CHAPTER
4

THE EAST ASIA CRISIS

How IMF Policies Brought the World to the Verge of a Global Meltdown

WHEN THE THAI baht collapsed on July 2, 1997, no one knew that this was the beginning of the greatest economic crisis since the Great Depression—one that would spread from Asia to Russia and Latin America and threaten the entire world. For ten years the baht had traded at around 25 to the dollar; then overnight it fell by about 25 percent. Currency speculation spread and hit Malaysia, Korea, the Philippines, and Indonesia, and by the end of the year what had started as an exchange rate disaster threatened to take down many of the region's banks, stock markets, and even entire economies. The crisis is over now, but countries such as Indonesia will feel its effects for years. Unfortunately, the IMF policies imposed during this tumultuous time worsened the situation. Since the IMF was founded precisely to avert and deal with crises of this kind, the fact that it failed in so many ways led to a major rethinking of its role, with many people in the United States and abroad calling for an overhaul of many of the Fund's policies and the institution itself. Indeed, in retrospect, it became clear that the IMF policies not only exacerbated the downturns but were partially responsible for the onset: excessively rapid financial and capital market liberalization was probably the single most important cause of the crisis, though mistaken policies on the part of the countries themselves played a role as well. Today the IMF acknowledges many, but not all, of its mistakes—its officials realize how dangerous, for instance, excessively rapid capital market liberalization can be—but its change in views comes too late to help the countries afflicted.

The crisis took most observers by surprise. Not long before the crisis, even the IMF had forecast strong growth.

Over the preceding three decades East Asia had not only grown faster and done better at reducing poverty than any other region of the world, developed or less developed, but it had also been more stable. It had been spared the ups and downs that mark all market economies. So impressive was its performance that it was widely described as the "East Asia Miracle." Indeed, reportedly, so confident had the IMF been about the region that it assigned a loyal staff member as director for the region, as an easy preretirement posting.

When the crisis broke out, I was surprised at how strongly the IMF and the U.S. Treasury seemed to criticize the countries—according to the IMF, the Asian nations' institutions were rotten, their governments corrupt, and wholesale reform was needed. These outspoken critics were hardly experts on the region, but what they said contradicted so much of what I knew about it. I had been traveling to and studying the area for three decades. I had been asked by the World Bank, by Lawrence Summers himself when he was its vice president for research, to participate in a major study of the East Asia Miracle, to head the team looking at the financial markets. Almost two decades before, as the Chinese began their transition to a market economy, I had been called upon by them to discuss their development strategy. In the White House, I continued my close involvement, heading, for instance, the team that wrote the annual economic report for APEC (the Asia-Pacific Economic Cooperation, the group of countries around the Pacific rim, whose annual meetings of heads of states had come increasingly into prominence as the economic importance of the region grew). I participated actively in the National Security Council in the debates about China—and indeed, when tensions over the administration's "containment"

policy got too heated, I was the cabinet member sent to meet with China's premier, Zhu Rongji, to calm the waters. I was one of the few foreigners ever invited to join the country's top leaders at their yearly August retreat for policy discussions.

How, I wondered, if these countries' institutions were so rotten, had they done so well for so long? The difference in perspectives, between what I knew about the region and what the IMF and the Treasury alleged, made little sense, until I recalled the debate that had raged over the East Asia Miracle itself. The IMF and the World Bank had almost consciously avoided studying the region, though presumably, because of its success, it would have seemed natural for them to turn to it for lessons for others. It was only under pressure from the Japanese that the World Bank had undertaken the study of economic growth in East Asia (the final report was titled *The East Asian Miracle*) and then only after the Japanese had offered to pay for it. The reason was obvious: The countries had been successful not only in spite of the fact that they had not followed most of the dictates of the Washington Consensus, but *because* they had not. Though the experts' findings were toned down in the final published report, the World Bank's Asian Miracle study laid out the important roles that the government had played. These were far from the minimalist roles beloved of the Washington Consensus.

There were those, not just in the international financial institutions but in academia, who asked, was there really a miracle? "All" that East Asia had done was to save heavily and invest well! But this view of the "miracle" misses the point. No other set of countries around the world had managed to save at such rates *and* invest the funds well. Government policies played an important role in enabling the East Asian nations to accomplish both things simultaneously.1

When the crisis broke out, it was almost as if many of the region's critics were glad: their perspective had been vindicated. In a curious disjunction, while they were loath to credit the region's governments with any of the successes of the previous quarter century, they were quick to blame the governments for the failings.

Whether one calls it a miracle or not is beside the point: the increases in incomes and the reductions in poverty in East Asia over the last three decades have been unprecedented. No one visiting these countries can fail to marvel at the developmental transformation, the changes not only in the economy but also in society, reflected in every statistic imaginable. Thirty years ago, thousands of backbreaking rickshaws were pulled for a pittance; today, they are only a tourist attraction, a photo opportunity for the camera-snapping tourists flocking to the region. The combination of high savings rates, government investment in education, and state-directed industrial policy all served to make the region an economic powerhouse. Growth rates were phenomenal for decades and the standard of living rose enormously for tens of millions of people. The benefits of growth were shared widely. There were problems in the way the Asian economies developed, but overall, the governments had devised a strategy that worked, a strategy which had but one item in common with the Washington Consensus policies—the importance of macrostability. As in the Washington Consensus, trade was important, but the emphasis was on promoting exports, not removing impediments to imports. Trade was eventually liberalized, but only gradually, as new jobs were created in the export industries. While the Washington Consensus policies emphasized rapid financial and capital market liberalization, the East Asian

countries liberalized only gradually—some of the most successful, like China, still have a long way to go. While the Washington Consensus policies emphasized privatization, government at the national and local levels helped create efficient enterprises that played a key role in the success of several of the countries. In the Washington Consensus view, industrial policies, in which governments try to shape the future direction of the economy, are a mistake. But the East Asian governments took that as one of their central responsibilities. In particular, they believed that if they were to close the income gap between themselves and the more developed countries, they had to close the knowledge and technology gap, so they designed education and investment policies to do that. While the Washington Consensus policies paid little attention to inequality, the East Asian governments worked actively to reduce poverty and limit the growth of inequality, believing that such policies were important for maintaining social cohesion, and that social cohesion was necessary to provide a climate favorable to investment and growth. Most broadly, while the Washington Consensus policies emphasized a minimalist role for government, in East Asia, governments helped shape and direct markets.

When the crisis began, those in the West did not realize its severity. Asked about aid for Thailand, President Bill Clinton dismissed the collapse of the baht as "a few glitches in the road" to economic prosperity.2 The confidence and imperturbability of Clinton was shared by the financial leaders of the world, as they met in September 1997 in Hong Kong for the annual meeting of the IMF and World Bank. IMF officials there were so sure of their advice that they even asked for a change in its charter to allow it to put *more* pressure on developing countries to liberalize their capital markets. Meanwhile, the leaders of the Asian countries, and especially the finance ministers I met with, were terrified. They viewed the hot money that came with liberalized capital markets as the source of their problems. They knew that major trouble was ahead: a crisis would wreak havoc on their economies and their societies, and they feared that IMF policies would prevent them from taking the actions that they thought might stave off the crisis, at the same time that the policies they would insist upon should a crisis occur would worsen the impacts on their economy. They felt, however, powerless to resist. They even knew what could and should be done to prevent a crisis and minimize the damage—but knew that the IMF would condemn them if they undertook those actions and they feared the resulting withdrawal of international capital. In the end, only Malaysia was brave enough to risk the wrath of the IMF; and though Prime Minister Mahathir's policies—trying to keep interest rates low, trying to put brakes on the rapid flow of speculative money out of the country—were attacked from all quarters, Malaysia's downturn was shorter and shallower than that of any of the other countries.3

At the Hong Kong meeting, I suggested to the ministers of the Southeast Asian countries with whom I met that there were some concerted actions which they could take together; if they all imposed capital controls—controls intended to prevent the damage as the speculative money rushed out of their countries—in a coordinated way, they might be able to withstand the pressures that would undoubtedly be brought down upon them by the international financial community, and they could help insulate their economies from the turmoil. They talked about getting together later in the year to map out a plan. But hardly had their bags been unpacked from the trip to Hong Kong than the crisis spread, first to

Indonesia, and then, in early December, to South Korea. Meanwhile, other countries around the world had been attacked by currency speculators—from Brazil to Hong Kong—and withstood the attack, but at high cost.

There are two familiar patterns to these crises. The first is illustrated by South Korea, a country with an impressive track record. As it emerged from the wreckage of the Korean War, South Korea formulated a growth strategy which increased per capita income eightfold in thirty years, reduced poverty dramatically, achieved universal literacy, and went far in closing the gap in technology between itself and the more advanced countries. At the end of the Korean War, it was poorer than India; by the beginning of the 1990s, it had joined the Organization for Economic Cooperation and Development (OECD), the club of the advanced industrialized countries. Korea had become one of the world's largest producers of computer chips, and its large conglomerates, Samsung, Daewoo, and Hyundai, produced goods known throughout the world. But whereas in the early days of its transformation it had tightly controlled its financial markets, under pressure from the United States it had reluctantly allowed its firms to borrow abroad. But by borrowing abroad, the firms exposed themselves to the vagaries of the international market: in late 1997, rumors flashed through Wall Street that Korea was in trouble. It would not be able to roll over the loans from Western banks that were coming due, and it did not have the reserves to pay them off. Such rumors can be self-fulfilling prophecies. I heard these rumors at the World Bank well before they made the newspapers—and I knew what they meant. Quickly, the banks which such a short time earlier were so eager to lend money to Korean firms decided not to roll over their loans. When they all decided not to roll over their loans, their prophecy came true: Korea *was* in trouble.

