

## Economic Development and Regional Cooperation in East Asia

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The East Asian region has suffered from a certain lack of confidence since the regional financial crisis of 1997–98. The earlier hubris, even conceit, following the East Asian miracle disappeared with the East Asian debacle. This came several years after the Japanese big bang, another disaster due to ill-considered financial liberalization. East Asian developments since then, especially greater regional cooperation, offer interesting lessons about the potential and limitations of the responses.

### **The East Asian miracle and differences within the region**

A dominant explanation for the East Asian miracle—sustained and rapid economic growth in the 1970s and 1980s—saw the phenomenon as essentially due to unfettered market forces (Little, Scitovsky, and Scott 1970). The obvious policy implication was to liberalize, open up, and globalize.

There were other, far less prominent efforts to explain the East Asian miracle, including heterodox viewpoints invoking institutionalist, evolutionary, post-Keynesian perspectives and so on.

During the 1980s, several influential Western authors recast the Northeast Asian experience separately in terms of the so-called developmental state, a conception that was nearly opposite to the emphasis on unfettered market forces (for example, see Johnson 1982; White 1988; Amsden 1989; Wade 1990). Others insisted on Northeast Asian exceptionalism, which was attributed to unique cultural or historical circumstances such as Confucianism and the Cold War. Hence, for them, Northeast Asia was deemed unsuitable for emulation.

Instead, Southeast Asia was promoted as the model for emulation, particularly by other developing countries and especially after the economic liberalization of the economies of Indonesia, Malaysia, and Thailand beginning in the mid-1980s.

Some heterodox economists from the region dissented, arguing that the *East Asian Miracle* volume (World Bank 1993), for example, failed to acknowledge Southeast Asia's inferior achievements. Our dissenting book (Jomo et al. 1997) was published the day before the East Asian financial crisis broke in Bangkok on 2 July 1997 and was wrongly credited with having predicted the debacle, which it had not done. Rather, we argued that the Southeast Asian success was much more modest than that of Northeast Asia and that the lessons being drawn from the region's experience were misleading, especially because they understated the role of government interventions in the region's economies. Furthermore, the average annual growth of the economies of Indonesia, Malaysia, and Thailand was about 6 percent, compared to about 8 percent for the East Asian newly industrializing economies before the 1990s. With far higher population growth in Southeast Asia, the actual difference in per capita terms was closer to 3 percent.

In Northeast Asia, domestic entrepreneurship and financial resources were more important, and foreign direct investment (FDI) accounted for less than 2 percent of gross domestic capital formation, whereas FDI was far more important in some countries of Southeast Asia than it was in most other developing countries.

Not surprisingly, no significant industrial entrepreneurial class has emerged in Southeast Asia, and this, in turn, accounts for the dominance of rentier elements particularly associated with finance capital. Southeast Asia has also been far more unequal than Northeast Asia. Many reforms in Northeast Asia were anticommunist in inspiration, such as Japanese stakeholder capitalism and the land reforms in Japan, the Republic of Korea, and Taiwan (China). Such initial conditions helped create more egalitarian, rapidly growing economies in which more people felt they had a stake.

There have also been other important policy differences within the East Asian region. For instance, there have been very few trade policy interventions in Singapore and Hong Kong (China). Not surprisingly, then, Hong Kong has been de-industrializing for well over two decades. While Singapore's industrialization has been led by proactive, selective interventions to attract foreign manufacturers such as through so-called free trade areas, the region's free trade areas are actually preferential trade areas. Recent free trade agreements have had little to do with traditional trade issues per se; they have had much more to do with strengthening intellectual property rights, investment incentives, and other privileges that have only mixed consequences on economic development.

Southeast Asia has inadvertently encouraged industrial dualism, while earlier attempts to promote import-substituting industries were followed by the promotion of export processing zones and licensed manufacturing warehouses. There is generally little integration of these manufacturing enclaves with the rest of the national economy, quite unlike the situation in Northeast Asia, where effective protection has often been conditional on export promotion. In other words, industries and firms have been provided with protection and other subsidies, but have also been required to export, so that production for the domestic market leads to production for export, unlike in Southeast Asia, where there is little connection between the two.

### **Market failure, government intervention, and other policy issues**

A different view about the East Asian miracle came about because of a rather fortuitous change in circumstances. Most importantly, beginning in the mid-1980s, the appreciation of the Japanese yen with respect to the U.S. dollar and an increase in Japan's efforts in official development assistance made Japan the second largest contributor to this sort of assistance after the United States. With its new clout, Japan insisted that the World Bank should reflect on why countries that had been following the structural adjustment prescriptions of the 1980s were experiencing only slow per capita growth, if not economic contraction, as well as greater inequality, as in, for example, much of Africa and Latin America. In contrast, much of East Asia, which had adopted more heterodox policies, was experiencing sustained high growth, often with only a little worsening in inequality, until the greater financial liberalization starting in the late 1980s.

