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To begin with there were significant underlying problems besetting the Asian economies, at both a macroeconomics and microeconomics level (especially within the financial sector). This paper provides a liberal diagnosis of the financial crisis in Asia. It builds on existing theories, and focuses on the empirical record in the lead-up to the crisis. The main goal is to emphasize the role of financial panic as an essential element of the Asian crisis. That the economic miracle was founded on political forces and imprudent speculation helped in seeing erstwhile developing economies collapse like a house built by pack of cards.

**Key words:** capitalism, Marxist thought, financial crisis, financial panic, economic miracle

*Corresponding author: *Sorab Sadri
INTRODUCTION

The crisis of capitalism is as old as Marxist thought. Marxists have all along warned about the crisis of capitalism and their prognosis seems to have come true at least in the periphery.

The East Asian financial crisis of recent years is remarkable in several ways. The crisis hit the most rapidly growing economies in the world, and prompted the largest financial bailouts in history. It is the sharpest financial crisis to hit the developing world since the 1982 debt crisis. It is the least anticipated financial crisis in years. The culprits within Asia, the Western media alleges, are the corrupt and mismanaged banking systems, marked by a lack of transparency in corporate governance. Marxists see this as an inherent shortcoming of state-managed capitalism. The economic miracle did not end with a bang but fizzled out without even a decent whimper leaving countless people unemployed and several economies in shambles.

At least as much attention, if not more, should be focused on the international financial system. The crisis is a testament to the shortcomings of the international capital markets and their vulnerability to sudden reversals of market confidence. The crisis has also raised serious doubts about the IMF’s approach to managing financial disturbances originating in private financial markets. Perhaps most importantly, the turmoil demonstrates how policy mis-steps and hasty reactions by governments, the international community, and market participants can turn a moderate adjustment into a financial panic and a deep crisis.

In this sense, the Asian crisis can be understood as a “crisis of success”, caused by a boom of international lending followed by a sudden withdrawal of funds. At the core of the Asian crisis were large-scale foreign capital inflows into financial systems that became vulnerable to panic. However, this is more than the bursting of an unwanted bubble. Much of the economic activity supported by the capital inflows was highly productive, and the loss of economic activity resulting from the sudden and enormous reversal in capital flows has been enormous. There were few, if any expectations, of a sudden break in capital flows. By early 1997, markets expected a slowdown — even a devaluation crisis — in Thailand, but not in the rest of Asia. Indicators as late as the third quarter of 1997
did not suggest a financial meltdown of the sort that subsequently occurred.

To begin with there were significant underlying problems besetting the Asian economies, at both a macroeconomics and microeconomics level (especially within the financial sector). This paper provides a liberal diagnosis of the financial crisis in Asia. It builds on existing theories, and focuses on the empirical record in the lead-up to the crisis. The main goal is to emphasize the role of financial panic as an essential element of the Asian crisis. That the economic miracle was founded on political forces and imprudent speculation helped in seeing erstwhile developing economies collapse like a house built by pack of cards.

To the liberal mind, there are five main types of financial crises, which may in fact be intertwined in any particular historical episode:

1) *Macroeconomic policy-induced crisis:* A balance of payments crisis (currency depreciation; loss of foreign exchange reserves; collapse of a pegged exchange rate) arises when domestic credit expansion by the central bank is inconsistent with the pegged exchange rate.

2) *Financial panic:* In general terms, a panic can occur when three conditions hold: short-term debts exceed short-term assets; no single private-market creditor is large enough to supply all of the credits necessary to pay off existing short-term debts; and there is no lender of last resort.

3) *Disorderly workout:* A disorderly workout occurs when an illiquid or insolvent borrower provokes a creditor grab race and a forced liquidation even though the borrower is worth more as an ongoing enterprise. It occurs especially when markets operate without the benefit of creditor coordination via bankruptcy law.

4) *Moral-hazard crisis:* A moral-hazard crisis arises because banks are able to borrow funds on the basis of implicit or explicit public guarantees of bank liabilities. If banks are undercapitalized or under-regulated, they may use these funds in overly risky or even criminal ventures. Krugman (1998) similarly argues that the Asian crisis is a reflection of excessive gambling and indeed stealing by banks that gained access to domestic and foreign deposits by virtue of state guarantees on these deposits.
5) Bubble collapse: Bubble occurs when speculators purchase a financial asset at a price above its fundamental value in the expectation of a subsequent capital gain. In each period, the bubble (measured as the deviation of the asset price from its fundamental price) may continue to grow, or may collapse with a positive probability. The collapse, when it occurs, is unexpected but not completely unforeseen, since market participants are aware of the bubble and the probability distribution regarding its collapse. According to Krugman the south East Asian bubble was destined to burst.

One reason that the crisis came as such a surprise was East Asia’s long track record of economic success. The broad outlines of that success are well-known. In Malaysia, Indonesia, and Thailand, average income more than quadrupled between 1965 and 1995, and in Korea, income rose seven-fold. Average incomes in these four countries climbed from 10 percent of the US average in 1965 to around 27 percent today. Life expectancy at birth rose from 57 years in 1970 to 68 years in 1995, and the adult literacy rate jumped from 73 percent to 91 percent. Notably, the benefits of economic growth were widely shared throughout the population. Incomes of the poorest quintile of the population grew just as fast as average incomes, and poverty rates fell substantially in each country. In Indonesia, for example, the share of the population living under the poverty line fell from 60 percent in the 1960s to under 15 percent in 1996.

The origins of Asia’s rapid growth have been hotly debated, and these discussions have taken on new energy with the onset of the financial crisis. It is also suggested, in the aftermath of the crisis that Asia’s rapid development was somehow a mirage that either never really happened, or has been completely wiped out by the crisis. This view is obviously mistaken. The enormous gains in income levels, health, education, and general welfare in Asia during the last three decades will not be dissipated by even an extended recession. After all, even if the crisis is followed by several years of zero growth, standards of living will still be four times higher than they were one generation ago, and 50 percent higher than they were just one decade ago.