The second was illustrated by Thailand. There, a speculative attack (combined with high short-term indebtedness) was to blame. Speculators, believing that a currency will devalue, try to move out of the currency and into dollars; with free convertibility—that is, the ability to change local currency for dollars or any other currency—this can easily be done. But as traders sell the currency, its value is weakened—confirming their prophecy. Alternatively, and more commonly, the government tries to support the currency. It sells dollars from its reserves (money the country holds, often in dollars, against a rainy day), buying up the local currency, to sustain its value. But eventually, the government runs out of hard currency. There are no more dollars to sell. The currency plummets. The speculators are satisfied. They have bet right. They can move back into the currency—and make a nice profit. The magnitude of the returns can be enormous. Assume a speculator goes to a Thai bank, borrows 24 billion baht, which, at the original exchange rate, can be converted into $1 billion. A week later the exchange rate falls; instead of there being 24 baht to the dollar, there are now 40 baht to the dollar. He takes $600 million, converting it back to baht, getting 24 billion baht to repay the loan. The remaining $400 million is his profit—a tidy return for one week's work, and the investment of little of his own money. Confident that the exchange rate would not appreciate (that is, go from 24 baht to the dollar to, say, 20 to the dollar), there was hardly any risk; at worst, if the exchange rate remained unchanged, he would lose one week's interest. As perceptions that a devaluation is imminent grow, the chance to make money becomes irresistible and

speculators from around the world pile in to take advantage of the situation.
If the crises had a familiar pattern, so too did the IMF's responses: it provided huge amounts of money (the total bailout packages, including support from G-7 countries, was $95 billion)4 so that the countries could sustain the exchange rate. It thought that if the market believed that there was enough money in the coffers, there would be no point in attacking the currency, and thus "confidence" would be restored. The money served another function: it enabled the countries to provide dollars to the firms that had borrowed from Western bankers to repay the loans. It was thus, in part, a bailout to the international banks as much as it was a bailout to the country; the lenders did not have to face the full consequences of having made bad loans. And in country after country in which the IMF money was used to sustain the exchange rate temporarily at an unsustainable level, there was another consequence: rich people inside the country took advantage of the opportunity to convert their money into dollars at the favorable exchange rate and whisk it abroad. As we shall note in the next chapter, the most egregious example occurred in Russia, after the IMF lent it money in July 1998. But this phenomenon, which is sometimes given the more neutral sounding name of "capital flight," also played a key role in the previous important crisis, in Mexico during 1994–95.
The IMF combined the money with conditions, in a package which was supposed to rectify the problems that caused the crisis. It is these other ingredients, as much as the money, that are supposed to persuade markets to roll over their loans, and to persuade speculators to look elsewhere for easy targets. The ingredients typically include higher interest rates—in the case of East Asia, much, much higher interest rates—plus cutbacks in government spending and increases in taxes. They also include "structural reforms," that is, changes in the structure of the economy which, it is believed, lies behind the country's problems. In the case of East Asia, not only were conditions imposed that mandated hikes in interest rates and cutbacks in spending; additional conditions required countries to make political as well as economic changes, major reforms, such as increased openness and transparency and improved financial market regulation, as well as minor reforms, like the abolition of the clove monopoly in Indonesia.
The IMF would claim that imposing these conditions was the responsible thing to do. It was providing billions of dollars; it had a responsibility to make sure not just that it was repaid but that the countries "did the right thing" to restore their economic health. If structural problems had *caused* the macroeconomic crisis, those problems had to be addressed. The breadth of the conditions meant that the countries accepting Fund aid had to give up a large part of their economic sovereignty. Some of the objection to the IMF programs was based on this, and the resulting undermining of democracy; and some were based on the fact that the conditions did not (and arguably were not designed to) restore the economies' health. But, as we noted in chapter 2, some of the conditions had nothing to do with the problem at hand.
The programs—with all of their conditions and with all of their money—failed. They were supposed to arrest the fall in the exchange rates; but these continued to fall, with hardly a flicker of recognition by the markets that the IMF had "come to the rescue." In each case, embarrassed by the failure of its supposed medicine to work, the IMF charged the country with failing to take the necessary reforms seriously. In each case, it announced to the world that there

were fundamental problems that had to be addressed before a true recovery could take place. Doing so was like crying fire in a crowded theater: investors, more convinced by the diagnosis of the problems than by the prescriptions, fled.5 Rather than restoring confidence that would lead to an inflow of capital into the country, IMF criticism exacerbated the stampede of capital out. Because of this, and the other reasons to which I turn shortly, the perception throughout much of the developing world, one I share, is that the IMF itself had become a part of the countries' problem rather than part of the solution. Indeed, in several of the crisis countries, ordinary people as well as many government officials and business people continue to refer to the economic and social storm that hit their nations simply as "the IMF"—the way one would say "the plague" or "the Great Depression." History is dated by "before" and "after" the IMF, just as countries that are devastated by an earthquake or some other natural disaster date events by "before" or "after" the earthquake.

As the crisis progressed, unemployment soared, GDP plummeted, banks closed. The unemployment rate was up fourfold in Korea, threefold in Thailand, tenfold in Indonesia. In Indonesia, almost 15 percent of males working in 1997 had lost their jobs by August 1998, and the economic devastation was even worse in the urban areas of the main island, Java. In South Korea, urban poverty almost tripled, with almost a quarter of the population falling into poverty; in Indonesia, poverty doubled. In some countries, like Thailand, people thrown out of jobs in the cities could return to their rural homes. However, this put increasing pressure on those in the rural sector. In 1998, GDP in Indonesia fell by 13.1 percent, in Korea by 6.7 percent, and in Thailand by 10.8 percent. Three years after the crisis, Indonesia's GDP was still 7.5 percent below that before the crisis, Thailand's 2.3 percent lower.

In some cases, fortunately, outcomes were less bleak than was widely anticipated. Communities in Thailand worked together to ensure that their children's education was not interrupted, with people voluntarily contributing to help keep their neighbors' kids in school. They also made sure that everyone had enough food, and because of this the incidence of malnutrition did not increase. In Indonesia, a World Bank program seemed to succeed in arresting the anticipated adverse effects on education. It was poor urban workers—hardly well off by any standards—who were made most destitute by the crisis. The erosion of the middle class, caused by usurious interest rates which threw small businesses into bankruptcy, will have the longest lasting effects on the social, political, and economic life of the region.

Deteriorating conditions in one country helped bring down its neighbors. The slowdown in the region had global repercussions: global economic growth slowed, and with the slowing of global growth, commodity prices fell. From Russia to Nigeria, the many emerging countries that depended on natural resources were in deep, deep trouble. As investors who had risked their money in these countries saw their wealth plummeting, and as *their* bankers called in their loans, they had to cut back their investments in other emerging markets. Brazil, dependent neither on oil nor on trade with the countries in deep trouble, with economic features far different from these countries, was brought into the unfolding global financial crisis by the generalized fear of foreign investors and the retrenchment in their lending. Eventually, almost every emerging market, even Argentina, which the IMF had long held up as the poster child of reform, largely for its success in

bringing down inflation, was affected.

HOW IMF/U.S. TREASURY POLICIES LED TO THE CRISIS

The disturbances capped a half decade of an American-led global triumph of market economics following the end of the cold war. This period saw international attention focus on newly emerging markets, from East Asia to Latin America, and from Russia to India. Investors saw these countries as a paradise of high returns and seemingly low risk. In the short space of seven years, private capital flows from the developed to the less developed countries increased sevenfold while public flows (foreign aid) stayed steady.6

International bankers and politicians were confident that this was the dawn of a new era. The IMF and the U.S. Treasury believed, or at least argued, that full capital account liberalization would help the region grow even faster. The countries in East Asia had no need for additional capital, given their high savings rate, but still capital account liberalization was pushed on these countries in the late eighties and early nineties. I believe that capital account liberalization was *the single most important factor leading to the crisis*. I have come to this conclusion not just by carefully looking at what happened in the region, but by looking at what happened in the almost one hundred other economic crises of the last quarter century. Because economic crises have become more frequent (and deeper), there is now a wealth of data through which one can analyze the factors contributing to crises.7 It has also become increasingly clear that all too often capital account liberalization represents risk without a reward. Even when countries have strong banks, a mature stock market, and other institutions that many of the Asian countries did not have, it can impose enormous risks.

Probably no country could have withstood the sudden change in investor sentiment, a sentiment that reversed this huge inflow to a huge outflow as investors, both foreign and domestic, put their funds elsewhere. Inevitably, such large reversals would precipitate a crisis, a recession, or worse. In the case of Thailand, this reversal amounted to 7.9 percent of GDP in 1997, 12.3 percent of GDP in 1998, and 7 percent of GDP in the first half of 1999. It would be equivalent to a reversal in capital flows for the United States of an average $765 billion per year between 1997 and 1999. While developing countries' ability to withstand the reversal was weak, so too was their ability to cope with the consequences of a major downturn. Their remarkable economic performance—no major economic recession in three decades—meant that the East Asian countries had not developed unemployment insurance schemes. But even had they turned their mind to the task, it would not have been easy: in the United States, unemployment insurance for those who are selfemployed in agriculture is far from adequate, and this is precisely the sector that dominates in the developing world.