The World Bank, meanwhile, argued that there should be a distinction between functional and strategic state interventions. Functional interventions were justified by the concept of market failure. In the face of market failures, governments needed to intervene by providing sound macroeconomic management, physical infrastructure, social services (particularly in health care and education), and other basic state functions such as ensuring the rule of law and so on. For the Bank, since the other sort of interventions—the strategic ones—were not justifiable in terms of market failure, they were likely to fail and should therefore not be pursued. Using moot methodologies, it proceeded to argue that trade policies, as well as industrial policies, had

basically failed, though the contribution of directed credit was conceded.<sup>1</sup>

The concept of market failure in economics assumes an inexorable systemic tendency to achieve equilibrium. But even if this is the case, achieving equilibrium has little to do with economic development. The concept of efficient market allocation is based on comparative statics, not on structural transformation to achieve new comparative advantage in a dynamic sense. In the real world, achieving economies of scale is important, especially for economic development, rather than the constant or declining returns assumed in economic models. The challenge is to identify and promote economic activities offering increasing returns to scale, as opposed to activities only offering decreasing returns such as agriculture. This has been the premise for favoring industrialization and for promoting infant industries.

Over the 20th century, there was a secular long-term tendency for the terms of trade of primary commodities to decline against manufactured goods, as suggested by Singer (1950) and Prebisch (1950). The decline in the terms of trade of tropical primary commodities against their temperate counterparts—observed by Arthur Lewis, in, for example, cotton versus wool—has also persisted over recent decades. More recently, in the last three or four decades, there has also been a significant decline in the terms of trade of generic manufactures, that is, those manufactures produced by industries with few entry barriers, compared to products strongly protected by monopolistic intellectual property rights.

The success of well-considered government intervention and its crucial role in late industrialization and economic development all over the world are important reasons for insisting on industrial or investment policy. Besides trade, there are other areas in which such policies have been important in East Asia. Examples are promoting new technology, improving human resources, and offering appropriate investment incentives conditional on meeting performance criteria such as effective protection that is conditional on export targets or export promotion. Preferential credit for desired economic activities and the converse for undesired activities have been justified by the idea of financial restraint, instead of the notion of financial repression, justifying financial liberalization.<sup>2</sup>

In a world of imperfect competition, then, profit maximization inevitably involves rent seeking. The key policy challenge becomes one of managing rents and of minimizing waste in the creation and distribution of rents.

### **Financial liberalization: the onset of crisis and beyond**

Financial liberalization has been the corollary of the rise of finance capital in the last three decades, especially after the demise of the Bretton Woods system, closely associated with the postwar Keynesian Golden Age when there was relatively rapid growth and some decline in inequality not only internationally, but also within most economies, partly because of social policies in Europe and Japan.

Financial liberalization has had adverse consequences for the developing world, undermining financial arrangements, institutions, and relations conducive to overcoming economic backwardness and market failure problems (Gerschenkeron 1962). To make matters worse, most advocates of financial liberalization have ignored the warnings of the gurus of financial liberalization. For example, McKinnon (1989) emphasized that correct sequencing is necessary in pursuing financial liberalization, and capital account liberalization should come last, rather than first as in some East Asian economies before the 1997–98 crisis.

Financial liberalization seemed to be associated with the regional boom beginning in the

late 1980s. In much of Southeast Asia, a series of devaluations in Indonesia, Malaysia, and Thailand and some financial liberalization in the mid-1980s were followed by a decade-long boom from the late 1980s until the 1997–98 crisis. There were three devaluations in Indonesia, one in Malaysia, and another in Thailand. This series of devaluations made production costs much cheaper, attracting investments for the boom. But the U.S. dollar pegs of the currencies of Indonesia, Malaysia, and Thailand became more problematic after mid-1995, when Eisuke Sakakibara, then Japanese vice minister for international affairs in the Ministry of Finance, and Larry Summers, then U.S. deputy treasury secretary, agreed to reverse the *endaka* (high yen) by letting the U.S. dollar appreciate against the yen after a decade of yen appreciation.

Other policy changes accompanying devaluation were also important. The Japanese Ministry of International Trade and Industry adopted a new Asia industrial development regional policy, encouraging Japanese firms to relocate not only in the East Asian newly industrialized economies of Korea, Hong Kong, Singapore, and Taiwan, but especially in the Southeast Asian newly industrializing countries, as well as China. Toward the end of the Chiang Ching-kuo era and with Lee Teng-hui's presidency in Taiwan Province, the government encouraged Taiwanese companies to move south to Southeast Asia, instead of to the mainland, fearing problems from closer integration with the mainland.

