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Financial Crisis in East Asia: Underlying and Precipitating Factors

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Introduction

Anne Krueger is best known around the world for her contributions to international economics – including economic development. But much of her work transcends these fields. Nowhere is this more evident than in her highly influential article published more than a quarter of a century ago: 'The Political Economy of the Rent-Seeking Society' (Krueger, 1974). This insightful contribution integrated elements of the economic theory of bureaucracy with the systematic study of economic policy making. This theory, in the hands of Professor Krueger and later writers, reveals how efforts of entrepreneurs, traders and managers to gain favourable treatment from government diverts energies and resources from productive activities, thereby curbing economic growth and also skewing the rewards from economic activity.

The corrosive effects of rent-seeking behaviour were very much in evidence in the East Asian economic crisis of 1997–99 in Thailand, Korea and Malaysia, and especially in Indonesia. This chapter seeks to show how rent-seeking behaviour interacted with underlying structural problems as well as transient economic events to yield disastrous outcomes in four East Asian nations in 1997–99.

This contribution identifies significant antecedents and precipitating factors for the financial meltdown in East Asia in 1997–98 following a quarter century of very strong economic performance of the emerging nations of the region. There are those who argue that the crisis stemmed largely from beyond the borders of the afflicted countries, including malevolent foreign *dei ex machina*. Others claim that the downturn in Malaysia, the virtual collapse of financial markets in Thailand and Korea and the free fall of the Indonesian economy in

1997–98 were primarily the consequences of self-inflicted policy wounds, many traceable to unusually intense rent-seeking behaviour.

The evidence shows that endogenous as well as exogenous factors were both important. The tap roots of the crisis were put down decades ago, when virtually all East Asian societies adopted the Japanese model of finance, thereby embedding very bad banking practices in highly vulnerable financial sectors. Other factors, economic and social, contributing to the crisis are also discussed. The chapter ends with a reminder that, in peering into the future, we should take care not to rely much upon extrapolations based upon the very recent, anomalous experience. The affected economies and societies are notably resilient; still, some will recover much later than others. In any case, virtually all of the basic attributes that fueled enviably high economic performance in emerging East Asian nations from 1970 to 1996 remain: strong national stress upon access to primary and secondary education, widespread habits of thrift and continued, if somewhat diminished reliance upon market forces instead of interventionist policies. Finally, there are also favourable demographics (Bloom and Williamson, 1998), including a declining dependency ratio, thereby increasing per capita productive capacity, and rising female participation in the labour force. Just as the almost unbridled euphoria about East Asian economic prospects in the early 1990s was misplaced, subsequent pronouncements of doom and gloom are also inappropriate, except perhaps for Indonesia, the nation most severely afflicted by the crisis.

As late as October 1997, the international press, indeed, articles in some economic journals, were still touting the ‘Asian Miracle’. In November 1997, the *World Paper* maintained that ‘Indonesia has no real problem’. Also in November, President Clinton dismissed Asian financial turmoil as ‘a few glitches in the road’ (*Economist*, 10 January 1998). It should not be surprising that it took months for impressions of ‘glitches’ to turn into cruel realities. Perceptions were clouded by three decades of experience with virtually unprecedented economic success recorded by the original ‘gang of four’ – Korea, Hong Kong, Taiwan and Singapore, the Asian economic tigers, and the later-emerging so-called tiger cubs: Thailand, Malaysia and Indonesia.

This chapter focuses upon the experiences of the recent ailments of one of the tigers, Korea, and the infirmities of three cubs: Indonesia, Malaysia and Thailand. All four experienced very strong performance through the 1980s and well into the 1990s. Acceleration of economic growth was especially notable in the ten years prior to the crisis for the three cubs, Thailand, Indonesia and Malaysia. By the 1980s all four countries were experiencing GDP growth rates at least three times as high as other middle-income developing nations, and at least twice as great as high income developed nations in Europe, Japan and North America. By the first half of the 1990s, annual rates of economic growth in the emerging East Asian nations were nearly four times those of high-income nations, and at least ten times higher than other middle-income countries (Gillis, 1998).

Moreover, all four countries reviewed herein posted remarkable export growth; all had brought inflation under control. Finally, all four experienced relative exchange rate stability up to mid-1997.

