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Crisis in Asia:
A Crisis of Globalisation?*

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Die Asienkrise hat zu einer neuen Diskussion über die Konsequenzen der Globalisierung geführt. Die heutigen Krisenländer galten jahrelang als die Musterknaben der Weltwirtschaft. Hohe wirtschaftliche Dynamik war gepaart mit einer Strategie der Öffnung zum Weltmarkt. Die Asienkrise hat diese Länder nun in erschreckender Weise zurückgeworfen: Internationale Finanzmärkte, aber auch das Krisenmanagement des IWF erwiesen sich als pro-zyklisch und haben die einmal ausgebrochene Krise weiter verschärft. Eine regionale Antwort auf die Krise blieb ebenso aus. Die Asienkrise zwingt zum Nachdenken über Reformen der heutigen Weltwirtschaftsordnung. Zugleich sind aber die Chancen für die Realisierung eines neuen Weltwirtschaftssystems eher ungünstig, da vor allem in den USA keine entschlossene Unterstützung für ein solches Projekt zu erkennen ist.

1 Introduction

Since July 1997, we have been witnesses of severe economic crises in East and Southeast Asia. There are at least two types of crises that we can distinguish from each other: first, the developing countries of the region have been subject to a sudden collapse in the confidence in their currencies and a subsequent dramatic devaluation. This process has started in Thailand in summer 1997 and has spread quickly through the region. Second, the affected countries in the region are confronted with a credit crisis at the same time: short-term loans from overseas lenders have been withdrawn and the affected countries were not able to roll over their debt.

When discussing causes and consequences of the Asian crisis,[1] one of the more important questions seems to be whether the economic problems have been caused by globalisation, in particular the increased flow of capital, or whether the origins of the crises lie in the economic policies of the affected countries. In other words: Are the economic problems of the region, as Stanley Fischer from the IMF has characterised them, "mostly homegrown", or are they caused by global forces which operate in financial markets designed in a wrong way?

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1 Although there is not just one crisis, I will use the generic term "Asian crisis" throughout the rest of the paper.

In this article, I will first look at the origins of the crisis in East and Southeast Asia. I will argue that, in contrast to the interpretation of the crisis by the IMF and other institutions, the reasons for the problems were only partly due to ill-advised policies in the region. Secondly, I will discuss some policy measures that could contribute to a more stable global economy. These measures basically can address the problem of instability and volatility on two levels: the level of national economic policy making and the level of a new or modified architecture of the world economy.

2 Origins of the Asian crisis

In order to develop proposals for both national and international strategies to avoid financial crises in the future, it is necessary to understand the Asian crisis better. The crisis could only develop because of a number of factors contributed to both the outbreak and the deepening of the crisis. The more important factors are:

2.1 The economic success of the Asian countries prior to the crisis

After the crisis had turned the formerly successful economies into countries characterised by poverty and despair, the successes of the past were forgotten too quickly.

Perhaps market participants were most shocked by the fact that they had not foreseen the crisis. Virtually nobody had predicted dramatic economic difficulties. As the crisis deepened, previous appraisals for the economic policies of the region were no longer heard: the entire development pattern in Southeast and East Asia, often praised as a model, suddenly was responsible for all the turmoil. Yesterday's advantages turned into today's obstacles for economic development:

> "The attachment to the family becomes nepotism. The importance of personal relationships rather than formal legality becomes cronyism. Consensus becomes wheel-greasing and corrupt politics. Conservatism and respect for authority become rigidity and an inability to innovate. Much-vaunted educational achievements become rote-learning and a refusal to question those in authority" (*The Economist*, 25 July 1998, p. 23).

It has to be stressed that the success of the past not only greatly reduced poverty in Southeast and East Asia, but also paved the way for a massive increase in the flow of foreign capital into the region. The inflow of foreign capital, however, was sharply reversed during the crisis.