Korean efforts to relocate in Southeast Asia were much more modest and largely limited to Indonesia and Vietnam. Singapore's Sijori (Singapore-Johor-Riau) growth triangle initiative with neighboring Johor in Malaysia and Riau in Indonesia beginning in 1986 was followed by other efforts to integrate with China (for example, Suzhou) and India (for example, Bangalore), with rather mixed consequences. Meanwhile, Hong Kong was de-industrializing, and manufacturing was being relocated to the Pearl River delta and beyond.

The impact of financial liberalization in East Asia proved disastrous, starting with the fallout from the big bang in Japan in the late 1980s and its near moribund economy in the decade and a half thereafter. Korea accelerated capital account liberalization to join the Organisation for Economic Co-operation and Development in the early 1990s, distorting the financial incentives for Korean conglomerate (*chaebol*) behavior, again with disastrous consequences. In Indonesia, bank proliferation starting in 1988 undermined monitoring and supervision, with cataclysmic consequences. In Thailand, the postcoup 1993 Bangkok International Banking Facility and the 1994 provincial counterpart had problematic consequences, culminating in the 1997–98 regional crisis.

After a serious banking crisis in the late 1980s, when the share of nonperforming loans reached 30 percent of the total commercial bank loan portfolio, the Malaysian authorities became more cautious with bank regulation. While careful about foreign bank borrowing, the Malaysian authorities aggressively promoted the stock market, especially after the break with the Singapore stock exchange in 1990. These successful efforts to promote the stock exchange in Malaysia attracted tremendous inflows of portfolio investment funds, particularly in 1992–93, which were subsequently reversed, with adverse consequences at the end of 1993. In early 1994, the Malaysian government temporarily introduced capital controls on inflows; these were subsequently removed after intense lobbying, leading to a new stock market bubble in 1995–96 that attracted fresh inflows.

Has international financial liberalization delivered on its own promises, even if not according to developmental criteria? Advocates of international financial liberalization have made three major claims. First, there should have been flows of funds from capital-rich to capital-poor economies. But, for most of Africa, Asia, Latin America, and the so-called

transitional economies, the net flows of funds have actually been in the opposite direction, from the poor to the rich economies. East Asia was an exception in the early and mid-1990s, as finance followed investment and growth. Second, financial liberalization promised to lower the cost of funds. However, the cost of funds has not gone down, but has actually gone up until recently, increasing financial rents in the economies of the Organisation for Economic Co-operation and Development. Third, financial liberalization also promised lower volatility and greater stability with financial deepening, especially with the development and availability of new financial derivatives. However, although new financial derivatives have reduced some old sources of volatility and instability, they have also introduced new sources of the same, notably hedge funds (de Brouwer 2001).

Two other adverse implications of international financial liberalization should also be mentioned here. With financial liberalization, financial interests have become far more influential. They have influenced public policy, with typically deflationary consequences. The trend in the last two decades toward more independent central banks has actually reduced the monetary policy discretion available to governments, besides reducing financial policy instruments for economic development. The recent emphasis on inflation targeting, rather than growth or employment targeting, has also resulted in slower employment expansion and growth because of the prioritization of deflationary macroeconomic policies. Financial liberalization has likewise undermined crucial financial industrial policy instruments for accelerating industrialization and other desired structural transformations.<sup>3</sup>

Massive capital inflows are presumed to have desirable consequences for economic growth somehow, though there is little empirical basis for this assumption. By their very nature, short-term inflows rarely contribute to real capital formation and, hence, to growth. Many East Asian countries have adopted monetary policies (for example, sterilization) to limit the adverse consequences of massive capital inflows into their economies, but these also reduce possible gains from such inflows. The claim that massive capital flows would be desirable for economic development is thus misleading.

Instead, massive capital flows have often had adverse consequences. First, there have been asset market bubbles—mainly in the stock and real property markets—and, consequently, the associated construction booms, which have often worsened trade deficits. Second, consumption binges tend to be fuelled by cheap credit; thus, the number of luxury cars sold in Thailand during the mid-1990s rose sharply. Not surprisingly, much of the elite and middle class like and support these financial policies, which do not contribute to and may even undermine the long-term development of these economies. Third, the availability of more and cheaper funds may encourage the misallocation of investment funds. While this may be true, the actual significance may be exaggerated by casual empiricism citing misleading anecdotal examples,<sup>4</sup> as in East Asia.

Various circumstances led to the 1997–98 crisis, including domestic and international financial liberalization and the mid-1995 Sakakibara-Summers reversal of the previous decade's dollar depreciation and rising yen. With this reversal, currency speculators began to look for new opportunities. With cheaply available foreign credit mainly denominated in U.S. dollars (even by European and Japanese banks), powerful vested interests in Southeast Asia wanted their currencies to continue to be pegged to the U.S. dollar, although such pegs would now render Southeast Asian economies less competitive.

