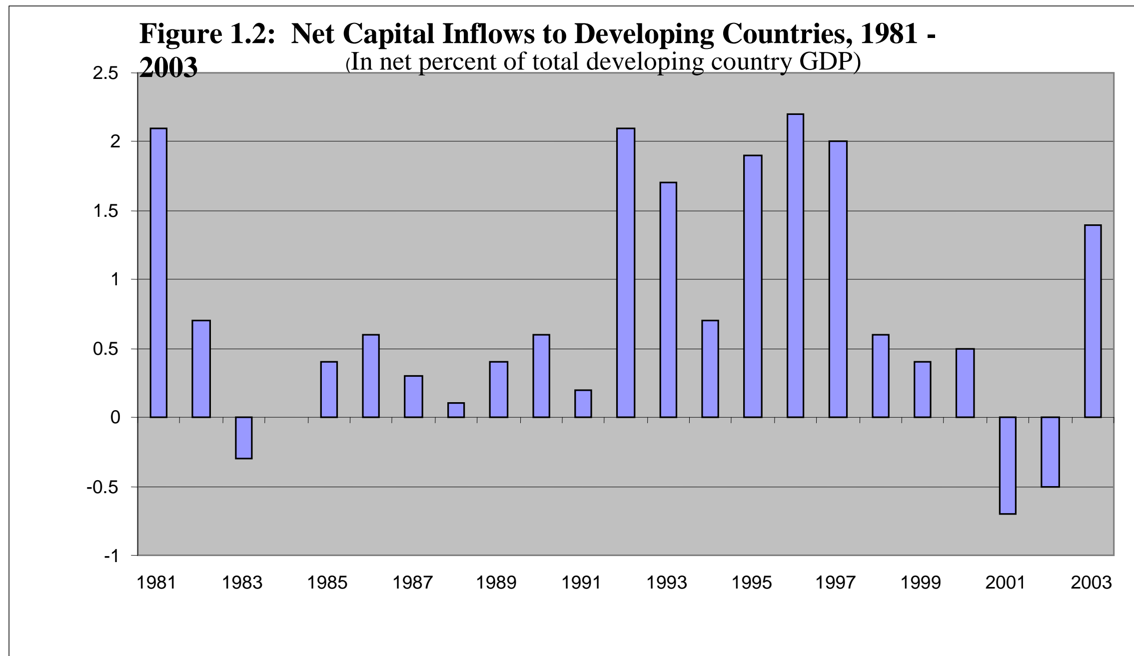


Figure 1.2: Net Capital Inflows to Developing Countries, 1981 - 2003
(In net percent of total developing country GDP)

Source: IMF: Report on the Evaluation of the IMF's Approach to Capital Account Liberalization
1/ changes in the private foreign liabilities, including equity portfolios. Excludes government borrowing.

1.3 CAPITAL CONTROLS

The use of capital controls as a policy prescription in response to an economic contraction is highly controversial and unorthodox. However, after Malaysia's deft use of capital controls as a tool in the country's overall plan during the East Asian crisis, the use of capital controls as a policy prescription has gained a measure of viability. However, it should be noted that a capital control regime as an economic policy will not, in and of itself, improve an economy in the middle of a contraction. Capital controls should be used prudently and as a part of an overall economic strategy. The use of such restrictions ought to be short-term and very specific. Malaysia proved that as a policy

response, controls can shield an economy from the turbulence of the global economy and allow time for policymakers to implement a plan.

There are various underlying reasons for installing capital account restrictions, most revolve around curtailing market asymmetries, efficiently managing the economy, and advancing market stability. Particularly during unstable and persistent capital flows, restrictions on capital mobility are often implemented to control "inflationary consequences of large inflows…and the buildup of unhedged foreign currency positions"[14]. Furthermore, capital controls are commonly used to maintain or augment monetary policy autonomy and to relieve pressure on fixed exchange rate regimes.

Short-term flows are often considered more risky than long-term flows because they are often speculative and can be volatile, while long-term capital flows are considered more stable and a reflection of the needs of the overall economy. Analyzing the effectiveness and impact of capital controls is problematic also due to the parity that can arise between short-term and long-term capital flows. For instance, short-term debentures are often repeatedly renewed, while long-term borrowings are sold on the secondary market.

Moreover, analyzing the consequences of controls to understand their effectiveness is difficult especially when competing macroeconomic policies may conceal the controls true effectiveness or influence. For instance, the implementation of prudent regulatory infrastructure may in fact be a cause of increased stability rather than capital restrictions. Moreover, "inflow controls may not be ideally suited as instruments

[14] IMF 2000 Pg. 5

of prudential policy, as they are often imposed and modified for macroeconomic rather than microeconomic reasons"[15].

There are various forms of capital restrictions depending on the policy and market objectives. There are direct and indirect controls. Direct controls explicitly place controls and prohibitions on inter-state movement of capital, such as payments, transactions, or transfers. Indirect controls can be implemented via taxes, limitations on transaction volume, maturity restrictions on inflows, and exchange rate regimes.

The use of capital controls during times of economic crisis has a limited record. However, the strategy gained acceptance after East Asia and Malaysia's "experiment". Capital mobility restrictions are placed on short-term flows, which are thought to be more speculative and volatile versus long-term flows. Capital controls attempt to thwart currency speculators and assuage downward pressure on domestic currencies. Furthermore, controls often allow time for the formulation of a coherent strategy to address fundamental market weaknesses and macroeconomic imbalances. Controls can also be applied arbitrarily to "insulate the real economy from volatility in the international financial markets"[16].

Furthermore, the implementation of capital controls may in the short-term offer needed monetary autonomy and market and currency stability, however in the long-term, restrictions may actually be far more detrimental to an economy as they may supplant and or retard the implementation of needed policy, market, regulatory, and financial reforms and adjustments. Finally, risks may be incurred owing to the perceived safety of said controls. During the long-term use of restrictions that are implemented without

[15] IMF 2000 Pg. 17
[16] IMF 2000 Pg. 18

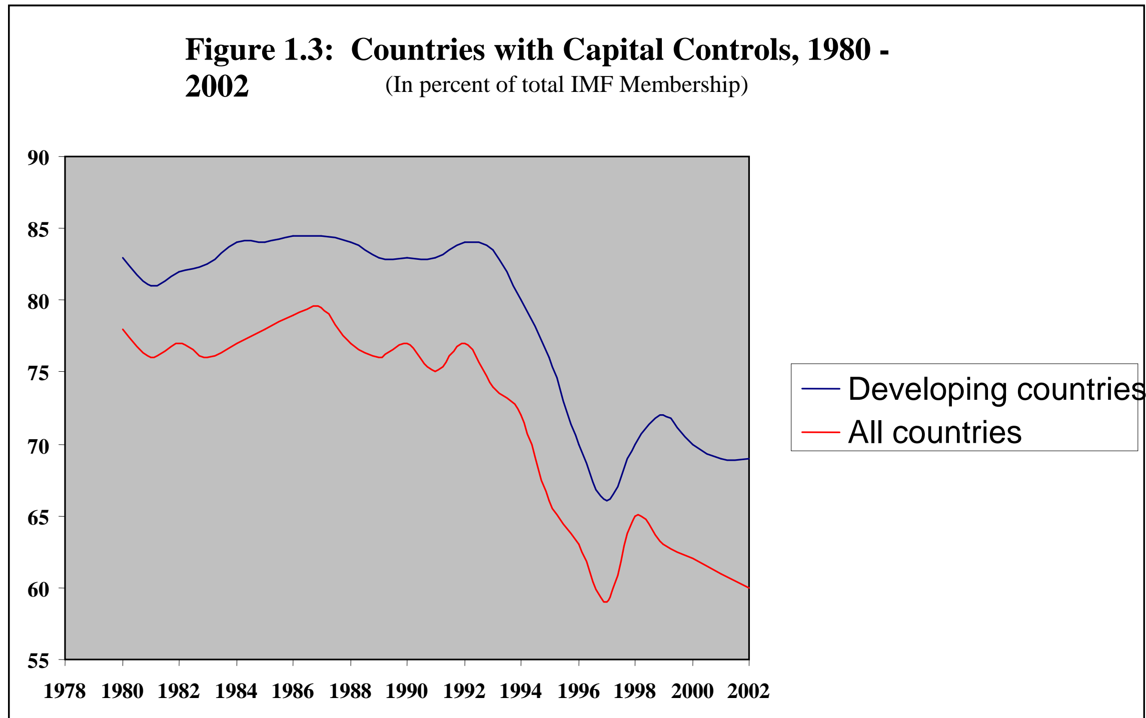
supporting macroeconomic and financial corrections, the restrictions may actually support additional capital flows, which will counter the basis for their initial implementation. The bottom-line is that capital controls cannot be utilized as an alternative to sound macroeconomic policies and strong regulatory, financial, and monetary infrastructures.

The IMF has not explicitly supported capital controls as it did for capital account liberalization. However, the Fund cannot require members, seeking balance of payments assistance, to remove capital controls as a condition. Section IV of the Fund's Articles of Agreement states that "Members may 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 or which will unduly delay transfers of funds in settlement of commitments"[17]. However, the Fund has supported the removal of barriers to capital mobility. As such, countries that maintain capital controls have dramatically decreased in the last two decades (See Figure 1.3).

For capital account controls to be effective they need to be implemented comprehensively and have firm policy supporting their enforcement. Without such support safeguards, loopholes may be exploited and through time, restrictions may become obsolete. Capital controls are not a panacea against currency or financial crises. However, there is a vast body of evidence indicating that capital controls protect emerging market economies from currency volatility. For instance, during the height of the Asian crisis when the contagion was affecting other seemingly disparate economies, India and China were unaffected. At the time, this was unusual for such large, export-

[17] http://www.imf.org/external/pubs/ft/aa/aa06.htm

oriented economies to remain unscathed. However, both countries had rigid capital control regimes in place prior to the onset of the crisis.



Source: IMF: Report on the Evaluation of the IMF's Approach to Capital Account Liberalization

1.4 GLOBALIZATION AND EMERGING MARKET INTEGRATION

The contagion affect, as witnessed in the East Asian crisis, was a product of the global economy and globalization. Many countries such as Brazil, Russia, South Korea, and Singapore with few direct ties to the affected countries of Thailand, Indonesia, and Malaysia, soon found themselves embroiled in the economic contraction. The ease of communication and speed of international transactions facilitated such contagion. However, such a phenomenon is not unique to the modern economy. During the last century, there have been two periods of significant globalization. The second movement is unfolding today, however the first major movement developed during the nineteenth century from 1890 to 1914 (circa). The first movement was as dynamic as the modern movement. "Bonds of more than sixty governments and shares of companies from

almost all continents and sectors were listed on the European exchanges."[18] John Maynard Keynes said of the period, "What an extraordinary episode in the economic progress of man that age was which came to an end in 1914… [any man] could adventure his wealth in…any quarter of the world...or he could decide to couple the security of his fortunes with…any substantial municipality in any continent"[19].

Globalization in both ages has changed paradigms and has wrought an increasingly complex world which has unfortunately, at times, yielded volatility, instability, and economic disruptions. The East Asian financial crisis highlighted the volatility and instability that the integrated global economy and globalization can affect. Michael Camdessus, Managing Director of the IMF, in a 1997 address to the U.N. General Assembly stated, "Countries are more vulnerable to shifts in market sentiment…changes in perception can trigger massive shifts in capital that can, in turn, precipitate banking sector crises and have serious spillover effects in other economies. Moreover, some countries are not well equipped to take advantage of the expansion of world trade and capital flows and therefore risk becoming marginalized from the world economy".[20]

However, globalization and market integration have numerous benefits for financial markets. With access to a global market, countries enjoy expansive and new opportunities, new markets for imports and exports, the ability to create new jobs, and to expand the economy more rapidly. Comparative advantage can be exploited for greater efficiency and utilization of resources. Globalization has facilitated private investment, by offering greater choice in new investment possibilities to private investors that may

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[18] Schularick Pg. 341
[19] Keynes Pg. 10
[20] http://www.imf.org/external/np/speeches/1997/mds9715.htm

offer portfolio diversity and higher returns. Finally, integration into the global economy places pressure on participating countries to promote sound economic policies and to implement and enforce strong regulatory oversight to encourage investor confidence, transparency, and market stability.

CHAPTER 2

THE EAST ASIAN MIRACLE

2.1 WAS IT MIRACULOUS?

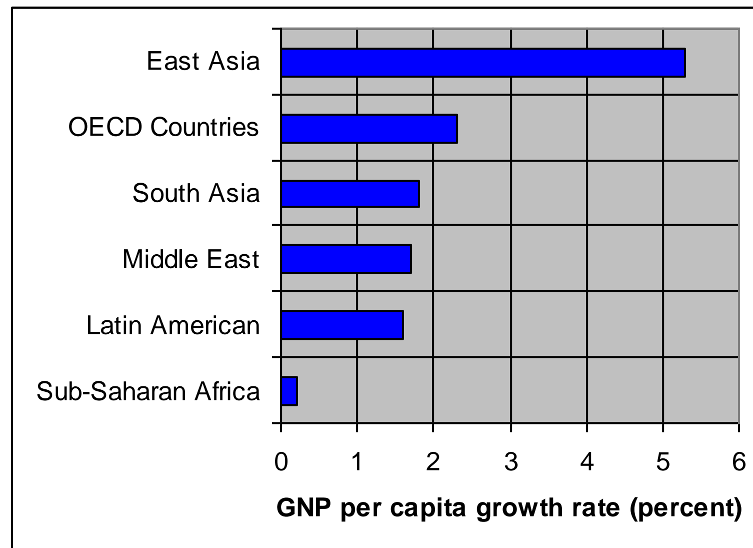
The remarkable transformation of East Asia is typically viewed by economists from two perspectives; one of miracle and one of crisis. Rightly or wrongly, "the miracle is, inevitably viewed through the lens of the crisis, while the crisis can only be elucidated as a product of the miracle"[21]. The East Asian region's growth has been extraordinary; no other region in the world enjoyed such sustained and rapid growth over three decades (see Table 2.1). The Asian tigers simply outpaced the rest of the world (see Figure 2.1). Since 1960, East Asia grew three times as fast as Latin America and five times more quickly than Sub-Saharan Africa. The region also appreciably outperformed the Middle-East and many industrialized nations[22]. The Economist in 1993 proclaimed "It is now likelier than not that the most momentous public event in [our] lifetime…will turn out to have been the modernisation of Asia"[23]. In a 1993 report on East Asia, the World Bank added additional perspective on the region's remarkable transformation, estimating that if "growth were randomly distributed, there is roughly one chance in ten thousand that success would have been so regionally concentrated"[24].

The economic transformation is even more remarkable considering the region was plagued historically by stagnant growth, high poverty rates, and political instability. However, beginning in the 1970's, there was a change from a controlled economy to a market-oriented economy and ultimately to an export driven economy. This shift was as

[21] Rigg Pg. 4
[22] World Bank 1993. Pg. 2
[23] Rigg Pg. 3
[24] World Bank 1993. Pg. 2

much economic as it was political. Capitalism was flourishing around the world as socialism's influence declined. East Asian countries invested in the service and manufacturing sectors and transformed their economies. Furthermore, the region implemented reforms, strategically chose specific industries for government intervention and development, and invested in education and technology to maximize human capital.

Figure 2.1: Average Growth Rate of GNP per Capita, 1965-1990



Source: World Bank. (1993)

However, what has been billed as miraculous is merely the implementation of prudent macroeconomic principles and sound strategies for industrial, technological, and human capital development. A study by the World Bank in 1993 noted that the region simply got the basics right[25] such as outward orientation, high domestic savings and investment rates, and finally efficient investment of FDI. East Asia crafted an economic plan in tandem with its macroeconomic policy. However, prior to the crisis, both Westerners and Asians deemed the "Asian Values" and a unique "Asian Capitalism" as the sources of the miracle. Nevertheless, what is miraculous is that Asia was able to break through "a long-standing historic barrier; until Asian economies began to take off,

[25] World Bank 1993 Pg. 5

economic development appeared to be a Western specialty, with only Japan…to challenge that monopoly"[26].

Table 2.1: Selected Macroeconomic Indicators

	1970 - 1979 Average Per Annum	1980 - 1989 Average Per Annum	1990 - 1995 Average Per Annum
GDP Growth (annual %)			
Thailand	7.3	7.4	9.0
Malaysia	7.8	5.8	9.5
Indonesia	9.2	6.2	8.0
South Korea	8.2	7.8	8.0
Philippines	5.9	2.0	2.1
Singapore	9.2	7.6	9.0
Inflation (annual %)			
Thailand	8.0	5.8	5.0
Malaysia	4.6	3.8	3.8
Indonesia	16.9	9.5	8.8
South Korea	15.0	8.3	6.5
Philippines	14.5	14.9	10.3
Singapore	5.9	2.9	1.8
Current Account Balance (% of GDP) positive number = account surplus			
Thailand	5.2	3.8	7.0
Malaysia	-3.0	2.8	5.8
Indonesia		2.9	2.3
South Korea	2.2	0.0	1.3
Philippines	4.6	3.5	4.0
Singapore	10.8	1.9	-12.0
Real Effective Exchange Rate Index (2000 = 100)			
Thailand			
Malaysia	147	152	122
Indonesia			
South Korea			
Philippines	141	124	110
Singapore	105	98	100
Unemployment (% of total labor force)			
Thailand		2.9	1.6
Malaysia		6.8	3.7
Indonesia		3	6
South Korea		3.7	2.1
Philippines		6.5	8.5
Singapore		3.2	2.9

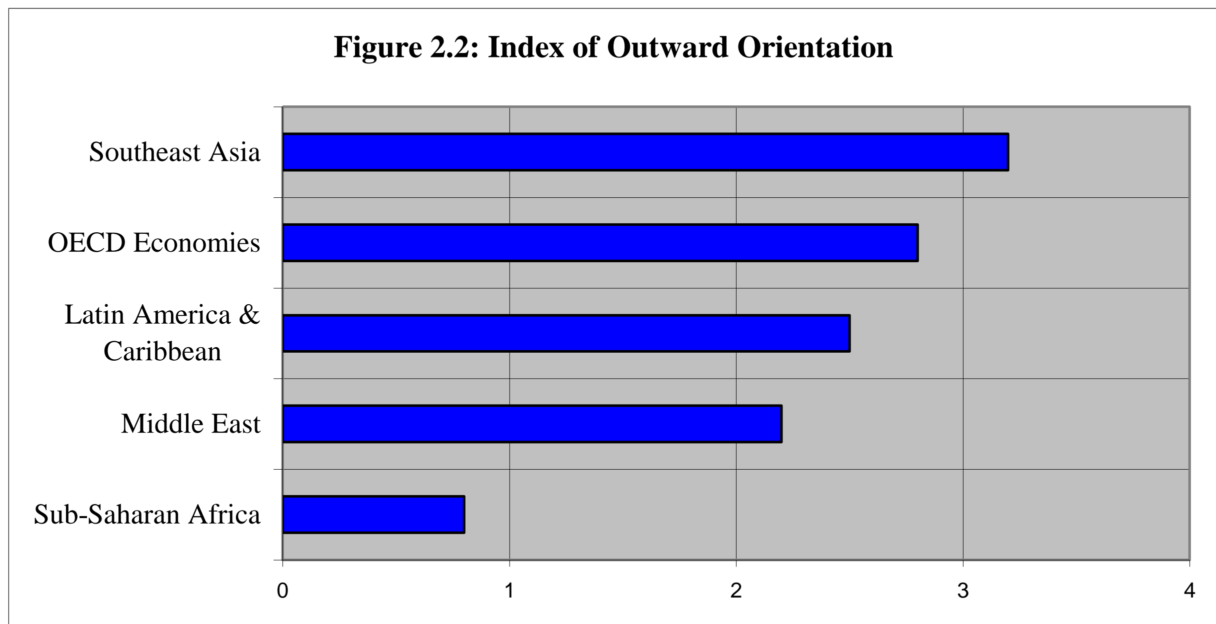
Source: World Development Index (WDI) (Author's Computations)

[26] Krugman Pg. 23

With the economic reforms and policies implemented, the region enjoyed double-digit GDP growth and was touted as the Asian Miracle. Many economists, including those at the IMF and World Bank, were praising the region for its economic expansion and were touting the region as an example of the successful implementation of their policies.

2.2 TRANSFORMATION & SOURCES OF GROWTH

The countries of East Asia are dynamic with over 1.9 billion people and covering 16.3 million square miles. Religion is equally as sundry with a large number of Muslims, Buddhists, Hindus, and Confucians. However, in spite of vast cultural, religious, ethnic, and political differences, a common strength was a vast culture of outward orientation. Outward orientation relates to an economy's openness to the world in terms of trade and investment. Many East Asian countries developed strong outward orientation not only as a policy, but also out of necessity due to their limited geographical and population size. Figure 2.2 shows the level of outward orientation among developing nations.



Source: The World Bank. (1993)

Outward orientation strategies are premised on the idea that with greater openness comes increased resource allocation efficiency and follows along with greater economic growth. This orientation allowed the region to import technology and foreign ideas to improve efficiencies and productivity.