The complaint against the IMF, however, runs deeper: it is not just that the Fund pushed the liberalization policies which led to the crisis, but that they pushed these policies even though there was little evidence that such policies promoted growth, and there was ample evidence that they imposed huge risks on developing countries.

Here was a true irony—if such a gentle word can be used. In October 1997, at the very beginning of the crisis, the Fund was advocating the expansion of precisely those polices which underlay the increasing frequency of crises. As an academic, I was shocked that the IMF and the U.S. Treasury would push this agenda with such force, in the face of a virtual absence of theory

and evidence suggesting that it was in the economic interests of either the developing countries or global economic stability—and in the presence of evidence to the contrary. Surely, one might have argued, there must be *some* basis for their position, beyond serving the naked self-interest of financial markets, which saw capital market liberalization as just another form of market access—more markets in which to make more money. Recognizing that East Asia had little need for additional capital, the advocates of capital market liberalization came up with an argument that even at the time I thought was unconvincing, but in retrospect looks particularly strange—that it would enhance the countries' economic stability! This was to be achieved by allowing greater diversification of sources of funding.8 It is hard to believe that these advocates had not seen the data that showed that capital flows were pro-cyclical. That is to say that capital flows out of a country in a recession, precisely when the country needs it most, and flows in during a boom, exacerbating inflationary pressures. Sure enough, just at the time the countries needed outside funds, the bankers asked for their money back.

Capital market liberalization made the developing countries subject to both the rational and the irrational whims of the investor community, to their irrational exuberance and pessimism. Keynes was well aware of the often seemingly irrational changes in sentiments. In *The General Theory of Employment, Interest and Money* (1935), he referred to these huge and often inexplicable swings in moods as "animal spirits." Nowhere were these spirits more evident than in East Asia. Slightly before the crisis, Thai bonds paid only 0.85 percent higher interest than the safest bonds in the world, that is, they were regarded as extremely safe. A short while later, the risk premium on Thai bonds had soared.

There was a second, hardly more credible argument that the advocates of capital market liberalization put forward—again without evidence. They contended that capital market controls impeded economic efficiency and that, as a result, countries would grow better without these controls. Thailand provides a case in point for why this argument was so flawed. Before liberalization, Thailand had severe limitations on the extent to which banks could lend for speculative real estate. It had imposed these limits because it was a poor country that wanted to grow, and it believed that investing the country's scarce capital in manufacturing would both create jobs and enhance growth. It also knew that throughout the world, speculative real estate lending is a major source of economic instability. This type of lending gives rise to bubbles (the soaring of prices as investors clamor to reap the gain from the seeming boom in the sector); these bubbles always burst; and when they do, the economy crashes. The pattern is familiar, and was the same in Bangkok as it was in Houston: as real estate prices rise, banks feel they can lend more on the basis of the collateral; as investors see prices going up, they want to get in on the game before it's too late—and the bankers give them the money to do it. Real estate developers see quick profits by putting up new buildings, until excess capacity results. The developers can't rent their space, they default on their loans, and the bubble bursts.

The IMF, however, contended that the kinds of restraints that Thailand had imposed to prevent a crisis interfered with the efficient market allocation of resources. If the market says, build office buildings, commercial construction *must be* the highest return activity. If the market says, as it *effectively* did after liberalization, build empty office buildings, then so be it;

again, according to IMF logic, the market *must* know best. While Thailand was desperate for more public investment to strengthen its infrastructure and relatively weak secondary and university education systems, billions were squandered on commercial real estate. These buildings remain empty today, testimony to the risks posed by excessive market exuberance and the pervasive market failures that can arise in the presence of inadequate government regulation of financial institutions.9

The IMF, of course, was not alone in pushing for liberalization. The U.S. Treasury, which, as the IMF's largest shareholder and the only one with veto power has a large role in determining IMF policies, pushed liberalization too.

I was in President Clinton's Council of Economic Advisers in 1993 when South Korea's trade relations with the United States came up for discussion. The negotiations included a host of minor issues—such as opening up South Korea's markets to American sausages —and the important issue of financial and capital market liberalization. For three decades, Korea enjoyed remarkable economic growth without significant international investment. Growth had come based on the nation's own savings and on its own firms managed by its own people. It did not need Western funds and had demonstrated an alternative route for the importation of modern technology and market access. While its neighbors, Singapore and Malaysia, had invited in multinational companies, South Korea had created its own enterprises. Through good products and aggressive marketing, South Korean companies had sold their goods around the world. South Korea recognized that continued growth and integration in the global markets would require some liberalization, or deregulation, in the way its financial and capital markets were run. South Korea was also aware of the dangers of poor deregulation: it had seen what happened in the United States, where deregulation had culminated in the 1980s savingsand-loan debacle. In response, South Korea had carefully charted out a path of liberalization. This path was too slow for Wall Street, which saw profitable opportunities and did not want to wait. While Wall Streeters defended the principles of free markets and a limited role for government, they were not above asking help from government to push their agenda for them. And as we shall see, the Treasury Department responded with force.

At the Council of Economic Advisers we weren't convinced that South Korean liberalization was an issue of U.S. *national* interest, though obviously it would help the *special* interests of Wall Street. Also we were worried about the effect it would have on global stability. We wrote a memorandum, or "think piece," to lay out the issues, stimulate a debate, and help focus attention on the matter. We prepared a set of criteria for evaluating which market-opening measures are most vital to U.S. national interests. We argued for a system of *prioritization*. Many forms of "market access" are of little benefit to the United States. While some specific groups might benefit a great deal, the country as a whole would gain little. Without prioritization, there was a risk of what happened during the previous Bush administration: one of the supposedly great achievements in opening up Japan's market was that Toys "R" Us could sell Chinese toys to Japanese children—good for Japanese children and Chinese workers, but of little benefit to America. Though it is hard to believe that such a mild-mannered proposal could be greeted with objections, it was. Lawrence Summers, at the time undersecretary of the Treasury, adamantly opposed the exercise, saying such prioritization was unnecessary. It

was the responsibility of the National Economic Council (NEC) to coordinate economic policy, to balance the economic analysis of the Council of Economic Advisers with the political pressures that were reflected in the various agencies, and decide what issues to take to the president for final decision.

The NEC, then headed by Robert Rubin, decided the issue was of insufficient importance to be brought to the president for consideration. The real reason for the opposition was only too transparent. Forcing Korea to liberalize faster would not create many jobs in America, nor would it likely lead to significant increases in American GDP. Any system of privatization would therefore not put these measures high on the agenda.10 But worse, it was not even clear that the United States would, as a whole, even benefit, and it was clear that Korea might in fact be worse off. The U.S. Treasury, which argued to the contrary both that it was important for the United States and that it would not lead to instability, prevailed. In the final analysis, such matters are the Department of the Treasury's province, and it would be unusual for the position of the Treasury to be overridden. The fact that the debate was conducted behind closed doors meant that other voices could not be heard; perhaps if they had, if there had been more transparency in American decision making, the outcome would have been different. Instead, Treasury won, and the United States, Korea, and the global economy lost. Treasury would probably claim that the liberalization itself was not at fault; the problem was that liberalization was done in the wrong way. But that was precisely one of the points that the Council of Economic Advisers raised: It was very likely that a quick liberalization would be done poorly.

THE FIRST ROUND OF MISTAKES

There is little doubt that IMF and Treasury policies contributed to an environment that enhanced the likelihood of a crisis by encouraging, in some cases insisting on, an unwarrantedly rapid pace toward financial and capital market liberalization. However, the IMF and Treasury made their most profound mistakes in their initial response to the crisis. Of the many failures outlined below, today there is widespread agreement on all but the criticism of IMF monetary policy.

At the onset, the IMF seemed to have misdiagnosed the problem. It had handled crises in Latin America, caused by profligate government spending and loose monetary policies that led to huge deficits and high inflation; and while it may not have handled those crises well —the region experienced a decade of stagnation after the so-called successful IMF programs, and even the creditors had eventually to absorb large losses—it at least had a game plan that had a certain coherency. East Asia was vastly different from Latin America; governments had surpluses and the economy enjoyed low inflation, but corporations were deeply indebted.

The diagnosis made a difference for two reasons. First, in the highly inflationary environment of Latin America, what was needed was a decrease in the excess demand. Given the impending recession in East Asia, the problem was not excess demand but insufficient demand. Dampening demand could only make matters worse.

Second, if firms have a low level of indebtedness, high interest rates, while painful, can still be absorbed. With high levels of indebtedness, imposing high interest rates, even for short periods of time, is like signing a death warrant for many of the firms—and for the economy. In fact, while the Asian economies did have some weaknesses that needed to be addressed, they were no worse than those in many other countries, and surely

nowhere near as bad as the IMF suggested. Indeed, the rapid recovery of Korea and Malaysia showed that, in large measure, the downturns were not unlike the dozens of recessions that have plagued market economies in the advanced industrial countries in the two hundred years of capitalism. The countries of East Asia not only had an impressive record of growth, as we have already noted, but they had had fewer downturns over the previous three decades than any of the advanced industrial countries. Two of the countries had had only one year of negative growth; two had had no recession in thirty years. In these and other dimensions, there was more to praise in East Asia than to condemn; and if East Asia was vulnerable, it was a newly acquired vulnerability—largely the result of the capital and financial market liberalization for which the IMF was itself partly culpable.