The foreign debt buildup was mainly short term, rather than long term, even when the debt was deployed for long-term investments, primarily because of the Bank for International

Settlements' capital adequacy requirements encouraging short-term lending. Stock markets in so-called emerging markets have been especially fickle and vulnerable to herd behavior by portfolio investors. A significant buildup of foreign assets in regional markets increased the likelihood of contagion from abroad. In Southeast Asia, such external shocks were exacerbated by the official policy responses of authorities in the region, often seriously compromised by influential vested interests, though such cronyism alone could not have caused the debacle.

Thus, economic vulnerability had been greatly increased by ill-considered economic liberalization policies, especially financial liberalization. Also, the initial policy responses in the region to the unfolding crisis were generally procyclical, as recommended or required by international financial institutions, especially the International Monetary Fund (IMF), and desired by market pundits in the business media. Such procyclical policy responses exacerbated the situation in Southeast Asia. Western-trained economists had imbibed currency crisis theories that did not take into account the different circumstances in the region relative to Latin America, for example. Also, many policies recommended to or even forced upon governments in the region were politically biased. For instance, in late 1997 and early 1998, the IMF favored the expanded "Berkeley mafia" in Indonesia and largely acted in concert with them, rather than on the basis of an informed, independent assessment of actual conditions in Indonesia and the causes of these conditions.

By early 1998, however, it was clear that IMF solutions were part of the problem, and there was a substantial shift away from the original diagnosis of the Asian crisis as a currency crisis. Instead, Asian values and business practices were blamed, especially poor corporate governance. Thus, social capital and corporatism were portrayed as cronyism, and profit maximization became rent seeking, as the earlier alleged foundations for the East Asian miracle were turned on their head in the wake of the debacle.

In the first year of the crisis, the tendency among pundits, particularly in the international business press, was to blame the victims and condemn the East Asian economies for alleged malpractices and so on. In mid-1998, U.S. President Clinton and others started talking about the desirability of a new international financial architecture, implicitly recognizing that the international monetary and financial system had developed in an ad hoc fashion after the Bretton Woods system had been undermined by U.S. President Nixon in 1971.

This change of heart was encouraged by the apparent spread of the crisis to Russia in August 1998. The crisis in Brazil and Russia precipitated the collapse of Long-Term Capital Management, a hedge processing fund. Fears that this collapse would have major repercussions on Wall Street encouraged the Federal Reserve Bank of New York to coordinate a private bailout of Long-Term Capital Management. The U.S. Federal Reserve then lowered interest rates—reversing the outflow of funds from East Asia—in the last quarter of 1998, thereby facilitating economic recovery in the region.

Economic recovery in the following period, especially in 1999 and 2000, was strongest in Korea. In Southeast Asia, the recovery started later, but was stronger in Malaysia compared to Indonesia and Thailand. When the Malaysian government introduced capital controls in September 1998, orthodox economists insisted that the measures would be disastrous. Although it is not possible to attribute Malaysia's strong recovery definitively to the capital controls, there is also no proof that the capital controls caused any significant harm to the Malaysian economy (Jomo 2003).

In the 1990s, more than 80 percent of foreign direct investment consisted of mergers and acquisitions—mainly acquisitions, rather than mergers—in emerging markets. World FDI also

declined beginning in the mid-1990s. Much more of the FDI going to East Asia now goes to China, with the proportion rising in less than a decade from under two fifths to over two thirds.

China's labor surplus economy has meant that its productivity gains have translated into consumer price deflation there. Consequently, China has become even more competitive, especially with its improving industrial policy initiatives. Thus, contrary to conventional wisdom, a state-owned enterprise, Shanghai Baosteel Group Corporation, has become the most efficient steel producer in the world, overtaking Pohang Steel Corporation (Posco), the Korean state-owned enterprise, once denounced by the World Bank as not worthy of industrial financing. China has thus become an increasingly diverse, formidable, and versatile economic force not only in the region, but in the world.

### **Lessons from the crisis**

Based on the experiences of the 1997–98 East Asian crisis, one might draw six key lessons for international financial reform. First, existing mechanisms and institutions for financial crisis prevention are grossly inadequate. The continuing trend toward financial liberalization is likely to increase, rather than decrease the likelihood, frequency, and severity of currency and financial crises. Outside Malaysia, too little has been done to discourage short-term capital flows, and too much faith has been invested in the protection expected from international adherence to codes and standards (Rodrik 1999).<sup>5</sup> Korea has joined China, Hong Kong, Japan, Singapore, and Taiwan in building up huge foreign currency assets (mainly U.S. dollars), at great cost, for self-insurance. This regional trend has also reduced the role and influence of the IMF in the region following its bitter experiences during the 1997–98 crisis. Financial liberalization has reduced the macroeconomic instruments available to governments for crisis aversion and has often left governments with little choice, except to react procyclically, tending to exacerbate economic downturns. National macroeconomic policy autonomy should be assured so as to enable governments to intervene countercyclically to avoid crises, which have generally had much more devastating consequences in developing countries than elsewhere.