For two decades before 1996, the economic policy prowess of all four nations had been repeatedly and roundly praised by the World Bank and International Monetary Fund (IMF) as exemplars for poorer emerging nations. Their credit ratings were glittering: for example, as recently as 1996, Thailand raised global money at just eighty basis points above US Treasury notes. Notwithstanding these seemingly unassailable strengths, only a few short months were required to bring three of these economies very close to the brink of collapse while applying a severe brake to the economic growth of a fourth, Malaysia.

Onset of acute crisis

The East Asian financial meltdown is best viewed against the backdrop of major changes in the structure of the international financial system. These changes have, by increasing competition and expanding international trade, helped to fuel large improvements in living standards, especially in East Asia. Under these circumstances, the meltdown was especially wrenching. Crises earlier in the decade wrought havoc in Mexico and several other Latin American nations, but nothing approaching the severity and scale of East Asia in 1997–99. Alan Greenspan has suggested that the recent turbulence is best seen as stemming from the same sources that have brought such marked increases in the efficiency of the international financial structure: while that structure induces potentially beneficial flows of productive capital to emerging nations, it has significantly increased capacities for creating chain reactions of losses by transmitting effects of ill-advised investments (Greenspan, 1998). Moreover, owing to greater and more readily accessible information, market discipline now is far more draconian and unforgiving than ever before.

These far-reaching changes provided an economic environment well suited for magnifying the effects of ongoing structural weaknesses, unbridled rent-seeking and policy missteps in four nations.

The factors triggering the 1997–98 East Asian financial calamity differ notably from the underlying factors. The latter account for the severity of the crash, once the house of cards had been shaken. We first examine the precipitating, then the underlying factors.

By 1997 the financial sectors of all four nations were saturated with a volatile mixture awaiting a spark that was not long in coming. The first spark stemmed from a little noticed event in May in Tokyo, which had its first important reverberations in Thailand within days, three months before the then-surprising devaluation of the Thai baht.

In early May, rumours spread from Tokyo that Japanese officials, concerned over the slippage of the yen, were about to raise interest rates. This was especially worrisome because it threatened the 'carry trade' – a financial technique allowing investment houses and insurers to borrow yen and dollars at low interest rates from lenders in Japan and the United States, then placing the proceeds in much higher-interest-bearing short-term loans in Southeast Asia, generally to finance longer-term projects. Incredibly, offshore lenders seemed to wholly ignore exchange-rate risks, not only because their loans were denominated in dollars or yen, but because exchange rates in the region had been stable for years. In the Thai case the government had repeatedly and solemnly promised that the baht dollar exchange rate would remain fixed (Feldstein, 1999, p. 6). The rumours from Tokyo, while unsubstantiated, were sufficient to induce an initial mild sell-off of Thai securities. In the very highly levered, feverishly speculative economic environment that was Thailand in May 1997, initially modest capital outflows became, in short order, a virtual avalanche of flight from Thai markets and the Thai baht. Business failures mounted steadily; by the end of June, there were reports of a 'hollowing out' of the Thai banking system and 16 of the largest finance companies had been closed. Before the end of July, the baht fell by 25 per cent. Shortly thereafter, what Paul Krugman (1998) has dubbed financial 'bahtulism' began to spread to other parts of Asia, as some jittery bankers and investors with more access to money than sense came to realize that Malaysia and Indonesia were – like Thailand – also in Asia. A contagion of panic clearly fuelled the crises for several months (Radelet and Sachs, August 1998; Feldstein, 1999; Dornbusch, 1998; Phelps, 1999). A major crisis had appeared almost out of nowhere.