The region also joined together to form regional synergies such as APEC, AFTA, AND ASEAN. By joining together, the region began to develop its economies, enhance political and cultural synergies, commence the modernization process, and compete with the West. This process started in the early 1960's with Hong Kong, Taiwan, South Korea, and Singapore. For instance, in 1963 South Korea, which was poorer than many of Africa's poorest nations, implemented an outward-looking strategy that maximized investment; today the disparity between South Korea's economy and Africa's poorest is stark. In a second wave, Indonesia, Malaysia, the Philippines, and Thailand formed the Association of Southeast Asian Nations (ASEAN) in 1967 to facilitate not only greater regional economic development and cooperation, but also integration.[27]

However, analyzing Southeast Asian growth and transformation over the last three decades is difficult. Academic literature on the subject is divided and difficult to reconcile. Divergences lie with competing economic theories. There are many economists who believe that growth is a phenomenon of governmental management and intervention, while others support the neoclassical theory that markets and incentives are the main causes for growth. For instance, Charles Wolf concluded that it was a,

> striking fact that the few relatively successful [economies] – Malaysia, Singapore, and the republic of Korea have greatly benefited from decisions and policies that limit government's role in economic decision

[27] See section 2.5 for additional detail regarding ASEAN.

> making, and instead allow markets – notwithstanding their imperfections…to exercise a decisive role in determining resource allocation[28].

However, for many of the region's economies to operate efficiently and allow the market to prudently allocate resources to the most profitable and productive industries, significant government intervention and activism was entailed. Macroeconomic strategies were applied to build an economy that was based on a directed investment model that was export-oriented and labor-intensive. Furthermore, governments utilized "strategies of selective promotion" to support industries that formulated the bedrock of their economic reform strategies. In many instances this was capital-intensive heavy industry and manufacturing.

Neoclassical theorists have downplayed the significant role of selectively protected industries, which were targeted for beneficial governmental policies. Such incentives ranged from low interest rates and creative tax and financial incentives, to public ownership and investment. Governments created the environment, directed the investment, strengthened financial institutions, and arbitrarily controlled interest rates and tax policy all geared towards an efficient, vibrant, and expansionary economy. It is foolhardy to believe that Southeast Asia, straddled by inefficient and depressed markets, which were trying to operate in highly volatile and politically unstable environments, would miraculously begin allocating resources efficiently and implement the necessary reforms without enormous governmental activism. Economist Alice Amsden noted that the experiences of many nations in Southeast Asia "provide evidence that governments can foster growth by governing markets and by systematically distorting incentives in

[28] Wolf, Charles Pg. 27

order to accelerate catching up…to facilitate the establishment and growth of industrial advantage"[29].

For instance, South Korea is often heralded by neoclassical economists for its market-driven transformation; however the republic "did not rely solely on markets to allocate savings. Rather they repressed interest rates and directed credit in order to guide investments"[30]. Additionally, South Korea was very selective in not only industry protection, but also arbitrarily controlled which firms entered the protected industries. When the government did promote an individual firm rather than the industry as a whole, this was to "rectify perceived entrepreneurial and skill deficiencies, using export performance to determine whether firms deserved continued promotion"[31].

There is little accord regarding the sources of Southeast Asia's growth. Many economists point to factor productivity as responsible for East Asian growth, while others rely on the expansion of factor inputs. The main source of growth was human and physical capital. With significant gains in education, the human capital stock increased and played a fundamental role in the region's growth. With high investment due to high rates of domestic savings, there was significant investment in the physical capital stock. Labor was a much smaller source of growth, however this is not atypical. In theory, capital and labor as resources are subject to diminishing returns. As such, there is a third element of growth - Total Factor productivity (TFP). TFP has traditionally been difficult to analyze in the region because it is so low.

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[29] World Bank 1993 Pg. 84
[30] World Bank 1993 Pg. 83
[31] World Bank 1993 Pg. 308

TFP is an "indirect measure of technological progress, calculated as the residual…between the rates of growth of an index of input and an index of output"[32]. As Southeast Asian economies expanded and improved there was not a similar improvement in total factor productivity. Paul Krugman explains that "most Asian economies weren't closing the productivity gap…Asia achieved remarkable rates of economic growth without correspondingly remarkable increases in productivity. Its growth was the product of resource mobilization rather than efficiency"[33].

Despite the difficulty of analyzing the level of TFP in East-Asia due to its negligible level, sources of growth (capital and labor) for the region were fairly stable from 1960 to 1994 (see Table 2.2). However, it should be noted that there were significant technological advances in the late 1980's and 1990's and TFP was most likely increased beyond the data as reflected in the Table below.

Table 2.2: Sources of Growth 1960 – 1994 (Percent per Year)

	Capital	Labor	Total Factor Productivity	Output
Thailand	3.7	2	1.8	7.5
Malaysia	3.4	2.5	0.9	6.8
South Korea	4.3	2.5	1.5	8.3
Philippines	2.1	2.1	-0.4	3.8
Singapore	4.4	2.2	1.5	8.1
Indonesia	2.9	1.9	0.8	5.6

Source: Rethinking the East Asian Miracle

In a paper by Jong-Il Kim and Lawrence Lau, the authors note that capital accumulation was the most important factor in East Asia's economic growth. East Asia experienced significantly higher growth rates of capital and labor inputs compared to advanced industrialized economies. Since inputs expanded more rapidly, outputs also expanded more rapidly as well. However, the authors' noted, "technical progress is even

[32] Krugman Pg. 29
[33] Krugman Pg. 32-33

less important as a source of growth for East Asia"[34]. They further noted that there were little organic improvements in technology. Many industries utilized mature technology and that East Asia was trying to catch-up to industrialized nations' technological capabilities. They concluded stating that analysis of their results is "somewhat puzzling why there is so little measured growth in productive efficiency over time"[35].

In a paper by Chang-Tai Hsieh he agrees with Kim and Lau's assessment that capital accumulation was the most important factor for growth. However, he notes that if growth were driven by capital accumulation and little technological improvements due to diminishing returns, the return to capital should have fallen. If this is the case, then most likely technology may have played a larger role than previously understood and what the data reflects. However, despite much scholarly work there continues to be debate amongst economists regarding the sources of growth and how to measure the growth. This paper does not attempt to answer the debate between factor accumulation and total factor productivity. However, the "rate of TFP is not a sufficient statistic to draw conclusions and to make any policy statement about growth in East Asia"[36].

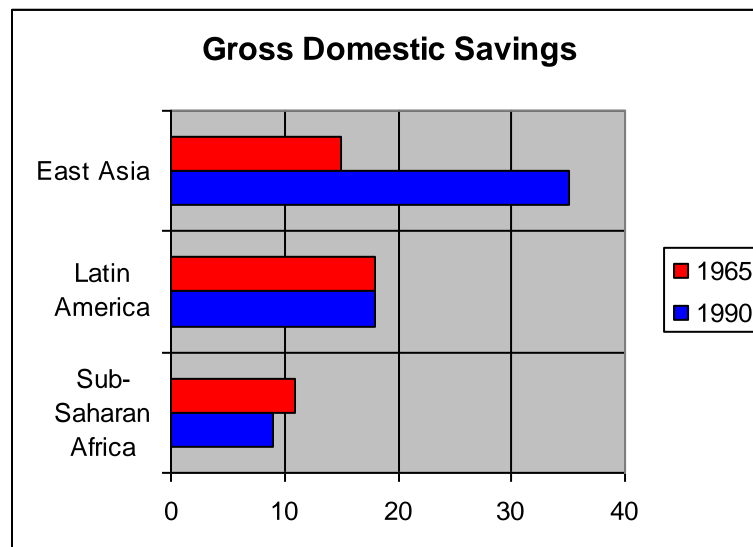
Nevertheless, it should be noted that East Asia was not only highly dependent on capital accumulation to drive growth, but also on the region's vast outward-orientation and need for foreign technology. This reliance was due to significant domestic deficiencies. Imported foreign technology and ideas were paramount to continued economic expansion. The importation of technology did indeed facilitate productivity and assisted with the region's unparalleled growth. TFP had an immeasurable impact, but one nonetheless.

[34] Kim & Lau Pg. 260
[35] Kim & Lau Pg. 265
[36] Felipe Pg. 17

2.3 SAVINGS AND INVESTMENT

The highly performing East Asian economies were the only "group of developing economies in which savings exceeds investment, making them exporters of capital"[37]. Between 1960 and 1990, the savings and investment rates of East Asia outpaced other developing regions. Gross domestic savings during that time grew by 133% (see figure 2.3).

Figure 2.3: Gross Domestic Savings as a Percentage of GDP



Source: World Bank 1993.

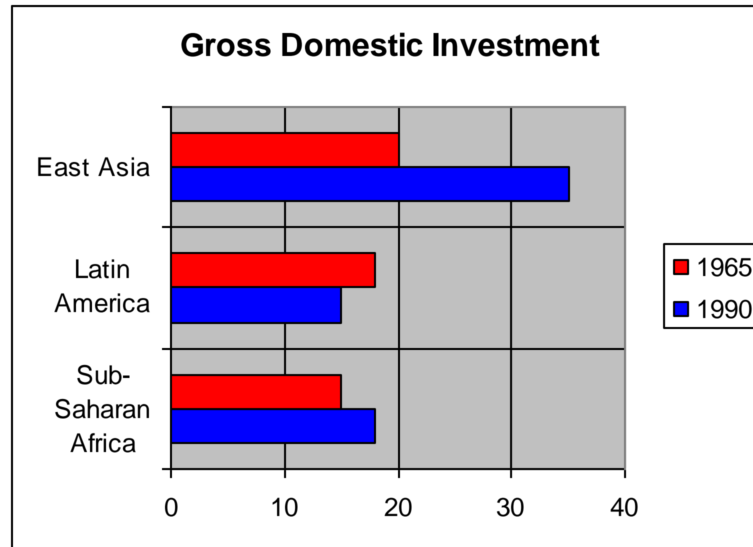
Gross domestic investment expanded by 75%. In 1965, Latin America enjoyed a higher rate of gross domestic savings than East Asia, but by 1990 this was markedly reversed. Regarding gross domestic investment, in 1965 Latin America and East Asia had comparatively similar levels of investment, however 25 years later East Asian investment levels outpaced Latin American levels by 170 basis points (see Figure 2.4).

The countries did not rely heavily on leveraged growth until the 1990's. Furthermore, "from the beginning of the Asian takeoff to the early 1990's, the region's

[37] World Bank 1993 Pg. 41

growth was overwhelmingly financed on a pay-as-you-go basis, out of each country's savings. Little money was borrowed; most of the capital that came from abroad took the form of direct foreign investment"[38].

Figure 2.4: Gross Domestic Investment as a Percentage of GDP



Source: World Bank 1993.

Prudent banking systems were formed that instilled consumer confidence. Financial system regulation and supervision tried to limit corruption and enhance depository stability. However, such policies were far from homogenous. Some countries implemented voluntary programs to facilitate savings, while others, like Malaysia and Singapore, chose to implement forced savings programs via provident fund contributions. Such programs automatically deposited a percentage of gross payrolls into funds. Regardless if savings was mandatory or voluntary, the end result was high rates of savings. Such levels continued fairly unimpeded due to high rates of return.

Furthermore, the region's high domestic savings assisted in fueling the high levels of investment needed to transform East Asian economies (see Table 2.3). The region developed domestic policies around supporting and increasing private investment. For

[38] Krugman Pg. 27

instance, attractive tax policies and low tariffs were utilized to maintain low capital goods prices. Finally, many governments utilized policies of financial repression by holding "deposit and lending rates below market clearing levels"[39]. The maintaining of low interest rates by governments was directed at spurring investment and expanding credit availability.

Table 2.3: Investment as a Percentage of GDP in Selected Countries 1986 – 1995 (Annual Average)

Country	1986 - 1990	1991 - 1995
Indonesia	26.3	27.2
Malaysia	23.4	39.1
Philippines	19.0	22.2
Singapore	32.4	34.1
Thailand	33.0	41.1

Source: UNTAD (1998), *Trade and Development Report*

2.4 COMPARATIVE ADVANTAGE

By exploiting comparative advantage, the governments of East Asia recreated their economies by emphasizing and constructing an export-oriented economy. In 1965 the region's share of global exports was only 7.9%. By 1990, the region enjoyed more than a 10% increase in global exports reaching 18.2%. In developing-economy exports, the regions share increased from 12.2% in 1965 to over half of the total developing-economy exports reaching 56.3%. The region's exports rapidly outpaced world trade. Such high levels of exports increased demand for FDI and investment. High exports increased global transactions, which supported for economic liberalization policies and gave firms access to international markets that they may not have had previously without such high level of exports.

Furthermore, the region's countries sought ways to exploit their comparative advantage for specialization and market efficiency. This created significant inter and

[39] World Bank 1993 Pg. 17

intra-regional trade. Many American and Japanese multi-national corporations began investing in the technology, electronics, and automobile sectors seeking lower cost and vertical integration of industries. To fulfill the demand for labor, there was a vast migration from rural communities to urban industrial centers. Furthermore, East Asia's relatively high interest rates and high growth rates attracted both investors and lenders. Low interest rates in the United States forced investors to seek attractive alternatives. East Asia became a beneficiary of much of this foreign direct investment.

Southeast Asia also began building labor-intensive industries. However, with foreign companies' investment in technology and manufacturing, countries such as Thailand, Malaysia, and Singapore soon shifted away from labor-intensive industries and concentrated on export-oriented industrialization. The role of foreign direct investment has been integral to the Asian transformation. ASEAN countries have utilized the investment for specialization, technological modernization, and the transfer of knowledge. This in turn created a vibrant export-oriented manufacturing sector, which drove most of these economies.

For instance, the Malaysian government in the 1960's and 1970's encouraged foreign direct investment, however due to a conflicting policy of the expansion of local industry ownership, FDI was inhibited. However, by the 1980's, new policies were implemented that "offered greater tax incentives and relaxed domestic equity participation requirements for potential investors, bringing new technology and export and employment opportunities".[40] Major beneficiaries of investment were electrical products, rubber products, metals, and petroleum.

[40] World Bank 1993 Pg. 302

Liberalization of FDI in the 1980's was not unique to Malaysia. The Asian region as a whole began to liberalize investment to further attract FDI. Policies were enacted to facilitate the repatriation of profits, provide export incentives, and to allow firms to accelerate depreciation to offset tax liabilities. Competition for FDI pushed the region's countries to offer incentives, preferential loans, and subsidies. The increases in FDI are exponential. From 1970 to 1995 the region enjoyed an overall increase in FDI of 1,454% (see Table 2.4). Increases in FDI fueled the expansion of productivity. The World Bank 1993 study on East Asia noted "such high levels of productivity growth are quite unusual…this superior productivity performance comes from the combination of unusual success at allocating capital to high-yielding investments and at catching up technologically to the industrial economies"[41].

Table 2.4: Foreign Direct Deposit – Net Flows (in millions, current US$)

	1970 -1979 Average per Annum	1980 -1989 Average per Annum	1990 -1995 Average per Annum
Thailand	81.3	507.5	2,361
Malaysia	326	909	4,173
Indonesia	195	326	2,134
South Korea	74.7	379	978
Philippines	56	214	934
Singapore	350	1,906	6,253
Total Average	180.5	707	2,805

Source: World Development Index (WDI) (Author's Computations)

Thailand also began implementing reforms to bolster FDI inflows. In 1984, the Thai baht was devalued by 14.8%. Furthermore, "significant fiscal consolidation began and a decisive change was made in the orientation of trade and industrial policies toward export-led growth. Thailand gave priority to promoting capital inflows through tax and

[41] World Bank 1993 Pg. 8

institutional reforms while concurrently developing financial markets"[42]. The countries favorable interest rates and relative currency stability via a fixed exchange rate regime promoted increased foreign direct investment inflows. Finally, Thailand implemented banking sector reforms to increase access to foreign financing. The country also adopted measures to liberalize payments and transfers for international transactions to meet the IMF Article VIII guidelines.

2.5 ASEAN, AFTA, & REGIONAL SYNERGIES

Despite the region's many differences, Southeast Asia has been able to create synergies that have not only made the region stronger, but have played an integral role in its growth. In 1967, the Association of Southeast Asian Nations (ASEAN) was formed to "accelerate economic growth, social progress and cultural development…[and to] create a stable, prosperous and highly competitive ASEAN economic region in which there is a free flow of goods, services, investment and a freer flow of capital, equitable economic development and reduced poverty and socio-economic disparities"[43].

A local dignitary present at the signing of the ASEAN agreement stated,

> The fragmented economies of Southeast Asia…with each country pursuing its own limited objectives and dissipating its meager resources in the overlapping or even conflicting endeavors of sister states carry the seeds of weakness in their incapacity for growth and their self-perpetuating dependence on the advanced, industrial nations. ASEAN, therefore, could marshal the still untapped potentials of this rich region through more substantial united action.[44]

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[42] IMFj Pg. 29
[43] http://www.aseansec.org/64.htm
[44] http://www.aseansec.org/7069.htm

Another official at the signing hoped that with the new economic agreement, the ASEAN region would develop into "a region, which can stand on its own feet, strong enough to defend itself against any negative influence from outside the region."[45]

The formation of ASEAN was in part to provide a semblance of stability in a highly volatile and unstable region. For the first two decades of the association, it was more political than economic. Political stability needed to be implemented before significant economic growth could be achieved. As such, the region concentrated early on fighting the threat of communism especially from Vietnam. For instance, the competence of ASEAN was tested in 1978 when Vietnam invaded Cambodia. ASEAN reacted quickly formally denouncing the military action and worked towards gaining global support of its position through the United Nations. "Not only did the Cambodian conflict become a rallying point for the ASEAN, but it also enhanced the regional and international stature of the organization"[46].

Early attempts at formulating economic projects amongst the member countries failed. "Regional trade liberalization was not seen as a high priority because trade between ASEAN states was so limited. At no time during the period from 1975 to 1985 did intra-ASEAN trade exceed 18 percent of total ASEAN trade". However, in the 1970's the organization began negotiating as a coalition when Japan announced its intentions to increase domestic use and production of synthetic rubber. At the time, natural rubber was a main export item of Thailand and other ASEAN members. With a strong unified lobbying bloc, Japan made concessions. Through collective action and a

[45] http://www.aseansec.org/7069.htm
[46] Kurus Pg. 822

cooperative approach to the economic and political defense of all member states, ASEAN achieved significant "structural empowerment".

ASEAN nations became more assertive regarding geopolitical and economic issues. ASEAN became an apparatus to coordinate efforts to deal with issues. The organization fostered cooperation and not competition. Thus, intra-ASEAN conflict was more easily resolved. For instance, Indochina and Malaysia were able to enjoy normal relations and end significant distrust and conflict between the two due to their alliance and shared objectives in ASEAN[47].

As regional stability increased and synergies grew, the member countries were able to pursue their individual trade policies while enjoying greater collective reliance and intra-regional trade expanded. Evidence supports the notion that ASEAN created and facilitated significant economic synergies, rather than independent economic accords between Southeast Asian nations. At an economic summit in 1992, Malaysia Prime Minister Mahathir Mohamad noted, "It is no accident that Southeast Asian countries of the ASEAN group are among the most dynamic in the world".[48] For instance, in 1968, the United Nations created the Generalized System of Preferences (GSP). The preferences allowed developing nations to enjoy higher quotas of exports, tariff concessions, and beneficial trade relationships with industrialized nations, especially the U.S. The association's members benefited from GSP solely by their membership. GSP became a large part of Southeast Asian's economic strategy for an export-oriented economy.

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[47] Kurus Pg. 826
[48] Kurus, Pg. 828

Two decades after ASEAN's formation the region undertook additional measures of economic and political unification by building on the foundation that ASEAN had laid. The ASEAN Free Trade Area (AFTA) was formed in 1992 to "promote the region's competitive advantage as a single production unit. The elimination of tariff and non-tariff barriers among Member Countries is expected to promote greater economic efficiency, productivity, and competitiveness"[49]. Without the stability and cohesion fostered by ASEAN, AFTA would have been impossible to implement.

AFTA has been far more successful economically than ASEAN, partly because ASEAN was more of a political rather than economical organization. The Centre for International Economics estimated in a study in 2000 that economic gains from AFTA were US $25.6 Billion.[50] Tariffs and barriers to trade have been vastly reduced and have eased restrictions and facilitated trade among member nations. For instance, as of January 2005, trade tariffs on 98.8% of intra-AFTA trade were lowered to 5% or below via a Common Effective Preferential Tariff (CEPT). However, AFTA is seeking total duty-free trade by 2010; CEPT is the precursor to a possible single integrated ASEAN market. Finally, AFTA has also assisted attracting foreign direct investment, especially the expansion of efficiency-seeking investment "in cross border production operations in vertically integrated industries…the ongoing process of trade liberalization in ASEAN countries has contributed to the expansion of cross-border production by making it easier to transfer inputs and outputs across borders among the countries in ASEAN"[51]. As trade increased, pressure to deregulate followed along with domestic market liberalization. AFTA further pressured these movements as trade tariffs were reduced or eliminated.

[49] http://www.aseansec.org/64.htm
[50] CIE Pg. vii
[51] Athukorala & Menon Pg. 169

The overall strategy of market liberalization and deregulation was to instill market transparency, consistency, and efficiency along with boosting investor confidence, and maintaining market stability.