Second, existing mechanisms and institutions for financial crisis management are also grossly inadequate. The greater likelihood, frequency, and severity of currency and financial crises in middle-income developing countries in recent times—with devastating results for the real economy and also for innocent bystanders in the neighborhood, as in the East Asian crisis—make speedy and effective crisis management imperative. There is an urgent need to increase the availability of emergency financing during crisis and to establish new, adequate procedures for timely and orderly debt standstills and workouts.<sup>6</sup> International financial institutions, including regional institutions, should be able to provide adequate countercyclical financing during a crisis (Ocampo 2000).<sup>7</sup> Instead of the current arrangements that tend to privilege foreign creditors, new procedures and mechanisms are required to ensure that foreign creditors also share responsibility for the outcomes of their lending practices.

Third, the agenda for international financial reform should go beyond the recent preoccupation with crisis prevention and resolution to address the declining availability and provision of development finance, especially to small, poor countries (Ocampo 2000) that have very limited and costly access to capital markets. There is growing pressure on the IMF, in particular, to return to its supposed core function of providing emergency credit and supposed core competencies of crisis prevention and crisis mitigation.<sup>8</sup> Furthermore, the World Bank and other multilateral development banks have abandoned or sharply reduced industrial financing,

for example, thereby limiting even further the likelihood that developing countries may secure funding to develop new economic capacities and capabilities. The United Nations Conference on “Financing for Development” in Monterrey, Mexico, in March 2002 did not adequately address this challenge.

Fourth, inertia and vested interests stand in the way of urgently needed international institutional reforms. The governance of existing international financial institutions should be reformed to ensure greater and more equitable developing-country participation in and, hence, ownership of operations, research, and decision making at all levels in various tasks that the international financial system must begin to address more adequately. There is also a related need to consider reducing the concentration of power among peak institutions such as the IMF by, for example, delegating authority to other agencies (for instance, a world financial organization or a world financial authority), as well as by encouraging decentralization, devolution, complementarity, and competition with other international financial institutions, including regional ones.<sup>9</sup>

The exaggerated effects of currency movements for developing countries can only be addressed by greater surveillance and cooperation among the three major international currency issuers, but, unfortunately, there is little evidence that the G-7 or other similar arrangements have had much success in international macroeconomic coordination or even mere monetary coordination in the last two decades. A greater role for the IMF in this regard, especially with a greater voice for developing-country interests, might go a long way, with greater legitimacy, than an arrangement that only involves the major industrial economies. Through the IMF, which they control anyway, the G-7 can more effectively consult developing countries in matters of international macroeconomic governance to minimize oversights, as well as additional loss of legitimacy (Rodrik 1999).

Fifth, the reforms should restore and ensure national economic sovereignty and autonomy, which have been significantly undermined by international liberalization, deregulation, and new regulation and which are essential for more effective macroeconomic management and development efforts. The policy conditionalities<sup>10</sup> accompanying IMF financing must be minimized if not eliminated. It is now clear that one size does not fit all and that externally imposed policies have not contributed much to either economic recovery or growth (Weisbrot, Naiman, and Kim 2000; Weisbrot, Baker, and Rosnick 2005), let alone sustainable development. Such national ownership will ensure greater legitimacy for public policies and must include regulation of the capital account, as well as the choice of the exchange rate regime.<sup>11</sup> Since it is unlikely that international financial reforms will soon adequately provide the global public goods and other affordable international financial services required by most developing countries, it is imperative that, while reforming the international system to serve the needs of these countries more effectively, national policy independence is also assured to serve regulatory and interventionist roles beyond global and regional purview.

Finally, regional monetary cooperation can help in the face of growing capital mobility and the increasing frequency of currency and financial crisis, often with devastating consequences for the real economy. Greater European monetary integration in recent decades arose out of the recognition by governments of their declining sovereignty in the face of expanding capital mobility, especially after their capital accounts were liberalized (Baines 2002). Instead of trying to assert greater national control, with limited efficacy, governments are concluding that regional cooperation is more likely to be effective in the face of the larger magnitude and velocity of capital flows. However, there is no single formula or trajectory for

fostering such cooperation, and such cooperation can probably not be successfully promoted independently of cooperation on other fronts.