It can be also argued, more reasonably, that there may have been something in Asia’s growth strategy that inevitably led to the financial crash. Problems began to emerge in both macroeconomic (capital inflows, real
exchange rate appreciation) and microeconomic fundamentals (credit expansion, financial regulation and supervision) in the 1990s that partially contributed to the onset of the crisis.

We may be tempted to rush to a conclusion that Asia’s development strategy led to a crash. Such a conclusion might be compelling if it were true that the Asian “miracle” in fact was due to strong authoritarian governments, a close-knit relationship between governments and corporate leaders in fostering heavy industry, or large state subsidies to help exporters gain market share. Although the view of the “Asian model of development” has gained widespread popularity during the last decade, it generally fails to hold up under close scrutiny.

The core industrial strategy in East Asia was the success in integrating national production with international production, not merely through export orientation, but through specific institutions such as technology licensing, original equipment manufacturing, and export processing zones, which helped to attract export-oriented foreign investment. This strategy enabled economies to begin with low-technology manufactured export activities (apparel, footwear, and electronics assembly) and gradually to upgrade to high-technology products, such as consumer electronics design and production. Of course, this outward oriented industrialization strategy also depended fundamentally on several core macroeconomic policies pursued throughout the region:

1. High rates of government and private saving;
2. Reliance on private ownership in the industrial sector;
3. Low inflation rates and restrained domestic credit policies;
4. Convertible currencies, with low or zero black-market premia on foreign exchange.

Any long-term development process involves the strengthening of financial institutions. As production processes become more complex and more deeply integrated with the world economy, a greater range of sophisticated and well-regulated financial services takes on greater importance. Changes in firm ownership structure and financing arrangements require deeper capital markets for equities, bonds, bank loans, and other forms of financial intermediation. More capital intensive
production processes require low cost long-
run financing in order to be competitive, and
a range of hedging instruments to protect
against a variety of market risks.

At least in part, the Asian financial crisis has
its roots in attempts at financial reforms in
East Asia in the early 1990s that were aimed
at upgrading financial institutions, but in
fact left the economies exposed to the
instabilities of the international financial
markets. In Indonesia, for example, a series
of financial deregulation packages led to a
tremendous expansion in the banking sector,
with the number of private banks (including
foreign and joint venture banks) nearly
tripling from 74 in 1988 to 206 six years
later. The centerpiece of Thailand’s effort to
compete with Singapore and Hong Kong as
a regional financial center was the
introduction of the now notorious Bangkok
International Banking Facility (BIBF) in
1992. The BIBF allowed for very rapid
growth in the number of financial
institutions that could borrow and lend in
foreign currencies, both on and offshore. In
Korea, financial market reforms in the mid-
1990s similarly opened the door towards
greatly expanded banking activity, and
increased access of domestic banks to short-
term international loans. As a general
matter, the rapid expansion in financial
services was not matched by careful
regulation and supervision. Regulatory
reforms tended to be partial and incomplete.
The piecemeal approach led to a situation in
which reforms in one area tended to open up
loopholes in other areas, which firms were
quick to exploit. State-owned banks in
Indonesia and Korea were allowed to break
many prudential regulations on a regular
basis without penalty. As in many countries
around the world, many banks were owned
by politically well-connected individuals
who used the banks to heavily finance the
operations of affiliated companies. In
Indonesia, for example, almost all the major
corporations also had their own banks, and
the division between the two was often
blurred.

To take a sympathetic view East Asia may
have become vulnerable to external financial
shocks in part because it attempted to reform
its financial markets in the 1990s in a
market-oriented manner. These reforms led
to a dramatic increase in the number of
banks and their linkages to the international
economy, which, in turn, increased the
exposure of these economies to international
financial shocks, mainly through the
remarkable buildup of short-term debts.
Asian countries with stronger financial
systems (e.g. Singapore and Hong Kong)
had taken steps to redress inadequate regulations and poor supervision, and thus were less prone to a crisis. At the other end of the spectrum, Asian countries that had not undertaken significant financial sector reforms (e.g. China, Vietnam) were shielded from the crisis by the fact that they had seen much less short-term capital inflow in the early 1990s. Seen in this light, the developments of 1997 may not have been the inevitable result of an “Asian Capitalist Model,” but rather the accidents of partial financial reforms that exposed the Asian economies more directly to international financial market instability. We now turn to the proximate causes of the crisis.

**Buildup to the Crisis: 1990-97**

There were indeed growing imbalances and weaknesses in the East Asian economies both at the microeconomic and macroeconomic levels. Most importantly, there was a rapid buildup of short-term external debt into weak financial systems made possible both because of East Asia’s successful track record which attracted foreign credits, and because of partial financial market liberalization in East Asia, which opened new channels for foreign capital to enter into the Asian economies. The inflows led to appreciating real effective exchange rates, a rapid expansion of bank lending, and especially to increasing vulnerability to a reversal in capital flows. When capital inflows waned in late 1996 and early 1997, a financial panic erupted following a series of missteps by the Asian governments, market participants, the IMF, and the international community. The result was a much deeper crisis than was either necessary or inevitable. One thing must be understood first of all. The USA and its allies buoyed up the economies artificially (for political reasons). This was to offset the rise of communism. But once the soviet hegemony came to an end, the threat of communist expansion petered away and the bubble burst. Economies could not sustain the growth without the active connivance of USA and its allies. Currencies, which were held high by political expediency, found their low-level equilibrium when economic reality took over. To the analyst, however, several aspects of the buildup to the crisis are worth highlighting:

- Capital inflows into the Asian-5 countries averaged over 6% of GDP between 1990 and 1996. Capital inflows into Thailand averaged over 10% of GDP during the 1990s, and reached a remarkable 13% of GDP in 1995 alone. Thailand’s inflows were predominately
borrowing by banks and financial institutions. In Malaysia, inflows averaged 9% of GDP, and jumped to over 15% of GDP in both 1992 and 1993 before tapering off. However, the bulk of Malaysia’s inflows came in as foreign direct investment, which of course is less prone to quick reversals. In Indonesia, inflows averaged a more modest 4% of GDP, mostly in the form of borrowing by private corporations.