The data in table 1 show that none of the economies displayed a deterioration of the macroeconomic data prior to the crisis. The current account deficits in Thailand were perhaps the most alarming figures, but in a situation with fully or partly liberalised capital account it is not clear which role autonomous capital imports play. Current account deficits do not necessarily have to reflect the decisions of economic agents in a given country, they can also reflect the decisions of foreign investors to import capital into an economy. Therefore, neither the current account deficits of the years prior to 1997 have to be a consequence of "wrong" economic policy nor do the substantial surpluses in both South Korea and Thailand in 1998 reflect "better" economic policies today. All we can say is that prior to the outbreak of the crisis capital flowed into the countries, since then they realise an outflow of capital.

Table 1: Macroeconomic indicators

	Indonesia	Malaysia	Philippines	South Korea	Thailand
Real growth of GDP p.a. in % 1990-95	8.0	8.8	2.3	7.8	9.0
Real growth of GDP p.a. in % 1996	8.0	8.6	5.7	7.1	6.4
Real growth of GDP p.a. in % 1997 [a)]	5.0	7.0	4.3	6.0	0.6
Rate of inflation p.a. in % 1975-82	15.0	5.3	11.0	17.6	9.0
Rate of inflation p.a. in % 1983-89	8.1	2.0	15.4	3.8	3.1
Rate of inflation p.a. in % 1990-95	8.7	3.5	10.8	6.6	5.0
Rate of inflation p.a. in % 1996	7.9	3.5	8.4	4.9	5.9
Rate of inflation p.a. in % 1997 [a)]	8.3	3.7	5.2	4.3	6.0
Balance of public budgets in % of GDP 1996	+1.4	+4.2	-0.4	/	+1.6
Balance of public budgets in % of GDP 1997 [a)]	+2.0	+1.6	-0.9	/	-0.4
Current account deficit in % of GDP 1990-95	-2.5	-6.2	-4.1	-1.4	-6.7
Current account deficit in % of GDP 1996	-3.3	-4.9	-4.7	-4.9	-7.9
Current account deficit in % of GDP 1997 [b)]	-1.2/-2.9	-9.9/-5.1	-2.9/-5.2	-2.0/-1.9	-2.0/-2.0
Rate of savings in % of GDP 1996	28.8	36.7	19.7	33.3	33.1
Rate of savings in % of GDP 1997 [a)]	27.3	37.0	21.0	32.9	33.8

a) Estimates.
b) IMF/BIS-data.
Sources: IMF, *World Economic Outlook*, Interim Assessment, December 1997, pp. 49-51; J.P.Morgan, *World Financial Markets*, First Quarter 1998; IMF 1998a; BIS 1998a, p. 34.

2.2 The dismantling of capital controls in the process of the deregulation of the Asian economies

Anybody who wished to understand the consequences of a deregulation of the financial sector including the dismantling of capital controls could have studied the experience of Australia and New Zealand in the 1980s. In a nutshell, both the Australian government as well as the New Zealand government sought to improve the efficiency of their financial sector by deregulating them and by allowing foreign competition. Capital could flow freely in and out of the country. The consequences were disastrous: Initially, money flowing into the Australian economy put upward pressure on the Australian dollar. In that situation, many private actors, permitted to do so in the deregulated environment, borrowed money abroad. Some Australian farmers, ill advised by their local bank manager, borrowed in foreign currency without knowing the risks. When the Australian dollar plunged, the crisis spread into the real economy. Both Australia's and New Zealand's foreign debt rose considerably after deregulation: in Australia, gross debt rose from A $ 35.7 billion (1983) to A $ 191.3 billion in 1992, in New Zealand the foreign debt rose from NZ $ 17.4 billion (1984) to NZ $ 62.1 billion in 1992.[2]

The situation in Southeast and East Asia is broadly comparable. Whereas in the 1980s the countries of the region had been reluctant to dismantle capital controls, in the 1990s these controls where reduced in order to increase the efficiency of the financial system. With the benefit of hindsight, the increase of efficiency, i.e. lower interest rates for domestic borrowers, was paid for with increased instability and volatility.