Reaction within the distressed economies and in leading world financial centres was one of near disbelief. On the eve of the meltdown, none of the four East Asian governments had resorted to excessive credit creation. In no case were exchange rates crassly overvalued

(Dornbusch, 1998). Large fiscal deficits, the source of dozens of currency crises in this century, were not in evidence in any of the four countries, although *prospective* fiscal deficits likely did play a role.[1]

The cascade of bad news continued unabated from June to January. Skittish investors found new grounds for pessimism in the unwillingness of the United States to consider measures to help soften the financial blow to Thailand. Other conditions in the region then came into play, creating a potent witches' brew. Had these other factors been absent, the crash might have been delayed by many months and, in any case, the region-wide consequences might have been less devastating. Indonesia was in an especially vulnerable condition, having accumulated as much as $65 billion in private sector dollar- and yen-denominated external debts, with an economy already severely hamstrung by deep-seated corruption arising from rent-seeking activities and governmental responses to them. Indonesia also had the misfortune of being in the middle of a disastrous drought in 1997, just as the health and the political supremacy of longtime President Suharto began to be publicly questioned and just as oil export prices began a slide toward $10 a barrel.

Malaysia was neither as vulnerable nor nearly as heavily mortgaged. Regrettably though, a relatively mild weakening of the Malaysian ringgit in the aftermath of the Thai devaluation called forth from the prime minister a series of epithets and incendiary pronouncements well suited to confirm all the worst fears of footloose global investors, who began in September 1997 to desert what had long been viewed as one of the most stable financial havens in the region.[2]

The unbroken flow of distressing news was not long in inciting herd instincts among foreign banks and foreign as well as local investors. A surge in outflows of capital pounded the financial markets and currencies of the whole of Southeast Asia, including largely innocent bystanders such as Singapore and the Philippines. Lenders discovered, to their acute dismay, that having loans denominated in dollars or yen is no insulation from exchange-rate risk when currencies plunge by 20, 30, or 80 per cent, for then foreign exchange loans tend not to be repaid, however they are denominated (Radelet and Sachs, 1998, p. 29). Hong Kong and Taiwan, armed with large reserves, and with sounder domestic financial institutions, received repeated shocks over the next six months, but emerged solvent if not unbowed. Korea stayed the course until late October, when the won also began a precipitous slide as offshore lenders began to realize that their assumptions about government guarantees on loans to private firms might have been misplaced. By late December 1997, seven of Korea's largest conglomerates (*chaebols*) had collapsed; more were to follow in 1998.

By January 1998 the frightful dimensions of the financial meltdown were starkly evident. Between stock market slides and currency depreciation, a $1 investment in the Singapore stock market in June 1997 was only worth $0.49 on 15 January 1998. One dollar invested in the Kuala Lumpur market was valued at $0.25 in mid-January. And one dollar sunk into the Jakarta stock exchange in June was worth about a dime in mid-January and only a nickel a week later. By way of contrast, a dollar invested in the Taiwan stock market still had a value of $0.75 in mid-January 1998.

Although the details varied from country to country, by early 1997 several financial commonalities were notable across the four afflicted nations.

1. Financial institutions only recently released from long-standing shackles, typical under directed-credit systems, were totally unprepared to function in a newly globalized world economy. Deeply embedded banking practices in concert with the worst forms of rent-seeking behaviour flourished.
2. There was an abundance of short-term external borrowing by financial institutions (bank and non-bank) and by politically connected private entities, who in turn lent heavily for long-term projects (Dornbusch, 1998).
3. Much of the credit made possible by heavy short-term offshore borrowing had been channelled toward very highly levered local clients (Krugman, 1998; Dornbusch, 1998).
4. Strong inflation had been much in evidence in local asset markets – especially for land and buildings (Krugman, 1998). In turn, this provided a basis for further borrowing through inflated values for collateral.

To these factors must be added the lemming-like tendencies of faraway as well as local investors, and specifically local conditions such as severe drought and political uncertainty in Indonesia, a sharp decline in oil export prices, affecting primarily Indonesia, egregiously inappropriate policy responses in Malaysia, and uncertainties stemming from elections in Korea in December 1998.

In all four of the afflicted nations, weakening currencies began to transform merely marginal loans into non-performing ones. By November, bad loans of East Asian banks, according to the *Economist*, accounted for over 15 per cent of total loans in Thailand, Indonesia, Korea and Malaysia.