2.6 EAST ASIA'S HUMAN WELFARE MIRACLE

Southeast Asia's transformation is visible in the standards of living of the people and improvement in human welfare (see Table 2.5); many were elevated out of poverty in less than three decades. With the region's significant improvement in health care and the availability of nutritious food, life expectancy increased from 55 years in 1960 to 72 years in 1998. The portion of the populace living in abject poverty, lacking the basic necessities of food, water, and shelter, decreased from 58% in 1960 to 17% in 1990.[52] Similar progress was made in education and literacy with 59% overall secondary education enrollment. By 1999, the region reached a 90% adult literacy rate. Comparable levels of progress were made in transportation infrastructure and ownership of consumer goods especially electronics.

Table 2.5: Selected Indicators: Development, Modernization, and Well-being

	Real GDP/($ PPP)[53]	Life Expectancy at Birth (years)		Infant Mortality[54]		Underweight Children[55]		Secondary school enrollment (%)		Adult Literacy (%)	
	2000	1960	1998	1960	1998	1975	1995 - 2000	1980	1994 - 1997	1970	1999
Indonesia	2,840	41	66	139	43	51	34	29	51	54	84
Malaysia	8,360	54	73	73	8	31	18	48	64	60	86
Philippines	4,220	53	69	80	32	39	28	65	78	83	95
Singapore	24,970	65	78	36	4	-	-	60	72	-	92
Thailand	6,330	52	69	103	29	36	19	29	31	79	95
Average		55	72	82	23	39	25	46	59	69	90

Source: Southeast Asia: the human landscape of modernization and development

[52] World Bank 1993. Pg. 4
[53] An international comparable scale of real GDPs using PPP rather than exchange rates as conversion factors.
[54] The annual number of deaths before the age of 1 per 1,000 births
[55] A measure of moderate and severe child malnutrition based on medium weight-for-age

The end result of these substantial increases in overall human welfare was a significant investment in human capital, which helped spur overall economic growth. Education was a staple element of the region's plan. Governments began by offering universal education at the elementary school level. This was followed later with advances and wider availability in secondary education. There was an emphasis on vocational and technological fields of study, which were conducive to rapid economic growth, development, and supported the needed skills for an export-oriented economy. Expansive secondary educational opportunities facilitated income distribution equality and the rise of a middle-class. Private and public funds afforded access for a greater percentage of the population to tertiary education.

The social and economic progress made over a relatively short timeframe in Asia was remarkable. Nonetheless, what has been billed as "the unique Asian capitalism" not only assisted with the region's exponential growth, it also contributed to the crisis. However, the crisis was not an indictment of the miracle. The financial crisis did not wipe out the real progress and growth. The contraction did retard growth, but it also forced Asian policymakers to rethink the mechanics of their economies and implement needed reforms and market adjustments. The East Asian Miracle, despite the crisis, continues to stand as an example to other underdeveloped regions of the ability to literally transform an entire region within a single generation's time.

CHAPTER 3

EAST ASIA IN CRISIS

3.1 INTRODUCTION

Despite the fact that in open economies, crises are a normal function for market correction and adjustment, the East Asian financial crisis is an interesting case study in economic and monetary theory. This is due to not only the region's remarkable transformation, but also due to the massive contraction and subsequent policy prescriptions. However, East Asia's crisis is not unique. "Crises are an unavoidable concomitant of the operation of financial markets."[56] However, emerging and developing economies are especially vulnerable to wide market fluctuations and susceptible to economic contractions because they typically do not have the regulatory, economic, or monetary infrastructures in place and lack established procedures and sophistication.

Economist Barry Eichengreen remarked during the Asian economic collapse that "the crisis problem is back"[57]. Furthermore, he stated, "relative to the pre-1914 era of financial globalization, crises are twice as prevalent today"[58]. In a study by the World Bank, it was estimated that there were 112 financial crises in 93 countries between the 1970's and the late 1990's[59]. The World Bank also estimated that the crises in the 1980's and 1990's alone cost in lost growth US$1 Trillion[60]. Such crises are caused in part by the modern and complex globally integrated economic and financial system. Many economic adjustments are caused by "the pursuit of unsustainable monetary, fiscal, and

[56] Eichengreen – Financial Crises pg. 4
[57] Wolf Pg. 304
[58] Wolf Pg. 280
[59] World Bank: Finance for Growth Pg. 75
[60] GOA June 2003 Pg. 1

exchange rate policies"[61] Furthermore, the lack of economic and policy transparency can also entrench downturns and exacerbate them. The current financial system has evolved from the gold standard to the current post-Bretton Woods floating currency exchange regime. With any complex system, sources of weakness and total breakdowns will occur. Causes of economic crises are varied as is the responses to contain and ameliorate them.

However, complexity of a system is not an excuse for the lack of prudential oversight and ongoing adjustments to a changing global economy. Financial crises in recent history have instigated debate on whether the world's current system of safeguards is adequate to predict and prudently respond to crises. For instance, the global economy has made dramatic changes since the IMF's inception in 1944; unfortunately, "time and again, panics in financial markets proved impervious to the ministrations of the people responsible for global economic policymaking"[62]. Furthermore, "the events of 1997-98 cast disquieting doubts on the IMF's capacity to maintain financial stability at a time when titanic sums of money are traversing borders"[63].

The East Asian financial crisis was unique in comparison to previous crises; regions experiencing such high levels of domestic savings and investment rates historically have not experienced economic recessions the magnitude of East Asia. Such high rates of savings and investment unfortunately led to complacency by both governmental and nongovernmental agencies that should have monitored the economy and macroeconomic fundamentals more closely. A year into the crisis, the Economist provided context, writing, "If anyone had predicted a year ago that Indonesia, South Korea, and Thailand would have to go cap in hand to the IMF, they would have been

[61] Eichengreen – Financial Crises Pg. 7
[62] Blustein Pg. 8
[63] Blustein Pg. 8

thought mad"[64]. Ironically, as Joe Stiglitz pointed out, "Many of the factors identified as contributors to East Asian economies' current problems are strikingly similar to the explanations previously put forward for their success."[65]

It seems unbelievable that the brightest minds did not foresee the looming crisis. Barry Eichengreen cynically observed, "Someone clearly saw the Asian crisis coming…although it is not clear that they saw it coming in Asia"[66]. The World Bank, even as late as 1996, prognosticated that growth would continue in the region, stating,

> Although looking into the future is always a risky business, some things are likely to be good bets. Rapid growth is likely to continue in East Asia, and the pace of change experienced by these economies should continue to be very impressive. East Asian economies are committed to an open and cooperative approach in the evolution of economic relations among themselves and with the rest of the world, and will use market-based and competitive means to achieve their goals.[67]

There were relatively few economists or organizations who foresaw the pending crisis. The 1995 – 1996 Asian Development Outlook Report completed by the Asian Development Bank was bullish on continued growth in Malaysia and Thailand. However the report did identify current account deficits as a cause for concern. The bank mitigated the risks associated with a widening current account deficit by offering the assurance that with continued growth, the deficit could easily be financed by FDI.

As the crisis evolved and gained momentum, it was characterized by a "herd mentality". Devaluation became a self-fulfilling prophecy as currency speculators began shorting the regions' currencies while others, both domestically and internationally, were

[64] Bhopal & Hitchcock pg. 19
[65] Stiglitz 1998
[66] Eichengreen: Financial Crises Pg. 160
[67] Bhopal & Hitchcock Pg. 21

desperately trying to liquidate investments. Thailand's adamant defense of the baht only fueled speculation. Banks declined to roll over short-term notes and began calling them, which led to a liquidity crisis for both governments and corporations. The real estate market bubble, especially in Thailand, collapsed wiping out billions of dollars in vacuous equity. Under heavy attack, governments scrambled to defend their pegged exchange rates. Thailand kept secret its perilous reserve situation from the world's economic community and the IMF. When it was made public, there was a massive run on the baht and devaluation followed.

Instead of a looking internally at a myriad of culpable variables, the region's governments blamed hedge fund managers and currency speculators for the crisis as a calculated attempt to destabilize the region. For instance, the most outspoken leader of the ASEAN nations, Malaysian Prime Minister, Dr Mahathir Mohamad stated that the attack on East Asia was a "well-coordinated effort to destabilise ASEAN currencies for self-serving purposes, thus threatening the stability of all ASEAN countries"[68]. He further stated that the sabotaging of currencies by international financial speculators should be a crime, "Otherwise, the currencies of developing countries will continue to be sabotaged…this phenomenon will be repeated and it is for this reason that we must regard it as a crime…anyone with a few billion dollars can destroy all the progress that we have made…We want to embrace borderlessness but we still need to protect ourselves from self-serving rogues and international brigandage"[69]. The Thai Foreign Minister, Prachuab Chaiyasarn, supported Malaysia's stance by calling for the region to

[68] http://www.twnside.org.sg/title/sab-cn.htm
[69] http://www.twnside.org.sg/title/sab-cn.htm

develop protections against currency speculators stating, "I call it a financial virus. We have to acquire immunity against this virus which has a tendency to relapse"[70].

At no other time in history has a region grown so quickly and then experienced such a devastating economic decline of the magnitude of East Asia. The crisis did not suddenly strike with the devaluation of the Thai Baht in July 1997, but was festering for over a decade. It started as a crisis of currency, but soon developed into a full economic crisis. The rapid expansion of credit was wreaking havoc on the region's central banks' ability to maintain stable exchange rates, to uphold interest rates conducive to growth, and finally to sustain foreign reserves. The central banks could have stemmed the expansion of credit by letting domestic currencies appreciate, however this would have led to less competitive exports and possibly the formation of a current account deficit.

The "impossible trinity", the theory that an economy cannot have a fixed exchange rate, the free movement of capital, and independent monetary policy hindered central banks' ability to control exchange rates and enjoy monetary autonomy. Faced with this dilemma, Thailand felt that a stable currency maintained investor and business confidence and was disinclined to either devalue or raise the domestic currency. However, the country was faced with increased pressure on the baht, precariously low reserve levels, and significant short-term foreign borrowings. Additionally, exports were slowing, the current account deficit was deepening, and the central bank was unwilling to raise interest rates, which might cause the economy to sag. It is apparent, that the devaluation of the baht in July 1997 was really not a shock at all. Something had to give.

[70] http://www.twnside.org.sg/title/sab-cn.htm

3.2 CAUSES OF THE CRISIS

The region had become a bastion of “hot” money in an age of globalism with significant capital mobility and loose regulatory infrastructures. The region’s relatively high interest rates and high growth rates attracted both investors and lenders. Banks in Japan and Europe were eager to lend money where they could enjoy higher yields in the region due to economic recessions plaguing their own economies. Furthermore, low interest rates in the United States “released a torrent of funds seeking higher yields in emerging markets”[71]. East Asia became the beneficiary of much of these investment funds and foreign direct investment.

Joseph Stiglitz, with the benefit of hindsight, stated “Financial and currency crises have hit with increasing frequency…premature financial market liberalization for instance, before the appropriate regulatory structures are in place, frequently leads to excessively risky lending by banks…given the Asian countries’ commitment to continue with financial market liberalization, there was no obvious way in which to manage the macroeconomics of the surge of financial capital, which left even more suddenly that it entered”.[72]

However, capital liberalization and foreign direct investment only tell part of the story. The region was reasonably stable. Unemployment was remarkably low, inflation was contained, and government budgets were, for the most part, in balance. The ASEAN-5 enjoyed an average of 8.5% GDP growth between 1990 and 1995. Monetary policy was expansionary, but policy prescriptions were far from irrational or out of control. Real estate asset values were stable and appreciating prior to the crisis.

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[71] Wong Pg. 391
[72] Stiglitz 1999b Pg. 1509

However, the Thai stock exchange showed signs of weakness as early as 1995, peaking in value in 1993. The exchange lost most of its value by 1997 (see Figure 4.3 pg. 72). Furthermore, "traditional measure of vulnerability did not signal a crisis…the problem was off the government's balance sheet: the underlying policy mistake was…not part of the government's visible liabilities until after the fact"[73].

If the economic vulnerabilities were not readily obvious, what then was the cause of the crisis? There is not a single pariah, but a litany of culpable factors that combined, overwhelmed the region and many economists. Paul Krugman opines that "the crisis is best seen not as a problem brought on by fiscal deficits, as in "first generation" models, nor as one brought on by macroeconomic temptation, as in "second generation" models, but as one brought on by financial excess and then financial collapse"[74]. Uncontrolled expansion of credit by banks and especially finance companies placed onerous pressure on the fixed exchange-rate regimes. Coupled with considerable domestic currency speculation, there were significant market weaknesses. Furthermore, rampant real estate speculation, which fueled the unnecessary expansion of credit and unsubstantiated asset values led to an overheated real estate bubble, drove East Asia into a crisis. There were other participants, but they were only secondary ailments who wielded their ugly heads after the initial shock and caused a chain reaction that plunged the region further into recession. These included crony capitalism, government and financial sector corruption and weakness, poor market fundamentals, and weak regulatory and economic infrastructures.

[73] Krugman 1998 Pg. 8
[74] Krugman 1998 Pg. 2-3

The weaknesses in East Asia were only amplified by capital account liberalization. The removal of impediments to free capital mobility did not necessarily cause the crisis. However without a strong and systematic sequencing methodology for the implementation of capital account liberalization (see Ch. 5.2) and a strong underlying macroeconomic foundation, the implementation of capital account liberalization leaves economies open to increasing risks in the forms of market asymmetries, currency and market volatility, moral hazards, investor herd behavior, and finally large swings in both capital inflows and outflows. The result is that an economy's ability and preparedness to adequately manage the swings in both inflows and outflows without economic upheaval is jeopardized.

Harvard economist, Jeffrey Sachs, noted that the "IMF which led the official international response, assigned primary responsibility to the shortcomings of East Asian capitalism"[75]. IMF economists were unwilling to shoulder any responsibility for their institutional policies that contributed to the disaster. The Fund had long supported the removal of barriers to capital mobility. While this was not an official mandate of the Fund, it was a position that the Fund tried to implement where possible. The IMF was not able to condition bailout loans to the removal of capital controls, however the organization encouraged member countries to liberalize. The IMF stressed the benefits of international capital flows, while deemphasizing their inherent risks. Capital account liberalization is a controversial topic, especially regarding the IMF, whose "role is particularly controversial because capital account liberalization is an area where there is little professional consensus"[76]. Furthermore there is much debate whether "liberal

[75] The East Asian Financial Crisis: Diagnosis, Remedies, Prospects Pg. 1
[76] IMF: Report on the Evaluation of the IMF's Approach to Capital Liberalization Pg. 6

capital accounts are intrinsically beneficial on which the broader academic literature has not been able to provide a definitive answer"[77].

Jeffrey Garten contends that the problem does not lie so much with the IMF but with its close ties to the U.S. Treasury. Furthermore, that the IMF has been unable to act with complete autonomy and independence due to the U.S. government's intrusion of Fund operations. William Greider stated, "The IMF takes instruction from the U.S. Treasury secretary. That is because we were the founder of the institution 50 years ago."[78] The U.S. Congress has also defended the Fund, possibly due to its close ties and oversight. At a U.S. Congressional Finance Committee Hearing, one congressman stated, "I feel that …attacking the IMF for devaluation is like blaming firemen for the fire that has been started somewhere else."[79] In response to the crisis, the IMF made a significant shift away from its advocacy of capital liberalization.

3.3 BANKING & ILLIQUIDITY

The banking sector played a fundamental role in not only precipitating the crisis, but also during the collapse of currencies and the development of the recession due to the lack of prudential crisis management. International lenders were attracted to the region due to high growth rates, currency stability, and attractive returns. Regulation, corporate governance, and reforms were not implemented in tandem with the expansion of credit. Such problems were exacerbated by poor domestic banking infrastructure, weak management, and limited regulatory enforcement. As such, banking and credit sector weaknesses were in part a direct cause of the crisis, both precipitating and feeding the contraction. Overinvestment and industrial overcapacity was caused in part by

[77] IMF: Report on the Evaluation of the IMF's Approach to Capital Liberalization Pg. 6
[78] Frontline - The Crash
[79] US congressional Hearing Pg. 39

unwarranted overextension of bank credit. The expansion of credit left financial institutions susceptible to shifts in capital and changes in economic performance. "The underlying fragility of financial systems in Asia was often overlooked because a high degree of monetary and exchange rate stability, allied with the rapid development of local banking systems, facilitated a long period of investment led growth. Many years of virtually uninterrupted growth led banks and others to underestimate the risks that were emerging."[80] Banks became extremely exposed to market contractions and falling asset values due to overvalued collateral.

The banking sector unfortunately was not being managed prudently. "Crony Capitalism" mired the banks with substantial inside lending to directors, managers, and their pet projects. Loans were not arms-length transactions and were not adequately structured or underwritten. Oversight and supervision were weak. Precarious levels of loan portfolio concentration were attained without third party interference or management. Portfolio analyses were not completed in a timely manner rendering loan risk classifications and loan loss provisions deficient.

Moreover, the lack of ongoing prudential bank management prior to the crisis hamstrung many banking institutions' ability to react and control the crisis. For instance, there were serious liquidity and currency mismatches (see Table 3.1). The Philippines and Malaysia were the only two countries that had reserves exceeding short-term debt. South Korea's, Indonesia's, and Thailand's short-term debt far exceeded reserve coverage, which placed immense pressure on the central bank and domestic currencies. Furthermore, many banks, especially in Thailand and Indonesia, had too much short-term borrowings dominated in foreign currencies. However, such mismatches soon became

[80] BIS 1998 Pg. 117

critical as they spurred speculative currency attacks and highlighted exchange rate changes aimed at defending the pegged exchange rate[81].

Table 3.1: Liquidity and Currency Mismatches as of June 1997

	Ratio of Short-term Debt to International Reserves	Short-term Debt as a Percentage of total Debt	Ratio of Broad Money to International Reserves
South Korea	3.0	67	6.2
Indonesia	1.6	24	6.2
Thailand	1.1	46	4.9
Philippines	0.7	19	4.9
Malaysia	0.6	39	4.0
Singapore	N/A	N/A	1.0

Source: The Asian Financial Crisis: Causes, Cures, and Systemic Implications

Furthermore, as Thailand and others were forced to defend their currencies they used much of their foreign currency reserves. The rollover of many short-term debt obligations was jeopardized. Additionally, many corporations were not hedging foreign currency risk, which helped further the decline of domestic currencies. With declining domestic currencies, corporate debt liabilities worsened placing serious question on their ability to service debt and maintain needed operable liquidity levels. The overall result exacerbated market confidence, which in turn negatively affected the economy and caused additional devaluations of domestic currencies.

The lack of oversight was due in part to excessive government ownership and participation in many of the countries' banks. There also was not an adequate banking regulatory infrastructure. A basic system was created to strengthen savings and spur investment to instill stability and consumer confidence. However, the managerial bureaucracy did not evolve or keep up with an economy rapidly integrating into the global economy. Complacency was widespread due to historic high and stable growth rates. To further complicate the ability to police the banking sector, the liberalization of

[81] Goldstein Pg. 9-11

banking placed additional burdens on regulatory bodies. By liberalizing the banking sector, natural safeguards protecting bank profitability were discarded. For instance, "Prior to liberalization, intermediation through banks was typically kept profitable by limits on the allocation and volume of bank lending and by interest rate ceilings on deposits"[82].

> In most ASEAN countries, exchange rate stability was part of government policy. The choice of exchange rate regime and the degree of financial openness are crucial for the rest of the economy. However these countries chose mainly to fix their exchange rates while controls had been relaxed or liberalized allowing international interest rate arbitrage flows to complicate the sustainability of domestic policies.[83]

Liberalization encouraged banks to undertake greater risks, expand credit into larger market sectors, and to search for new business with higher yields as competition increased. Furthermore, persistent growth rates fueled bank sector optimism. The future appeared bright due to past positive historical growth rates. The end result was a massive reversal of capital flows that left banking, the corporate sector, and investors faced with not only a serious currency crisis, but also a crisis of liquidity and continued operability (see Table 3.2).

Table 3.2: Net Private Capital Flows to East Asian Region

	1996	1997	1998	1999
	in Billions of US dollars			
Total Flows	104	-1	-43	-27
Direct Investment	53	55	58	50
Portfolio Investment	13	4	-18	-6
Other Inflows	38	-60	-83	-71

Source: Bank of International Settlements, 70th Annual Report 2000

[82] BIS 1998 Pg. 118
[83] Chirathivate & Murshed Pg. 9

However, the response of FDI was lagged compared to portfolio investment and Other Flows that had an immediate impact on the business sector's liquidity (see Table 3.3). This is especially evident in the cases of Thailand, South Korea, the Philippines, and Singapore with little change in the two years following the crisis. The new millennium average is down by 15% since 1996. The region's "paper" economic gains during the 1990's were literally wiped out by the crisis.