2.3 The use of open financial systems that were not properly prepared for international competition

Closely related is the deregulation of the financial sectors. The dismantling of capital controls does not improve the efficiency of the financial sector if there is no deregulation and no increase in competition. Again, experiences elsewhere could have shown that such a move results in substantial risks. The debt crisis (once more, it is rather crises) in Latin America in the 1980 proved that private borrowers can lead an economy into an unwanted situation. It may be rational for an individual borrower to use cheaper credit available on international markets, but for the entire economy of a country this collective behaviour may result in a risky situation. It is interesting to note the comments Stanley Fischer made on that issue before he became Deputy Managing Director of the IMF:

> Domestic firms should not be given unrestricted access to foreign borrowing, particularly non-equity financing. In both Chile and Argentina, the lenders in essence forced the government to take over the debt of failing private borrowers. The argument was that the credit of the country would be impaired unless the government stood behind its domestic firms. It might have been expected that the lenders' interest in being repaid would be sufficient for them to exercise due caution in lending. But there is much evidence of unwise lending that imposes externalities on other firms and the government of a country. For this reason, governments should monitor even private sector borrowing, and may sometimes have to limit such borrowing (Stanley Fischer: *Issues in Interna-*

2 For a more detailed discussion of the consequences of deregulation in Australia and New Zealand see Dieter 1998d, pp. 36ff.

tional Economic Integration, Bangkok: 1991, p. 20; quoted in Gruen 1991, p. 13).

In this context, it is certainly true that banking supervision in the Asian countries was not very good. However, by that standard it was not very good in the lending banks' countries either. The problem is that the bank supervisors in Thailand are not informed if a Thai company borrows, say, from the Dresdner Bank in Germany. The German authorities are informed, but they do not intervene. And why should they: As long as there is no risk for the lending bank to go bust, there is no problem for the bank supervision in Germany. Lending by its very nature is risky and only those failing to take risks will not loose money, but they also will not make money in the first place. Therefore, the calls for better banking supervision miss the picture at least partly. The calls for better supervision also miss another point: the credit crisis in Asia was in part a consequence of the currency crisis. Without the collapse of the value of the currencies many more borrowers would have been able to service their debts. Currency crises, however, can hardly be predicted, let alone be taken into account by bank supervisors.

2.4 Wrong judgements by economic policy makers in the Asian countries

Not only policy makers, but almost entire societies seemed to have ignored the risks of their activities. Although it is easy to ignore the past prosperity once the crisis has hit, one should consider the background of developments in Asia. The countries of the region had enjoyed impressive economic growth. Within one generation, poverty in countries like Indonesia was greatly reduced. But continuous high growth also led to complacency. Also, some managers and policy makers might have known crises only from history books: before the current crisis the last years in which real GDP growth of less than 5 per cent were recorded were 1985 in Indonesia, 1980 in South Korea and 1972 in Thailand. Furthermore, not only the absence of experiences with crises, but also the structures of companies, the financial sector and the government were unable to cope with the rapid growth (cf. BIS 1998a, p. 35). In particular, there was a lack of skilled staff in the financial sector.

Another reason why policy makers underestimated the risks lies in the potential analogy between markets for goods and markets for financial services. Policy makers might have thought that they would be able to replicate the strategies they used previously in the markets for goods. By opening financial sectors asymmetrically it could have been hoped that only the domestic companies would have advantages. Foreign banks, for instance, were not allowed to have full access to the domestic market, but Asian banks and companies could exploit the advantages of having access to the international financial markets. The problem is that the forces at play in financial markets work in a different way: when customers in one export market stop buying your products you can still switch to another market, but when creditors call in their money they all tend to do it at the same time. Therefore, the risk of asymmetrical opening of the financial sector is completely different from a mercantilist delay in the opening of the domestic market for goods.

2.5 The new, increased power of international speculators, who first brought down the Thai baht and then other currencies

At the beginning of the crisis, much was said about international speculation that brought down the currencies of the region. In particular Malaysia's Prime Minister, Mahathir Mohamad, accused speculators. In 1998, Mahathir renewed his criticism, but avoided using the idea of a conspiracy again:

> They do not work in concert of course. Nor do they enter a conspiracy. But they do behave like herds. Thus when one of the more important members swing in one direction, the other will follow. The effect is not unlike acting in concert (Mahathir 1998).