Regional arrangements also offer an intermediate alternative between national and global levels of action and intervention and reduce the otherwise monopolistic powers of global institutions or arrangements. To be successful and effective, such regional arrangements must be flexible, but credible and capable of effective countercyclical capacity for crisis prevention, as well as crisis management. In East Asia, the Japanese proposal for an Asian monetary facility soon after the outbreak of the East Asian currency crisis might have made a big difference in checking and managing the crisis, but was thwarted by Western opposition. With the growing reluctance in the West, especially in the United States, to allow the IMF to serve as a lender of last resort (as in the more recent Argentine crisis), there should be more tolerance of regional cooperation in monetary and financial affairs.

### **Regional financial cooperation**

Following the yen appreciation in the mid-1980s, the East Asian region was poised for greater regional cooperation despite lingering resentment of Japanese hegemony because of its unwillingness to atone fully for its wartime record. In response to the failure to conclude the Uruguay Round of the General Agreement on Tariffs and Trade negotiations in December 1989, then Malaysian Prime Minister Mahathir famously called for an East Asian economic grouping. Earlier, Japanese Prime Minister Nakasone's proposal for East Asian economic cooperation had been referred by the Australian government to the United States for approval. The U.S. response was to insist on Pacific rim cooperation in the form of Asia-Pacific Economic Cooperation, which has little to show after a seemingly promising start in the mid-1990s.

The 1997–98 East Asian financial crisis and the international responses to it have profoundly reshaped the region. This is apparent not only in the greater official interest in East Asian—as opposed to Asia-Pacific or Pacific rim—regional cooperation in recent years. The Association of Southeast Asian Nations (ASEAN) seems to have lost some of its earlier relevance and dynamism following its expansion to include Cambodia, Laos, Myanmar, and Vietnam, and the ASEAN Free Trade Area has failed to deliver on expectations.

Yet, the seemingly awkward ASEAN 10+3 East Asian regional arrangement, including the 10 ASEAN members, plus China, Japan, and Korea, has quickly attained an unanticipated relevance in both political and economic spheres. Admittedly, the European attempt at engaging East Asia through the Asia-Europe meetings has not yielded much, but the fate of the effort may well be a reflection of the difficulties of engaging two rather different and varied regions.

Meanwhile, the decline of Asia-Pacific Economic Cooperation has been apparent since the second half of the 1990s. In 1995, the Osaka Summit checked or altered some of the commitments to trade liberalization made only a year earlier. The Western, especially American, response to the regional financial crisis beginning in July 1997 only served to deepen the Pacific gulf. East Asians perceived some Western glee at the end of the Asian miracle, following the Japanese slowdown after its financial big bang less than a decade earlier, when both the IMF and the market quickly blamed the East Asians themselves for the debacle.

Initially, the problems in East Asia were portrayed as similar to those of Latin American macroeconomic populism because they involved fiscal profligacy. The crisis economies were advised or even forced to adopt contractionary fiscal and monetary measures, which only served to exacerbate the crisis, instead of providing the sorely needed countercyclical impetus. After it

became abundantly clear that the East Asian macroeconomic authorities had been fiscally prudent, the IMF reversed itself on fiscal policy, but continued to press for tight monetary measures as the only option consistent with capital account openness.

By early 1998, however, the refrain in Washington had changed. In a succession of speeches at the beginning of the year, U.S. Federal Reserve Board Chairman Alan Greenspan, U.S. Deputy Treasury Secretary Lawrence Summers, and IMF Managing Director Michel Camdessus pronounced the new mantra, blaming the crisis on poor corporate governance in East Asia. Soon, media and academic pundits were waxing eloquent in denouncing the East Asian miracle's ostensible basis in Confucian cultural or social capital because, they said, it was cronyism and stood at the root of the crisis.

Regional responses may actually have reflected growing nationalism when the absence of helpful responses by the West aggravated consternation and resentment. The latter were especially pronounced in long-time U.S. allies such as Korea and Thailand, where the ruling regimes were replaced by the main political opponents. The political discourse turned decidedly nationalist on all sides in Thailand because the crisis provided a rallying point previously absent in a kingdom that had never been formally subjugated by any colonial power. In Korea, the already strong nationalist discourse broadened from its previous anti-Japanese focus, but was also mixed with strong democratic and anti-*chaebol* (anticonglomerate) impulses.

In Malaysia, Prime Minister Mahathir's unorthodox policy responses played to a nationalist gallery as he disguised his use of state resources to save business cronies and the preemptive elimination of his designated successor, generally perceived as the only available political alternative in the long-standing one-party state. In Indonesia, where the crisis was most protracted and economically damaging, opposition to foreign involvement was less significant than the opportunity to get rid of a 32-year-old military despot and his privileged business cronies.