- Governments maintained exchange rates either with very little variation (Malaysia, Thailand, the Philippines) or small, predictable changes (Indonesia, Korea). In effect, the central banks absorbed the risks of exchange rate movements on behalf of investors, which helped encourage capital inflows, especially with short maturity structures.

- Exchange rates appreciated in real terms as the capital inflows (brought about at the behest of US) put upward pressure on nontradeables prices prior to the crisis. Real exchange rates appreciated by more than 25% in the four Southeast Asian countries between 1990 and early 1997. In Korea, the appreciation was about 12%. However, that the real appreciations in Asia during the 1990s were relatively modest compared with other developing countries. Brazil and Argentina, for example, have seen real appreciations of more than 40% since 1990.

- Export growth, measured in current US Dollars, began to slow in the mid-1990s, and then dropped sharply in each country (except the Philippines) in 1996. In Thailand, exports actually fell in nominal Dollar terms in 1996, while in Korea exports increased just 3.7 percent. Several factors probably contributed: the increasing overvaluation of the exchange rates, the appreciation of the Japanese Yen against the Dollar after 1994, the devaluation of the Chinese yuan in January 1994, the competitive effects of Mexico’s participation in NAFTA and the Peso devaluation, and the worldwide glut in semi-conductor production.

- Domestic bank lending expanded rapidly throughout the region. In Thailand, Korea, and Malaysia, banking claims on the private sector increased by more than 50 percent relative to GDP in seven years, reaching 140 percent of GDP in 1996. The Philippines, starting from a much lower base, recorded private credit growth of over 40 percent per year.
between 1993 and 1996. Only in Indonesia did credit growth remain at more modest levels (but here, private corporations were borrowing directly offshore). The banks borrowing offshore financed much of the new lending. In Korea, 15 foreign liabilities of the banking system more than doubled from 4.5 percent of GDP in 1993 to 9.5 percent of GDP in mid-1997. In the Philippines, these liabilities soared from 8.8 percent of GDP at the end of 1995 to an astonishing 21 percent of GDP in mid-1997, just 18 months later. The most extreme case was Thailand, where, after the introduction of the BIBF, foreign liabilities of banks and financial institutions increased rapidly to over 28 percent of GDP by 1995.

- Apparently, a modestly increasing share of domestic bank lending was used for real estate, property, and purchases of equity funds.

- A rising share of foreign borrowing was short-term debt, especially in Korea, Thailand, and Indonesia. Short-term debts to offshore banks in these three countries reach $68 billion, $46 billion, and $34 billion, respectively, at the end of 1996. In Thailand, Korea and Indonesia -- the three countries hardest hit by the crisis -- the ratio of short-term debt to foreign exchange reserves exceeded one after 1994. A ratio greater than is not by itself sufficient to spark a crisis, since it can be sustained as long as foreign creditors are willing to roll over their loans. A high ratio, however, does indicate vulnerability to a crisis. Once something sparks a withdrawal of foreign capital, each foreign creditor has the incentive to demand repayment quickly, since they each know that there is not enough foreign exchange available to repay everyone.

Capital Withdrawal and Panic

It all began when pressure mounted at nearly the same time in early 1997 in both Korea and Thailand. In Korea, Hanbo Steel declared bankruptcy in January, leaving $6 billion in debts. In the next few months, both Sammi Steel and Kia Motors faced similar difficulties. These problems put increasing pressures on merchant banks (which had borrowed offshore to lend to these and other chaebol), and began to raise concerns about the financial strength of other chaebol. In Thailand, property prices started falling in late 1996. It was becoming clear that financing companies, which had exposed

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themselves to the Bangkok property market, were in trouble. The Baht came under attack in late 1996, and twice more in the early months of 1997. In March, the Thai government promised to buy $3.9 billion in bad property debt from finance companies, but then quickly reneged on its promise. As evidence grew of the fragile condition of the property sector and the financial institutions, speculation mounted that foreign exchange reserves were dwindling and that the government would have to float the Baht.

The government’s protestations that it would not allow Finance One (the largest financial institutions) to go under, and that it would not allow the Baht to float, were to no avail. By late June, Thailand had sharply reduced its liquid foreign exchange reserves, and the Baht was cut loose on July 2. Foreign creditors reacted by withdrawing capital from around the region, and exchange rates came under intense pressure. By early September, currencies in the each of the four Southeast Asian countries had fallen by 20% or more. As the currencies fell and capital flows reversed, several forces came into play to create a self-reinforcing spiral that quickly evolved into a panic.

- First, in the early stages, creditors made little effort to distinguish amongst the

Southeast Asian countries, and assumed that if Thailand was in trouble, the other countries could not be too far behind.

- Second, as exchange rates depreciated and the domestic currency costs of servicing foreign debts rose, foreign creditors became more reluctant to extend new loans and roll over existing loans. Domestic debtors had to buy foreign exchange to retire these debts, which put more pressure on exchange rates, which in turn reinforced the tendency for creditors to not roll over loans.

- Third, domestic debtors, many of which had not hedged their foreign exchange exposure, began to purchase foreign exchange to try to close their positions.

- Fourth, the major ratings agencies belatedly began to downgrade countries in the region, triggering further creditor withdrawals.

- Fifth, both governments in the region and the international community made several mistakes in handling the crisis that added fuel to the fire.

As international confidence in these strategies waned, and democracy was thrown to the winds, investors panicked.
There was just too much politics with the economics and not enough economics with the politics. An anti-Communist USA and its Asian epigones soon realized that the economics of bread and butter or the *Gospel of Mammon* (to use Thomas Carlyle’s language), as a motivator was stronger than sentiment, the cookie crumbled. Very soon it became clear that the economic contractions in the region would be much larger than what was originally made out, creditors withdrew even more funds, intensifying the panic.