It has to be asked whether Mahathir's accusations contain an element of truth. To understand that matter better, the mechanisms of speculation against a currency have to be taken into consideration.

The basic formula is quite simple: if a speculator expects the devaluation of a currency, for instance the Thai baht, he has to take up a loan denominated in Thai baht. That sum is then transferred into another currency, e.g. US-Dollars. Once the currency the debt is denominated in is devalued, the speculator can pay back the loan using less US-Dollars than he had got before the devaluation. It is important that the speculator holds an open position, i.e. that he doesn't hold assets in the attacked currency, since that would impair him from benefiting from a devaluation.[3]

It has to be taken into consideration that speculation of that kind is only possible in open financial markets. Only if no capital controls exist can speculators borrow substantial amounts of money in the target country. Without that lever speculation against a central bank that holds substantial currency reserves is not possible. Although it is possible that the owners of domestic currency loose confidence in their currency and try to exchange it for US-Dollar or other hard currency, their levers are, as long as capital controls exist, substantially weaker than those used in Asia.[4]

Since the beginning of the Asian crisis, Paul Krugman has looked at speculation several times. He concluded, however, that speculation against a currency is only possible if fundamental problems existed:

> Even in models with self-fulfilling features, it is only when fundamentals – such as foreign exchange reserves, the government fiscal position, the political commitment of the government to the exchange regime – are sufficiently weak that the country is potentially vulnerable to speculative attack (Krugman 1998a, p. 6).

Krugman's argument is both theoretically weak as well as not verifiable in empirical analysis. He gives no hint regarding the amount of reserves that are necessary and which fiscal position is without risk. Also, the use of an indicator that cannot be measured, the commitment of a government, does not make his argument more plausible. Without some figures regarding the necessary level of reserves and a

3 For a description of the opening of positions see Köhler 1998, p. 192f.

4 Basically, owners of domestic currency will have to smuggle it out of the country. As everybody knows, this is not impossible, but the risk of being caught and losing money certainly does not provide a strong incentive to violate capital controls.

more precise definition of "political commitment", Krugman's argument does not help us to understand the collapses of the currencies in Asia.

After the Asian crisis, we may have to redefine our understanding of the power of speculation in globalised, deregulated markets. The empirical evidence we now have shows that even countries with high reserves and high fiscal surpluses, like Thailand, can be attacked successfully by speculators.[5]

2.6 Institutional investors have gained in importance

Another point to consider when thinking about the reasons for the crisis in Asia is the rapidly growing power of institutional investors, which comprise pension funds, insurance companies and mutual funds. In 1995, institutional investors, according to BIS-data, held investments worth over US$ 20,950 billion. By comparison, the GDP of the G-7 countries in 1994 totalled US$ 17,150 billion. Each category of institutional investors roughly holds one third of the total. By country, however, differences are more marked. Half of the investments of institutional investors are held by American companies (US$ 10,500 billion), whereas Japan (US$ 3,035 billion) and Great Britain (US$ 1,790 billion) are on places two and three.

Without going into a detailed analysis of the ways these institutional investors work, it seems fair to say that they have not contributed to a greater stability of the world financial system. Rather, they have made financial markets significantly more volatile. The fear of being beaten by other fund managers as well as institutional requirements that hinder in particular the managers of pension funds to hold a certain position once that investment has been downgraded by rating agencies, result in herd behaviour rather than anti-cyclical self-balancing of the market. The Bank for International Settlements has underlined these risks:

> The fear that underperformance, even if it could be attributed to purely random events, may lead to cash outflows and hence lower management fees creates the incentive to avoid positions that can result in large deviations from the benchmark. Managers' incentive to follow each other's trading strategies closely is further strengthened when the evaluation is performed against a peer universe (BIS 1998a, p. 91).