Table 3.3: Foreign Direct Investment – Net Flows (in millions, current US$)

	1996	**1997**	**1998**	**1999**	**2000 - 2004 Average Per Annum**
Thailand	2,336	3,895	7,314	6,103	2,314
Malaysia	5,078	5,136	2,163	3,895	2.928
Indonesia	6,194	4,677	-241	-1856	-1162
South Korea	2,325	2,844	5,412	9,333	5,383
Philippines	1,516	1,222	2,287	1,724	988
Singapore	9,499	13,496	7,404	16,601	12,334
Total Average	4,491	5,211	4,056	5,967	3,797

Source: World Development Index (WDI) (Author's Computations)

Corporations were constrained in their ability to draw on lines of credit. Banks had substantial amounts of nonperforming loans, with assets tied to speculative real estate. Therefore, their ability to lend funds was restricted. Additionally, many banks refused to rollover short-term notes. Finally, there were serious liquidity and currency mismatches (see Table 3.1). Many banks had too much short-term borrowing denominated in foreign currencies. The rampant governmental and corporate illiquidity was a product of capital liberalization policies that were instituted without a supported and comprehensive macroeconomic plan.

Table 3.4: Short Term Debt versus Reserves						
Short Term Debt (millions US$)						
	Indonesia	Korea	Malaysia	Philippines	Thailand	Total
Jun-90	10,360	15,528	1,761	3,019	7,026	37,694
Jun-94	18,882	34,908	8,203	2,646	27,151	91,790
Jun-97	34,661	70,182	16,268	8,293	45,567	174,971
International Reserves (millions of US$)						
	Indonesia	Korea	Malaysia	Philippines	Thailand	Total
Jun-90	4,693	14,642	8,114	948	11,882	40,279
Jun-94	10,915	21,684	32,608	6,527	27,375	99,109
Jun-97	20,336	34,069	26,586	9,781	31,361	122,133
Debt to Reserves Ratio						
	Indonesia	Korea	Malaysia	Philippines	Thailand	Total
Jun-90	2.208	1.061	0.217	3.185	0.591	0.936
Jun-94	1.730	1.610	0.252	0.405	0.992	0.926
Jun-97	1.704	2.060	0.612	0.848	1.453	1.433

Source: The Asian Liquidity Crisis, BIS, & IMF.

Furthermore, on a grander scale, many of East Asia's financial systems faced international illiquidity due to insufficient foreign currency reserves to short-term debt (see Table 3.3). Short-term debt obligations in various foreign currencies (mainly US dollars) exceeded the amount of foreign currency reserves that they had access to in the short-term. For instance, prior to the onset of the crisis in June 1997, the ASEAN-5 had $174 million in short-term debt, but only $122 million in international reserves. The region's debt-to-reserves ratio was 1.433. Throughout the 1990's the region had been running slightly less than a 1:1 ratio. Most serious were the positions of Thailand and Korea, who alone encompassed 66% of total short-term debt and only 53% of total reserves.

3.4 EXPANSION OF CREDIT & REAL ESTATE

There was little regard for the prudential extension of credit. Prior to the 1990's, investment was self-financed due to the high rate of domestic savings. However, by the

early 1990's, the region's self-sufficiency dramatically changed[84]. Leveraged investment began fueling growth, especially in the real estate market. With rapid market growth and corresponding appreciations in collateral, credit was approved liberally. Financial intermediaries, whose assets were perceived to have an implicit government guarantee and who were highly unregulated, aggressively expanded credit into risky ventures.[85] With the expansion of credit, upward pressures on inflation of asset prices soon caused a real estate bubble. In addition, escalating asset values were relied upon instead of hard equity. This reliance on soft "inflated" equity proved disastrous when the real estate bubble burst and asset values plummeted leaving creditors under-secured.

Furthermore, governments practiced financial repression by maintaining artificially low interest rates as a means of expanding credit. However, as credit availability and credit demand expanded rapidly, there was an increased risk that the investment of capital into market sectors was not conducive to overall market growth or complimentary to government economic strategies. The result was widespread inflated real estate values, especially in Thailand. High asset values and low interest rates fueled rampant real estate speculation. This caused both lenders and borrowers to increase speculative activity.

Competition amongst financial institutions increased. As such, interest margins narrowed while profits tightened. Finally, the expansion of credit was not in profitable and prudential business ventures or strong organic portfolio growth. There was significant funding of speculative real estate projects. There was also very little change in operating costs between the periods of 1990 – 1994 and 1995 – 1996, however as costs

[84] Krugman 1999 Pg. 84
[85] Krugman 1998 Pg. 3

remained static, net interest margins were squeezed by a regional average of 32 basis points. Furthermore, although the average annual rate of expansion in the region was negligible at 3 basis points, bank private sector credit became a significant portion as a % of GDP. For instance, in Thailand bank credit was 105% of the country's GDP (see Table 3.5).

Table 3.5: Bank Credit Expansion and Indicators of the Banking Industry

	Bank credit to the Private Sector			**Indicators of the Banking Industry**			
	Annual Rate of Expansion		**As a % of GDP**	**Operating Costs**		**Net Interest Margin**	
	1981 - 1989	**1990 – 1997**	**1997**	**1990 - 1994**	**1995 - 1996**	**1990 - 1994**	**1995 – 1996**
				as a percentage of assets			
Indonesia	22	18	57	2.3	2.8	3.3	3.6
Korea	13	12	64	1.9	2.1	2.2	2.2
Malaysia	11	16	95	1.6	1.4	4.7	3.2
Philippines	-5	18	52	4	3.5	5.3	4.8
Singapore	10	12	97	0.8	0.7	2.2	2
Thailand	15	18	105	1.9	1.8	3.6	3.6

Source: Bank for International Settlements: 68th Annual Report 1998

With emphasis on the real estate sector, bank portfolio concentration became unbalanced and unduly heavy in the real estate sector. This was a serious risk due to an overheated market with unsustainable prices. When the boom subsided, weaknesses in the market were exposed. Banks were left in a precarious position after the crisis and paid a heavy price. Thousands were forced to close by both the government. Many depositors lost their savings. The crisis was especially devastating in Thailand and Indonesia where non-performing loans encompassed 38.6% and 37% of the total loan portfolios respectively (see Table 3.6). South Korea was the only nation to book positive return on assets (ROA) two years after the crisis.

Table 3.6: Indicators of Bank Performance in the Asian Crisis Countries								
	Korea		Thailand		Malaysia		Indonesia	
	1996	1999	1997	1999	1997	1999	1997	1999
	at end-year, in percentages and percentage points							
Non-performing Loans	4.1	6.2	22.5	38.6	3.2	9.0	7.1	37.0
Return on Assets	0.3	3.3	-0.1	-2.5	0.6	-0.2	-0.1	-17.4
Intermediation spread	3.6	2.2	3.8	4.8	2.5	4.4	1.5	7.7
Capital / asset ratio	9.1	9.8	9.3	12.4	10.3	12.5	4.6	-18.2

Source: Bank of International Settlements, 70th Annual Report 2000

The accessibility of credit did not necessarily fuel the real estate boom, but it helped. Significant appreciation in the real estate market drove new and especially speculative construction as the real estate boom helped drive growth in East Asia. However, as growth slowed, exports were not as expansionary as in the past, and interest rates slowly increased. Supply soon outpaced demand with a glut of product on the market. Serious downward pressure was placed on financial institutions that held vast concentrations of real estate loans with devalued collateral. Banks were failing in part because they began repossessing collateral that they could not sell at breakeven prices. They soon realized that cash flow not collateral repays loans.

Real estate prices are a product of the availability of credit, rates of appreciation, both real and expected, and demand for additional product. However, prior to the crisis, Asia's growth rate far exceeded its ability to manage the inflationary pressures. For instance, growth rates generally exceeded 20%, whereas typical rates in the United States and Europe were 10%. However, this rate disparity is not surprising since real demand for real estate in rapidly industrializing countries is typically significant. Asian countries historically were rural and agrarian, however with modernization a vast urban sector developed which placed significant pressures for housing and also retail and office space.

A viable construction industry soon blossomed spurring additional economic growth, but also strong growth in employment, wages, and further investment.

However, as demand slowed, the real estate market was sluggish to react to oversupply and irrational prices. "Unlike equity prices, however, real estate prices do not always decline quickly when excess supply emerges…there have been significant falls in prices in recent years after the massive increases registered in earlier periods, usually after a significant tightening of monetary policy."[86] When the correction did hit the real estate industry, real estate losses and high real estate sector unemployment placed immense downward pressure on an already fragile economy, thus deepening the contraction.

After years of substantial expansion, growth began to slow as the U.S. economy recovered from its early 1990's recession and began to contain inflation by increasing interest rates. This attracted investors and capital to the U.S. that were formerly investing in East Asia. Furthermore, with a strengthening U.S. economy, the U.S. dollar gained strength. With a domestic currency pegged to the U.S. dollar, a stronger U.S. dollar made Asian exports less competitive due to domestic currency appreciation due to the strengthening dollar. Even prior to the attack on the Baht, there was growing evidence of a significant slow down of exports, which led to an expanding current account deficit position (see Table 3.7).

Of the main exporter East Asian nations, Thailand experienced a significant change in merchandise exports from 23% growth in 1995 to almost no growth in 1996. In South Korea there was only a modest single-digit expansion over the prior year. However, this limited expansion followed 30% growth the year before. Indonesia,

[86] BIS 1997 Pg. 106

Malaysia, and the Philippines also experienced export merchandise slow downs in 1996, however these were much more temperate compared to prior years. However, such declines in export growth rates did not raise concerns at the time that such changes were to develop into lasting trends.

Table 3.7: Growing Current Account Deficit and slowing Exports

	Current Account Balance (% of GDP)		**Merchandise Exports (Annual % Growth)**	
	1995	1996	1995	1996
Thailand	-7.9	-7.9	23.1	0.5
Indonesia	-3.3	-3.3	13.4	9.7
Malaysia	-10	-4.9	20.3	6.5
Philippines	-4.4	-4.7	28.7	18.7
Singapore	16.8	15.7	13.7	5.3
South Korea	-2	-4.9	30.3	3.7

Source: The Asian Financial Crisis: Causes, Cures, and Systemic Implications

Finally, China played a key role in the expansion of the current account deficits of the nations of East Asia. With the transition of the East Asian economies from agrarianism to an export-oriented economy, China's emergence as a major exporter, especially in the textile industry, became a source of significant competition for ASEAN export markets. China also competed directly with East Asia for foreign direct investment from the same sources. Regarding exports & FDI, there was a shift in comparative advantage away from East Asia favoring China. Increases in Chinese exports exacerbated the current account deficits of the East Asian tiger economies while these countries maintained pegged exchange rates with the U.S. dollar.

3.5 CONTAGION

Why did a seemingly controlled crisis in Thailand infect surrounding countries and soon affect much larger economies? Thailand, Indonesia, and Malaysia did have competing export goods, however, there were few direct connections that would not only

explain the contagion, but also the infection of much larger and stable economies such as South Korea. In a study by the Institute for International Economics, it noted that it was unlikely that bilateral trade with Thailand was the cause of contagion (see Table 3.8). The study notes that the size of the transactions with Thailand was too small to significantly impact the trading economies.[87]

Table 3.8: Bilateral Trade Shares with Thailand, 1996

	Exports to Thailand (as a percentage of total exports)
South Korea	2.0
Indonesia	1.8
Malaysia	4.1
Philippines	3.8
Singapore	5.7

Source: The Asian Financial Crisis

The likely cause of the contagion, much like the originating crisis, is the result of multiple variables. First, there was a domino effect. East Asian countries' willingness to defend their currencies most likely encouraged and inflamed speculation "despite the vulnerabilities of their economies and their ineptitude at defending themselves successfully against such attacks"[88]. Furthermore, as countries experienced a currency attack and subsequent devaluation, countries that did not devalue as well were less competitive, especially regarding their exports. This further fueled speculation and attack. With the devalued currency of a competing country, it was inevitable that other countries would follow suit by devaluing either voluntarily or by speculative attack. Furthermore, with the devaluation of the baht, there was intense review of Thailand's macroeconomic fundamentals. As weaknesses were identified and analyzed, it soon was apparent that the same macroeconomic weaknesses that caused the crisis in Thailand

[87] Goldstein Pg. 17-18
[88] Wong Pg. 396

were apparent in varying degrees in the other East Asian Nations. The crisis spread not only due to a practical reassessment of the region by both creditors and investors, but also out of pure panic by investors fearful of losses. Prior to the crisis there was little scrutiny by external credit agencies due to the region's strong growth, however, once the crisis started, credit agencies soon downgraded their risk ratings (see Table 3.9). Such ratings are important because they reflect the probability of a default and losses arising due to a default.

Table 3.9: Portfolio Investment Risk				
Date	**Moody's**	**Standard & Poor's**	**Moody's**	**Standard & Poor's**
	Indonesia		**Korea**	
Nov. 1996	Baa3	BBB	-	AA
Jan. 1998	Baa3	BBB	-	B+
Dec. 1998	BB	BB+	Ba1	BB+
Jan. 2000	B3	CCC+	Baa2	BBB
	Malaysia		**Thailand**	
Nov. 1996	A1	A+	A2	AA
Jan. 1998	A1	A+	Baa3	BBB
Dec. 1998	Baa3	BBB	Ba1	BBB
Jan. 2000	Baa3	BBB	Ba1	BBB

Source: Capital Account Liberalization. Bakker & Chapple

All four countries listed in the Table above in November 1996 had investment grade ratings by Moody's. Investment grade was the highest possible rating section with the highest quality and lowest risk. However, in the cases of Indonesia, South Korea, and Thailand, they were lowered to speculative ratings. Malaysia's rating was lowered to a moderate risk with speculative characteristics. Standard & Poor in November 1996 also rated all four countries as investment grade. However Indonesia and South Korea were lowered to non-investment grade (junk bonds), while Malaysia and Thailand maintained a medium risk rating just above non-investment grade.

However, despite the lack of significant direct financial linkages between the affected countries, they were linked due to foreign investors and funds. "Flows of money into the region were often channeled through "emerging market funds" that lumped all the countries together".[89] Therefore, unfavorable economic conditions in one country would adversely impact other countries. Also, the region's attempts to unite to create regional synergies, coupled with East Asian leaders' past proclamations of a unique "Asian system" with "Asian values" led to "one" East Asian miracle, this led to the perception that if one country was sick, then all must be. "The market's loss of confidence started a vicious circle of financial and economic collapse. It did not matter that these economies were only modestly linked…they were linked in the minds of investors, who regarded the troubles of one Asian economy as bad news about the others".[90]

Finally, there is a link between the contagion and the IMF. The Fund was not directly responsible for the contagion, however it certainly created an environment ripe for contagion and economic instability. As a result of the Fund-forced austerity and a "cookie-cutter" policy prescription in Thailand and Indonesia "output in some of the affected countries fell by 16% or more. Half the businesses…were virtually bankrupt…unemployment soared…and real wages plummeted…not only was the IMF not restoring economic confidence in East Asia, it was undermining the region's social fabric"[91]. When reinflation and Keynesian policies should have been implemented, instead the Fund instituted high interest rates, inflation controls, reduced governmental expenditures, and tight monetary policies. Such policies drove the region's economies

[89] Krugman 1999 Pg. 97
[90] Krugman 1999 Pg. 99
[91] Stiglitz 2000 Pg. 4

into recession. Due to economic instability, international investors were skittish. The crisis soon overcame Russia and Brazil. Had the Fund implemented a prudent expansionary policy in the region, the crisis could possibly have been resolved expeditiously, with minimal casualties, and without the degree of contagion effect.[92]

Table 3.10: Chronology of a Crisis: 1997 – 1998

Year	Date	Event
1997	2 July	Thai baht collapses under speculative pressure
	11 July	Philippine peso is allowed to float
	24 July	Malaysia ringgit hits a three-year low
	28 July	Thailand calls in the IMF
	20 August	IMF-led rescue package of US $17.1 billion approved for Thailand
	2 September	Philippine peso falls to historic low against the US$
	8 October	Indonesia announces its intention to call on the IMF for assistance
	17 October	New Taiwan dollar allowed to float
	20 October	Hong Kong stock market loses a quarter of its value over four days
	5 November	Stand-by credit of US$43 billion approved by the IMF for Indonesia
	7 November	The government of Thailand falls, a casualty of the crisis
	21 November	South Korea wracked by economic instability, states it will seek IMF assistance
	4 December	IMF-led rescue package of US$58.2 Billion approved for South Korea
1998	4 May	The governor of the central bank of Thailand resigns
	21 May	Indonesia's president resigns
	1 September	Currency and capital controls are introduced in Malaysia
	2 September	Malaysia fires the finance minister over differences about how to manage the crisis
	16 December	Thai government auctions US$10 billion worth of assets seized from liquidated finance companies

Source: Southeast Asia: the human landscape of modernization and development

3.6 CONCLUSION

As the economic crisis deepened, a political crisis soon ensued. The region became politically unstable with rampant rioting. Many governments were unable to control their populaces. In Thailand for instance, five months after the devaluation of the baht, intense public rioting, due to the crisis, caused the fall of the 30-year Suharto

[92] See Chapter 4 for additional information on the IMF's response and alternative strategies

regime. In May 1998, Indonesia's president resigned and in Malaysia the finance minister was fired over his management of the crisis and differing opinions on recovery. There was also intense pressure placed on local governments by the public to not only contain and ameliorate the crisis but also to restore stability and confidence.

The people did not fully understand the dynamic causes of crisis. They were directly affected by the economic collapse and would unfortunately not be made financially whole by the IMF or others. They were the ones that would bear the burden of not only the economic contraction, but also paying back the IMF austerity programs. To them, this was not about currency speculations, real estate bubbles, corrupt governments, reckless bank lending, and fixed-exchange rate regimes. The people suddenly saw their savings eroded and jobs lost as prices for staple items skyrocketed. The people responded by selling their consumer goods, while medical treatment and education became expendable as they began tightening their budgetary belts.

A decade after the crisis, the region was still struggling to fully recover. However, by 2003, East Asia seemed to have turned a corner. Although average GDP growth per annum from 2000 to 2005 was moderately below the 1970 – 1995 average, there was significant improvement. For instance, Thailand, which had the deepest contraction, also enjoyed the highest three-year average GDP growth rate from 2002 to 2005. Inflation declined substantially over the region's historical rate. In most instances, the average rate of inflation from 2000 to 2005 is half the average rate from 1970 to 1995. However, the current account has not enjoyed comparable improvement. While for most of the region's countries, deficits are narrowing from the four-years immediately following the crisis; Singapore's deficit consistently is averaging double digits. The

country's five-year millennial average is -20.6. However, Thailand's is -5.8 and South Korea's is -2.2 (see Table 3.15). If such trends persist, it is likely that many countries in East Asia will enjoy positive current accounts in this decade.

The outcome for East Asia during and following the crisis appeared bleak. However, the region has much to be bullish about regarding its future. The region may very well regain its historic pattern of high stable growth. "The high savings rates, the policies friendly to the promotion of manufacturing exports, the high levels of human capital in Singapore, Taiwan, and Korea, and the abundance of natural resources in Indonesia, Malaysia, Thailand are all still there…what look like big problems now will become less consequential once growth resumes and Asia's strong fundamentals reassert themselves."[93] Furthermore, due to the currency crisis contagion there is renewed debate for a greater level of regional cooperation and integration. Interest in an Asian Monetary Union and a single currency has gained support especially in relation to the IMF's failure to not only prognosticate the crisis, but also contain and ameliorate it as well. The crisis was stoked due to common weaknesses amongst ASEAN member countries. The region's countries want to be more assertive in molding and protecting their economic future. "The story of East Asia…is far from over, and it would be premature to reach any final verdicts."[94]

[93] Eichengreen 1998 Pg. 1-2
[94] Sitglitz 1999b Pg. 1520

Table 3.11: Selected Macroeconomic Indicators										
	'70 – '95 Avg. Per Annum	'00 – '05 Avg. Per Annum	1996	1997	1998	1999	2000	2001	2002	2003	2004
GDP Growth (annual %)											
Thailand	7.9	4.8	6.0	-1.0	-11.0	1.6	5.0	2.0	5.0	7.0	6.0
Malaysia	7.7	5.0	10.0	7.0	-7.0	6.0	9.0	0.0	4.0	5.0	7.0
Indonesia	7.8	4.8	8.0	5.0	-13.0	1.0	5.0	4.0	4.0	5.0	5.0
S. Korea	8.0	5.1	7.0	5.0	-7.0	9.0	8.0	4.0	7.0	3.0	5.0
Philippines	3.3	4.6	6.0	5.0	-1.0	3.0	6.0	2.0	4.0	5.0	6.0
Singapore	8.6	5.0	8.0	8.0	-1.0	7.0	10.0	-2	4.0	3.0	9.0
Inflation (annual %)											
Thailand	6.3	2.5	6.0	6.0	8.0	0.0	2.0	2.0	1.0	2.0	3.0
Malaysia	4.1	1.6	3.0	3.0	5.0	3.0	2.0	1.0	2.0	1.0	1.0
Indonesia	11.7	8.5	8.0	6.0	58.0	20.0	4.0	12.0	12.0	7.0	6.0
S. Korea	9.9	3.3	5.0	4.0	8.0	1.0	2.0	4.0	3.0	4.0	40.
Philippines	13.2	5.2	8.0	6.0	9.0	6.0	4.0	7.0	3.0	3.0	6.0
Singapore	3.5	0.8	1.0	2.0	0.0	0.0	1.0	1.0	-0	1.0	2.0
Current Account Balance (% of GDP) positive number = account surplus											
Thailand	5.3	-5.8	8	2	-13	-10	-8.0	-5.0	-6.0	-6.0	-4.0
Malaysia	1.9	-10.2	4	6	-13	-16	-9.0	-8.0	-8.0	-13.0	-13.0
Indonesia	1.7	-3.6	3	2	-4	-4	-5.0	-4.0	-4.0	-4.0	-1.0
S. Korea	1.2	-2.2	4	2	-12	-6	-2.0	-2.0	-1.0	-2.0	-4.0
Philippines	4.0	-4.0	5	5	-2	-9	-8.0	-2.0	-6.0	-2.0	-2.0
Singapore	0.2	-20.6	-15	-16	-22	-18	-13.0	-17.0	-18.0	-29.0	-26.0
Real Effective Exchange Rate Index (2000 = 100)											
Thailand			103	97	85	89	79	81	80	81	82
Malaysia	140.3	99.0	127	123	98	99	100	105	105	99	95
Indonesia			105	98	48	73	-	-	-	-	-
S. Korea			102	96	75	83	-	-	-	-	-
Philippines	125.0	93.0	130	129	108	114	100	96	96	89	86
Singapore	101.0	96.0	109	110	108	100	100	100	98	94	93
Unemployment (% of total labor force)											
Thailand	1.5	2.2	1	1	3	3	2	3	2	2	2
Malaysia	3.5	3.8	2	2	3	3	3	4	4	4	4
Indonesia	3.0	8.6	5	6	6	6	6	8	9	10	10
S. Korea	1.9	3.6	2	3	7	6	4	4	3	3	4
Philippines	5.0	10.0	7	8	10	9	10	10	10	10	11
Singapore	2.0	4.2	3	2	3	5	4	3	5	5	5

Source: World Development Index (WDI) (Author's Computations)

CHAPTER 4

CASE STUDY: THAILAND & MALAYSIA

4.1 INTRODUCTION

There has been widespread controversy regarding not only East Asia's growth, but also financial crisis. There is little consensus among economists and policymakers regarding the reasons for the region's growth and collapse. There has been equally strong debate regarding the strategies chosen to resolve the crisis by Thailand and Malaysia. Furthermore, the IMF's credibility was severely tested due to its policy prescriptions in Thailand. Much of the controversy regarding the crisis center's on the IMF's austerity response in Thailand and Malaysia's use of capital controls to support a strategy of reinflation This chapter attempts to answer, through the experiences of Thailand and Malaysia, whether capital controls were a better approach to resolving the 1997 crisis than the policy advocated by the IMF.