Inflated asset prices, especially in the overinvested land and property sectors, began to spiral downward soon after the initial shocks in May–June, adding mightily to financial stress for the already very heavily indebted firms that had benefited from the pre-crash loan bubble and who had posted grossly inflated asset values as collateral. In the pre-crisis year 1996, private flows from commercial banks to the most severely affected Asian nations reached $56 billion. Very little time was required for ample capital inflows to turn into frenetic capital flight from the four countries. By 1998, there was a net negative flow of nearly $20 billion back to foreign banks. Growing downward pressure on the baht, rupiah, ringgit and won made it progressively more difficult to imagine repayment *ever*, of debts that had financed acquisitions of what became steadily deteriorating asset values.

The economy of the entire region edged closer to free fall in November and December. By early January 1998, debt ratings for all the troubled economies save Malaysia had been downgraded to junk status. By late January, Korea and Malaysia began to arrest the process of economic decline. Still, Korea suffered only after major bankruptcies in carmaking, steel, shipbuilding, and construction. By January, Korea's problem was one not of insolvency, but of illiquidity: Korean foreign debt in late December was but $150 billion, but somewhat more than half of that was short term. By April 1999, Korea's debt rating was restored to pre-crisis level. Thailand suffered a contraction of nearly 7 per cent in GDP in 1998 amidst growing insolvency of financial institutions, but also has begun to claw its way back to growth. Still, tens of thousands of jobs were lost all across the Asian arc of crisis.

In the end, Indonesia may end up paying the heaviest price of all. The cumulative effects of decades of cupidity and duplicity in finance and government threatened to wreck the economy throughout 1998 and well into 1999.

Antecedents to crisis

The crash was not *caused* by the threat of movements in Japanese interest rates, or by the poor health of Suharto, or the severe drought in Indonesia, or by the intemperate, inflammatory remarks by Prime Minister Mahathir of Malaysia. Nor was the crisis caused by speculators, or by the panicked behaviour of other investors including European and American banks as well as Asians themselves.[3] Such transient factors merely provided the sparks to light a financial bonfire that had been decades in the making.

Sociopolitical factors

The financial meltdown was traceable to multiple underlying factors both sociopolitical and economic, most of which were of relatively long standing. All were present to greater or lesser degree in all four countries, although the relative roles played by each varies greatly as between them. Some were exogenous in origin, well beyond the control of the afflicted countries. It is nevertheless true, however, that in all four nations there were an ample number of largely self-inflicted wounds. Among the several roots of the East Asian financial crisis one stout, well-nourished, and deep tap root stands out: the prevalence of the Japanese model for banking and finance throughout the nations of the region. In the financial field, as in almost no others, East Asian nations have generally sought to emulate the Japanese. Unfortunately, they succeeded.

The postwar Japanese model for banking and finance is perhaps best characterized as a cumbersome, bank-centred command and control system for channelling financial resources from small and medium-sized savers to much larger borrowers, at subsidized rates. The Japanese model of finance was at least consistent with Japanese efforts to pioneer the industrial order of the past. The basic idea was to squeeze consumption in order to supply Japanese industry with very cheap subsidized capital. (By early 1999 the discount rate in Japan had been pushed down to 0.25 per cent in the hopes of averting a deflationary spiral.) And where financial processes in North America tend to be transparent, in Japan they strongly tend toward opacity. In the Japanese model, banks are intimately involved in the operations of borrowing firms, to an extent unthinkable in North America. Also typical in the Japanese model are relationships between bank regulators and regulatees that are rather tighter and cosier than is usually thought consistent with financial probity.[4] The system is further complicated by the existence of intricate cross-shareholding arrangements between large firms. Traditional Japanese-style finance also allows very ample scope for exercise of central government discretion in directing loans to favoured sectors, to specific enterprises, and even individual cronies. Where the banking system is also dominated by government-owned banks, as in Indonesia, the influence of government officials can be quite direct, as in so-called ‘command’ loans to particular firms.[5] In other East Asian nations, including Korea as well as Japan, the role of governments in directing loans tends to be more subtle, and indirect: over the years banks in both nations have been well conditioned by the government to lend money to firms and industries.