The herd behaviour of actors in financial markets is nothing new, however. Robert Skidelsky rightly points out that Keynes had already produced a convincing analysis of the reactions of financial markets in the event of a crisis (cf. Skidelsky 1998).

2.7 The pro-cyclical behaviour of the international rating agencies

Closely related with the increasing power of institutional investors is the rising influence of rating agencies. Ideally, rating agencies should be able to spot dangerous developments and report them to the markets before everybody else can see the trouble. Unfortunately, however, this is not the case. As a look at the development

5 In late September 1998, however, we have also learnt that speculators themselves can loose substantial amounts of money, as shown by the collapse of John Meriwether‘s hedge fund, the "Long-Term Capital Management" (LTCM).

of ratings in Asia shows, the rating agencies have basically followed the panic of the markets. In fact, the agencies may even have contributed to the deterioration of confidence.

Table 2: Development of the ratings by Moody's und Standard & Poor's for sovereign, long-term debt denominated in foreign currency

	Moody's		Standard & Poor's	
	Rating	Date	Rating	Date
Indonesia	Baa3 ↓	14.3.1994	BBB- ↓	20.7.1992
			BBB ↑	18.4.1995
			BBB- ↓	10.10.1997
	Ba1 ↓	21.12.1997	*BB+* ↓	31.12.1997
	B2 ↓	9.1.1998	*BB* ↓	9.1.1998
			B ↓	27.1.1998
	B3 ↓	20.3.1998	*B-* ↓	11.3.1998
South Korea	A2 ↓	18.11.1988	A+ ↓	1.10.1988
	A1 ↑	4.4.1990	AA- ↑	3.5.1997
			A+ ↓	24.10.1997
	A3 ↓	27.11.1997	A- ↓	25.11.1997
	Baa2 ↓	10.12.1997	BBB- ↓	11.12.1997
	Ba1 ↓	21.12.1997	*B+* ↓	22.12.1997
			BB+ ↑	18.2.1998
Thailand	A2 ↓	1.8.1989	A- ↓	26.6.1989
			A ↑	29.12.1994
	A3 ↓	8.4.1997	A- ↓	3.9.1997
	Baa1 ↓	1.10.1997	BBB ↓	24.10.1997
	Baa3 ↓	27.11.1997		
	Ba1 ↓	21.12.1997	BBB- ↓	8.1.1998

↓ = downgrading; ↑ = upgrading;
ratings in italics characterise non-investment-grade (high-risk) ratings.

Source: BIS 1998a, p. 127.

Neither of the two big ratings agencies has spotted the problems that we now see in the case of Indonesia and South Korea. In the case of Thailand, Moody's can claim that they downgraded Thailand in April 1997, but the country's rating at that time (A3) certainly did not indicate any dramatic problem. Rather, the rating agencies deepened the trouble by rapidly downgrading the countries once the crisis had begun.

Up to know, I have concentrated on the activities of the private sector. It is evident that uncontrolled forces have not been self-regulating, but have instead displayed the ineffectiveness of markets, at least in specific conditions. In contrast to what neo-liberal thinking would suggest, markets have dramatically overshot and have not shown self-regulating features. Governments and government-funded agencies, like the IMF, did, however, not fare substantially better.

2.8 The increased power of the IMF, that primarily had the well-being of international investors in mind

Once the crisis in Thailand hit, it could have been hoped that the crisis management orchestrated by the International Monetary Fund would help to clear up the mess. Unfortunately, this did not happen. The IMF instead fuelled the crisis by adopting the wrong policies and thereby increasing the instability and volatility in the markets.

The IMF's importance in the crisis management cannot be overstated. Not only did the Fund use a substantial part of its own resources, but it also worked as a catalyst for raising money from other multilateral as well as bilateral donors. Furthermore, the IMF's insistence on the implementation of the policies the Fund regarded as appropriate as well as its opposition to other, regional mechanisms to calm the crisis, make the IMF fully responsible for the current turmoil in the affected countries.