Hooverite Contractionary Policies: An Anomaly in the Modern World

For more than seventy years there has been a standard recipe for a country facing a severe economic downturn. The government must stimulate aggregate demand, either by monetary or fiscal policy—cut taxes, increase expenditures, or loosen monetary policy. When I was chairman of the Council of Economic Advisers, my main objective was to maintain the economy at full employment and maximize long-term growth. At the World Bank, I approached the problems of the countries in East Asia with the same perspective, evaluating policies to see which would be most effective in both the short and long term. The crisis economies of East Asia were clearly threatened with a major downturn and needed stimulation. The IMF pushed exactly the opposite course, with consequences precisely of the kind that one would have predicted.

At the time of the onset of the crisis, East Asia was in rough macrobalance—with low inflationary pressures and government budgets in balance or surplus. This had two obvious implications. First, the collapse of the exchange rate and the stock markets, the breaking of the real estate bubbles, accompanied by falling investment and consumption, would send it into a recession. Second, the economic collapse would result in collapsing tax revenues, and leave a budget gap. Not since Herbert Hoover have responsible economists argued that one should focus on the actual deficit rather than the structural deficit, that is, the deficit that would have been there had the economy been operating at full employment. Yet this is precisely what the IMF advocated.

Today, the IMF admits that the fiscal policy it recommended was excessively austere.11 The policies made the recession far worse than it needed to be. During the crisis, however, in the *Financial Times* the IMF's first deputy managing director Stanley Fischer defended the IMF's policies, writing, in effect, that *all* the IMF was asking of the countries was to have a balanced budget!12 Not for sixty years have respectable economists believed that an economy going into a recession should have a balanced budget.

I felt intensely about this issue of balanced budgets. While I was at the Council of Economic Advisers, one of our major battles was over the balanced budget amendment to the Constitution. This amendment would have required the federal government to limit its expenditures to its revenues. We, *and Treasury,* were against it because we believed that it was bad economic policy. In the event of a recession, it would be all the more difficult to use fiscal policy to help the economy recover. As the economy goes into a recession, tax revenues decrease, and the amendment would have required the

government to cut back expenditures (or increase taxes), which would have depressed the economy further. Passing the amendment would have been tantamount to the government walking away from one of its central responsibilities, maintaining the economy at full employment. Despite the fact that expansionary fiscal policy was one of the few ways out of recession, and despite the administration's opposition to the balanced budget amendment, the U.S. Treasury and the IMF advocated the equivalent of a balanced budget amendment for Thailand, Korea, and other East Asian countries.

Beggar-Thyself Policies

Of all the mistakes the IMF committed as the East Asian crisis spread from one country to another in 1997 and 1998, one of the hardest to fathom was the Fund's failure to recognize the important interactions among the policies pursued in the different countries. Contractionary policies in one country not only depressed that country's economy but had adverse effects on its neighbors. By continuing to advocate contractionary policies the IMF exacerbated the *contagion*, the spread of the downturn from one country to the next. As each country weakened, it reduced its imports from its neighbors, thereby pulling its neighbors down.

The beggar-thy-neighbor policies of the 1930s are generally thought to have played an important role in the spread of the Great Depression. Each country hit by a downturn tried to bolster its own economy by cutting back on exports and thus shifting consumer demand to its own products. A country would cut back on exports by imposing tariffs and by making competitive devaluations of its currency, which made its own goods cheaper and other countries' more expensive. However, as each country cut back on imports, it succeeded in "exporting" the economic downturn to its neighbors. Hence the term *beggarthy-neighbor*.

The IMF devised a strategy that had an effect which was even worse than the beggar-thy-neighbor policies that had devastated countries around the world during the depression of the 1930s. Countries were told that when facing a downturn they must cut back on their trade deficit, and even build a trade surplus. This might be logical if the central objective of a country's macroeconomic policy were to repay foreign creditors. By building up a war chest of foreign currency, a country will be better able to pay its bills—never mind the cost to those inside the country or elsewhere. Today, unlike the 1930s, enormous pressure is put on a country not to increase tariffs or other trade barriers in order to decrease imports, even if it faces a recession. The IMF also inveighed strongly against further devaluation. Indeed, the whole point of the bailouts was to *prevent* a further decrease in the exchange rate. This itself might seem peculiar, given the IMF's otherwise seeming faith in markets: why not let market mechanisms determine exchange rates, just as they determine other prices? But intellectual consistency has never been the hallmark of the IMF, and its single-minded worries about inflation being set off by devaluation have always prevailed.

With tariffs and devaluations ruled out, there were but two ways to build a trade surplus. One was to increase exports; but this is not easy, and cannot be done quickly, particularly when the economies of your major trading partners are weak and your own financial markets are in disarray, so exporters cannot obtain finance to expand. The other was to reduce imports—by cutting incomes, that is, inducing a major recession. Unfortunately for the countries, and the world, this was the only option left. And this is what happened in East Asia in the late 1990s:

contractionary fiscal and monetary policies combined with misguided financial policies led to massive economic downturns, cutting incomes, which reduced imports and led to huge trade surpluses, giving the countries the resources to pay back foreign creditors. If one's objective was to increase the size of reserves, the policy was a success. But at what expense to the people in the country, and their neighbors! Hence the name of these policies—"beggar-thyself." The consequence for any country's trading partners was exactly the same as if beggar-thy-neighbor policies had actually been pursued. Each country's imports were cut back, which is the same as other countries' exports being cut. From the neighbors' perspectives, they couldn't care less *why* exports were cut; what they saw was the consequence, a reduction of sales abroad. Thus the downturn was exported around the region. Only this time, there was not even the saving grace that as the downturn was exported, the domestic economy was strengthened. As the downturn spread around the world, slower growth in the region led to a collapse in commodity prices, like oil, and the collapse in those prices wrought havoc in oil-producing countries like Russia.

Of all the failures of the IMF, this is perhaps the saddest, because it represented the greatest betrayal of its entire raison d'être. It did worry about contagion—contagion from one capital market to another transmitted through the fears of investors—though as we saw in the last section, the policies it had pushed had made the countries far more vulnerable to the volatility of investor sentiment. A collapse in the exchange rate in Thailand might make investors in Brazil worry about markets there. The buzzword was *confidence*. A lack of confidence in one country could spread to a lack of confidence in emerging markets. But more generally, the IMF's performance as market psychologist left something to be desired. Creating deep recessions with massive bankruptcies and/or pointing out deepseated problems in the best performing region of the emerging markets are policies hardly designed to restore confidence. But even had it done better in restoring confidence, questions should have been raised: in focusing on protecting investors, it had forgotten about those in the countries it was supposed to be helping; in focusing on financial variables, like exchange rates, it had almost forgotten about the real side of the economy. It had lost sight of its original mission.

Strangling an Economy with High Interest Rates

Today, the IMF agrees that the *fiscal* policies (those relating to the levels of government deficits) it pushed were excessively contractionary, but it does not own up to the mistakes of monetary policy. When the Fund entered East Asia, it forced countries to raise interest rates to what, in conventional terms, would be considered astronomical levels. I remember meetings where President Clinton was frustrated that the Federal Reserve Bank, headed by Alan Greenspan, an appointee from past administrations, was about to raise interest rates one-quarter or one-half percentage point. He worried that it would destroy "his" recovery. He felt he had been elected on a platform of "It's the economy, stupid," and "Jobs, Jobs, Jobs" and he didn't want the Fed to hurt his plans. He knew that the Fed was concerned with inflation, but thought those fears were excessive—a sentiment which I shared, and which the subsequent events bore out. The president worried about the adverse effect interest rate increases would have on unemployment, and the economic recovery just getting underway. And this in the country with one of the best

business environments in the world. Yet in East Asia, IMF bureaucrats, who were even less politically accountable, forced interest rate increases not ten but fifty times greater—interest rate increases of more than 25 percentage points. If Clinton worried about the adverse effects of a half-point increase on an economy experiencing a nascent recovery, he would have been apoplectic about the effect of those huge increases in interest rates on an economy plunging into a recession. Korea first raised its interest rates to 25 percent, but was told that to be serious it must allow interest rates to go still higher. Indonesia raised its interest rates in a preemptive move before the crisis, but was told that that was not good enough. Nominal interest rates soared.

The reasoning behind these policies was simple, if not simplistic. If a country raised interest rates, it would make it more attractive for capital to flow into that country. Capital flows into the country would help support the exchange rate and thus stabilize the currency. End of argument.

At first glance, this appears logical. However, consider the case of South Korea as an example. Recall that in South Korea the crisis was started by foreign banks refusing to roll over their short-term loans. They refused because they worried about South Korean firms' ability to repay. Bankruptcy—default—was at the center of the discussion. But in the IMF model—as in the models of most of the macroeconomics textbooks written two decades ago—bankruptcy plays no role. To discuss monetary policy and finance without bankruptcy is like *Hamlet* without the Prince of Denmark. At the heart of the analysis of the macroeconomy *should* have been an analysis of what an increase in interest rates would do to the chances of default and to the amount that creditors can recover in the event of default. Many of the firms in East Asia were highly indebted, and had huge debt equity ratios. Indeed, the excessive leverage had repeatedly been cited as one of South Korea's weaknesses, *even by the IMF*. Highly leveraged companies are particularly sensitive to interest rate increases, especially to the extremely high levels urged by the IMF. At very high interest rate levels, a highly leveraged company goes bankrupt quickly. Even if it does not go bankrupt, its equity (net worth) is quickly depleted as it is forced to pay huge amounts to creditors.