This kind of 'hand-in-glove' relationship between governments and financial institutions easily degenerates into 'hand-in-the-till' arrangements. Accordingly, Dornbusch has succinctly labelled the Asian financial crisis as a 'crisis of corrupt governments' (Dornbusch, 1998; see also Phelps, 1999, and Barth et al., 1999). Examples of deep-seated financial corruption in a network of crony capitalism are plentiful from Jakarta to Tokyo.[6] Moreover, partly because of the absence of arm's-length lending, and partly because of the ability of banks to exert ongoing direct control over enterprise management, finance on the Japanese model has typically involved acceptance of degrees of enterprise leverage that would be unimaginable in North American practice, often resulting in debt–equity ratios in excess of ten-to-one or even twenty-to-one (Dornbusch, 1998; Gillis and Wells, 1980) and typically involving misallocation of resources to projects that cannot generate income to cover debt service.

Deep involvement of bankers in the operations of borrowing firms might have been less damaging had loan proposals from client firms been systematically evaluated using modern banking methods. However, systematic loan analysis as it is known, but perhaps not always practiced in Canada and the United States is still not all that common in Japan, and is almost absent in the East Asian nations that adhere to patterns of banking developed in Japan.[7] Rather, even when political connections do not intrude, reliance in lending is placed, loosely, on the availability of collateral rather than on projected or even past rates of return.

With little or no systematic analysis of borrowers' requests, it should not be surprising that such a large proportion of recent loans in East Asia ended up in the hands of property developers to finance acquisition and construction of land and buildings, relentlessly driving up the prices of these assets (Krugman, 1998; Phelps, 1999). Seen against the unusually high lender tolerances for debt-financed projects, one is tempted to look no further for a fairly plausible explanation for the severity of the crash. But there was much more.

If these considerations were not enough, other very serious deficiencies of the institutional framework for banking and finance in Korea and the three other nations predisposed their systems to a very high degree of vulnerability. Disclosure requirements for firms, both private and government owned, remain grossly defective, where they are even present. Especially in Indonesia and Thailand, and to a significant extent Malaysia and Korea, lenders as well as outside stockholders have little notion of the accuracy of financial data supplied to banks, much less published by firms. In addition core accounting conventions and standards date mainly from colonial times, and bear little resemblance to modern internal information systems of larger North American enterprises. To be sure, the murky accounting rules prevailing in East Asia do generate large quantities of information, but much of it is essentially useless to the uninitiated outsider, if not the owners. There are, therefore, many serious issues of non-transparency in borrowing and lending, a condition well suited for flourishing rent-seeking activity. The combination of very weak disclosure requirements and defective accounting systems means that lenders typically have had only the faintest idea of the financial state of health of borrowers. Under such circumstances it is understandable that banks rely heavily upon the borrower's government and/or family or political connections as indicators of creditworthiness.

The East Asian crisis also reflects failures in financial regulation.[8] Financial rules and regulations are rudimentary in all four countries. In Indonesia, private banks habitually breached rules prohibiting lending of more than 20 per cent of a bank's capital to related parties. And as in Japan, financial regulation throughout the region is not infrequently hamstrung by corruption. Severe regulatory failure has extended well beyond Japan, to what passes as the region's paragon of financial correctness: Hong Kong. There, a large, aggressive, allegedly dynamic, and now extinct investment bank (Peregrine) had, by 1996, managed to bestow loans equal to almost 40 per cent of its capital on a single debtor in Indonesia, simply because of her family connections.

Cultural factors helped, in some afflicted East Asian nations, to exacerbate the problems just noted. Particularly in Indonesia and Malaysia, and to an extent in Thailand, subordinates tend strongly to avoid bringing bad news to superiors, both in the public and private sector. There is an oft-repeated phrase in Indonesia that encapsulates this tendency: 'Sedang bapak senang'. That is, as long as the boss (or father) is happy, do not ruin his day (with bad news). This attitude accounts for the fact that news of a major failure of the all-important rice crop in May 1972 reached the Indonesian cabinet only in August of that year. It helps us understand why in 1982 the cabinet and the president remained unaware – for seven months – that on the Indonesian Island of Kalimantan a forest area the size of Belgium had burned. It helps to explain why in 1997 distressing financial news out of Jakarta, Bangkok and Kuala Lumpur tended to dribble out over a period of months, not days.