In September 1997, soon after the regional crisis had begun in Thailand on July 2, the Japanese Ministry of Finance proposed a US\$100 billion Asian monetary fund or facility to help authorities in the region cope with the crisis. The initial Chinese response is reported to have been negative because Beijing had not been consulted prior to the announcement and may have been wary of Japanese intentions of strengthening regional hegemony through the new fund, but the Chinese authorities have since been keen to promote this sort of regional cooperation. Japanese Finance Vice Minister for International Affairs Eisuke Sakakibara had assumed there would be U.S. approval for the scheme when he briefed his counterpart, Lawrence Summers, but, instead, faced rebuffs from the United States, as well as the IMF, after the announcement. The United States then convened the Manila Framework Group in November 1997, but offered few real resources, and the group had little perceptible effect. The crisis conditions continued to deteriorate.

Only in mid-1998, a year after the crisis began, did the Clinton administration begin to raise the need for a new international financial architecture. The architecture would avert and manage more effectively the increasing frequency of currency and financial crises following international financial liberalization after the demise of the Bretton Woods system in the early 1970s and the international (sovereign) debt crises of the 1980s. The Russian crisis of August 1998 moved the United States to action. Besides the need to prop up the Yeltsin government after more than a half decade of economic collapse, there was a palpable fear that the East Asian crisis was spreading to the West and threatened other economies closer to home. After the criticism of Asian bailouts as evidence of cronyism, it was proving awkward to need to explain

the coordination by the U.S. Federal Reserve of the initiative to contain the collapse of the hedge fund, Long-Term Capital Management, following the Russian crisis. Soon thereafter, the Federal Reserve lowered interest rates, thereby encouraging funds to flow back to East Asia, which helped to stabilize the region's currencies and enabled a sharp, V-shaped recovery everywhere in the region, except in Indonesia, where new political dynamics compromised the economic recovery effort.

Japanese Finance Minister Miyazawa's new initiative for Asia at the annual IMF–World Bank meetings in October 1998 was warmly welcomed by the United States as the prospect of Latin American crisis loomed large. The quid pro quo involved Japan funding a new short-term IMF facility to bail out Latin American countries, while the U.S. Congress appropriated US\$18 billion for an IMF capital increase (Tadokoro 2003, 232). The Miyazawa initiative offered bilateral assistance of up to US\$30 billion in the form of loans and credit guarantees to help revive the East Asian region's crisis economies. Most importantly, it complemented IMF assistance and was not linked to any alternative multilateral institutional framework for regional cooperation on monetary and financial matters. In the following year, the Japanese established currency-swap backup facilities for the Korean and Malaysian central banks.

Beginning in 1999, the ASEAN+3 finance ministers began meeting annually in conjunction with the Asian Development Bank board of governors meetings (Amyx 2002). At their second meeting in Chiang Mai, Thailand, in May 2000, they announced new arrangements to increase liquidity in the event of a future currency crisis by expanding the existing ASEAN Swap Agreement and setting up a bilateral currency-swap network involving China, Japan, and Korea. Efforts have also been made to enhance related monitoring, surveillance, and training. However, countries need to have an IMF-supported programme in place before they may access more than 10 percent of the available funds. Thus, the funds actually available are even less and can barely be expected to withstand concerted speculative attacks. Most importantly, the arrangements have remained formally bilateral, rather than multilateral, and many of the bilateral currency-swap agreements have not yet actually been signed. Finally, in May 2005, the ASEAN+3 finance ministers agreed to multilateralize the arrangement to enable the relevant bilateral agreements to be collectively activated more promptly in case of emergency.

The memory of the Asian crisis lingers and has encouraged several East Asian economies to develop self-insurance arrangements against the threat of currency crisis. To accomplish this, they have accumulated large foreign exchange reserves, mostly in U.S. Treasury bonds. Such self-insurance is undoubtedly very expensive not only because of the low interest rates accruing to the bonds and the decline of the greenback in recent years, but also because it diminishes funds that might be more productively deployed in an economy or in a region. Recognition of the continuing problems of global and regional hegemony has animated recent debates about alternative arrangements.

The Asian bond market was launched in mid-2003 by the Executives' Meeting of East Asia–Pacific Central Banks. This organization launched the US\$1 billion dollar Asian Bond Fund to invest in U.S. dollar sovereign and quasi-sovereign bonds issued in countries of the organization, except Australia, Japan, and New Zealand. Later that year, ASEAN+3 launched the Asian Bond Markets Initiative to provide the necessary infrastructure for a well-functioning regional bond market. Subsequent developments suggest slow, but steady progress in local-currency bond market development (Chin 2005). Development of the Asian bond market will broaden financial intermediation within the region, encouraging regional recycling of funds without strengthening the banking sector, while reducing vulnerability to currency mismatch

problems.