Table 3: Financial aid from bi- und multilateral donors in billion US-Dollar

	Agreed Financial Contributions			
	IWF	World Bank and ADB	Bilateral	Balance
Indonesia	9.9	8.0	18.7	36.6
South Korea	20.9	14.0	23.3	58.2
Thailand	3.9	2.7	10.5	17.1
Balance	34.7	24.7	52.5	111.9

Source: IMF 1998a, p. 2 (Annex).

From the beginning of the crisis, the IMF had a very simplistic view of what had happened. Basically, the IMF and, as its most outspoken analyst, Stanley Fischer regarded the crisis as caused by failures of economic policy in the Asian countries. In a nutshell, Fischer characterised the Asian crisis as "mostly homegrown" (Fischer 1998a, p. 2). The cure of the IMF consequently was based on its standard programmes. Accordingly, the IMF's medicine was trying to address problems that were, in some cases, non-existent. The IMF asked for a tightening of the governments' fiscal position, in a situation that was marked by fiscal surpluses before the crisis began, and demanded a substantial rise in domestic interest rates. Both these policies actually worsened the problems:

- A tightening of the fiscal position during the crisis is pro-cyclical and counter-productive. It will increase instability rather than decrease it. These policies are quite similar to those employed by President Hoover in the US and Chancellor Brüning in Germany in the 1930s. Even if a Keynesian anti-cyclical approach is not regarded as useful, fiscal policy should at least have remained neutral.

- The lifting of interest rates during economic turbulence added to the trouble of the private sector. The rise of interest rates increased the cost of debt service of domestic debt, while the cost of servicing debt denominated in foreign currency goes up due to devaluation. Higher interest rates actually are instruments that should be used to cool overheated economies. In Asia, they led the countries straight into recession.

These policies could perhaps be justified if they showed some success. However, the desired stabilisation of exchange rates was not achieved nor was the general deterioration of the economic situation halted.

Table 4: The development of selected currencies in Asia 1997-1998

	Exchange rate to the US-Dollar on 24 June 1997	Exchange rate to the US-Dollar on 24 June 1998	Devaluation against the US-Dollar in per cent
Indonesia	2.432	14.750	83.5
Malaysia	2.52	3.95	36.2
Philippines	26.4	41.5	36.4
Singapore	1.43	1.66	13.9
S. Korea	888	1.381	35.7
Taiwan	27.9	34.4	18.9
Thailand	25.3	41.1	38.4

Source: *The Economist*, 27.6.1998, p. 124.

Looking at the data in table 4, one has to ask whether the situation could perhaps have been worse. Is it reasonable to expect a stronger devaluation in case the IMF would not have intervened? Probably not. At least in the case of Indonesia, the devaluation against the dollar has been so strong that the rupiah has been worthless anyway. The other countries that received IMF help also have witnessed devaluations of over one third, which is quite substantial by any standard and particularly remarkable when considering the spotless macroeconomic record prior to the crisis.

Nevertheless, the IMF has time and again declared that its policy recommendations were adequate and the only possibility in the given economic environment (see, for example, IMF 1997a, p. 5; Fischer 1998a, p. 2; IMF 1998a, p. 3). That, however, is questionable. More and more observers argue that the IMF badly mishandled the crisis (see, for example, Bello 1998; Feldstein 1998; Nunnenkamp 1998; Wade 1998; Sachs 1997b). The IMF could have recommended a different policy:

- It could have stressed the liquidity help element in its programmes. Even if there have been elements of crony capitalism in Southeast Asian countries, a crisis certainly is not the right time to address these problems and force the countries in trouble to adopt a radical policy shift (cf. Feldstein 1998). Also, one has to ask why those problems (lack of transparency, nepotism, etc.) were not raised by the IMF earlier.

- The IMF accepts that markets "overreacted" and that the devaluation of currencies went too far (cf. Fischer 1998a, p. 2). At the same time, the IMF stopped the Indonesian government from implementing a currency board. The problem here is that the IMF did not offer any alternative solution to Indonesia's problems. It continued to expect the markets to provide solutions in a time when markets clearly were undervaluing currencies and thereby deepening the (credit) crisis.
- The IMF acted as an agent for creditors and ignored the consequences of its policies for the people in the affected countries. It bailed out foreign investors, without forcing them to share a substantial part of the burden, and imposed the hardship on the population in the countries in crisis.[6] As John Kenneth Galbraith put it:

> The peculiar genius of the IMF is to bail out those most responsible and extend the greatest hardship to the workers, who are not responsible (*The Observer*, 21 June 1998, B 4).