**Initial Responses to the Crisis**

It is likely that had Thailand reacted differently to the fall in land and stock prices and the growing fragility of the financial institutions in late 1996 and early 1997, it would have escaped a serious crisis. Contagion to the rest of the region would then also have been avoided. Despite the fall in property prices, the warnings of investment analysts, and the large infusions of money to ailing banking institutions, the government staunchly maintained the exchange rate peg of the Baht to the U.S. Dollar, thereby leading to a massive loss of reserves. By the time the currency was allowed to float in July, the government had spent considerable foreign exchange reserves in defense of the currency, and has committed large amounts of foreign exchange to forward purchases of Baht, as well as billions of Dollars in Baht prop up failed banking institutions without taking fundamental steps towards their closure, merger or rehabilitation. The result was that Thailand became extremely vulnerable to investor panic, since investors recognized that Thailand’s available foreign exchange reserves had fallen far below the outstanding short-term debts owed to international banks.

Once the crisis began to spread, other countries also made mistakes that accelerated the capital withdrawals. Malaysian Prime Minister Mahathir’s harsh comments about foreign investors and his threats to ban foreign currency trading are prime examples. Thailand and Malaysia imposed mild capital controls. Malaysia announced it would establish a fund to support stock prices, then abandoned the plan a few days later. Korea seemed to be boldly facing some of its problems by allowing some of the chaebol to go bankrupt, but it inexplicably spent down its reserves in a desperate attempt to defend the won in October and November. Ironically, Indonesia was at first widely praised for its handling of the crisis, as it first widened the
trading band on the rupiah, and then floated the currency in August. It resisted the temptation to spend reserves, eased the rules governing foreign ownership of stocks, and announced that it would postpone over 100 investment projects. However, it retracted that decision for several large projects, then later postponed them again. These on-again and off-again pronouncements, and the government’s instructions for state enterprises to pull their large deposits out of the banking system (which sharply increased interest rates) frayed nerves and encouraged further withdrawals of foreign funding.

The initial IMF programs, rather than inspiring confidence, seem to have accelerated the flight of currency from the region, despite the pledge of more than $100 billion in emergency funds to Thailand, Indonesia, and Korea. The initial Fund programs focused on fiscal deficits, high interest rates, restrictive money growth, and the immediate closures of insolvent financial institutions. The original Fund programs in Thailand, Indonesia, and Korea were discarded within months. Korea’s first program lasted but three weeks. In each country, the signing of Fund agreements was greeted by brief enthusiasm, followed by continued depreciation of the exchange rate and falls in stock prices. The first signs of the end of the currency free-falls came only on December 24th, when the international community changed its strategy and initiated a different approach to the problem based on debt restructuring, accelerated disbursements of international funding, and more comprehensive and rational financial sector restructuring.

In this section we come up with two broad categories of explanations for the East Asian crisis:

(1) Shifts in international market conditions

(2) Growing weaknesses and mismanagement in the Asian economies

All these factors have played their role to the hilt. The shifts in international conditions and mis-management coupled with corruption played a dominant role. It is also clear that intrinsic capital market instability is a key feature of the depth, severity, extent, and simultaneity of the crisis in the region.

**Shifts in International Market Conditions**

On the most general level, international market conditions were benign or favorable before the onset of the East Asian crisis. U.S. interest rates remained low. World commodity markets were relatively stable. Risk premia on loans to emerging markets
were falling, not rising. The growth in total volume of international trade was strong, if a little bit slower in the aggregate in 1996 and 1997 compared with 1993-95. World export volumes worldwide grew 6% in 1996, down slightly from the 9% recorded in 1994 and 1995 but still above the world average for the early 1990s.

Despite this favorable environment, there are several specific hypotheses that have been advanced about unexpected international shocks to the Asian economy. Upon closer inspection, however, it appears that these shocks were at best a modest contributor to the crisis. The suspicion centers around the collapse of export growth in 1996 in two of the five crisis countries, Thailand and Korea as well as the slowing of export growth in Malaysia and Indonesia. The most extreme case was Thailand, were the Dollar value of exports actually fell 1 percent in 1996, after two years of growth in excess of 20 percent. Korea’s exports grew by just 4 percent (down from 30 percent growth in 1995), and Malaysia’s by only 6 percent (down from 26 percent the previous year). Indonesia’s situation was a bit different, as it registered 10 percent export growth, about the same as in the previous three years (but well below the 1990-92 average). Only the Philippines registered substantial export growth of 19 percent in 1996. The division of the fall in Dollar exports earnings between volume and unit value differs widely across countries. World prices for manufactured exports fell about 2% in 1996 (IMF, 1997). Semiconductors were hit especially hard, with prices estimated to have fallen by as much as 80% in 1996. The rapid growth in electronics production in East Asia, coupled with the addition of China and Mexico to these markets, probably created excess productive capacity and contributed to these price declines. This provides a plausible explanation for the fall in unit values in Korea and Malaysia, both of which export substantial amounts of electronic products.

A second and closely related hypothesis suggests that the rise of China may have dramatically shifted export-oriented production away from South East Asia. Chinese firms compete directly against other firms in the region in textiles, apparel, and electronics, and in certain products, China was clearly gaining market share. Nevertheless, while China’s emergence may have affected certain markets, its overall impact on the Southeast Asian export slowdown in 1996 was probably modest at best.
A third view is vis-à-vis the U.S. market, which remains the single most important market for the crisis countries of Asia. The passage of NAFTA and the dramatic surge of Mexico’s exports (especially in the wake of the 1994 Peso devaluation) may have resulted in intense new competition for East Asia. Mexico’s total exports soared from $52 billion in 1993 to $96 billion in 1996, with gains in several areas that directly compete with East Asia (electronic machinery, apparel, and automotive components). However, as with China, while the effect on certain sectors was probably important, the overall impact of Mexico’s surge on Asia’s exports was moderate.

Probably each of these factors contributed to the export slowdown in 1996, which, in turn, probably raised concerns among Southeast Asia’s creditors about the ability of firms in these countries to repay their debts.