Thailand and Malaysia were chosen for comparative analysis both for their similarities, but also for their differences. Both countries developed economies around export-oriented manufacturing. In addition, the Thai and Malay populaces underwent a massive demographic shift from rural agrarianism to urban industrialization. This shift was in response to the industrialized-centers' demand for inexpensive labor and also by the prospect of abundant jobs in prospering and growing cities. In addition, the countries' investment in human capital contributed to the shift. Substantial advances in universal education and healthcare gave rise to a bourgeoning middle-class. Furthermore, the two countries pursued greater economic and political stability and were founding members of ASEAN and AFTA. Finally, Thailand and Malaysia grew

exponentially during the 1980's and 1990's due to vast amounts of foreign direct investment. Politicians encouraged by the IMF and World Bank, fast tracked capital liberalization policies to exploit FDI. The sustained high growth rates obscured serious macroeconomic weaknesses. A domino effect started in 1996 with cooling exports, an expanding current account deficit, and an emerging bank scandal that soon enveloped most of Asia.

However, Thailand and Malaysia were also chosen for their different responses to the crisis. Thailand received an IMF loan, while Malaysia chose a strategy independent of the Fund. Thailand, following the Fund's plan, implemented a contractionary economic policy, while maintaining full mobility of capital account transactions. Subsequently, unfulfilled IMF expectations of returning FDI were the foundation for maintaining open capital transactions. Malaysia, on the other hand, pursued a reflationary and Keynesian strategy, which was supported by capital controls on specific short-term outflows. Malaysia ignored established orthodox economic theory by implementing controls. Utilizing barriers to capital account transactions as a tool in an overall economic plan in response to a major economic contraction had a very limited track record and was extremely controversial.

As a result of Malaysia's expansionary response in conjunction with the capital controls, the Malay economy was only moderately affected in comparison to Thailand's. The contraction was not as deep and the recovery was more rapid, while the Thai economy languished and soon suffered from a recession. Finally, in a comparative analysis of the two disparate strategies utilized by Thailand and Malaysia, the evidence supported the conclusion that Malaysia would not have been better off had the country

pursued an IMF rescue package or implemented an alternative strategy other than the one the country ultimately pursued.

4.2 POLITICAL HISTORY

The kingdom of Thailand was founded in the thirteenth century. It is the only country in Southeast Asia to avoid European colonization. However, despite this autonomy, the Thai people have enjoyed very little political stability. Historically, the country was defined politically by its absolute monarchy. However, in 1932, a bloodless coup transformed the country from an absolute monarchy to a constitutional monarchy. Since 1932, while Thailand has continued its constitutional form of government, the country has been ruled by successive military governments, rising to power by coups d'etats, with brief periods of democracy interspersed. The latest coup was in 2006, which also implemented a new interim constitution.

Malaysia has not enjoyed the same level of independence from foreign interests. For hundreds of years Chinese, Arab, and Indian merchants have utilized Malaysia as an important trade route for goods. Prompted by this profitable trade advantage, Portugal conquered the country in the 1500's; Malaysia became the first country to fall to the European Southeast Asian expansion. Furthermore, due to 15th Century Islamic invaders, the country today is predominately Muslim. For the next three hundred years, Malaysia was passed from one European country to another. European control was briefly interrupted during World War II while the Japanese occupied the country. In 1957 the country gained its independence. Malaysia is ruled by a constitutional monarchy and operates by a bicameral parliament. Since gaining independence, the country has enjoyed relative political stability with a single party holding power by coalition.

Thailand has an abundance of natural resources including, tin, rubber, natural gas, timber, and lead, while Malaysia is endowed with petroleum, natural gas, and a wide range of tropical crops and fruits. Malaysia's economy has developed into an export-oriented one that is driven by consumer electronics exports. Thailand, due to its proximity to the Indian Ocean, enjoys a well-developed fishing industry. As an export-oriented economy, Thailand's economy is fueled by merchandize exports, which account for over 60% of GDP. However, the main source of employment remains agriculture. Thailand's people are relatively homogenous with 89% of Thai ethnicity and 94% Buddhist, while Malaysia is diverse both ethnically and religiously. Both countries have made significant investments in human capital.[95]

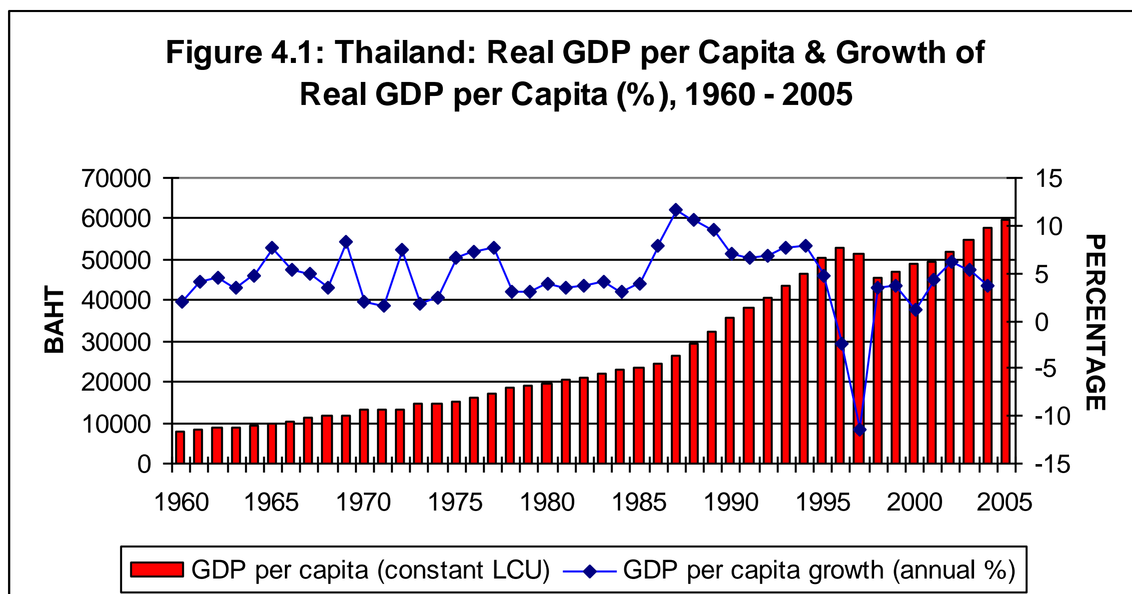
4.3 THAILAND: BOOM & BUST

The East Asian crisis first struck the kingdom of Thailand. Thailand, in earning this dubious distinction was a victim of weak macroeconomic variables, a high short-term debt load to reserves, and a rising current account deficit. Many other countries in the region suffered from similar economic weaknesses, however, currency traders and speculators sniffed out Thailand's inability to support its currency peg and began shorting the Thai Baht. What started as a currency crisis soon evolved into a bank and economic crisis. However, "it is not possible to understand the crisis of 1997 except in the context of the boom that preceded it, because the crisis was the collapse of the boom"[96]. For much of Thailand's history, the country suffered from stagnant growth and high poverty, with very little economic development. In its more recent history since the 1960's, Thailand's economic record was volatile. GDP growth year over year fluctuated widely

[95] Historical data compiled from the U.S. State Department's web site (www.State.gov)
[96] Warr Pg. 8

until stagnating in the early 1980's. However, by the mid-1980's Thailand entered into a decade of extreme growth.

From 1986 to 1996, Thailand was the fastest growing economy in the world. The government implemented an aggressive plan to modernize the country, lower incidence of poverty, and build and improve the infrastructure of transportation, communication, and urbanization. The rapidly developing economy was supported by a massive population shift from rural agrarianism to urban industrialization, which supplied cheap labor. In 1960, per capita GDP was 8,076 baht; conversely by 1996 at the height of the country's growth, real per capita GDP had grown by 553% reaching 52,801 baht. During those 36-years, average per capita GDP growth rate was 5.38%. However, during the economic boom years of 1986 to 1996, average real per capita GDP growth rate was 7.3% (see Figure 4.1). From 1986 to 1996, the economy's growth was remarkably stable and consistent. As in all economic expansions, growth will hide and even mitigate many fundamental economic weaknesses and bad policy.



Source: World Development Index (WDI) Author's Computations

Table 4.1 reveals an erosion of the decades of growth during the crisis and post-crisis years. 1998 per capita GDP was 15.7% below the country's high per capita GDP level experienced only two-years prior. However, the growth was not expunged. The country had made significant real progress. The 1998 per capita GDP was still 5.6 times that of 1960.

Table 4.1: Thailand: Rates of growth of GDP & GDP per capita, 1951 to 2003

Period	Real GDP Growth	Real GDP Growth per capita
1951 to 1986 (Phase I Pre-boom	6.5%	3.9%
1987 to 1996 (Phase II) Boom	9.2%	8.0%
1997 to 1998 (Phase III) Crisis	-6.1%	-7.1%
1999 to 2003 (Phase IV) Prost-crisis	4.0%	3.3%
Whole Period 1951 to 2003	6.2%	4.2%

Source: Thailand Beyond the Crisis

4.4 CAPITAL INFLOWS & CAPITAL STERILIZATION

The Bank of Thailand was formally organized during WWII to implement central bank activities. These included implementing monetary policy, maintaining monetary stability, managing international reserves, acting as banker of last resort, and finally supervising financial institutions. The bank has prided itself on containing inflation, a role it sees as paramount to the long-term success of the economy.

Prior to the 1990's the country had extensive capital controls that restricted the free movement of capital. Such a policy allowed Thailand "a significant degree of monetary independence in spite of its fixed exchange rate"[97]. However, during the early boom years, the controls were dismantled. Current account liberalization was implemented to assist with the rapid growth. The IMF at least tacitly approved of the removal of the controls. By removing the capital controls, Thailand met the obligations

[97] Warr Pg. 14

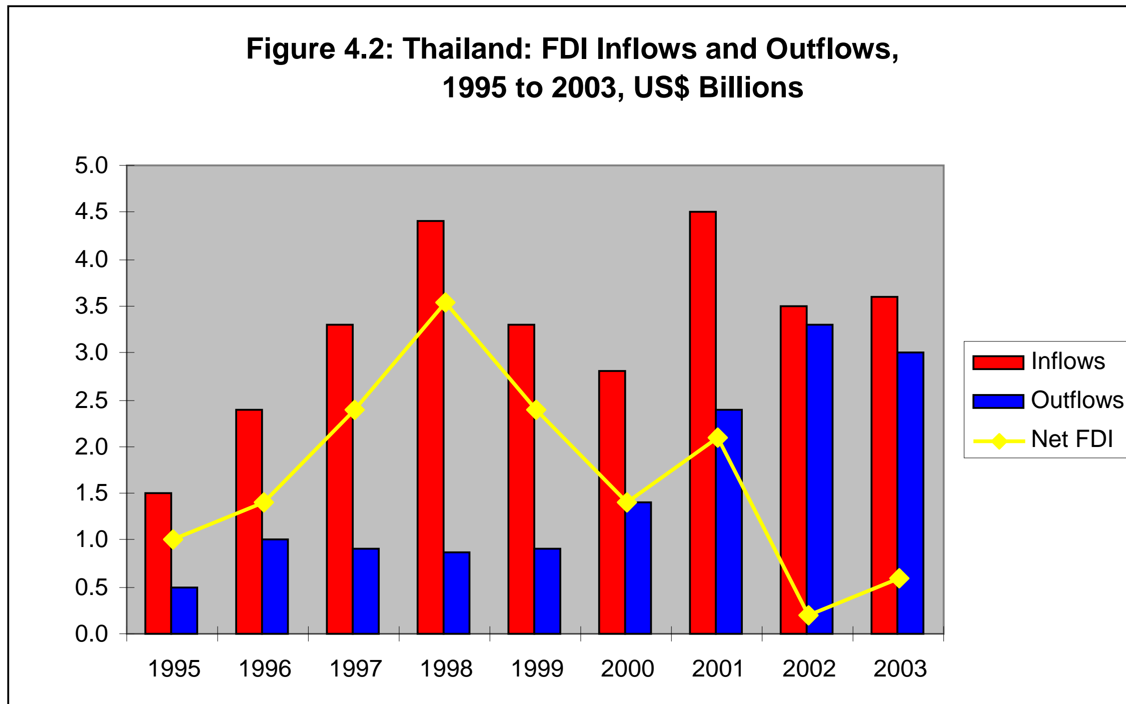
of Article VIII of the Articles of Agreement of the IMF, which stipulates that any barriers or restrictions to international transactions and involving foreign-exchange transactions be removed.

To facilitate such international obligations, Thailand created the Bangkok International Banking Facility (BIBF), which permitted "local and foreign commercial banks in Thailand to take deposits or borrowings in foreign currencies from abroad, and lend them both here [Thailand] and abroad. Lenders, borrowers, and investors were extended greater autonomy. As a result, massive amounts of currency flowed into the Kingdom"[98]. This also allowed domestic firms to borrow from abroad and lend domestically. With a pegged exchange rate and relatively higher domestic interest rates than foreign lending rates, the spread was attractive. Thus interest rate and exchange rate risk were removed. This caused a boom in non-bank financial institutions that were loosely regulated. Without such systemic safeguards, cronyism and poor management led many banks to pursue speculative lending.

With restriction on the movement of capital lifted, Thailand became a substantial beneficiary of foreign direct investment (see Figure 4.2). However, swelling capital inflows are a paradox, in that the capital's benefits are eroded by the threat of currency appreciation, which can be detrimental to exports. Also, inflation is a significant concern with expanding capital inflows. Capital inflows increase foreign exchange reserves, "as these reserves are used to buy domestic currency, the domestic monetary base expands without a corresponding increase in production: too much money begins to chase too few goods and services"[99]. "Surging capital inflows can also be something of a double-edged

[98] Bhaopichitr
[99] Lee

sword, inflicting rather less welcome and destabilizing side effects, including a tendency for the local currency to gain in value, undermining the competitiveness of export industries, and potentially giving rise to inflation".[100] However, as reflected in Figure 4.2, after the crisis FDI levels did not immediately decrease. However, by 2003, net FDI was approximately one sixth of the net FDI of the peak in 1998.



Source: Thailand Beyond the Crisis

To mitigate the risks of inflation, currency appreciation, and less competitive exports, the Bank of Thailand attempted to sterilize capital flows. "In a successful sterilization operation, the domestic component of the monetary base (bank reserves plus currency) is reduced to offset the reserve inflow, at least temporarily. In theory, this can be achieved in several ways, such as by encouraging private investment overseas or allowing foreigners to borrow from the local market".[101] However, sterilization policies are very difficult to implement without stimulating further capital inflows. Typical

[100] Lee
[101] Lee

sterilization policies center on central bank open-market operations, which is selling government financial instruments to reduce bank reserves and overall currency. Thailand's relatively high domestic interest rates fueled increased FDI, as did the central bank's attempt to utilize open-market operations, which proved costly and ineffective resulting in higher inflows. Thailand changed from open-market operations to fiscal adjustment policies. Furthermore, the country also switched public-sector deposits from the commercial banking system to the central bank. Such deposits swaps were highly effective as a means of sterilizing capital inflows[102].

Finally, Thailand lowered taxes to motivate domestic investment to offset foreign inflows. The result of the sterilization policy was "domestic interest rates were bid up, despite the fixed exchange rate and the increased openness of the capital market, confirming that foreign and domestic assets were imperfect substitutes"[103]. As a consequence to Thailand's inadequate sterilization policy, domestic interest rates increased which led to additional capital inflows responding to higher rates of return. Furthermore, foreign exchange levels increased, as did the current account deficit.

Thailand's struggles to mitigate the risks of surging capital inflows were exacerbated by significant levels of bank exposure, especially in imbalanced portfolios, and considerable real appreciation. Such conditions, existing in tandem, signal extreme vulnerability to a crisis, which can be caused by only a minor catalyst. By 1995, Thailand was already highly vulnerable to a financial crisis.

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[102] Lee
[103] Warr Pg. 14

The crisis in Thailand was not inevitable. Had the Thai government chosen a different path to its economic development, the country may have skirted disaster. For instance, Thailand,

> "Before it felt pressure to liberalize, had imposed limitations on bank lending to speculative real estate. It had been aware that such lending is a major source of instability and, moreover, it was still under the impression that investing in employment – creating factories – provided better foundations for a growth strategy than building empty office buildings. But under pressure from those who pushed on it the doctrines of the liberalized market, it succumbed to the judgment of the market with disastrous consequences"[104].

Therefore, it is ironic that capital liberalization policies wreaked such instability, when the main arguments advocating capital account liberalization and the removal of capital controls are greater stability and less risk through diversification.