The Fund recognized that the underlying problems in East Asia were weak financial institutions and overleveraged firms; yet it pushed high interest rate policies that actually exacerbated those problems. The consequences were precisely as predicted: The high interest rates increased the number of firms in distress, and thereby increased the number of banks facing nonperforming loans.13 This weakened the banks further. The increased distress in the corporate and financial sectors exacerbated the downturn that the contractionary policies were inducing through the reduction in aggregate demand. The IMF had engineered a simultaneous contraction in aggregate demand *and* supply.

In defending its policies, the IMF said they would help restore market confidence in the affected countries. But clearly countries in deep recession did not inspire confidence. Consider a Jakarta businessman who has put almost all of his wealth into East Asia. As the regional economy plummets—as contractionary policies take hold and amplify the downturn—he suddenly realizes that his portfolio is hardly sufficiently diversified, and shifts investment to the booming U.S. stock market. Local investors, just like international investors, were not interested in pouring money into an

economy going into a tailspin. Higher interest rates did not attract more capital into the country. On the contrary, the higher rates made the recession worse and actually drove capital *out* of the country.

The IMF came up with another defense, of no more validity. They argued that if interest rates were not greatly increased, the exchange rate would collapse, and this would be devastating to the economy, as those who had dollar-denominated debts would not be able to pay them. But the fact was that, for reasons that should have been apparent, raising interest rates did not stabilize the currency; the countries were thus forced to lose on both accounts. Moreover, the IMF never bothered to look at the details of what was going on inside the countries. In Thailand, for instance, it was the already bankrupt real estate firms and those that lent to them who had the most foreigndenominated debt. Further devaluations might have harmed the foreign creditors but would not have made these firms any more dead. In effect, the IMF made the small businesses and other innocent bystanders pay for those who had engaged in excessive dollar borrowing —and to no avail.

When I pleaded with the IMF for a change in policies, and pointed out the disaster that would ensue if the current course were to be continued, there was a curt reply: If I were proven correct, the Fund would change its policies. I was appalled by this wait-and-see attitude. All economists know there are long lags in policy. The benefits of changing course will not be felt for six to eighteen months, while enormous damage could be done in the meantime.

That damage was done in East Asia. Because many firms were highly leveraged, many were forced into bankruptcy. In Indonesia, an estimated 75 percent of all businesses were put into distress, while in Thailand close to 50 percent of bank loans became nonperforming. Unfortunately, it is far easier to destroy a firm than to create a new one. Lowering interest rates would not un-bankrupt a firm that had been forced into bankruptcy: its net worth would still have been wiped out. The IMF's mistakes were costly, and slow to reverse.

Naive geopolitical reasoning, vestiges of Kissinger-style *realpolitik* compounded the consequences of these mistakes. In 1997, Japan offered $100 billion to help create an Asian Monetary Fund, in order to finance the required stimulative actions. But Treasury did everything it could to squelch the idea. The IMF joined in. The reason for the IMF's position was clear: While the IMF was a strong advocate of competition in markets, it did not want competition in its own domain, and the Asian Monetary Fund would provide that. The U.S. Treasury's motivations were similar. As the only shareholder of the IMF with veto power, the United States had considerable say in IMF policies. It was widely known that Japan disagreed strongly with the IMF's actions—I had repeated meetings with senior Japanese officials in which they expressed misgivings about IMF policies that were almost identical to my own.14 With Japan, and possibly China, as the likely major contributors to the Asian Monetary Fund, their voices would predominate, providing a real challenge to American "leadership"— and control.

The importance of control—including control over the media—was brought home forcefully in the early days of the crisis. When World Bank Vice President for East Asia Jean Michel Severino pointed out in a widely discussed speech that several countries in the region were going into a deep recession, or even depression, he received a strong verbal tongue-lashing from Summers. It was

simply unacceptable to use the R (for recession) or D (for depression) words, even though by then it was clear that Indonesia's GDP was likely to fall between 10 to 15 percent, a magnitude that clearly warranted the use of those harsh terms.

Eventually, Summers, Fischer, Treasury, and the IMF could not ignore the depression. Japan once again made a generous offer to help under the Miyazawa Initiative, named after Japan's finance minister. This time the offer was scaled down to $30 billion, and was accepted. But even then the United States argued that the money should be spent not to stimulate the economy through fiscal expansion, but for corporate and financial restructuring —effectively, to help bail out American and other foreign banks and other creditors. The squashing of the Asian Monetary Fund is still resented in Asia and many officials have spoken to me angrily about the incident. Three years after the crisis, the countries of East Asia finally got together to begin, quietly, the creation of a more modest version of the Asian Monetary Fund, under the innocuous name of the Chang Mai Initiative, named after the city in northern Thailand where it was launched.

THE SECOND ROUND OF MISTAKES: BUMBLING RESTRUCTURING

As the crisis worsened, the need for "restructuring" became the new mantra. Banks that had bad loans on their books should be shut down, companies that owed money should be closed or taken over by their creditors. The IMF focused on this rather than simply performing the role it was supposed to fill: providing liquidity to finance needed expenditures. Alas, even this focus on restructuring failed, and much of what the IMF did helped push the sinking economies down further.

Financial Systems

The East Asia crisis was, first and foremost, a crisis of the financial system, and this needed to be dealt with. The financial system can be compared to the brain of the economy. It allocates scarce capital among competing uses by trying to direct it to where it is most effective, in other words, where it yields the highest returns. The financial system also monitors the funds to ensure that they are used in the way promised. If the financial system breaks down, firms cannot get the working capital they need to continue existing levels of production, let alone finance expansion through new investment. A crisis can give rise to a vicious circle wherein banks cut back on their finance, leading firms to cut back on their production, which in turn leads to lower output and lower incomes. As output and incomes plummet, profits fall, and some firms are even forced into bankruptcy. When firms declare bankruptcy, banks' balance sheets become worse, and the banks cut back lending even further, exacerbating the economic downturn.

If enough firms fail to repay their loans, banks may even collapse. A collapse of even a single large bank can have disastrous consequences. Financial institutions determine creditworthiness. This information is highly specific, cannot easily be transmitted, and is embedded in the records and institutional memory of the bank (or other financial institution). When a bank goes out of business, much of the creditworthiness information it has on its borrowers is destroyed, and that information is expensive to recreate. Even in more advanced countries, a typical small or medium-sized enterprise may obtain credit from at most two or three banks. When a bank goes out of business in good times, many of its customers will have difficulty finding an alternative supplier of credit overnight. In developing countries, where sources of finance are even more limited, if the

bank that a business relies upon fails, finding a new source of funds—especially during an economic downturn—may be nearly impossible.

Fears of this vicious circle have induced governments throughout the world to strengthen their financial systems through prudent regulation. Repeatedly, free marketeers have bridled against these regulations. When their voices have been heeded the consequences have been disastrous, whether in Chile in 1982–83, in which Chilean gross domestic product fell by 13.7 percent and one in five workers was unemployed, or the United States in the Reagan era, where, as we noted earlier, deregulation led to the savingsand-loan debacle, costing American taxpayers $200 billion.

A recognition of the importance of maintaining credit flows has similarly guided policy makers in trying to deal with the problems of financial restructuring. Fears about the adverse effects of this "destruction of informational capital" partially explain why the United States, during the S&L debacle, closed down very few banks outright. Most of the weak banks were taken over by or merged into other banks, and customers hardly knew of the switch. In this way, the information capital was preserved. Even so, the S&L crisis was an important contributing factor to the 1991 recession.

Inducing a Bank Run

Although financial system weaknesses were far more pervasive in East Asia than in the United States, and the IMF's rhetoric continually focused on these weaknesses as underlying the East Asia crisis, the IMF failed to understand how financial markets work and their impact on the rest of the economy. Its crude macromodels never embraced a broad picture of financial markets at the aggregate level, but were even more deficient at the microlevel—that is, at the level of the firm. The Fund did not adequately take into account the corporate and financial distress to which its so-called stabilization policies, including the high interest rates, contributed so strongly.

As they approached the problem of restructuring, IMF teams in East Asia focused on shutting down weak banks; it was as if they had a Darwinian model of competition in mind, so the weak banks *must* not survive. There was some basis for their position. Elsewhere, allowing weak banks to continue to operate *without tight supervision* resulted in their making highly risky loans. They gambled by making high-risk, high-return loans—if they were lucky, the loans would be repaid, and the higher interest rates would bring them back to solvency. If they were unlucky, they would go out of business—with the government picking up the pieces—but that is what would happen to them in any case if they did not embark on the risky loan strategy. But too often, such risky loans indeed turn out to be bad loans, and when the day of reckoning comes, the government faces an even bigger bailout than if the bank had been shut down earlier. This was one of the lessons that had emerged so clearly from the U.S. savings-and-loan debacle: the refusal of the Reagan administration to deal with the problem for years meant that when the crisis could no longer be ignored, the cost to the taxpayer was far larger. But the IMF overlooked another critical lesson: the importance of keeping credit flowing.