Economic Management and Asian Capitalism

The second major hypothesis holds that weaknesses in Asian economic management brought on the crisis. There were clearly growing weaknesses in the Asian economies in the early 1990s that increased their economic vulnerability. Asia’s haphazard and partial financial liberalization, coupled with pegged exchange rates, seems to have worsened the allocation of investment funds within the economy. New banks and finance companies were allowed to operate without supervision or adequate capitalization. The issue is the extent to which these problems were responsible for the capital withdrawals, panic, and deep economic contraction, which followed.

If Asian “fundamental weaknesses” are really fully to blame then:

- the apparently unanticipated nature of the crisis, and
- the continued high levels of capital inflow into East Asia until the very brink of the crisis itself should be accounted for.

One ingenious attempt at reconciling these factors within an overall critique of “Asian capitalism” is the arguments of Krugman (1998) and Dooley (1997) that foreign investors expected to be bailed out from East Asia’s faulty use of the loans. Assume that foreign creditors lent to Asian banks in the expectation that the Central Banks plus the IMF would provide funds to the Asian banks to prevent their collapse in the event of a funding crisis. In that case, foreign
credits to the banks would be safe up to the amount of the expected bailout, which might (crudely) equal the foreign exchange reserves of the Central Bank plus an anticipated sum from the IMF. If such a bailout were confidently expected, foreign creditors would have little need to do due diligence on the repayment potential of the debtor financial institutions.

One indicator of growing pressures in real estate markets is property prices. If the countries in crisis had indeed been in the midst of a speculative frenzy, we would expect to see real estate prices growing rapidly in the run-up to the crisis, and then crashing. In Thailand, stock prices rose very sharply in the early 1990s, then fell after 1995 and dropped sharply in the second half of 1996. What is interesting is that the property prices were seemingly not rising at all between 1992 and 1996. In Indonesia, there is even less evidence of a boom-bust pattern. Stock prices rose steadily after 1992, and continued to do so right up until the Baht was floated, without a bust preceding the crisis. Land prices were almost exactly the same in June 1997 as they had been in June 1993, displaying no evidence of either a sharp rise or fall. The boom-bust cycle probably was a feature in Thailand (and perhaps to a lesser degree in Korea as well), but it was not in Indonesia which ended up being hardest hit by the crisis.

A possible indicator of loan quality is the share of non-performing loans (NPLs) to total loans. In each of the Asian countries, reported NPLs actually fell during the 1990s. In Indonesia, the volume of NPLs peaked in 1993, two years after a dramatic monetary tightening put bank balance sheets under severe pressure. As banks became more profitable starting in 1994, many loans were written off. The NPL ratio was also helped when a large state-owned bank (Bank Negara Indonesia) cleaned up its balance sheet prior to listing its shares publicly. In Malaysia, the dramatic drop in NPLs is probably a combination of both the rapid increases in bank lending and a concerted effort to clean up balance sheets in the early 1990s. It is probably true that loan quality deteriorated as lending expanded in the 1990s, especially lending in for certain activities, such as real estate. Without question, NPLs rose sharply for Thai financial institutions with heavy exposure to property markets when property prices fell in Bangkok in early 1997, and the costs of those bad debts mounted sharply in early 1997. However, a dramatic deterioration in
loan quality throughout the early 1990s, as some have suggested is not evident.

A crude macroeconomic indicator of the quality of investment is the incremental capital-output ratio (ICOR), which is the ratio of the value of new investment to the change in output in a given year. This measure has to be viewed with some caution, since it does not provide for necessary lags between investment and subsequent changes in output. Generally speaking, when investment quality deteriorates, these ratios increase as more investment spending is needed to support a given increase in GDP. Indeed, investment rates rose in the Asian-5 in the early 1990s, as the increased capital inflows added to already high savings to create a large pool of investment funds. Economic growth continued to be brisk, but did not rise commensurately with the increase in investment. As a result, ICORs rose in each country in the region except for Philippines.

*Did foreign lenders believe that Asia’s financial situation was unsustainable, but continued to lend with the expectation of an eventual bail out?* For example, if lenders perceived a growing risk in Asia, spreads on Asian bonds should have increased in the run up to the crisis.

Another possible indicator that international markets perceived the risks of a crisis and bailout in Asia were growing are the rating compiled by Moody’s, Standard and Poor’s, and Euromoney. If creditors believed that the risks of a government-led bailout were increasing, it should have been reflected by a decline in ratings for long-term government bonds. But these rating were either stable or improving in each of the Asian-5 crisis between 1995 and 1997, and did not fall until after the onset of the crisis. Even in Thailand, where private investors began to become concerned in late 1996 and early 1997 when property prices fell, sovereign bond ratings remaining high right up to the float of the Baht.

If foreign investors believed that a widespread crisis was impending (with only the timing uncertain), it would have shown up in the reports and newsletters of investment banking firms. Instead, these reports gave a more nuanced picture. They often pointed out weaknesses in the Asian economies (slower export growth, rapid loan growth, booming property markets), but they did not give any sense of a bubble waiting to burst. Most investment analysts displayed guarded confidence in Southeast Asia’s prospects, in both the short and the long run. Thus, there is little evidence to
support the idea that the majority of investors expected a crisis in Asia any time soon. There is no question that many banks and firms across Asia had close government connections that supported their profitability. State-owned banks in obviously could expect to be bailed out if there were a crisis. Korea’s Chaebol had long been given strong support, and none had been allowed to fail for a decade before Hanbo steel collapsed in early 1997. In Indonesia, firms closely connected with the first family or the army have long been given special privileges. It is hard to make the case, however, that foreign investors felt themselves in a general way to be indemnified against risk through the prospects of generous bailouts. Thus, it is probably fairer to say that foreign investors thought too little about risk because they expected rapid growth and high profitability to continue, not because they expected a bailout.

Thus we can say, the combination of the rapid inflows of foreign capital, the appreciating real exchange rate, and rapid growth in bank lending undoubtedly led to a some deterioration of the quality of investments in Asia. Lenders to some well-connected firms, or to major commercial banks, no doubt felt secure in their positions, confident that they would make a nice profit and that the odds of default on a protected project were slim. Some observers, but relatively few, foresaw a major financial crisis on the horizon. Speculators certainly did not smell a kill in Asia on the heels of the Mexican peso crisis. There was almost no expectation of a widespread financial crash cum subsequent bailout.