4.5 THE IMF: "SCREAMING FIRE IN A BURNING BUILDING"

The International Monetary Fund (IMF) was formed at the Bretton Woods economic conference in 1944. It was initially formed to avoid the replication of economic mistakes that led to the Great Depression. The founders wanted to instill global monetary stability through prudential macroeconomic and monetary policies and have a means of oversight for a global monetary system. The IMF was established to "promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment."[105]

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[104] Stiglitz 1999b Pg. 1510
[105] http://www.imf.org/external/about.htm

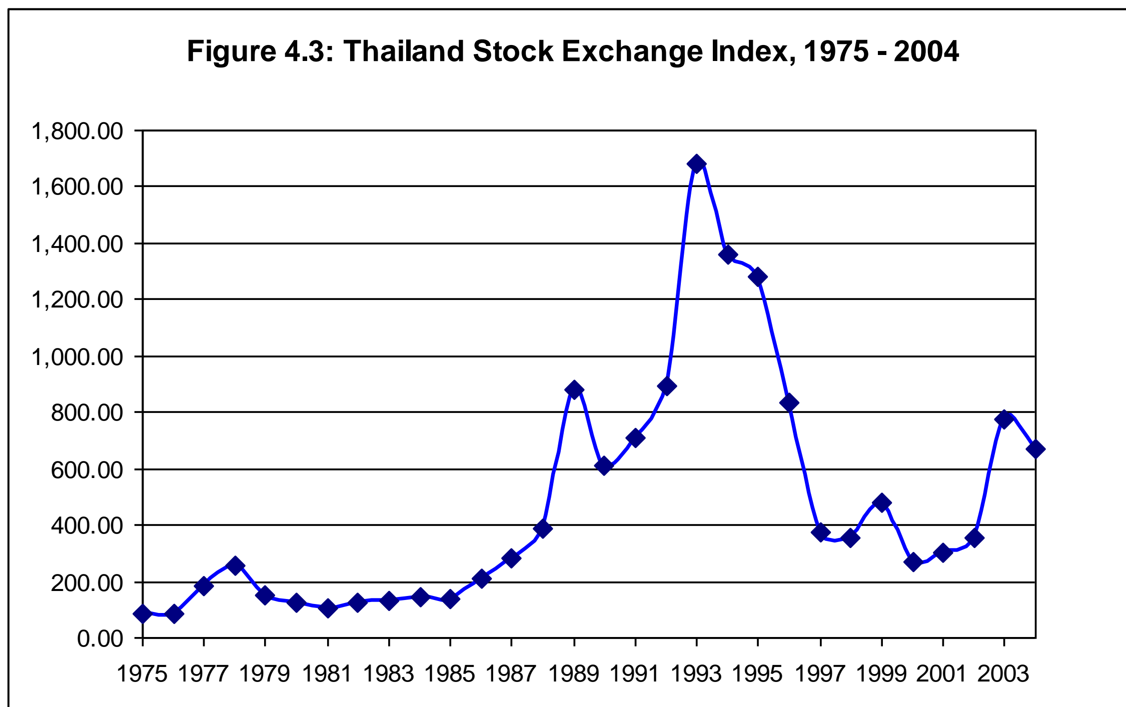
The Fund's charter is to lend funds to member countries with balance of payment difficulties. Temporary financial assistance can be requested if alternative sources of financing cannot be attained at reasonable terms. Financing can assist with currency reserves, and currency stability. IMF loans ease "the adjustment policies and reforms that a country must make to correct its balance of payments problem and restore conditions for strong economic growth"[106]. Lastly, "the IMF provides countries with technical assistance and training in its areas of expertise. Supporting all three of these activities is IMF work in economic research and statistics."[107]

The IMF has found itself embroiled in controversy for its handling of the East Asian crisis. The Fund's initial policy prescriptions, especially in Thailand, were viewed as antithetical to the underlying problems and were discarded part way through the recovery process in May 1998. The Fund's contractionary response, its detractors have stated, was tantamount to "screaming fire in a burning building"[108]. They charge that the IMF deepened the crisis and arbitrarily created a recession through austerity. During 1996, Thailand's remarkable growth began slowing as the economy cooled. A major contributor in the collapse was the export slow down. In 1994, exports of the top fifteen commodities were 611,536 million baht and had experienced a 21% expansion over the previous year. However, two years later exports had decreased by over three percent, led mainly by labor-intensive manufactured exports such as textiles. The export slowdown may be explained by the U.S. recession during this time. While the export slow down did not directly cause the crisis, the lack of growth exacerbated a growing current account

[106] http://www.imf.org/external/np/exr/facts/howlend.htm
[107] http://www.imf.org/external/work.htm
[108] Wolf Pg. 288

deficit, which led to the erosion of market confidence. By 1996, speculation of a pending currency devaluation was rampant. In response, FDI outflows increased.

The attrition of market and business confidence was reflected in the Thailand Stock Exchange Index. The Index's peak was in 1993 and steadily decreased over the next four-years. During the third quarter of 1996, the stock exchange index began a substantial decline; by year-end 1997, the index had fallen by 55% over the previous year's close (see Figure 4.3). The economy was not only showing signs of weakness, but also loss of investor confidence the four years preceding the currency shock in 1997.

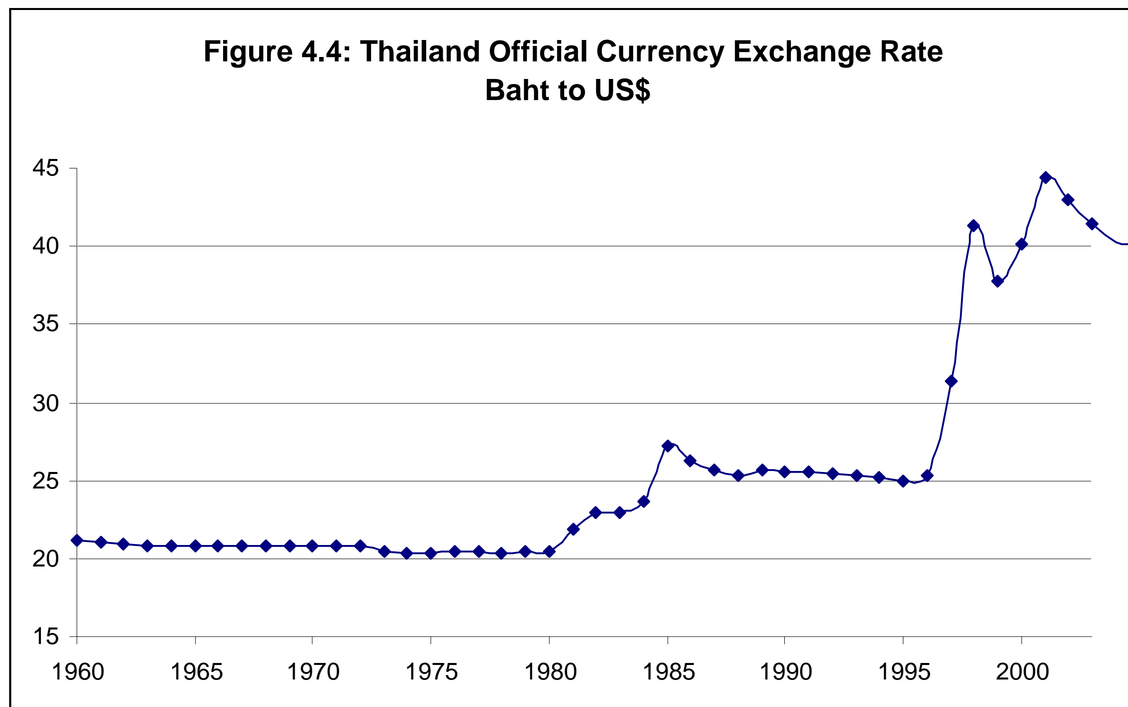


Source: Thailand Stock Exchange Index

Furthermore, in 1996 a scandal involving the Bangkok Bank of Commerce (BBC) erupted, which impelled foreign lenders to scrutinize their loans. The BBC was bankrupt and plagued by escalating bad debts that resulted from phony loans to bank cronies. The government took the bank over and charged its president and two upper managers with malfeasance and embezzlement. The economic declines, poor stock index, current

account deficit, and emerging bank scandal were the first signs of the impending crisis. However, the stock index had peaked in 1993 and annually declined thereafter. Prior to the 1997 collapse, the country already suffered from a contraction.

With the erosion of market and business confidence, an expanding current account deficit, and a tenuous international reserve position, speculation and downward pressure by currency speculators swelled in the first two quarters of 1997. The central bank announced a currency float on 02 July. The official rate moved from 25 baht per US$ to 30 baht (see figure 4.4).



Source: International Financial Statistics (data)

In response to the managed float, Stanley Fischer, Acting Managing Director of the International Monetary Fund, stated,

> In response to recent developments, Thailand's exchange rate system has been changed…to a managed float, with the value of the baht being determined by market forces in line with economic fundamentals…The Thai authorities are also considering supplementary measures to alleviate

> potential negative effects on debt servicing and prices that may result from adjustments in the value of the baht. In conjunction with the recent measures in the financial sector, and the previously announced strengthening of fiscal policy, the IMF welcomes today's important steps aimed at addressing Thailand's present economic difficulties and adopting a comprehensive strategy to ensure macroeconomic adjustment and financial stability. The Thai authorities have requested technical assistance from the IMF for the effective implementation of these measures[109]

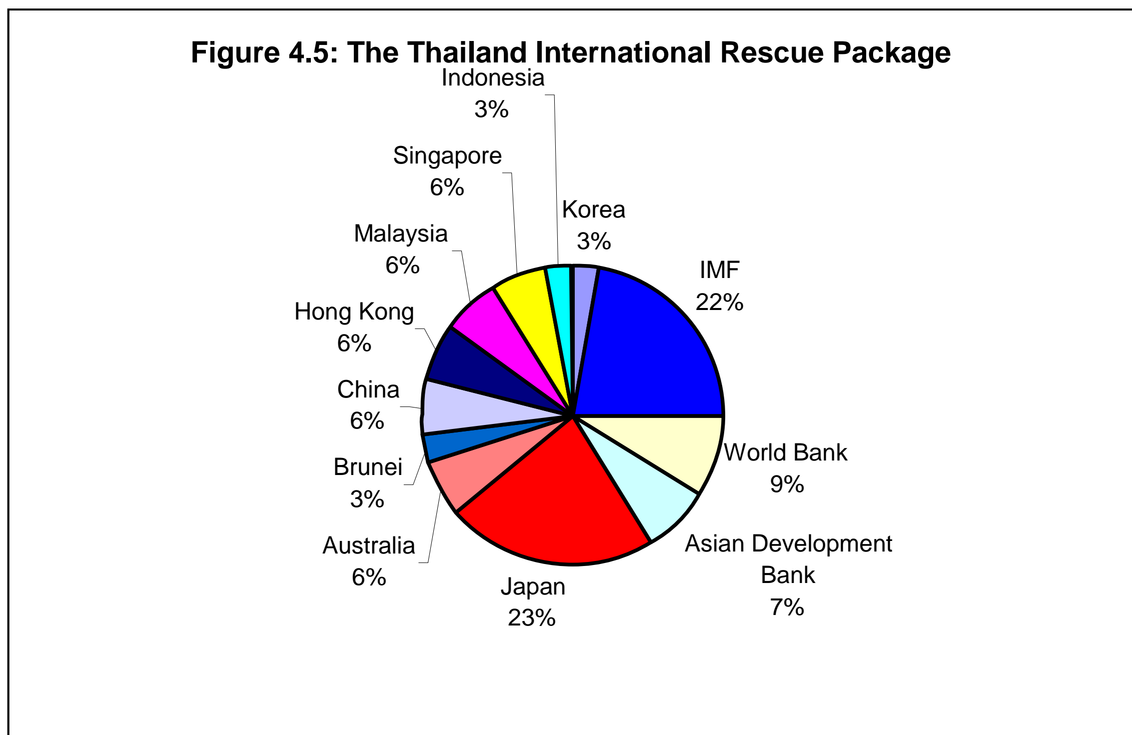
The IMF worked quickly, at the behest of the Thai government, to formulate a rescue package. By 14 August 1997, the IMF issued its first Letter of Intent outlining policies that were to be implemented over the following three years. Thailand requested a 34-month Stand-By Arrangement in an amount equivalent to SDR 2,900 million or 505% of its IMF quota. Funding of the package was a joint international effort. Malaysia, Singapore, and Indonesia, who would soon face their own crises, funded 15% of the credit facility, however, the bulk of the facility was funded by the IMF, the World Bank, the Asian Development Bank, and Japan (see Figure 4.5).

The IMF program focused on "exchange markets, financial sector reforms, and fiscal policies aimed at an orderly reduction in the external current account deficit"[110]. Such policy considerations were aimed at immediately restoring market confidence to dispel currency speculation, stabilize the currency, and strengthen the financial system. Other main policy objectives were to rebuild international reserves and reduce the current account deficit to about 3% to 4% of GDP. Furthermore, the Fund wanted Thailand to

[109] IMF News Brief 97/12
[110] IMFe

have a budgetary surplus of approximately 1% over the previous year's 1.6% deficit. The Fund described its surplus strategy stating,

> This will be done through strict prioritization and control of capital expenditure, with the aim of maintaining essential infrastructure investments… [however] the fiscal program will also be structured to limit the negative effects of the expenditure cuts on economic growth and income distribution[111].



Source: The World Bank

The Bank of Thailand, much like the U.S. Federal Reserve, was stridently defensive regarding inflation. Additionally, Thailand historically had always enjoyed low levels of inflation. Inexplicably in the face of not only such a policy towards inflation, but also strong past inflation containment performance, the Fund also planned to lower inflation to approximately 3%. As a part of the rescue package's inflation reduction

[111] IMFe

policy, the Fund gave the public and private sectors wage guidance to keep wages from expanding and placing upward pressure on prices. The policy backfired and further eroded public and private sector confidence. The Fund also wanted the Thai government to raise selective tax rates and interest rates. The Value-added Tax rate (VAT) was raised from 7% to 10%. The overnight repurchase rate was raised to between 14% and 17%.

The IMF also implemented a financial-sector restructuring plan, whereupon illiquid or bankrupt intuitions would be closed or consolidated. The Fund felt that the following transparency would then garner public-sector confidence. However, as the Fund forced the closure of many financial institutions, the action had an opposite effect and market confidence continued to slump. Furthermore, the depreciation of the baht had literally overnight wrecked the balance sheets of most Thai companies and had deteriorated the quality of bank assets fueling the collapse of the real estate bubble and provoking a banking crisis. The commercial sector literally had nowhere to go. Its banks were being closed, its balance sheets in tatters, and high interest rates only exacerbated an already eroded domestic currency. Lastly, due to the problems just listed, banks were just not lending any money. "The deprecation of the baht wreaked havoc with the balance sheets of most Thai firms so that no rational lender would lend to them."[112]

Finally, the Fund dismantled the capital controls on baht borrowing by nonresidents that Thailand had imposed in May 1997. The controls were initially implemented to stabilize the foreign exchange market. By removing the controls, the fund wanted to "encourage reflows of foreign capital"[113]. The country continued to hemorrhage capital and such outflows remained a significant source of instability. A

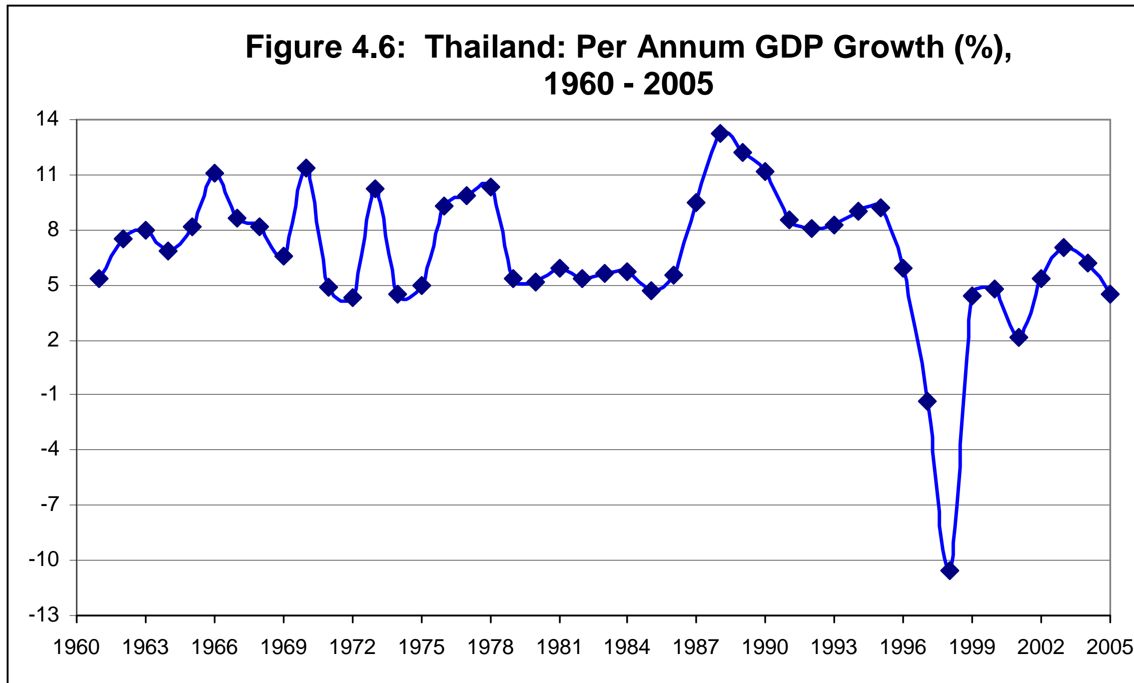
[112] Warr Pg. 73
[113] IMFe

capital liberalization policy under these conditions was wishful thinking that capital flows would reverse and the domestic currency would stabilize without any policy measure to stabilize the currency and stop the outflows. There were too many market sector and macroeconomic weaknesses to overcome to entice investors to either leave capital in the country or to invest new capital.

Finally, the IMF believed that an overall economic and monetary contractionary strategy of higher taxes, higher interest rates, and lower governmental expenditures was going to fuel an expedited recovery from the previous year's slow economic growth and contraction. The fund was bullish on not only the success of its policy prescriptions, but also the expeditious fulfillment of the plan, stating, "We strongly believe that the policies outlined here will serve to quickly restore market confidence to the high levels of previous years by addressing the two underlying sources of current economic difficulties, namely, the imperative need to restructure large parts of the financial sector and to reduce the high level of the external current account deficit".

The IMF has been the target of intense criticism for its policy prescription of fiscal austerity. In many respects, the Fund implemented a boilerplate package patterned after the Latin America debt crisis rescue packages, which were formulated to contain hyperinflation, ameliorate substantial public sector debt, and low rates of domestic savings. Furthermore, Latin America was plagued by poor government. Thailand's economic fundamentals lacked any of the weaknesses plaguing that of Latin America. "The problem was not imprudent government…the problem was an imprudent private sector – all those bankers and borrowers, for instance, who'd gambled on the real estate

bubble."[114] The combined result of the various policy prescriptions was a colossal reduction of private spending and a significant contraction in the economy (see Figure 4.6). After 6% growth in 1996, 1997 experienced the first negative growth rate in over fifty-years with a contraction of -1.4%. The following year was substantially worse at -10.5%.



Source: World Development Index (data)

The IMF reevaluated its initial policy prescriptions with the release of its second Letter of Intent on 25 November 1997. The Fund introduced the new policies recognizing that the Fund's original program had "to contend with a less favorable short-term macroeconomic outlook than originally anticipated"[115]. Particularly, the lack of a rebound of public and private sector confidence continued to place depreciative pressure on the exchange rate. Declines in private investment and consumption were sharper than

[114] Stiglitz 2000 Pg. 1-2
[115] IMFf

anticipated. The Fund held to its belief that overall growth would be positive and measurably lowering the current account deficit was a realistic prescription.

There were no changes to the contractionary policy, even in the face of failure of the policy. The 1997 revenue shortfall was estimated to be 133 billion baht; nevertheless the IMF was "determined to maintain the fiscal goal of keeping the consolidated public sector in a surplus of 1% of GDP in 1997-98. This will ensure an orderly offset to the anticipated costs of the financial sector restructuring, while also providing a clear signal of the government's intent to implement the economic program"[116].

By the beginning of 1998, it was clear that the IMF's strategy was not working and was actually antithetical to ameliorating the maladies plaguing the Thai economy. The Fund's third Letter of Intent dated 24 February 1998 offers the first hint of a change in policy and an indication by the IMF that possibly the previous policy was wrong. The Letter stated,

> There is a need to make some modifications to the program to take into account recent developments. In particular, we have to contend with new challenges that have arisen from the regional situation, and which have put additional pressures on the capital account; these have resulted in the further depreciation of the baht, and a much larger-than-anticipated decline in economic activity. The modifications to the program give clear priority to stabilizing quickly the exchange rate, while limiting the magnitude and negative social impact of the economic downturn.[117]

However, there were no material changes to the policy and greater emphasis to the restructuring of the financial sector was given. Three months later, with the fourth Letter of Intent, dated 26 May 1998, the Fund finally changed course, stating,

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[116] IMFf
[117] IMFg

> Nevertheless, while important progress has been made…conditions in the real economy are still deteriorating as the economic decline during the first half of 1998 is proving to be deeper than previously anticipated… Domestically, there has been more pronounced weakness in private consumption and investment demand, and continued liquidity shortages…the immediate priority under the program is to minimize any further decline of the economy and bring about early recovery, while sustaining the stabilization gains. Thus, the focus of policies will shift to adapting macroeconomic settings, strengthening structural policies, and ensuring the adequacy of the social safety net.[118]

The Fund advocated lower interest rates and higher monetary growth rates to assist with liquidity. Furthermore, the proceeds from a sovereign bond issue were to be used for banks to increase lending capacity and meet the liquidity needs of the commercial sector. The IMF, in light of the budget surplus, finally advocated an adjustment in fiscal targets to allow for deficits to minimize any further declines in the economy. Instead of a 1% surplus, the Fund planned for a 3% deficit. Public works programs that had previously been prevented were extended an increased budget of one half of GDP. Additional letters of intent continued to advocate an expansionary policy, deepening the deficit to 6%.

However, the Keynesian policy prescriptions proved futile and medicine rendered too little too late. By the third quarter of 1998, interest rates had fallen. However, corporate balance sheets were ravaged and the economy suffered from a significant amount of excess capacity. Banks continued to be reluctant to lend money. By 1998, Thailand was at the nadir of its recession. The country's prospects for the coming year were bleak. Considering the lack of success of the IMF's initial plan in Thailand, were

[118] IMFh

there alternative strategies that could have been utilized in mid-1997 to instill market confidence and head-off speculation of the baht? With international reserves precariously low, a tight monetary policy was justifiable. With a sustained attack on the baht, higher interest rates were needed to prevent significant capital outflows. However, the fiscal austerity was not justified even with hindsight. Stanley Fisher defended the Fund's macroeconomic policy prescriptions as "appropriate to the circumstances of individual countries and that the structural changes in these economies supported by IMF programs are necessary for the sustainable return of growth"[119]. However, the Fund, with the benefit of time and hindsight, did learn from its debacle in Asia. In the IMF 2000 Annual Report of the Executive Board for the Financial Year Ended, the Fund notes, "In Asia, the recovery from the 1997-98 financial crisis and subsequent recession was impressive. The recoveries in Korea, Malaysia, and Thailand were supported by expansionary fiscal and monetary policies"[120].