In addition, the legal infrastructures of many, but not all, East Asian nations contain notable obstacles to bankruptcy.[9] As a result, managers, workers, lenders and investors face diminished incentives, relative to North American firms, to act prudently. In the United States, when bankruptcy threatens, the creditors can force a firm into bankruptcy. Whereas in East Asia, insolvent companies can continue to act with impunity, delaying interminably the needed restructuring of overleveraged firms.

The example of Taiwan, which succeeded in avoiding through 1998 the worst of the East Asian meltdown, may be instructive. There, legal obstacles to bankruptcy have virtually vanished, and bankruptcy when it occurs is not a particularly unusual or disruptive event. By contrast, it is not even clear that the thousands of Thai, Indonesian and Malaysian enterprises that stopped servicing their debts in 1996 can be forced into bankruptcy under prevailing law or under so-called reforms enacted in 1998 and 1999. In all three nations so-called extrajudicial procedures will likely be necessary to close them.

Economic factors

Internal vulnerabilities would in any case have rendered the financial sectors of East Asian nations highly susceptible to very serious financial distress – even without disruptive pressures from the external sector. Unfortunately, such pressures were present; their effects were greatly magnified by the dramatic increases in international capital flows over the past decade. But the benefits of financial globalization have been accompanied by an ever more harsh market discipline.

Virtually all East Asian nations had, prior to 1997, liberalized domestic financial policies so as to better partake of the benefits of financial globalization – cheaper capital and readier access to the accompanying technology.

As long as new capital inflows, especially debt, find their way to good projects capable of generating sufficient returns to keep lenders and investors happy, the combination of globalization and domestic financial liberalization, in East Asia as elsewhere, is good for all concerned: banks, borrowers, investors and workers. Nevertheless, there are additional risks – in borrowing or lending – in a currency not your own, especially when borrowers are financial institutions who turn around and extend uncovered loans denominated in local currency. This practice involves risks even in the most serene market circumstances. But the risks are especially large when, as in much of East Asia in recent years, there is growing mismatch between maturities: borrowing short-term to finance longer-term projects (Dornbusch, 1998; Krugman, 1998). Moreover, growing globalization of finance has, inevitably, been accompanied by growing volatility in financial markets. Perturbations in these markets may leave nations with large financial systems such as the United States or Japan relatively unscathed, but can easily swamp more vulnerable nations, even large ones who nevertheless have relatively small financial markets. It is worth remembering that although Thailand has nearly 60 million inhabitants, her financial system is, in terms of assets, like that of Malaysia, far smaller than that of the state of Texas.

The problem, however, is more than just one of size. In Korea, Indonesia and Thailand, the banking sector is much larger than either the bond or equity sectors (Barth et al., Summer/Fall 1998, p. 38). This contrasts sharply to the United States, where the banking sector is less than half the size of the bond and equity sectors. Where the banking sector is large relative to the total financial system, it stands to reason that such a financial system will be greatly affected by difficulties arising from the banking sector. Where banking has a relatively small share of total finance, vulnerability to banking shocks is less severe, as in the S&L crisis in the United States in the 1980s.

The foregoing elements made up a truly infernal mixture, made even more unstable by one additional consideration: 'moral hazard'. Moral hazard stems from the undervaluation of risks associated with one's actions, where the consequences of this undervaluation are shifted to others. In finance, moral hazard arises when, in the presence of insured risk (de facto or de jure) there is little or no pay-off to the insured for taking measures to reduce risk of loss. Clearly, when the liabilities of financial institutions are perceived as explicitly *or* implicitly guaranteed by the government, moral hazard is present.[10] Moral hazard has an international dimension when foreign money centre banks have the expectations that they will be bailed out, especially when they overlend to firms or governments abroad.

In Indonesia, Korea and Thailand, to a lesser extent Malaysia, and perhaps in the operations of the IMF in East Asia, moral hazard has been much in evidence in national and international financial transactions. Even though creditors of financial institutions rarely had explicit guarantees of repayment backed by governments, American, Japanese and European banks (and other financial institutions and private investors) nevertheless tended strongly to view their loans as wholly or partially guaranteed by the governments of the borrowers or, indirectly, by the International Monetary Fund.[11] Offshore lenders then had little incentive to exercise due diligence – or indeed any diligence – in vetting loans to East Asian borrowers, since they perceived little of their own money to be at risk. In the words of one French banker in 1998, later deeply mired in Korean private sector debt problems, 'We thought we were making a loan to Korea Inc.'