The official international response to the Asian crisis, led mainly by the International Monetary Fund (IMF or the Fund) has evolved over time. During August - December 1997, the Fund signed three emergency lending agreements with Thailand (August), Indonesia (November), and Korea (December). These programs established packages of international financial support at an unprecedented cumulative sum of approximately $110 billion. This represents the sum of commitments of $18 billion for Thailand, $35 billion for Indonesia, and $57 billion for Korea. However, these figures overstate the actual amount of funding made available. $22 billion of the funds for Indonesia and $22 billion for Korea were “second line of defense” funds from individual donor governments (mainly the U.S., Japan, Singapore, and Europe), with relatively little likelihood of being available early in the
program. Of the remaining money, only a part could be disbursed early in the adjustment program.

The basic character of the three loan agreements was similar. All of the IMF programs were predicated on the following design:

1. A package of loans to the respective central bank and governments, that could be drawn upon directly or indirectly to help support the repayment of debts falling due to international creditors, and directly or indirectly to help stabilize exchange rates.

2. A macroeconomic framework based on budget balance or surplus, and high nominal interest rates and restrictive domestic credit targeted at exchange rate stability.

3. A program of drastic financial sector restructuring, built upon the immediate closures or suspensions of several financial institutions, and a significant intensification of financial sector supervision in various forms.

4. Other “good governance” and “structural” measures, aimed at increased transparency and competitiveness of the economic system, including: accelerated trade reform, demonopolization, and privatization.

The concepts underlying these programs may be summarized as follows. First, the IMF envisioned that the immediate objective was to re-establish financial market confidence, most importantly by stabilizing the exchange rate. Exchange rate stabilization was to be based on a combination of macroeconomic discipline (fiscal balance, high interest rates, tight credit), the increased availability of foreign exchange reserves, and confidence that fundamental reforms of the economic system were moving forward. These reforms, in turn, would be signaled by decisive actions at the start of the program to close or suspend loss-making financial institutions, as well as the announcements of a strict timetable of longer-term reforms regarding financial markets, corporate governance, and increased market competition in various areas.

The foreign creditors were allowed to escape losses; Government took over the burden of repaying the foreign debts (which were now owed to the IMF, rather than to the international private creditors). The Fund has stressed that the goal of the lending packages was to support stabilization, not
merely to bail out foreign financial institutions. The Fund hoped that its role as a quasi \textit{Lender of last resort} would restore enough market confidence to obviate the need for the Asian Governments to actually draw down the full package of loans. If the exchange rate could be stabilized and default avoided, the thinking presumably ran, then private lending would be restored. The Fund feared that an outright default in Asia would trigger a massive upheaval in other emerging markets. Therefore, even if the loan packages did little more than to repay creditors and forestall default in Asia, it might have important salutary effects in the rest of the emerging markets.

During the period August to December, the IMF programs failed dramatically to meet the objective of restoring market confidence. In all three countries, the exchange rate was expected to stabilize, but in fact quickly depreciated far below the targets set in the program, and this despite a very sharp increase in interest rates. Foreign investors remained unconvinced about the debt servicing capacity of the private debtors despite the announced availability of IMF loans, and continued to demand the repayment of short-term loans as they fell due. Official reserves fell more rapidly than the IMF had predicted. In the case of Korea, the withdrawal of short-term debts was so much more intense than predicted in the December 3 program that Korea faced imminent default by December 24. Indeed, on December 22, Moody’s downgraded the sovereign debts of all three bailout countries, Indonesia, Korea, and Thailand, to “junk-bond” status.

The most important measure of failure of the IMF programs lies in the outcomes on economic growth. The basic goals of IMF programs were to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustment’s in their balance of payments without resorting to measures destructive of national or international prosperity. This purpose has not been well served. Since the launch of the IMF programs in each country, actual outcomes have turned out to be far worse than projected.

With Korea on the brink of default, the U.S. Government decided to press the foreign commercial banks to roll over their short-term credits on an enforced basis, rather than waiting for market confidence to be restored. Initially, the banks and the Korean
Government announced a standstill on debt servicing, pending a formal agreement. The Korean Government and the banks agreed to a complete rollover of all short-term debts falling due in the first quarter of 1998. On January 28th, an agreement was reached to convert $24 billion in short-term debt into claims of maturities between 1 and 3 years. Notably, the IMF, with U.S. Government backing, insisted on the comprehensive debt rollover as a condition for further disbursements of the IMF lending package. Those disbursements were in fact accelerated as part of the new arrangement. The new Korean arrangements put a brake on the fall of the Won. However the currencies in Thailand and Indonesia continued to depreciate, however, for several more weeks. In Thailand, the end of currency depreciation seems to have occurred when the Thai Government formalized its guarantees of all liabilities owed by Thai commercial banks, including those liabilities owed to foreign creditors. The clarification of such state guarantees on what had been private-sector debts, in combination with other policy actions and the improvements in Korea, stemmed the collapse of the Baht, and initiated a period of currency appreciation. Thai corporate debts owed to foreign creditors, in the meantime, fell into partial suspension, though systematic data on the extent of debt servicing by non-financial corporate borrowers is not available.

In Indonesia, the situation became more chaotic when the government announced January 6th announcement of its proposed budget for the new fiscal year (starting April 1, 1998). The budget called for a 32% increase in spending in nominal rupiah terms. The proposed budget was immediately strongly denounced by the US Treasury and the IMF as being inconsistent with the IMF program and signaling that Indonesia was not seriously implementing the program. Since few outsiders actually had seen the confidential IMF documents, these claims could not be independently verified, and the markets plummeted. Unfortunately for Indonesia, the statements from Washington turned out to be too hasty. The increased spending was entirely due to pass through effects of the depreciation, and in real terms, the budget represented a reduction in spending. The Indonesian Government and the IMF signed a new agreement, revising the agreement. Surprisingly this new agreement simply intensified the previously agreed strategy, based on the IMF loan package and accelerated structural reforms. The strategy
failed once again to spur a revival of market confidence. The markets reacted negatively to this new package, resulting in further declines in the exchange rate. The turn in Indonesia towards a modicum of financial market stabilization came two weeks later, when the Government of Indonesia made two policy announcements. First, a de facto suspension of payments on short-term debt. And second a government guarantee of all commercial bank liabilities, both to foreign and domestic depositors and other creditors. Despite considerable other turmoil the following weeks (including the government’s flirtation with a currency board, the re-election of the President, and the replacement of the Cabinet), the steep decline of the rupiah halted. The voluntary suspension of debt payments was in one sense merely reporting the actual state of affairs, since most corporate debts were not being paid.