4.6 ALTERNATIVES TO THE IMF POLICY

A rational alternative to the crisis would have been to immediately implement a Keynesian expansionary policy "in order to counter the steep fall in investment and negative absorption effect of the sharp currency deprecation"[121]. The economy already suffered from overcapacity, especially in commercial real estate. The economy needed a targeted reflationary policy. However, by delaying the expansionary policy, such a policy's impact, when finally implemented was retarded and the public debt burden was increased due to the increased use of government bonds. Finally, the economy was much worse in 1998 than 1997 and therefore an expansionary policy had far more ground to

[119] Frontline – East Asian Financial Crisis
[120] IMFi Pg. 14
[121] Warr Pg. 99

cover to get the economy on sound footing to begin the healing process. By 2003, it was apparent that Thailand had finally recovered from the crisis. However, the recovery has been slow and painful. 2003 was the first year in which GDP growth reached the precrisis level of 1996. However, the economy still has a long way to go. Net FDI in 2003 was one sixth of the peak 1998 level.

Capital controls as a means of impeding currency speculation and capital outflows, stabilizing the baht, and preventing currency devaluation were not considered. It is unknown whether either the lack of credence in capital controls as a viable macroeconomic strategy or due to the lack of prevailing economic theory advocating such methods prevented Thailand from implementing capital controls. However, it is apparent that negative international market reaction to such a policy and pressure by Washington most likely influenced Thai officials. In September 1997, at a meeting of ministers of the Southeast Asian countries in Hong Kong, Joe Stiglitz was advising the countries on what they could do collectively in response to the crisis. He counseled that if all of them implemented capital controls "in a coordinated way, they might be able to withstand the pressures that would undoubtedly be brought down upon them by the international financial community and they could help insulate their economies from the turmoil".[122] However, it can only be speculated whether such controls would have been a better strategy than one pursued by the IMF. Nevertheless, it should be noted that Thailand did not have the political unity to implement concise and directed controls. The country suffered from rampant public riots and the 30-year Suharto government had fallen, a victim of the crisis and antipathy of the people. The Thai government was in absolute disarray, with significant infighting.

[122] Stiglitz Pg. 93

Furthermore, Thailand would have had to follow that path alone, without IMF support as Malaysia did. The Fund was resolutely against controls and as previously stated had forced Thailand to dismantle the controls that were implemented in May 1997. Since Thailand's economy was not nearly as strong as Malaysia's and the Thai contraction was far worse than Malaysia's, it is debatable whether Thailand could have successfully recovered without IMF support. However, based on the economic fundamentals at the time that the contraction took place and the subsequent recessionary effect the IMF policy had on the Thai economy, the evidence supports the conclusion that the IMF implemented a "cookie cutter" approach patterned after the Latin America Debt Crisis with a solution that did not fit the market weaknesses present at the time of the onset of the crisis.

4.7 MALAYSIA AND CAPITAL CONTROLS

Ten years prior to the crisis in East Asia, Malaysia appeared to have everything under control. The country enjoyed an average GDP growth rate of 8%. Furthermore, inflation was contained, unemployment was low, and investment in human capital was visible in high living standards. "With this impressive record, coupled with political stability and policy continuity, the international community had begun to admire Malaysia as the best 'development success story' among the second-tier newly industrialized economies of East Asia."[123] With the onset of the financial crisis, such sentiments were reevaluated.

In 1997, Malaysia's economic outlook was far brighter than Thailand's. As Thailand was mired in the nadir of its currency and economic crisis, Malaysia was mainly concerned with the possibility of a widening current account deficit and lower exports

[123] Athukorala Pg. 21

growth. Its real estate sector was cause for concern with a construction slowdown and high bank portfolio concentration. However, responding to these weaknesses, Bank Negara Malaysia implemented initiatives to increase transparency in light of Thailand's problems and the need for financial sector reform and regulation. However, no one was predicting a currency crisis or economic recession of the magnitude that Thailand was suffering at this time.

Malaysia had a relatively low level of external debt compared to Thailand's. Moreover, the Malaysian economy was far larger than Thailand's and was also stronger and more mature. It was also widely thought that Malaysia did not have the structural weaknesses that Thailand had. However, by the middle of 1998 Malaysia was fending off its own currency crisis mainly due to contagion and speculative currency positions by traders in the offshore ringgit market. There was also a significant deterioration of market confidence and higher offshore ringgit interest rates placed upward pressure on domestic interest rates. All of which led to vast capital outflows that placed further pressure on an unstable currency. The currency devaluation and accompanying baggage led to an overall slowdown of the economy.

In contrast to Thailand's stratagem of reliance on the IMF, floatation of its exchange rate, tightening of fiscal policy, the raising of interest rates, and the implementation of banking sector and structural reforms, Malaysia chose to follow a wholly heterodox approach. In September 1998, Malaysia ignored the IMF and undertook a largely unprecedented and unorthodox macroeconomic strategy by implementing controls on capital account transactions. The country also implemented a Keynesian reflationary macroeconomic plan. By undertaking a policy antithetical to the

IMF's policy prescriptions for the rest of East Asia, Malaysia ran the risk of alienating investors and market strategists who tend to be apprehensive of countries taking such an individualized plan without international consensus. Furthermore, any market skittishness could have translated into further capital flight and currency devaluation and instability. However, despite a lucid policy rationale and apparent macroeconomic benefit, capital controls on hemorrhaging capital outflows as a means of crisis resolution was, and continues today, to be hotly debated with little consensus amongst economists.

However, was Malaysia's economic convalescence attributable to the capital controls or some other stimuli? Did the controls expedite the recovery? Additionally, would the country have faired better had it chosen to follow East Asian sister countries with the implementation of IMF policy prescriptions? In analyzing the Malaysia experience, it was difficult understanding which affects were attributable to the capital controls and which, if any, affects were due to strictly timing and macroeconomic influences.

The capital controls were not employed hastily. The country's initial response to the crisis was to mirror IMF prescriptions in Thailand with severe governmental spending cuts, the raising of interest rates, and a tightening monetary policy. The public message from the government, to advocate stability, was exchange rate flexibility and maintenance of capital account liberalization. However, "the Malaysian economy failed to respond to the orthodox policies. Consumption and investment demand plunged as a result of capital outflows, high interest rates, and a pessimistic outlook"[124]. In response to the economic downturn, an expansionary macroeconomic strategy was executed with little success due to continued ringgit speculation. From early 1997 to mid-1998 capital

[124] Kaplan & Rodrik Pg. 9

outflows were estimated at $10 billion and encompassed about one-third of 1996 reserves. Additionally, the ringgit had depreciated by 40% and the stock market had declined by 75%[125]. Malaysia had tried fiscal austerity advocated by the IMF and also an expansionary policy both with little success. It was apparent that there was one element missing in the overall strategy and that was capital controls (see Table 4.2).

Table 4.2: Malaysia: Chronology of Events, 1997 – 1999

1997	March	Kuala Lumpur stock exchange price began to fall
	August	Ringgit devaluation policy commences
	September	Prime minister's statement that currency trading ought to be illegal
	November	Further fall of stock prices
1998	January	Signs of bank runs
	March	Adoption of macro-stabilization and financial sector package
	September	Deputy Prime Minister Anwar removed from office and arrested. Bank Negara governor and deputy governor resign. Malaysia Capital controls implemented; Removed from investment indices
1999	January	New lending for residential development restricted by Bank Negara Malaysia
	February	Capital controls are eased, including 12-month holding period for repatriation of portfolio capital.
	April	Implementation of corporate restructure and oversight and bank reforms; disallowance of bank lending to controlling shareholders
	November	Malaysia reincluded in the Dow Jones investment index.

Malaysia's policy rationale advocating capital control was the fundamental paradox of the "impossible trinity" economic theory. Malaysia chose to resolve its goals of expansionary monetary policy and stable exchange rates by abandoning free capital movements. The controls were not implemented as a means of economic recovery in and of themselves, but to support the country's overall economic plan and to end currency speculation. The controls were utilized to initially buoy and then compliment the overall

[125] IMF Occasional Paper 2001 Pg. 13 (Malaysia: From Crisis to Recovery)

reflationary strategy. The overall economic plan was useless while the ringgit fought against intense attacks.

Malaysia's only obvious alternative to capital controls was IMF assistance, which was highly untenable for Prime Minister Mahathir Mohamad. There were political considerations as well. The day after the capital controls were introduced, the deputy Prime Minister and the Minister of Finance, a key contact and proponent of the IMF, were removed from office. The Minister of Finance was the lead policymaker in implementing the nation's initial contractionary response to the crisis. However, despite any political motivations and a lack of accord on policy between the prime minister and the minister of finance, there is a lack of evidence reflecting that an IMF assistance package would have been successful in lieu of capital controls. As previously noted, Malaysia had already tried following an austerity plan with little success (see section 4.7).

The government's response was to carefully and selectively craft capital account controls on specific transactions. The controls were applied transparently to preempt any perception of cronyism or corruption. Malaysia pegged the ringgit at RM 3.8 per US$. The government also imposed a one-year holding period for the repatriation of portfolio capital. Malaysian nationals were also forbidden to export more than RM 10,000 during any foreign travel. To shut down the foreign ringgit market, which was driving the speculation, the government implemented a total prohibition on offshore ringgit transactions. Nonresidents had to attain prior governmental approval to buy or sell ringgit forward. Finally all sales of ringgit assets had to be transacted through approved domestic intermediaries. There was also a general concern that the controls would

adversely effect foreign direct investment, which the whole region relied on for its miraculous growth. Malaysia crafted the capital controls to ensure that FDI was not imperiled. The government allowed the repatriation of approved FDI transactions. In addition, current account transactions denominated in foreign currency were unimpeded. This allowed the government to finance the current account deficit through continued foreign direct investment.

The control's effects were immediate; Malaysia was removed from most investment indices, which caused its sovereign bond spreads to rise, increasing the cost of bonds as a source of financing. Moody's downgraded all Malaysian securities. There was an international outcry denouncing the controls. Washington powerbrokers, the IMF and U.S. Treasury officials were swift in their opposition to the controls. For instance, "appalled Treasury officials privately voiced hopes that the move would quickly boomerang so other countries wouldn't be tempted to follow Malaysia's example. Many foreign analysts and officials warned that investors would never return to a country that had treated them so shabbily."[126]

Furthermore, in a press conference, a reporter asked U.S. Treasury Secretary Robert Rubin what Washington's position on capital controls was. Secretary Rubin responded, "We do not believe that capital controls particularly the kinds of comprehensive capital controls that, for example, Malaysia has put in place, are a sensible approach or an approach that's consistent with…promoting long-term economic growth in the global economy"[127]. Additionally, Morgan Stanley "dropped Malaysia from its international index, stating that Malaysia would permanently be excluded from it

[126] Blustein 1999
[127] Press Briefing 10-30-1998

and that its previous inclusion had been a mistake in the first place"[128]. Analysts predicted doomsday scenarios of hyperinflation, a total market collapse, black market ringgit transactions, and finally that the controls would conceal bad governmental policy.

There were a few "courageous" economists who publicly supported the controls. For instance, Harvard economics professor Robert J. Barro stated, "counter to my initial instincts, there is some logic behind the capital controls. The Malaysians are probably right that the usual policy sanctioned by the IMF…would be worse than capital controls in the present environment"[129]. Other notable economists offering support were professors Max Corden of John Hopkins and Paul Krugman of Princeton, and World Bank chief Joseph Stiglitz.

4.8 VINDICATION OF CAPITAL CONTROLS

The controls gave Malaysia breathing room to implement major reforms and strengthen its banking system. The controls also shielded Malaysia from the global turmoil with rampant speculation and destabilizing capital flows. Furthermore, Joe Stiglitz noted, "While restructuring is, in any case, a slow process, the government…of Malaysia took an active role, and succeeded within a remarkably short period of time…in completing the financial restructuring…By contrast, restructuring in Thailand, which followed the IMF strategy, languished"[130]. Malaysia also understood that the controls were a short-term solution as an integrated part of a comprehensive economic plan to resolve the financial crisis. The controls themselves would not solve the crisis and due to the fungibility of capital, Malaysia could not rely exclusively on the controls.

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[128] Kaplan & Rodrik Pg. 11
[129] Barro Pg. 11
[130] Stiglitz Pg. 118

Although there was significant adverse market reaction to the capital controls suggesting a deterioration of investor and market confidence, such negative affects on the economy were relatively short lived. Figures 4.7 and 4.8 detail the market reaction to the capital controls regarding foreign exchange reserves and the Malaysian stock market index. Figure 4.7 reflects limited reserves at the nadir of the crisis, however after the implementation of the controls and the subsequent effect on currency speculation, reserves recovered rapidly.

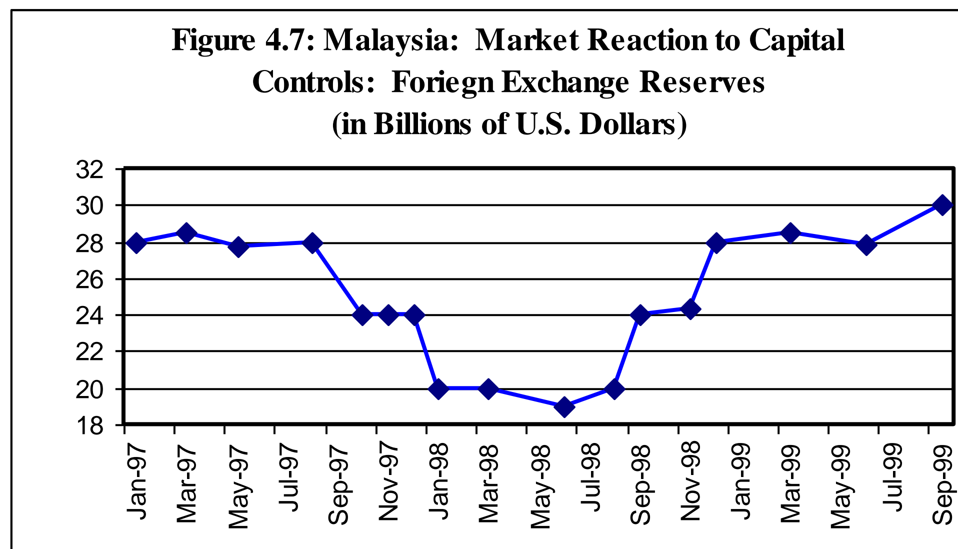
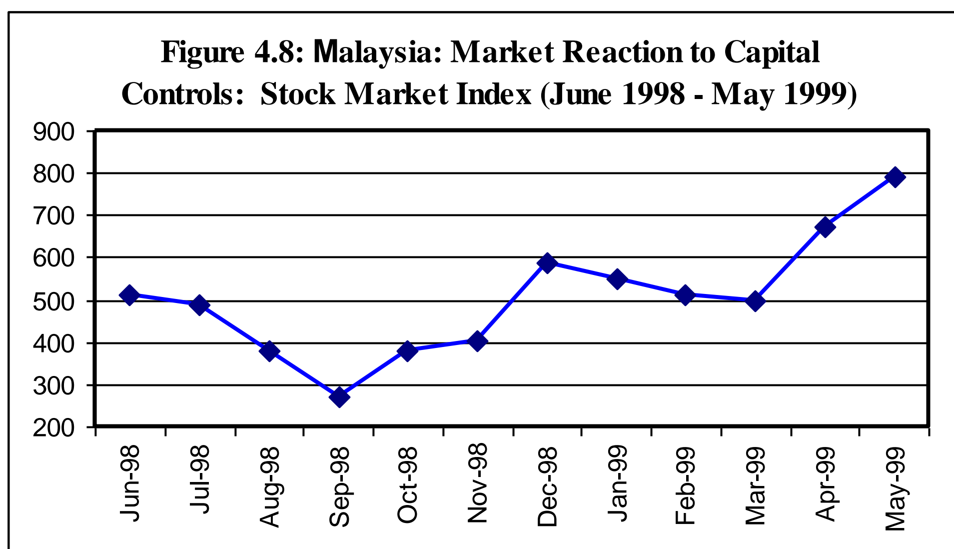


Figure 4.7: Malaysia: Market Reaction to Capital Controls: Foriegn Exchange Reserves (in Billions of U.S. Dollars)

Source: IMF 2000

Figure 4.8 details the stock market's reaction. "The stock market initially fell by 13.3%, to its lowest level in 1998, but rose subsequently."[131] The stock market hit its lowest point as the controls were implemented, however as investors saw that the controls were temporary and selective, investor confidence rapidly recovered.

[131] IMF 2000 Pg. 101



Source: IMF 2000

Why did Malaysia feel that controls were the only sensible answer? Especially in light of the fact that the plan was contrary to accepted economic theory. At the time that the controls were implemented, there was a general recovery in the region, which gave the appearance that the controls were unneeded. Thailand and others had not utilized capital controls to drive their recoveries. There was and continues to be an immense amount of skepticism among economists as to the effectiveness and utilization of the controls. For instance, economist and Asian economic development expert Linda Lim, testifying before the U.S. Congressional Subcommittee on Asia and the Pacific Committee on International Relations in 1999 stated,

> Following the imposition of capital controls, economic indicators in Malaysia did indeed start improving. But they also improved at the same time in the other crisis-hit countries which did not impose such controls but maintained open capital accounts…Until very recently, the recovery in Malaysia actually lagged behind that of its neighbors who were IMF patients…My own opinion is that capital controls in Malaysia were neither necessary nor sufficient for economic recovery…given Malaysia's much stronger macroeconomic fundamentals and financial institutions

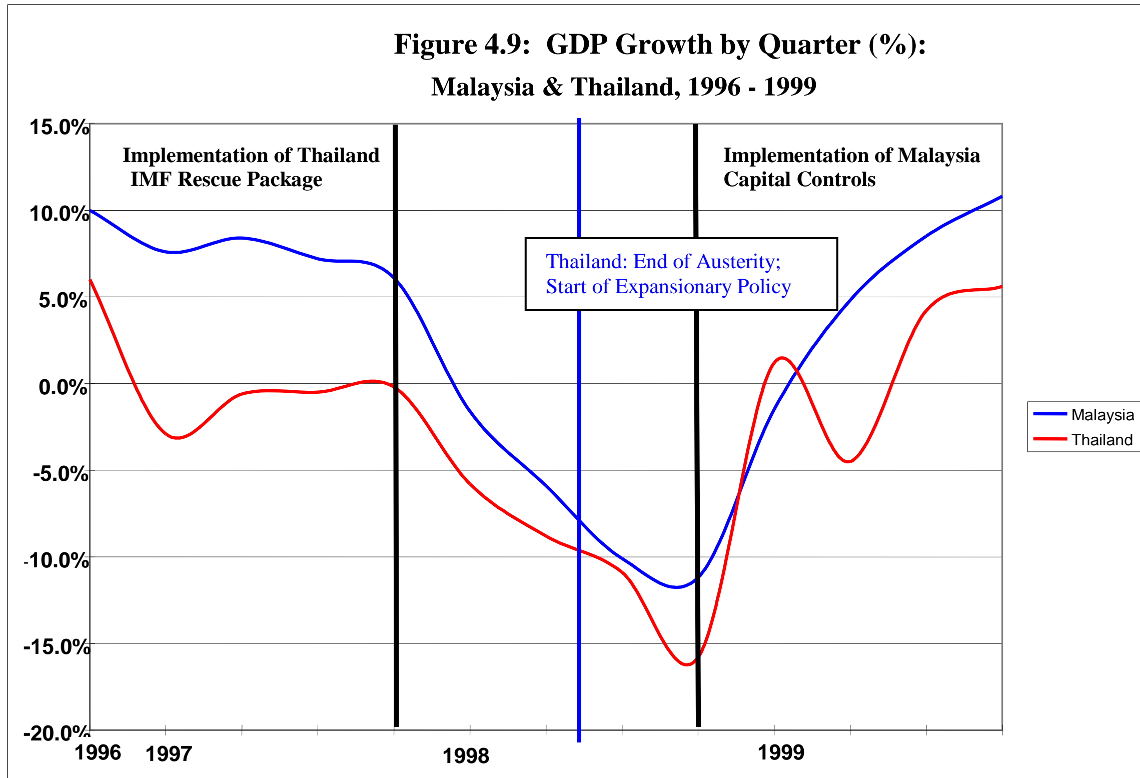
> before the crisis, one would have expected its recovery to be faster and stronger than that of the other countries. That this has not happened suggests that capital controls…may be exerting a drag on recovery through the discouragement of some foreign capital inflow[132].

Furthermore, Paul Krugman, who initially voiced support prior to the announced implementation of the controls, was asked by the Malaysian government in 1999 to tour the country and inspect the effect of the controls since he was one of only a few prominent economists to support the plan. Krugman noted,

> There is a recovery in progress throughout Asia. South Korea, which did not impose controls…has bounced back with stunning speed; Thailand is growing too… In general, the market panic of 1997-98 was, it turns out, coming to an end just about the time that Malaysia decided to make its big break with orthodoxy. You can argue that the controls may have allowed Malaysia to recover faster, with less social cost, than it would have otherwise.[133]

These are compelling arguments made by noted economists. However, it is intellectually tenuous to assume that Malaysia was at the brink of a corresponding recovery with the other Asian region countries. The data actually reflects the opposite (see Figure 4.9). Malaysia was at the nadir of its crisis when the country implemented controls; in 1998, third quarter GDP growth was -10%. Something dramatic had to be done to stop the slide. About the time Malaysia implemented capital controls, Thailand's economy was bottoming out and experiencing significant negative GDP growth; its contraction was substantially worse than Malaysia's. The IMF finally reversed course and implemented an expansionary policy. The data reflect an immediate response to the policy prescriptions.