What is to be done?

The Asian financial meltdown has brought forth several proposals to reduce the scope of future crises. Many of these schemes focus upon reforms seeking a 'new global financial architecture'. Virtually all of these call for radical restructuring of the International Monetary Fund or the World Bank, or both. While some changes in the mission or the structure of the Fund and Bank might help ameliorate some future crises, emerging nations are well advised to also devise measures to protect themselves. Some have stressed the need to control risk at the international level. Dornbusch (1998) offers a fairly ambitious proposal that would provide timely assistance to countries who comply with a tightly written and audited scheme requiring greater attention to balance sheets, with assistance conditional upon compliance with strict capital standards for banks. Greenspan (1998) has suggested a similar approach. Some argue that greater liquidity is the key to such self-protection (Feldstein, 1999).[12] Others stress the need for adequate hedging of bank borrowing dominated in foreign currency (Lal, 1998).

International reforms could help, but most of what has to be done to allow resumption of sustained economic progress in East Asia will need to be accomplished internally, because the roots of the problem are mostly internal. The process has been and will be painful. It goes without saying that thoroughgoing, fundamental reform of financial legislation is in order, sooner not later. The help of outsiders, however, remains essential. Moral hazard is, nevertheless, a problem for those who would render assistance. Those who argue that 'bail-outs' only encourage future outbreaks of irresponsible financial behaviour in the future do have a legitimate point. The trick will be to find ways of reducing moral hazard to tolerable levels. At the same time, there is some plausibility to the claim that the refusal of the United States to take an active role in stabilizing Thailand in the summer of 1997 caused the crisis to spread unduly rapidly to other countries in the region.

Now is not the most propitious time to place new limits upon the ability of the IMF to respond in timely fashion to such crises. However, once a modicum of stability is restored, the IMF and, to an extent, the World Bank will need to begin rethinking their missions and policies. The Fund in particular needs to consider well the meaning of 'Procrustean'; one size does not fit all in programmes of economic rescue. The Fund also needs to reflect at length on how its operations may contribute to international moral hazard in bank lending. There are, after all, cases in which applications of IMF orthodoxy may have hastened economic collapse (Dornbusch, 1998; Barth et al., 1998; Radelet and Sachs, 1998; Lal, 1998).

In the end, the restoration of prospects for economic progress in the afflicted nations requires internal corrective measures that will bear full fruit only over many years. Measures to narrow the scope for the most corrosive forms of rent-seeking are clearly in order. A good beginning would be the adoption of fundamental reforms in accounting conventions and standards – along with legislation allowing for greater transparency in financial markets (financial disclosure, arms'-length lending practices) adoption of workable bankruptcy laws as well as relatively rudimentary regulations regarding capital requirements for financial institutions, systematic analysis of loan requests, measures to narrow the scope for conflicts of interest (especially those related to self-dealing), and penalties for irresponsible financial practices. It is also supremely important that governments in the region henceforth go to great lengths to avoid anything resembling implicit – much less explicit – government guarantees of loans made to local financial institutions by making it abundantly clear that anything that might be perceived as implicit guarantees will be honoured only with implicit repayments.

Above all, banking and other financial practices suitable for the next century will need to be developed and embedded in financial systems throughout East Asia. The Japanese bank-centred financial model so widely utilized in East Asia may have been appropriate for Japan at one point, but it is clearly unsuited to the needs of the smaller nations in the region – and most likely is no longer suited for Japan.

A decade of unwarranted euphoria over East Asian economic prospects turned into equally ill-founded myopia within a few short weeks in 1997. Virtually all of the afflicted economies began recovering within a year, save Indonesia. Real growth for Korea in 1999 was just above 10 per cent, and is projected at 11 per cent for 2000. In mid-April 1999 Korea was able to sell $1 billion of five-year notes, the first offering to win investment grade since end-1997. Indeed, by the end of 1999 interest rates have fallen below pre-crisis levels. Thailand seemed to have turned the corner in 1998, while Malaysia's political troubles seem to overshadow any strictly economic ills. But even optimists forecast zero growth for Indonesia in 1999. Real growth for that year was, however, positive. The rest of the world should take care that it does not learn too much from this debacle, while bearing in mind that most of the very strengths that carried East Asian economies to such commendable heights, until suddenly in the summer of 1997, are still very much in evidence.