The two main regional initiatives thus far—the elaborate bilateral currency-swap arrangements for liquidity support and the regional bond market—hardly threaten global hegemonic interests. In fact, development of the regional bond market has secured support from those “outside the region who are eager to benefit from its expected by-products, including financial liberalization and reform in ASEAN+3 economies” (Amyx 2004, 3). After all, the U.S. dollar remains the anchor currency for most Asian monetary authorities maintaining currency pegs.

However, the region, especially China, is also very mindful of the likelihood that Japan will use regional initiatives to its own advantage. During 2001–02, Japanese Ministry of Finance officials seemed to be trying to use the ASEAN+3 cooperative framework to promote a yen-centered regional exchange rate regime. The promotion of the yen as the region’s common currency was seen as an attempt to revive Japanese financial markets, that is, to promote “regional integration through the prism of Japan’s national interests rather than through the prism of greater regional collective interests” (Amyx 2004, 9).

In early 2005, the executive secretary of the United Nations Economic and Social Commission for Asia and the Pacific proposed the creation of an Asian Investment Bank, to be patterned after the European Investment Bank, for mobilizing private funds more effectively in order to finance the region’s infrastructure finance needs, estimated by the Japan Bank for International Cooperation at around US\$200 billion annually. The Asian Development Bank, which was also initially proposed by the United Nations Economic and Social Commission for Asia and the Pacific and is now widely seen as controlled by the Japanese Ministry of Finance, currently provides about a quarter of that amount on concessionary terms. Such a regional infrastructural investment financing facility—drawing on private sector funds, but accessible to sovereign borrowers on better terms than otherwise available in commercial financial markets—may also increase financial intermediation within the region, besides helping to recycle funds for more productive uses.

## Notes

<sup>1</sup> An exceptional paper authored by Joseph E. Stiglitz, who received the Nobel Prize in Economics in 2001, acknowledged that directed credit had succeeded. (See Stiglitz 1994, 1996.)

<sup>2</sup> In 1973, Shaw (1973) and McKinnon (1973) developed their critique of financial repression based on the case of Korea in the 1960s. Ironically, contrary to what their works suggest, savings and investment rates actually rose in the peninsula despite the ostensibly repressed financial system that had emerged under the military dictator General Park Chung Hee.

<sup>3</sup> In Singapore, which has not implemented much trade policy, financial policy has facilitated the emergence and growth of institutions such as the Development Bank of Singapore in its early role, while other financial policies have also been important in the effort to “catch up.”

<sup>4</sup> It made sense to invest in the production of dynamic random access memory devices in the late 1980s when the unit price was well over US\$80. Not surprisingly, a great number of Korean and Taiwanese firms went into this production, driving down the unit cost to under \$2 by the mid-1990s. With the benefit of hindsight, it is easy to criticize overinvestment or misallocation of resources, but that was certainly not foreseeable at the time of investment. In any case, procyclical market tendencies (for example, capital following growth or finance following

investment) tend to exacerbate such problems.

<sup>5</sup> Pistor (2000) has demonstrated that international legal standards are unlikely to have the desired outcomes owing to the significance of historical original conditions and variances in “path dependence.”

<sup>6</sup> There is a growing consensus on the need to set up standstill and other procedures for international debt workouts akin to U.S. bankruptcy provisions for corporations and municipal authorities, though the Krueger (2001, 2002) proposals have not been well received by those governments most likely to be affected. These governments are wary of the adverse selection consequences on them.

<sup>7</sup> Social safety nets should not be seen as a substitute for social policy, which should be adequate to ensure a decent standard of living within a government’s means and to develop human resources.

<sup>8</sup> Then U.S. Treasury Secretary and former World Bank Vice President and Chief Economist Lawrence Summers is a prominent proponent of this view; for example, see his speech at the London Business School on 14 December 1999 and reported in the *Financial Times* the next day (Summers 1999).

<sup>9</sup> As Ocampo (2000) put it, “The required financial architecture should in some cases have the nature of a network of institutions that provide the services required in a complementary fashion (in the areas of emergency financing, surveillance of macroeconomic policies, prudential regulation and supervision of domestic financial systems, etc.), and in others (particularly in development finance) should exhibit the characteristics of a system of competitive organizations.”

<sup>10</sup> These have been shown to be ill informed, erroneous, and irrelevant to the problems at hand, besides exacerbating the crises in East Asia.

<sup>11</sup> Interestingly, then IMF Senior Deputy Managing Director Stanley Fischer (2001) admitted that “*willingly or otherwise*, a growing number of countries have come to accept [the belief that intermediate regimes between hard pegs and free floating are unsustainable]. . . . Proponents of the bipolar view—myself included—have perhaps exaggerated their argument for dramatic effect.”

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