[132] Kaplan & Rodrik Pg. 12
[133] Krugman 1999b Pg. 2



Source: International Financial Statistics (data)

Furthermore, when Thailand called in the IMF, Malaysia experienced 7.2% GDP growth that quarter in comparison to Thailand's -0.5%. Following the implementation of Thailand's IMF rescue package, Thailand experienced -0.2%, -5.8%, -8.8%, and -10.9% quarter-over-quarter GDP growth by third quarter 1998. It is apparent that the IMF's strategy was not working. As has been previously stated, the improvement in Malaysia's economy is not solely due to capital controls. Capital controls were only one piece of an overall economic plan. The controls gave Malaysian authorities time to craft a rational policy intended to quickly bring the country out of recession and instill economic and currency stability, while encouraging market and public confidence. Furthermore, the controls shielded Malaysia from speculators and the turbulent global economy. The end result was that Malaysia was able to recover far more quickly than Thailand and did not experience the level of contraction that Thailand did. Malaysia followed prudent

prescriptions of limited controls to instill stability followed by a sensible expansionary policy that has proved to be the correct formula.

Furthermore, there is far too much reliance on the fact that other Asian countries, Thailand included, began recovering coincidentally at the same time that Malaysia implemented capital controls. There were key timing differences between Thailand and the other countries' recoveries and that of Malaysia. When Malaysia implemented the controls, the country was not at the precipice of economic convalescence, but was facing a similarly dire economic situation to Thailand when Thailand called in the IMF. Something drastic had to be done to stop the economic decline. Malaysian authorities believed that its expansionary policy prescriptions were ineffective due to continued and intense speculative pressure against the ringgit even while other regional currencies began to enjoy modest appreciation. Finally, Thailand had the benefit of about 18-months of IMF assistance and reform programs prior to Malaysia's policy change, including an aggressive expansionary policy. Thailand's currency had appreciated significantly and the country's interest rates had fallen to reasonable levels. The Thai recovery was well underway.

However, in defense of the controls, in a study conducted by the IMF entitled, "Capital Controls: Country Experiences with Their Use and Liberalization" it states that the main objectives justifying capital controls are to "improve economic welfare by compensating for financial market imperfections…[preserve] autonomy to direct monetary policy…and reduce pressure on the exchange rate."[134] The study further notes that liberalized capital flows can cause inflationary consequences of large inflows,

[134] IMF Pg. 5

monetary instability by persistent outflows, and inadequate assessment by banks. The study concludes,

> It is difficult to disentangle the impact of Malaysia's capital controls from broader international and regional developments…Nevertheless, preliminary evidence suggests that the controls have been effective in realizing their intended objective of reducing the ringgit's internationalization and helping to contain capital outflows by eliminating the offshore ringgit market[135].

Malaysia presciently identified that short-term capital flows could be a source of economic instability and installed some capital controls in 1994 to control inflation, financial market instability, and monetary policy autonomy. Nevertheless, in 1998, after substantial capital outflows, Malaysia introduced additional capital controls to try to curtail currency speculation, to increase reserves, and to also gain monetary autonomy. Evidence suggests that the controls implemented were successful in eliminating speculation in the ringgit and allowed the country to regain control and expand monetary and fiscal policy. Joseph Stiglitz supported the controls, stating, "It was clear that Malaysia's capital controls allowed it to recover more quickly, with a shallower downturn, and with a far smaller legacy of national debt burdening future growth. The controls allowed it to have lower interest rates…Today, Malaysia stands in a far better position than those countries that took IMF advice"[136].

Further defense of the Malaysian controls was in the 2000 Asian Development Outlook Report by the Asian Development Bank noted, "Malaysia has survived the dire

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[135] IMF 2000 Pg. 104 - 105
[136] Stiglitz Pg. 125

prediction made by many analysts when it imposed selective capital controls…At a time when international investors had yet to regain confidence in the region, capital controls gave the authorities sufficient flexibility to pursue expansionary fiscal and monetary policies that would stimulate domestic demand without precipitating capital flight".[137]

Furthermore, although Paul Krugman initially supported Malaysia's plan and subsequently after an inspection of the country a year after the controls were imposed was less enthusiastic of the controls, is a voice of moderation, stating,

> The truth is that while Malaysia's recovery has proved the hysterical opponents of capital controls wrong… Malaysia has proved a point--namely, that controlling capital in a crisis is at least feasible. Until the Malaysian experiment, the prevailing view among pundits was that even if financial crises were driven by self-justifying panic, there was nothing governments could do to curb that panic except to reschedule bank debts--part, but only part, of the pool of potential flight capital--and otherwise try to restore confidence by making a conspicuous display of virtue. Austerity and reform were the watchwords. The alternative--preventing capital flight directly, and thereby gaining a breathing space--was supposed to be completely impossible, with any attempt a sure recipe for disaster. Now we know better. Capital controls are not necessarily the answer for every country that experiences a financial crisis; sometimes confidence can be restored without the need for coercive measures, and even when calming words fail, "burden sharing" by banks and other lenders will often be enough. But it would now be foolish to rule out controls as a measure of last resort.[138]

Finally, the IMF grudgingly found that the controls were effective in stabilizing the ringgit. IMF report noted that there were,

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[137] Asian Development Outlook Report 2000 Pg. 102

[138] Krugman 1999b Pg. 2-3

> Only a few reports of efforts to evade controls, and no indications of circumvention through underinvoicing or overinvoicing of imports…the controls were effective in eliminating the offshore ringgit market and choking off speculative activity against the ringgit… [furthermore] controls were successful in lowering interest rates, stabilizing the exchange rate, and reducing the co-movement of Malaysia overnight interest rates with regional interest rates.[139]

Managing Director Michel Camdessus was conciliatory, stating, "Consensus seems to be emerging that controls may have a place when there's risk of a crisis…but only as a breathing space while other fundamental measures can take effect…I praise the way in which Malaysia has been able to adopt a soft system of controls". [140] In addition, Margaret Kelly, the senior adviser in the IMF's Asia-Pacific Department stated, "They have certainly moved quite far ahead in terms of restructuring their financial sector and their macroeconomic policies have been good…they've wisely used the breathing space provided by the controls."[141] Finally, in a November 1997 study, in response to the Asian crisis, on prudential capital account liberalization sequencing, the Fund noted that capital account liberalization should be paced and integrated into a comprehensive economic plan. Furthermore, "countries may also need to rely temporarily on selective capital controls as part of their financial regulatory frameworks"[142].

4.9 SHOULD MALAYSIA HAVE PURSUED IMF ASSISTANCE?

There is a correlation between recession and financial crisis. Countries burdened by financial crisis typically experience significant GDP declines resulting in economic recessions. The IMF has attempted to anticipate recessions as a means of deflecting an

[139] Kaplan & Rodrik Pg. 3
[140] Blustein 1999
[141] Blustein 1999
[142] IMFj Pg. 11

impending crisis. The Fund has relied on World Economic Outlook Reports (WEO) to anticipate recessions and track growing areas of concern. WEO has a dismal track record for predicting recessions. WEO failed to predict most of the recessions of the 1980's and 1990's. A United States General Accounting Office (GAO) report on financial crises during the years 1991 – 2001 noted 134 recessions in 87 emerging market countries. The report also found that WEO correctly predicted only 11% of those recessions. Inexplicably, WEO predicted GDP expansions in an additional 119 recessions.

Obviously the IMF needs additional tools to not only predict economic contractions, but also crises. In response to the East Asian crisis, the Interim Committee of the IMF stated in the fall of 1998, "The reach of the crisis has underscored the need to reexamine and to strengthen the architecture of the international monetary system in order to better tailor its roles and institutions to the evolving needs of the global economy and international financial system"[143].

The IMF's initial failure in Asia did not start with its poor and imprudent policy prescriptions in Thailand, but years before the onset of the crisis when it did not predict the pending crisis. The Fund failed to identify weaknesses in the Asian economies and make the appropriate policy recommendations. Furthermore, as previously noted, Malaysia had initially prescribed traditional IMF austerity remedies in response to the crisis. Those proved ineffective as did the IMF's own policies in Thailand. In addition, there is little argument that an IMF loan package would have sustained the ringgit's value and allowed a brief respite for the country to fight speculators; however, for how long and to what end is unknown. Furthermore, Martin Wolf lists the IMF's blunders stating, "the IMF applies a one-size-fits-all policy of austerity to all countries; it failed to foresee

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[143] http://www.imf.org/external/am/1998/speeches/pr06e.pdf

the risks of capital account liberalization; its policy recommendations for dealing with the Asian crisis, in particular, amounted to screaming fire in a burning building, thereby turning a problem of illiquidity into one of insolvency; it has created moral hazard by lending too much and bailing out the imprudent lenders"[144].

In conclusion, the IMF readily admitted making policy mistakes in response to the crisis. The Fund applied a "cookie-cutter" approach patterned after the Latin American debt crisis to the crisis and formulated prescriptions that were not inimitable to the countries in question. Furthermore, Joseph Stiglitz stated, "IMF boosters suggest that the recession's end (Thailand) is a testament to the effectiveness of the agency's policies…[nonetheless] every recession eventually ends. All the IMF did was make East Asia's recessions deeper, longer, and harder. Indeed, Thailand, which followed the IMF's prescriptions the most closely, has performed worse than Malaysia and South Korea, which followed more independent courses"[145].

When the Fund should have been implementing an expansionary monetary policy by lowering taxes, increasing governmental spending, and lowering interest rates, the Fund did the exact opposite by utilizing fiscal austerity. Ironically, as East Asia was hemorrhaging capital due to persistent outflows, the IMF sanguinely continued to advocate capital account liberalization, which led to further destabilizing speculation and an increase in outflows. Finally, in Thailand the IMF discarded its own policy of austerity by May 1998 for one of expansion. Malaysia enacted controls less than five months later. Had the IMF not learned anything from its own dismal failure? Malaysia had tried fiscal austerity advocated by the IMF and also an expansionary policy both with

[144] Wolf Pg. 288
[145] Stiglitz 2000 Pg. 5

little success. It was apparent that there was one element missing in the overall strategy and that was capital controls. Therefore, the benefit of time and hindsight has not offered compelling evidence or a rational basis supporting the hypothesis that Malaysia would have been better off to have pursued IMF assistance and the corresponding policy prescriptions or that an alternative strategy, other than the one ultimately chosen, would have been either more successful or prudential.

CHAPTER FIVE

LESSONS LEARNED

5.1 INTRODUCTION

Few economists would have predicted the global economic chaos that followed Thailand's forced currency devaluation. The crisis not only inflamed the debate regarding the merits of the "Washington Consensus" and capital account liberalization, but also heralded the age of contagion. This paper has not attempted to resolve long-standing disagreements regarding the risks of capital account liberalization, the merits of capital controls, or the sources of Asia's remarkable growth. Analysis of these controversial subjects is merely suggestive rather than irrefutably resolved. However, the paper has drawn reasonable conclusions based on data, available scholarly work, and the author's own analyses of tested hypotheses. There are significant lessons to be learned from the East Asian financial crisis. The crisis reminded economists that the modern global economy is volatile. Countries that open their economies to capital account liberalization are increasingly vulnerable to sudden capital outflows, which can lead to currency depreciations, recessions, and economic and financial instability. It is ironic that capital liberalization policies wreaked such instability, when the main arguments advocating capital account liberalization and the removal of capital controls are greater stability and less risk through diversification.

Additionally, paramount is the understanding that "no country should consider itself immune to financial crisis"[146]. Furthermore, regarding East Asia's remarkable transformation,

[146] Moskow Pg. 1

> The Asian financial crisis may have finally put to rest the myth that the region's success has come about as a result of a unique system of capitalism rooted in Asian values – a system immune to the depressions and other troubles that economies in the West have to endure.[147]

However, it should be noted that the crisis was not an indictment of the miracle. The financial crisis did not wipe out the real progress and growth of the region and its populace. The contraction did retard growth, but it also forced Asian policymakers to rethink the mechanics of their economies and implement needed reforms and market adjustments. The East Asian Miracle, despite the crisis, continues to stand as an example to other underdeveloped regions of the ability to literally transform an entire region within a single generation's time. Furthermore, the ASEAN was also able to overcome the Western development barrier that only Japan had previously been able to conquer.

Additionally, the crisis highlighted the consequences of the uncontrolled expansion of credit by banks and especially loosely regulated finance companies. Such an unbridled expansion placed onerous pressure on the fixed exchange-rate regimes. Furthermore, rampant real estate speculation, which helped fuel the speculative expansion of credit, inflated asset values and collateral. When the real estate bubble burst, as in Thailand, banks were bereft what amounted to unsecured loans. As pressures mounted, currency speculators attacked East Asian currencies placing further pressure on domestic currencies and fixed-exchange rate regimes. There were other weaknesses that contributed to the contraction, but they were only secondary ailments that wielded their ugly heads after the initial shock and caused a chain reaction that plunged the region further into recession. These included crony capitalism, government and financial sector

[147] Wong Pg. 391

corruption and weakness, poor market fundamentals, and weak regulatory and economic infrastructures.

The weaknesses in East Asia were amplified by capital account liberalization. The removal of impediments to free capital mobility did not necessarily cause the crisis. However without a strong and systematic sequencing methodology and a strong underlying macroeconomic foundation, the implementation of capital account liberalization leaves economies open to increasing risks in the forms of market asymmetries, currency and market volatility, moral hazards, investor herd behavior, and finally large swings in both capital inflows and outflows. The result is that an economy's ability and preparedness to adequately manage the swings in both inflows and outflows without economic upheaval is jeopardized.

The role of contagion in the crisis cannot be discounted. What started as a regional problem soon spread to other continents. Furthermore, in many respects, other East Asian countries like South Korea should not have been affected by what was initially a Thai problem. In the age of aggressive currency trading, speculators were encouraged by many countries' willingness to stubbornly defend their currencies. Furthermore, many countries were forced to devalue so that their exports remained competitive with countries that had already devalued. Finally, with devaluation came an intense review of Thailand's macroeconomic fundamentals. As weaknesses were identified and analyzed, it soon was apparent that many of the same macroeconomic weaknesses were apparent in varying degrees in many of the East Asian nations.

Finally, the cost of resolving crises once they have transpired is substantial[148]. As such, global managers need better tools to analyze the economy and identify weaknesses. Furthermore, it is apparent that capital account liberalization is an established component of the modern economy. As such, to mitigate the inherent risks associated with capital account liberalization, to preempt future crises like Asia, and to fully enjoy the benefits of capital mobility, countries must prudentially implement capital account liberalization sequencing into a fully integrated and comprehensive macroeconomic plan.

5.2 SEQUENCING & INTEGRATION

Capital account liberalization may precipitate crises, however the root cause of financial crisis is not capital liberalization. Typically, such crises are accompanied by poor macroeconomic policies, weak regulatory and financial infrastructures, and poor overall economic management and supervision; free capital flows amplify such weaknesses. Asia was not only plagued by these weaknesses, but also by an engrained culture of cronyism and corruption in the banking sector. Therefore, it is not enough solely to employ a prudential sequencing policy for the implementation of capital account liberalization. Such a sequencing policy must be paced and integrated into a comprehensive and coordinated economic plan that builds the proper macroeconomic, regulatory, and financial infrastructures. Such a policy will also attract foreign direct investment in emerging economies and assuage investor concerns of bank solvency and economic instability.

In a study conducted by the IMF in late 1997 in response to the Asian crisis, the Fund suggested that the liberalization of portfolio capital flows should be undertaken with reforms in the domestic financial sector. Such reforms include the "liberalization of

[148] Moskow Pg. 1

interest rates, development of indirect monetary control procedures, and strengthening banks and capital markets…through improved regulations”[149]. While the liberalization of foreign direct investment should be accompanied by the implementation of reforms in the “real sector and export potential of the economy, including reforms to the trade and investment regimes, exchange rate adjustments to improve competitiveness, and liberalization of exchange controls on current international transactions”.[150] The report further noted that where financial sector weaknesses exist that these should be addressed either concurrent with the liberalization of the capital account or in advance of such a policy. Finally, the study concluded that reliance on temporary capital controls may be necessary to employ reforms and garner economic and financial stability.

5.3 PREDICTION, PREVENTION, AND MANAGEMENT

It is apparent that East Asia was due for a significant market adjustment after a decade of phenomenal, and in some opinions, excessive growth. “But the total collapse of the monetary and financial systems…was unnecessary and could have been avoided if better policies had been adopted to manage the speculative attacks.”[151] The manner in which governments react to potential market and economic weaknesses is important in trying to not only prevent an economic crisis, but also not provoke speculators and exacerbate weaknesses.

For instance, Thailand inflamed the downward pressure on its currency by its crisis resolution and the lack of governmental transparency. Thailand tried to fight the speculators prior to the July 1997 baht devaluation. The bank responded to currency speculation by raising interest rates and contracting market liquidity. “Raising interest

[149] IMFj Pg. 11
[150] IMFj Pg. 11
[151] Wong Pg. 396

rates did little to discourage the speculators, and ended up actually enriching those who sold the baht short…the higher interest rates also inflicted terrible damage on the Thai people."[152]

While the Thai central bank defended the currency, the bank kept secret its dire foreign reserve position. The bank did this as a desperate attempt to maintain the value of the baht. The bank felt that disclosure of the actual level of foreign reserves would only encourage further speculation. When the bank finally disclosed its reserve level there was a run on the baht and the bank soon was forced to devalue. Therefore, the policy measures that countries undertake prior to a crisis can impact not only the onset of the crisis, but also the depth and duration of the contraction. Such policy measures are unique to the given situation and market and economic variables. However prudential policies regardless of prevailing and accepted economic theory and despite the whims of Washington should be implemented to contain a crisis. At times difficult situations will necessitate difficult and possibly independent strategies to be implemented, as in the case of Malaysia.

The Asian crisis also highlighted the need for increased government and corporate transparency. Transparency in government is as important as market perspicuity. Transparency breeds trust and stability. "The Southeast Asian corporate culture and governance mechanisms have come under increased scrutiny since the onset of the crisis. Government and business relations give privileges to big conglomerates…the limited progress in dismantling these kinds of government business relations diminishes the

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[152] Wong Pg. 395

[region's] ability to enforce new policies, and also leads to the erosion of the strength of the region's business management."[153]

In response to the crisis, the Interim Committee of the IMF stated in the fall of 1998, "The reach of the crisis has underscored the need to reexamine and to strengthen the architecture of the international monetary system in order to better tailor its roles and institutions to the evolving needs of the global economy and international financial system"[154]. One economist summed up opinion of the Fund and its handling of the crisis, stating,

> The push towards capital market opening in developing countries has however come under serious reconsideration in the aftermath of the onset of the…crisis…there has been a huge swing in informed opinion towards thinking that those countries which still maintain closed capital account regimes should undertake the liberalization of…capital movements only gradually and [with] extreme caution... And even the IMF, despite its continued flirting with mandatory capital account convertibility, has recently become more sympathetic to this cautious approach.[155]

In addition to offering balance of payments assistance, the Fund is now trying to better anticipate, prevent and to resolves crises. However, it is impossible to predict and prevent all crises. With this caveat in mind, the Fund and the World Bank began conducting joint economic and country assessments in the late 1990's of member countries to identify areas of concern and weakness. The Fund also began to "promote adherence to voluntary standards…to improve transparency in government economic data, fiscal, monetary, and financial policies, and guidelines on strengthening the

[153] Chirathivat & Murshed Pg. 8
[154] http://www.imf.org/external/am/1998/speeches/pr06e.pdf
[155] Athukorala Pg. 1-2

financial and corporate sectors"[156]. The Fund has implemented numerous new tools to deflect pending crises (see Table 5.1)

Table 5.1: IMF Initiatives to Anticipate, Prevent, and Resolve Financial Crises		
Anticipation	**Prevention**	**Resolution**
Vulnerability Assessment Framework	**Long-term Reforms**	**Debt Restructuring Proposals**
World Economic Outlook	Financial Sector Assessment Program	Sovereign Debt Restructuring Mechanism
Early Warning Systems Models	Reports on the Observance of Standards and codes	Collective Action Clause
Country External Financing Requirements		Strengthening of Lending Policies
Market Information		
Financial Sector Vulnerability		
Country Expert Perspectives		

Source: GOA June 2003[157]

[156] GAO June 2003 Pg. 3
[157] GAO June 2003 Pg. 4

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Jeff earned a baccalaureate degree in foreign language from the University of Kansas while continuing a career in banking, concentrating in commercial finance. Jeff continued his studies by completing the necessary coursework for a Master's degree in International Studies with a concentration in International Business from the University of Kansas. Jeff's studies included advanced accounting and finance, economics, and international business. Jeff's thesis combines areas of interest including economic theory, financial crises, and international business.

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