Its strategy for financial restructuring involved triage—separating out the really sick banks, which should be closed immediately, from the healthy banks. A third group were those that were sick but reparable. Banks are required to have a certain ratio of capital to their outstanding loans and other assets; this ratio is termed the *capital adequacy ratio*. Not surprisingly, when many loans are

nonperforming, many banks fail to meet their capital adequacy ratio. The IMF insisted that banks either shut down or *quickly* meet this capital adequacy ratio. But this insistence on banks quickly meeting capital adequacy standards exacerbated the downturn. The Fund made the kind of mistake that we warn students about in the first course in economics, called "the fallacy of composition." When only one bank has a problem, then insisting on its meeting its capital adequacy standards makes sense. But when many, or most, banks are in trouble, that policy can be disastrous.
There are two ways of increasing the ratio of capital to loans: increasing capital or reducing loans. In the midst of a downturn, especially of the magnitude of that in East Asia, it is hard to raise new capital. The alternative is to reduce outstanding loans. But as each bank calls in its loans, more and more firms are put into distress. Without adequate working capital, they are forced to cut back on their production, cutting into the demand for products from other firms. The downward spiral is exacerbated. And with more firms in distress, the capital adequacy ratio of banks can even be worsened. The attempt to improve the financial position of the banks backfired.
With a large number of banks shut down, and with those managing to survive facing an increasingly large number of loans in distress, and unwilling to take on new customers, more and businesses found themselves without access to credit. Without credit, the one glimmer of hope for a recovery would be squashed. The depreciation of the currency meant that exports should have boomed, as the goods from the region became cheaper, by 30 percent or more. But while export volumes increased, they did not increase nearly as much as expected, and for a simple reason: to expand exports, firms needed to have working capital to produce more. As banks shut down and cut back on their lending, firms could not even get the working capital required to maintain production, let alone to expand.
Nowhere was the IMF's lack of understanding of financial markets so evident as in its policies toward closing banks in Indonesia. There, some sixteen private banks were closed down, and notice was given that other banks might be subsequently shut down as well; but depositors, except for those with very small accounts, would be left to fend for themselves. Not surprisingly, this engendered a run on the remaining private banks, and deposits were quickly shifted to state banks, which were thought to have an implicit government guarantee. The effects on the Indonesia banking system, and economy, were disastrous, compounding the mistakes in fiscal and monetary policy already discussed, and almost sealing that country's fate: a depression had become inevitable.
In contrast, South Korea ignored outside advice, and recapitalized its two largest banks rather than closing them down. This is part of why Korea recovered relatively quickly.

Corporate Restructuring

While attention focused on financial restructuring, it was clear that the problems in the financial sector could not be resolved unless the problems in the corporate sector were effectively addressed. With 75 percent of the firms in Indonesia in distress, and half of the loans in Thailand nonperforming, the corporate sector was entering a stage of paralysis. Firms that are facing bankruptcy are in a state of limbo: it is not clear who really owns them, the current owners or the creditors. Issues of ownership are not fully resolved until the firm emerges from bankruptcy. But without clear owners, there is always a temptation for current management and the old owners to strip assets, and such asset stripping did occur. In the United States and other countries, when

companies go into bankruptcy, trustees are appointed by the courts to prevent this. But in Asia there were neither the legal frameworks nor the personnel to implement trusteeships. It was thus imperative that bankruptcies and corporate distress be resolved quickly, before stripping could occur. Unfortunately, IMF's misguided economics, having contributed to the mess through the high interest rates which forced so many firms into distress, conspired with ideology and special interests to dampen the pace of restructuring.

The IMF's strategy for corporate restructuring—restructuring the firms that were effectively in bankruptcy—was no more successful than its strategy for restructuring banks. It confused *financial* restructuring—entailing straightening out who really owns the firm, the discharge of debt or its conversion to equity—with *real* restructuring, the nuts-and-bolts decisions: what the firm should produce, how it should produce its output, and how it should be organized. In the presence of the massive economic downturn, there were real macrobenefits from rapid financial restructuring. Individual participants in the bargaining surrounding bankruptcy workouts would fail to take into account these systemic benefits. It might pay them to drag their feet—and bankruptcy negotiations are often protracted, taking more than a year or two. When only a few firms in an economy are bankrupt, this delay has little social cost; when many firms are in distress, the social cost can be enormous, as the macroeconomic downturn is prolonged. It is thus imperative that the government do whatever it can to facilitate a quick resolution.

I took the view that the government should play an active role in pushing this financial restructuring, ensuring that there were real owners. My view was that once ownership issues were resolved, the new owners should set about the task of deciding the issues of real restructuring. The IMF took the opposite view, saying that the government should *not* take an active role in financial restructuring, but push for real restructuring, selling assets, for instance, to reduce South Korea's *seeming* excess capacity in chips and bringing in outside (typically foreign) management. I saw no reason to believe that international bureaucrats, trained in macromanagement, had any special insight into corporate restructuring in general, or the chip industry in particular. While restructuring is, in any case, a slow process, the governments of Korea and Malaysia took an active role, and succeeded within a remarkably short period of time, two years, in completing the financial restructuring of a remarkably large fraction of the firms in distress. By contrast, restructuring in Thailand, which followed the IMF strategy, languished.

THE MOST GRIEVOUS MISTAKES: RISKING SOCIAL AND POLITICAL TURMOIL

The social and political consequences of mishandling the Asian crisis may never be measured fully. When the IMF's managing director Michel Camdessus, and G-22 finance ministers and central bank governors (the finance ministers and central bank governors from the major industrial countries, plus the major Asian economies, including Australia) met in Kuala Lumpur, Malaysia, in early December 1997, I warned of the danger of social and political unrest, especially in countries where there has been a history of ethnic division (as in Indonesia, where there had been massive ethnic rioting some thirty years earlier), if the excessively contractionary monetary and fiscal policies that were being imposed continued. Camdessus calmly responded that they needed to follow Mexico's

example; they had to take the painful measures if they were to recover. Unfortunately, my forecasts turned out to be all too right. Just over five months after I warned of the impending disaster, riots broke out. While the IMF had provided some $23 billion to be used to support the exchange rate and bail out creditors, the far, far smaller sums required to help the poor were not forthcoming. In American parlance, there were billions and billions for corporate welfare, but not the more modest millions for welfare for ordinary citizens. Food and fuel subsidies for the poor in Indonesia were drastically cut back, and riots exploded the next day. As had happened thirty years earlier, the Indonesian businessmen and their families became the victims.

It was not just that IMF policy might be regarded by softheaded liberals as inhumane. Even if one cared little for those who faced starvation, or the children whose growth would be stunted by malnutrition, it was simply bad economics. Riots do not restore business confidence. They drive capital out of a country; they do not attract capital into a country. And riots are predictable—like any social phenomenon, not with certainty, but with a high probability. It was clear Indonesia was ripe for such social upheaval. The IMF itself should have known this; around the world, the IMF has inspired riots when its policies cut off food subsidies.

After the riots in Indonesia, the IMF reversed its position; food subsidies were restored. But again, the IMF showed that it had not learned the basic lesson of "irreversibility." Just as a firm that was bankrupted by the high interest rates does not become "un-bankrupted" when the interest rates were lowered, a society that is rendered asunder by riots induced by cutting out food subsides just as it is plunging into depression is not brought together when the food subsidies are restored. Indeed, in some quarters, the bitterness is all the greater: if the food subsidies could have been afforded, why were they taken away in the first place?

I had the opportunity to talk to Malaysia's prime minister after the riots in Indonesia. His country had also experienced ethnic riots in the past. Malaysia had done a lot to prevent their recurrence, including putting in a program to promote employment for ethnic Malays. Mahathir knew that all the gains in building a multiracial society could be lost, had he let the IMF dictate its policies to him and his country and then riots had broken out. For him, preventing a severe recession was not just a matter of economics, it was a matter of the survival of the nation.

RECOVERY: VINDICATION OF THE IMF POLICIES?

As this book goes to press, the crisis is over. Many Asian countries are growing again, their recovery slightly stalled by the global slowdown that began in 2000. The countries that managed to avoid a recession in 1998, Taiwan and Singapore, fell into one in 2001; Korea is doing far better. With a worldwide downturn affecting the United States and Germany as well, no one talked about weak institutions and poor governments as the cause of recessions; now, they seemed to have remembered that such fluctuations have always been part of market economies.

But although some at the IMF believe their interventions were successful, it's widely agreed that serious mistakes were made. Indeed, the nature of the recovery shows this. Almost every economic downturn comes to an end. But the Asian crisis was more severe than it should have been, recovery took longer than it needed to, and prospects for future growth are not what they should be. On Wall Street, a crisis is over as soon as financial variables begin to turn around. So long as exchange rates are

weakening or stock prices falling, it is not clear where the bottom lies. But once the bottom has been reached, the losses are at least capped and the worst is known. However, to truly measure recovery, stabilization of exchange rates or interest rates is not enough. People do not live off exchange rates or interest rates. Workers care about jobs and wages. Although the unemployment rate and real wages may have bottomed out, that is not enough for the worker who remains unemployed or who has seen his income fall by a quarter. There is no true recovery until workers return to their jobs and wages are restored to precrisis levels. Today, incomes in the countries of East Asia affected by the crisis are still 20 percent below what they would have been had their growth continued at the pace of the previous decade. In Indonesia, output in 2000 was still 7.5 percent lower than in 1997, and even Thailand, the IMF's best pupil, had not attained its pre-crisis level, let alone made up for the lost growth. This is not the first instance of the IMF declaring victory prematurely: Mexico's crisis in 1995 was declared over as soon as the banks and international lenders started to get repaid; but five years after the crisis, workers were just getting back to where they were beforehand. The very fact that the IMF focuses on financial variables, not on measure of real wages, unemployment, GDP, or broader measures of welfare, is itself telling.