2.9 The absence of a regional power that could have taken measures against the collapse of the affected economies

The crisis could also develop because there was no decisive regional effort to bring it to a halt. Japan could perhaps have made a convincing effort to help the region out of trouble, but a combination of lack of political will in Japan as well as opposition from both the US-government and the IMF stopped the initiative for an Asian Monetary Fund (AMF). In August/September 1997, the idea for an AMF was brought into the debate by Japan. The AMF would have been equipped with capital of US$ 100 billion and was meant to have various functions: the funds should have been used against currency speculation, as liquidity help in acute balance of payments problems as well as help to finance long-term programmes for economic restructuring. In general, the AMF's approach would have been less austere than the IMF programmes (cf. Bello 1998). On a more political level, the AMF contains, just like the "East Asian Economic Caucus", an element of "Thinking East-Asian", i.e. a deliberate attempt to develop a way of thinking and of economic policy that contrasts with Western approaches (cf. Higgott 1998b, p. 12).

The failure of Japan to establish the AMF will weaken Japan's position in East Asia, perhaps decisively. The establishment of the Asian Monetary Fund could have supported Tokyo's claims for leadership in the region. It even represented, as Walden Bello called it, a "golden opportunity" for Japan (see Bello 1998, p. 18). The inability of the Japanese political elites to use this opportunity may have been caused by the country's position somewhere between the West and the East. But whereas this

6 We still have not seen the entire dimension of the crisis in particular in Indonesia. According to a UNICEF study, due to malnutrition and an increasing number of school drop-outs, as well as declining health services, an entire „lost generation“ could suffer from the consequences of the crisis (cf. *Sydney Morning Herald,* 20 October 1998).

might have been an advantage in the past, today Japan seems to be more isolated than ever. The big winner could be China, which helped to calm the situation in particular by not devaluing its own currency when all other countries in the region did exactly that (cf. Dieter/Higgott 1998).[7]

It has to be noted that the unsolved financial sector crisis in Japan was another factor that contributed towards the development of the crisis. The reason for that is that the Japanese government and central bank tried to stabilise the ailing financial sector by keeping interest rates very low: since September 1995 the central bank's benchmark rate stands at 0.5 per cent.[8] The consequence of this was, however, that capital was moved out of Japan into more profitable investments, many of them in Thailand, South Korea and Indonesia. Japanese creditors had, in early 1998, outstanding debts to the five countries most affected of about US$ 97.2 billion, more than French, German, British and American banks together at the same time (cf. *Financial Times*, 30.1.1998, p. 11).[9] In other words; most of the "hot money" that was invested in the emerging Asian markets came from basically bankrupt Japanese banks. The fact they are now faced with another crisis does not ease their situation at home.

How the problems of the Japanese financial sector can be solved is currently intensely debated. It seems fair to say that the present Japanese government is unable to both revitalise the economy and at the same time provide a solution for the financial sector. Most economists seem to have run out of ideas, too: In a quite interesting manner some observers have asked for the creation of confidence, but how exactly that could be created remains a myth. Paul Krugman, never reluctant to offer an unconventional solution, suggested the creation of inflation to achieve a negative real interest rate in Japan (cf. *The Economist*, 25.7.1998, p. 80). The problem is that with Japan's newly deregulated financial system negative real interest rates in Japan would only result in a further flow of capital out of the country. To stop precisely this has been the centrepiece of a proposal by Richard McCormack, Under Secretary of State in the US Department of State. He suggested the introduction of a tax on capital exports from Japan (cf. *Financial Times*, 28.8.1998, p. 14).