Notes

1. A recent paper by Burnside, Eichenbaum and Rebelo argues that the crisis was caused by large prospective deficits associated with implicit bail-out guarantees to failing banking systems: investors realized that large losses in the banking system were associated with large increases in government deficits in the near term, and that the public knew that the banks were in trouble before the currency crisis. There seems to be little doubt that expectations of government bail-outs of banking enterprises was one of many factors exacerbating the crisis once it had been set in motion (see Burnside, Eichenbaum and Rebelo, 1998). For a contrary view, see Radelet and Sachs (1998, pp. 52–3).
2. The recent policies of the Mahathir government seem well characterized by the philosophy 'ready, fire, aim'. One example was the hastily announced measure imposing capital controls, which remained in effect from September 1998 to February 1999, giving temporary relief to the economy but even greater succor to influential domestic private sector actors.
3. Two recent papers, one focusing upon currency markets of Southeast Asia, the other focused on the Korean equities market, find little or no evidence that foreign investors were behind the severe market meltdowns in 1997 (see Brown, Park and Goetzmann, 1998; and Choe, Kho and Stulz, 1998).
4. The system is deeply imbedded, so much so that through 1998 it proved remarkably resistant even to the determined reform efforts of chief regulator Hakuo Yanagisawa, facing in 1999 financial bail-out costs of between $300 and $600 billion.
5. The role of state-owned banks in the collapse was especially important in Indonesia, where 48 per cent of bank assets resided in state-owned institutions. In 1997 comparable figures for Korea, Malaysia and Thailand were 13 per cent, 8 per cent, and 7 per cent, respectively (Barth et al., 1999, p. 38).
6. Former Federal Reserve Chair Paul Volcker visited Indonesia in January 1998 at the request of decision-makers there, to provide his perspectives on the region-wide meltdown. At the end of the discussion, Indonesian President Suharto asked, in clear puzzlement, 'But we are doing little today that is much different from what we have been doing all along. Why now are we in such distress?' Mr Volcker had no ready answer, but upon his return to the United States in mid-January asked the author his views on the matter, from

his perspective of 25 years of involvement in East Asian economic policy issues. The author's answer was that President Suharto's general impression was correct. They were doing little different than before. What the president failed to acknowledge were the pernicious cumulative effects of three decades of rampant corruption in undermining the bases of virtually all institutions in the economy, financial, fiscal, social and cultural.

7. In the United States, the loan approval process ordinarily involves, at a minimum, close scrutiny of *recent* financial performance and – according to the Federal Reserve System – in about 30 per cent of cases formal projections of borrowers' future performance (Federal Reserve Bank of Dallas, 1998). Evidently, for loans to Korean and Indonesian borrowers, US banks neglected to apply the same standards as in loans to US firms.
8. Not everyone agrees that inadequate bank supervision and legislation were major reasons for the recent severe *banking* problem in East Asia. Dissenters argue that the problem was not one of regulatory failure, but rather was a predictable outcome under the economic theory of regulation when state ownership of banks is widespread (see Barth et al., 1999). There is merit in this view, so far as it goes. But denial of any role for regulatory failure in East Asia reflects a certain lack of institutional knowledge of Asian financing.
9. Until 1999 it was virtually impossible to force a debtor into bankruptcy in Indonesia. One may easily file bankruptcy papers in Korea, but with little or no concrete results. In both Thailand and Philippines the problem is similar to Korea's. According to the *Economist* (24 January 1998), 14 000 Korean firms did go bankrupt in 1997, but very few cases were settled.
10. For a lucid, rigorous discussion of moral hazard in the recent East Asian context, see Krugman (1998).
11. For a discussion of international moral hazard implicit in recent IMF operations in East Asia, especially Indonesia, see Lal (1998).
12. The experiences of Taiwan, Hong Kong and Singapore in the recent crisis support the view that countries with large foreign exchange reserves can more easily ward off currency attacks.

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