The question of how best to manage a recovery is difficult, and the answer clearly depends on the cause of the problem. For many downturns, the best prescription is the standard Keynesian one: expansionary fiscal and monetary policy. The problems in East Asia were more complicated, because *part* of the problem was weaknesses in finance—weak banks and firms with excess leverage. But a deepening recession makes these problems worse. Pain is not a virtue in its own right; pain by itself does not help the economy; and the pain caused by IMF policies, deepening recession, made recovery more difficult. Sometimes, as in Latin America, in Argentina, Brazil, and a host of other countries during the 1970s, crises are caused by profligate governments spending beyond their means, and in those cases, the government will need to cut back expenditures or increase taxes —decisions which are painful, at least in the political sense. But because East Asia had neither loose monetary policies nor profligate public sectors—inflation was low and stable, and budgets prior to the crisis were in surplus—those were not the right measures for dealing with East Asia's crisis.

The problem with the IMF's mistakes is that they are likely to be long-lasting. The IMF often talked as if what the economy needed was a good purgative. Take the pain; the deeper the pain, the stronger the subsequent growth. In the IMF theory, then, a country concerned about its *long-run* prospects—say twenty years from now—should swallow hard and accept a deep downturn. People today would suffer, but their children at least would be better off. Unfortunately, the evidence does not support the IMF's theory. An economy which has a deep recession may grow faster as it recovers, but it never makes up for the lost time. The deeper today's recession, the lower the likely income even twenty years from now. It is not, as the IMF claims, that they are likely to be better off. The effects of a recession are long-lasting. There is an important implication: The deeper the recession today, not only is output lower today, but the lower output is likely to be for years to come. In a way, this is good news, since it means that the best medicine for today's health of the economy and the best medicine for tomorrow's coincide. It implies that economic policy should be directed at minimizing the depth and duration of any

economic downturn. Unfortunately, this was neither the intention nor the impact of the IMF prescriptions.

Malaysia and China

By contrasting what happened in Malaysia and in China, two nations that chose not to have IMF programs, with the rest of East Asia, which did, the negative effects of the IMF policies will show clearly. Malaysia was severely criticized during the crisis by the international financial community. Though Prime Minister Mahathir's rhetoric and human rights policies often leave much to be desired, many of his economic policies were a success. Malaysia was reluctant to join the IMF program, partly because officials there did not want to be dictated to by outsiders but also because they had little confidence in the IMF. Early on in the 1997 crisis, IMF chief Michael Camdessus announced that Malaysia's banks were in a weak position. An IMF/World Bank team was quickly dispatched to look at the country's banking system. While there was a high level of nonperforming loans (15%), Malaysia's Central Bank had imposed strong regulations which had resulted in banks making adequate provisions for these losses. Moreover, Malaysia' strong regulatory stance had prevented banks from exposure to foreign exchange volatility (the danger of borrowing in dollars and lending in ringgit), and had even limited the foreign indebtedness of the companies to which these banks lent (precautionary prescriptions which were, at the time, not part of the IMF standard package).

The standard way to assess the strength of a banking system is to subject it, in simulation exercises, to stress tests and evaluate its response under different economic circumstances. The Malaysian banking system fared quite well. Few banking systems could survive a long recession, or a depression, and Malaysia's was no exception; but Malaysia's banking system was remarkably strong. During one of my many visits to Malaysia, I saw the discomfort of the IMF staffers writing the report: how to formulate it without contradicting the managing director's assertions and yet remain consistent with the evidence.

Within Malaysia itself, the issue of the appropriate response to the crisis was hotly debated. Finance Minister Anwar Ibrahim proposed "an IMF program without the IMF," that is, raising interest rates and cutting back on expenditures. Mahathir remained skeptical.

Eventually, he dumped his finance minister and economic policies were reversed.

As the regional crisis grew into a global crisis, and international capital markets went into a seizure, Mahathir acted again. In September 1998, Malaysia pegged the ringgit at 3.80 to the dollar, cut interest rates, and decreed that all offshore ringgit be repatriated by the end of the month. The government also imposed tight limits on transfers of capital abroad by residents in Malaysia and froze the repatriation of foreign portfolio capital for twelve months.

These measures were announced as short term, and were carefully designed to make it clear that the country was not hostile to long-term foreign investment. Those who had invested money in Malaysia and had profits were allowed to take them out. On September 7, 1998, in a now-famous column in *Fortune* magazine, the noted economist Paul Krugman urged Mahathir to impose capital controls. But he was in the minority. Malaysia's Central Bank governor Ahmad Mohamed Don and his deputy, Fong Weng Phak, both resigned, reportedly because they disagreed with the imposition of the controls. Some economists—those from Wall Street joined by the IMF—predicted disaster when the controls were imposed, saying foreign investors would be scared off

for years to come. They expected foreign investment to plummet, the stock market to fall, and a black market in the ringgit, with its accompanying distortions, to form. And, they warned, while the controls would lead to a drying up of capital *inflows*, they would be ineffective in stopping capital *outflows*. Capital flight would occur anyway. Pundits predicted that the economy would suffer, growth would be halted, the controls would never be lifted, and that Malaysia was postponing addressing the underlying problems. Even Treasury Secretary Robert Rubin, usually of such quiet demeanor, joined in the communal tongue-lashing.

In fact, the outcome was far different. My team at the World Bank worked with Malaysia to convert the capital controls into an exit tax. Since rapid capital flows into or out of a country cause large disturbances, they generate what economists call “large externalities”—effects on other, ordinary people not involved in these capital flows. Such flows lead to massive disturbances to the overall economy. Government has the right, even the obligation, to take measures to address such disturbances. In general, economists believe that market-based interventions such as taxes are more effective and have fewer adverse side effects than direct controls, so we at the World Bank encouraged Malaysia to drop direct controls and impose an exit tax. Moreover, the tax could be gradually lowered, so that there would be no large disturbance when the interventions were finally removed.

Things worked just as planned. Malaysia removed the tax just as it had promised, one year after the imposition of controls. In fact, Malaysia had once before imposed temporary capital controls, and had removed them as soon as things stabilized. This historical experience was ignored by those who attacked the country so roundly. In the one-year interim, Malaysia had restructured its banks and corporations, proving the critics, who had said that it was only with the discipline that comes from free capital markets that governments ever do anything serious, wrong once again. Indeed, it had made far more progress in that direction than Thailand, which followed the IMF prescriptions. In retrospect, it was clear that Malaysia’s capital controls allowed it to recover more quickly, with a shallower downturn,15 and with a far smaller legacy of national debt burdening future growth. The controls allowed it to have lower interest rates than it could otherwise have had; the lower interest rates meant that fewer firms were put into bankruptcy, and so the magnitude of publicly funded corporate and financial bailout was smaller. The lower interest rates meant too that recovery could occur with less reliance on fiscal policy, and consequently less government borrowing. Today, Malaysia stands in a far better position than those countries that took IMF advice. There was little evidence that the capital controls discouraged foreign investors. Foreign investment actually increased.16 Because investors are concerned about economic stability, and because Malaysia had done a far better job in maintaining that stability than many of its neighbors, it was able to attract investment.

CHINA WAS THE other country that followed an independent course. It is no accident that the two large developing countries spared the ravages of the global economic crisis—India and China—both had capital controls. While developing world countries with liberalized capital markets actually saw their incomes decline, India grew at a rate in excess of 5 percent and China at close to 8 percent. This is all the more remarkable given the overall slowdown in world growth, and in trade in particular, during that period. China achieved this by following the

prescriptions of economic orthodoxy. These were not the Hooverite IMF prescriptions, but the standard prescriptions that economists have been teaching for more than half a century: When faced with an economic downturn, respond with expansionary macroeconomic policy. China seized the opportunity to combine its short-run needs with long-run growth objectives. The rapid growth over the preceding decade, anticipated to continue into the next century, created enormous demands on infrastructure. There were large opportunities for public investments with high returns, including projects underway that were sped up, and projects that were already designed but had been put on the shelf for lack of funds. The standard medicines worked, and China averted a growth slowdown.

While making economic policy decisions, China was aware of the link between macrostability and its microeconomy. It knew that it needed to continue restructuring its corporate and financial sector. However, it also recognized that an economic slowdown would make it all the more difficult to proceed with a reform agenda. An economic slowdown would throw more firms into distress and make more loans nonperforming, thereby weakening the banking system. An economic slowdown would also increase unemployment, and rising unemployment would make the social costs of restructuring the state enterprises much higher. And China recognized the links between economics and political and social stability. It had in its recent history all too often experienced the consequences of instability, and wanted none of that. In all respects, China fully appreciated the *systemic* consequences of macroeconomic policies, consequences that the IMF policies habitually overlooked.

This is not to say that China is out of the woods. The restructuring of its banking and state-owned enterprises still represents a challenge for it in the years ahead. But these are challenges that can be far better addressed in the context of a strong macroeconomy.

Though the differences in individual circumstances make the reasons either for the occurrence of a crisis or for quick recovery hard to ascertain, I think it is no accident that the only major East Asian country, China, to avert the crisis took a course directly opposite that advocated by the IMF, and that the country with the shortest downturn, Malaysia, also explicitly rejected an IMF strategy.

Korea, Thailand, and Indonesia

Korea and Thailand provide further contrasts. After a short period of policy vacillation from July through October 1997, Thailand followed IMF prescriptions almost perfectly. Yet more than three years after the beginning of the crisis, it was still in recession, with a GDP approximately 2.3 percent below the pre-crisis level. Little corporate restructuring had taken place, and close to 40 percent of the loans were still nonperforming.