Indonesia signed another agreement with IMF, which finally included provisions on restructuring private sector foreign debt and a more comprehensive strategy for reorganizing the commercial banks. It also eased requirements on fiscal stringency and the timetable for removing subsidies. The achievement of currency market stability across the region during the first quarter of 1998 (and even nominal appreciation in the cases of Korea and Thailand) came in conjunction with a relaxation of the IMF’s fiscal targets. In all three countries, the IMF relented on its goal of a fiscal surplus in 1998. In the revised programs, Indonesia, Korea, and Thailand will aim for modest fiscal deficits. The currency markets demonstrated that exchange rate movements were not closely linked to the realization of budget surpluses.

The management of crisis clearly entered a distinctive phase with a new set of principles guiding IMF strategy given as:

1. Partial suspensions of foreign debt payments, based on collective agreements between creditors and debtors (Korea) or unilateral actions to be followed by creditor-debtor negotiations (Indonesia);

2. Government guarantees of all bank liabilities (in contrast, for example, to the policy in the November program of Indonesia, in which only small depositors in the closed banks were protected);

3. Reduced focus on bank closures in the short term, and more focus on longer-run restructuring and bank recapitalization.
(the IMF dropped, for example, a
demand for further Indonesian bank
 closures that it had tabled in discussions
in early January);

(4) An abandonment of fiscal surplus
targets.

However certain principles remained
unchanged, especially:

(1) The targeting of exchange rate stability
through high interest rates and restrictive
domestic credit policies;

(2) The implementation of a wide range of
 structural measures, in finance, trade,
and corporate governance.

**Why did the Original IMF Programs fail?**

Though it is too early to comment on the
success of the IMF program the Asian
countries are currently suffering an extreme
contraction of economic activity in 1998,
despite the commitment of $110 billion in
emergency international support. The IMF
programs failed to achieve their goal of
maintaining moderate economic growth in
the Asian countries. The programs also
failed on several intermediate goals,
including the preservation of
creditworthiness, the continuation of debt
payments, and the stabilization of the
exchange rate at levels that prevailed upon
the signing of the original lending
agreements. In our view, there are reasons
for that failure. *First*, the IMF is rather
poorly placed in any circumstance to rally
market confidence in the short term. *Second*,
the IMF greatly amplified the jitters that it
naturally creates by declaring both for
negotiating purposes and as a result of
substantive institutional views that the
financial crisis engulfing Asia was mostly
the result of deep fundamental weaknesses,
not a self-fulfilling panic among creditors.

*Third*, the basic IMF approach to restoring
market confidence was based on a very
peculiar hypothesis. That tough actions of
financial market restructuring including
closures of financial institutions, tightened
regulatory standards, and the like would
reassure creditors so much that they
would roll over their short-term claims as they fell
due is questionable. There is simply no
reason to believe that strong regulatory
actions to close down banks and finance
companies in the middle of a panic, and to
tighten supervisory standards, would in fact
restore market confidence, in the sense of
halting the demand for repayments of short-
term debts. Indeed, the logic of creditor
panics is the opposite: the sudden realization
that a bank will not be bailed out by a lender
of last resort can easily incite a panic that would not have arisen. The IMF’s actions in Indonesia were particularly egregious. Sixteen commercial banks were suddenly closed with the explicit proviso that deposits over 20 million Rupiah (approximately $5,000 at the time) would be unprotected. This was a recipe for panic. Even relatively strong banks came under intense pressure as foreign creditors refused to roll over loans and depositors fled to state and foreign owned banks. By January, the banking systems in Indonesia, Korea, and Thailand had nearly ground to a halt. Foreign banks stopped accepting letters of credit written by banks in these countries, and firms whose banks had been closed had difficulty finding new banks to service their needs. Ironically, even exporters were badly affected, despite the potential for increased profitability from the exchange rate depreciation. There were widespread reports of exporters with confirmed orders unable to obtain needed trade credits because banks were simply not making new loans. Thai exports in January 1998 were actually 8 percent below the level of January 1997, despite the massive depreciation. Despite having an estimated $1 billion in confirmed export orders for the first six months of 1998, these firms were unable to arrange for the working capital credits that they need to import the inputs.

Fourth, the IMF’s fiscal and monetary policy approach was also problematic. The IMF put great stress on the need for strong fiscal contraction in order to ensure a fiscal surplus in 1998, even though the countries were already being hard hit by the contractionary force of the withdrawal of foreign credits. The IMF asserted that fiscal adjustments were core components of confidence building measures needed for currency stabilization. There is no evidence that the currency markets reacted at all favorably to the fiscal surplus targets.

The monetary targets are more conventional, but also problematic. The IMF used interest rates as both instruments and intermediate targets to achieve financial stabilization. Most macroeconomists share the view that interest rate increases would help to support currency stabilization, and yet this basic proposition becomes problematical -- even doubtful -- in the context of an extreme creditor panic. Tight money in a given financial center can serve either to attract funds or to repel them, depending on the expectations that a rise in interest rates generates. With inelastic expectations -- no fear of crisis or of
currency depreciation -- an increase in the discount rate attracts funds from abroad, and helps to provide the cash needed to ensure liquidity; with elastic expectations of change -- of falling prices, bankruptcies, or exchange depreciation -- raising the discount rate may suggest to foreigners the need to take more funds out rather than bring new funds in. This point is not just a theoretical curiosity. The experience of the Asian currencies in the second half of 1997 gives some direct support.