In contrast, Korea did not close down banks according to the standard IMF prescription, and the Korean government, like Malaysia's, took a more active role in restructuring corporations. Moreover, Korea kept its exchange rate low, rather than letting it rebound. This was ostensibly to enable it to reestablish its reserves, since by buying dollars for its reserves it depressed the value of the won. Actually, Korea kept the exchange rate low in order to sustain exports and limit imports. Moreover, Korea did not follow the IMF's advice concerning *physical* restructuring. The IMF acted as if it knew more about the global chip industry than these firms who had made it their business, and argued that Korea should quickly get rid of the excess capacity. Korea, smartly, ignored this

advice. As the demand for chips recovered, the economy recovered. Had the IMF's advice been followed, the recovery would have been far more muted.

In evaluating the recoveries, most analysts put Indonesia aside, simply because the economy has been dominated by political events and social turmoil. However, the political and social turmoil are themselves attributable in no small measure to IMF policies, as we have seen. No one will know whether there could have been a more graceful transition from Suharto, but few would doubt that it could have been more tumultuous.

Effects on the Future

Despite the many hardships, the East Asian crisis has had salutary effects. East Asian countries will undoubtedly develop better financial regulatory systems, and better financial institutions overall. Though its firms had already demonstrated a remarkable ability to compete in the global marketplace, Korea is likely to emerge with a more competitive economy. Some of the worst aspects of corruption, the so-called crony capitalism, will have been checked.

However, the manner in which the crisis was addressed—particularly the use of high interest rates—is likely to have a significantly adverse effect on the region's intermediate, and possibly long-term, economic growth. There is a certain irony in the central reason for this. Weak, underregulated financial institutions are bad because they lead to bad resource allocations. While East Asia's banks were far from perfect, over the preceding three decades their achievements in allocating the enormous flows of capital were, in fact, quite impressive—this was what sustained their rapid growth. Although the intention of those pushing for "reforms" in East Asia was to improve the ability of the financial system to allocate resources, in fact, the IMF's policies are likely to have impaired the *overall* efficiency of the market.

Around the world, very little new investment is financed by raising new equity (selling shares of stock in a company). Indeed, the only countries with widely diversified share ownership are the United States, the United Kingdom, and Japan, all of which have strong legal systems and strong shareholder protections. It takes time to develop these legal institutions, and few countries have succeeded in doing so. In the meantime, firms around the world must rely on debt. But debt is inherently risky. IMF strategies, such as capital market liberalization and raising interest rates to exorbitant levels when a crisis occurs, make borrowing even riskier. To respond rationally, firms will engage in lower levels of borrowing and force themselves to rely more heavily on retained earnings. Thus growth in the future will be constrained, and capital will not flow as freely as it otherwise would to the most productive uses. In this way, IMF policies lead to less efficient resource allocation, particularly capital allocation, which is the scarcest resource in developing countries. The IMF does not take this impairment into account because its models do not reflect the realities of how capital markets actually work, including the impact of the imperfections of information on capital markets.

EXPLAINING THE MISTAKES

While the IMF now agrees it made serious mistakes in its fiscal policy advice, in how it pushed bank restructuring in Indonesia, in perhaps pushing capital market liberalization prematurely, and in underestimating the importance of the interregional impacts, by which the downfall of one country contributed to that of its neighbors, it has not admitted to the mistakes in its monetary policy, nor has it even sought to explain why its models failed so

miserably in predicting the course of events. It has not sought to develop an alternative intellectual frame—implying that in the next crisis, it may well make the same mistakes. (In January 2002, the IMF chalked up one more failure to its credit—Argentina. Part of the reason is its insistence once again on contractionary fiscal policy.)

Part of the explanation of the *magnitude* of the failures has to do with hubris: no one likes to admit a mistake, especially a mistake of this magnitude or with these consequences. Neither Fischer nor Summers, neither Rubin nor Camdessus, neither the IMF nor the U.S. Treasury wanted to think that their policies were misguided. They stuck to their positions, in spite of what I viewed as overwhelming evidence of their failure. (When the IMF finally decided to support lower interest rates and reversed its support for fiscal contraction in East Asia, it said it was because the time was right. I would suggest that it reversed courses partly due to public pressure.)

But in Asia other theories abound, including a conspiracy theory that I do not share which views the policies either as a deliberate attempt to weaken East Asia—the region of the world that had shown the greatest growth over the previous forty years—or at least to enhance the incomes of those on Wall Street and the other money centers. One can understand how this line of thinking developed: The IMF first told countries in Asia to open up their markets to hot short-term capital. The countries did it and money flooded in, but just as suddenly flowed out. The IMF then said interest rates should be raised and there should be a fiscal contraction, and a deep recession was induced. As asset prices plummeted, the IMF urged affected countries to sell their assets even at bargain basement prices. It said the companies needed solid foreign management (conveniently ignoring that these companies had a most enviable record of growth over the preceding decades, hard to reconcile with bad management) and that this would only happen if the companies were sold to foreigners—not just managed by them. The sales were handled by the same foreign financial institutions that had pulled out their capital, precipitating the crisis. These banks then got large commissions from their work selling the troubled companies or splitting them up, just as they had got large commissions when they had originally guided the money into the countries in the first place. As the events unfolded, cynicism grew even greater: some of these American and other financial companies didn't do much restructuring; they just held the assets until the economy recovered, making profits from buying at the fire sale prices and selling at more normal prices.

I believe that there is a simpler set of explanations—the IMF was not participating in a conspiracy, but it was reflecting the interests and ideology of the Western financial community. Modes of operation which were secretive insulated the institution and its policies from the kind of intensive scrutiny that might have forced it to use models and adopt policies that were appropriate to the situation in East Asia. The failures in East Asia bear much in common with those in development and in transition, and in chapters 8 and 9 we will take a closer look at the common causes.

AN ALTERNATIVE STRATEGY

In response to the complaints I continue to raise about the IMF-Treasury strategy, my critics have rightly asked what I would have done. This chapter has already hinted at the basic strategy: Maintain the economy at as close to full employment as possible. Attaining that objective, in turn, entails an expansionary (or at least not contractionary) monetary and fiscal policy, the exact mix of which would

depend on the country in question. I agreed with the IMF on the importance of financial restructuring—addressing the problems of weak banks—but I would have approached it totally differently, with a primary objective of maintaining the flow of finance, and a standstill on existing debt repayment: a debt restructuring, such as that which eventually worked for Korea.

Maintaining the flow of finance, in turn, would require greater efforts at restructuring existing institutions. And a key part of corporate restructuring would entail the implementation of a special bankruptcy provision aimed at the quick resolution of distress resulting from the macroeconomic disturbances that were well beyond the normal. The U.S. bankruptcy code has provisions which allow for relatively quick reorganization of a firm (rather than liquidation), called *Chapter 11*. Bankruptcy induced by macroeconomic disturbances, as in East Asia, call for an even faster resolution—in what I refer to as a *super-Chapter 11*.

With or without such a provision, strong intervention of government was required. But the intervention of the government would have aimed at financial restructuring—establishing clear ownership of firms, enabling them to reenter credit markets. That would have enabled them to take full advantage of the opportunities for export that resulted from their lower exchange rate. It would have eliminated the incentive for asset stripping; it would have provided them with strong incentives to engage in any real restructuring that was required—and the new owners and managers would have been in a far better position to guide this restructuring than international or domestic bureaucrats, who, as the expression goes, had never met a payroll. Such financial restructuring did not require huge bailouts. The disillusionment with the large bailout strategy is now almost universal. I cannot be sure that my ideas would have worked, but there is little doubt in my mind that the chance of success with this strategy was far greater than with the IMF's plan, which failed in ways that were perfectly predictable, at huge costs.

The IMF did not learn quickly from its failures in East Asia. With slight variants, it repeatedly tried the large bailout strategy. With the failures in Russia, Brazil, and Argentina, it has become clear that an alternative strategy is required, and there is today increasing support for at least some of the key elements of the approach I have just described. Today, five years after the onset of the crisis, the IMF and the G-7 are all talking about giving greater emphasis to bankruptcy and standstills (short-term freezes on payments), and even the temporary use of capital controls. We will return to these reforms later, in chapter 9.

THE ASIAN CRISIS has brought many changes that will stand the countries in good stead in the future. Corporate governance and accounting standards have improved—in some cases putting these countries toward the top of the emerging markets. The new constitution in Thailand promises a stronger democracy (including a provision embracing the citizens' "right to know," not even included in the U.S. Constitution), promising a level of transparency certainly beyond that of the international financial institutions. Many of these changes put in place conditions for even more robust growth in the future.

But offsetting these gains are some real losses. The way the IMF approached the crisis has left in most of the countries a legacy of private and public debt. It has not only frightened firms off the excessively high debt that characterized Korea, but even off more cautious debt levels: the exorbitant interest rates forcing thousands of firms

into bankruptcy showed how even moderate levels of debt could be highly risky. As a result, firms will have to rely more on self-finance. In effect, capital markets will work less efficiently—a casualty too of the IMF's ideological approach to improving market efficiency. And most important, growth of living standards will be slowed.

The IMF policies in East Asia had exactly the consequences that have brought globalization under attack. The failures of the international institutions in poor developing countries were longstanding; but these failures did not grab the headlines. The East Asia crisis made vivid to those in the more developed world some of the dissatisfaction that those in the developing world had long felt. What took place in Russia through most of the 1990s provides some even more arresting examples why there is such discontent with international institutions, and why they need to change.