A fifth important reason for the failures of the IMF programs was that the IMF loan packages provided only a weak shadow of a true lender of last resort facility. While we are not enthusiastic about the possibilities of success in casting the IMF as a true international lender of last resort, we stress that announcements of large sums of money that are not readily available for short-term support are unlikely to succeed in stopping a creditor run.

Commitments were made as both “first lines” and “second lines” of defense. The first line of defense was made up of funding committed from the IMF, the World Bank, the Asian Development Bank, and in the case of Thailand only, from bilateral donors. The funding that is announced in the packages is for three years, and the money is traunched (i.e. available only in “slices” over the program period).the second line of defense includes bilateral individual donor.

In two other regards, the IMF programs were far from optimal in restoring financial market confidence in the short term. First, these programs have covered a very wide range of policies beyond the immediate financial crisis, including trade liberalization, de-monopolization, privatization, and so forth. Reforms in such areas may well be desirable, and some may be germane to strengthening the weak banking sector (e.g., monopolies with effective open lines of credit with the commercial banks). Most of the structural reforms in the programs, however, are simply a distraction from the financial crisis. These reforms have taken government expertise, negotiating time, and political capital away from the core issues of financial markets, exchange rate policy, and the like. Second, the first-round programs were not released to the public. The secrecy of those programs, a traditional feature of IMF loan agreements, was a major liability in the Asian circumstances since the programs aimed in large part to restore public confidence in the short term.
An Evolving Framework

The depth of the crisis, however, is still to be determined. Though Asian financial markets began to strengthen again in early 1998, the real effects of the reversal of credit flows are yet to be fully felt. The effective time-out on debt servicing in Korea and Indonesia -- the first by negotiation and the latter by default -- have given some breathing space for longer-term solutions. Several urgent issues remain to be addressed. The continuing overhang of short-term debt will continue to plague all three of the economies. Considerable amounts of short-term debt remain to be paid. The experience from Mexico and Argentina suggests that bank creditors are likely to continue to demand the repayments of short-term debt as they fall due, even if some new foreign investors begin to enter these economies.

There is a reasonable chance that all three economies will need a further stretching out of debt payments for the remainder of 1998. (Korea, however, was able to return to the markets and effectively refinance some debt payments with a new bond issue of $4 billion floated on April 8, 1998). If there is a renewed significant net outflow of funds, a further debt restructuring should be carried out in an orderly manner, without desperate measures to avoid another round of negotiation. There is no justification, for example, in further boosts of interest rates in order to try to forestall another round of concerted roll overs of short-term debts. Furthermore, the IMF and Asian countries should insist on debt restructurings, rather than the drawing down of IMF funds, as the more effective way to meet the net debt servicing obligations coming due. Not only do concerted workout arrangements introduce much less moral hazard into rescue operations, but as we note below, there are far more effective uses of the IMF program funds than simply recycling them to international creditors.

The banking sectors in all of the crisis countries remain illiquid and heavily undercapitalized. Since the banks are net borrowers from abroad, the sharp real depreciation’s of the national currencies almost surely has meant that a large proportion of net worth has been wiped out. On paper, the banks generally tried to hedge their positions, with Dollar-denominated lending roughly in balance with Dollar-denominated borrowing. Since much of the Dollar lending, however, was to domestic investors that will face bankruptcy in the wake of the sharp exchange rate
depreciation’s, even banks that are hedged on paper will suffer a large loss of net worth. The evidence suggests a not-surprising soaring rate of non-performing loans. Even more dangerously, almost all non-foreign commercial banks in Indonesia, and many in Thailand and Korea, have been so sharply downgraded as credit risks that they are no longer able to open letters of credit that are recognized by international banks. In the short term, a portion of the emergency IMF loans could be used to create dedicated pools of working capital to help finance credits for exporters (for example, this funding could provide guarantees on letters of credit opened by commercial banks). In the medium term, the commercial banks will need to be re-capitalized and re-floated to private investors. There is also an important need to mobilize public funds to back the recent public guarantees of bank deposits and liabilities. Again, part of the IMF loan program could be usefully dedicated to establishing a rudimentary deposit insurance fund, partly as a way to strengthen public confidence in the banking sector.

In conjunction with bank restructuring and capitalization will be enterprise restructuring and capitalization in the non-financial corporate sector. Each of the three countries is in the process of establishing new bankruptcy mechanisms to facilitate the inevitable financial reconstruction of the corporate sector. This will include the widespread conversion of debt to equity, and the transfer of equity of insolvent enterprises from existing shareholders to creditors.

Another part of the IMF funds should provide the gross reserves needed to back a more appreciated level of the exchange rate in the three countries. New exchange rate targets will be viable if accompanied by realistic reschedulings of the foreign debt obligations falling due in the year. There is little case for a return to pegged exchange rates, and still less for the establishment of a currency board. Nonetheless, there is a useful and realistic possibility for nudging the real exchanges rates of the Asian countries towards more realistic, post-panic levels. The availability for this purpose of adequate and usable gross reserves will surely help to establish greater market confidence.

Macro mismanagement of the Indian Economy during the last five years is legion. Our Growth rate has dwindled from 8.5% p.a. to 4.3% p.a. There is too much politics with our economics and too little economics with our politics. 60% + of the population depends on agriculture and 53% of the GDP
contribution comes from the Service Sector that includes IT and ITES companies. The twin evils of uneven distribution of wealth income and opportunity on the one hand and the uneven development of peoples, regions and sectors have jointly created a macroeconomic disequilibrium and its negative social side effects are obvious. Our Planning Commission is still fixated on the policy of export led growth when the need of the hour is growth led export as was argued by this author way back in 1989. If we in India do not wake up now and pursue a positive and proactive developmental-growth policy the lessons of Far Eastern Asia would be lost on us. Perhaps we should revisit Marx who had prophetically said “history repeats itself; on the first occasion it is a tragedy while on the second it is a farce.”

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