In October 1998, the Japanese government announced that the financial sector will be bailed out with taxpayer's money, with the bill coming up to US$ 600 billion. With no details being given, one has to ask where they could get that money from. Raising taxes would further weaken the economy and borrowing the money would certainly not create the confidence in the future that Japan seems to need today. For the time being, the rest of the world can only witness Japan's muddling through an ever deeper crisis (cf. Lincoln 1998).[10]

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7 Needless to say that most other countries did not devalue deliberately. Also, China’s economic problems are far from over.

8 The financial sector in Japan is suffering from the speculative excesses of the 1980s. Estimates of the bad loans vary between US-Dollar 700 and 2000 billion.

9 Indonesia, Thailand, Malaysia, Philippines, South Korea. The relatively low exposure of American creditors in early 1998 can partly be attributed to the recalling of loans early in the crisis. That exposure may also underestimate the position of American banks in the market for derivatives.

10 For a discussion of the solutions available to Japanese policy makers see Dieter 1998d, pp. 144-151.

2.10 The absence of a supranational regional institution that could have developed a joint strategy to master the crisis

Finally, the absence of a powerful regional institution made the development of a strategy to overcome the crisis difficult. In particular the Asia-Pacific Economic Cooperation (APEC) ceased to be heard during the crisis. The APEC Summit in November 1997 only produced harmless recommendations and expressed just the need for economic reform in the affected countries. What a contrast to the years before, when APEC supporters claimed to have found the most convincing approach for regional integration. Today, we have learned that institutions that cannot help their member countries in a crisis loose a lot of their shine. The 1998 Summit in Kuala Lumpur made no contribution to the revitalisation of APEC. The APEC countries failed to produce a convincing programme for the solution of the Asian crisis. Also, the absence of President Clinton further weakened a project that in the past was mainly driven by "peer pressure". Once the peers stay away, the pressure disappears as well.

The decentralised structure of APEC, which was praised in the past as "regional integration without bureaucratic institutions", is unable to produce a regional, as opposed to an IMF-led, solution to the crisis. The lack of institutional strength is the main cause of that dilemma; decentralised APEC departments in the Ministries of Foreign Affairs of the member countries cannot provide this incentive.

The consequence of APEC's failure, together with the potential rise of China as both the economic and political leader of East Asia, will probably lead to a new regional integration project. In the medium term, a distinctively Asian project may suit the elites of East Asia better than the APEC, which has frequently been regarded to be a tool for US-American interests (cf. Nesadurai 1996).

To *sum up* the findings; a combination of factors was responsible for the outbreak of the Asian crisis. Certainly the governments in the affected Asian countries made mistakes, but so did everybody else. The unregulated flow of capital and the subsequent withdrawal of short-term loans have not been the only reasons for the crisis, but it has become obvious that countries showing too much confidence in the self-regulation of globalised financial markets will suffer. In that respect, the call for unregulated global markets suffered a severe setback. As a consequence of the Asian crisis, the calls for deregulated markets in particular and for globalisation in general will be received with much greater caution, especially in the developing world. However, a more cautious approach towards capital flows does not mean we shall automatically return to protectionist policies. As Jagdish Bhagwati pointed out, free trade does not equal free flow of capital (cf. Bhagwati 1998). After the immediate consequences of the Asian crisis will have been overcome, the emphasis should lie on the search for new types of measures to defend smaller developing and emerging economies against the volatility of financial markets.

3 National measures to defend an economy against the volatility of international financial markets

After the Asian, Russian and the Brazilian crises, one of the main questions of economic policy today is how to defend a country against both speculative attacks on its currency as well as avoid the "hot money" of investors.

3.1 Avoiding speculation against a currency

Speculative attack on a currency can partly be avoided by following a strategy of undervaluing a currency. However, even that is difficult. To start with, it is difficult to measure the "real" value of a currency. Floating exchange rates are not an answer because they expose the country to exchange rate volatility, an undesirable consequence.

To avoid the massive speculation that characterised the Thai case the only possibility, apart from more massive capital controls, is to prohibit the use of domestic credit by foreigners. The reason is that speculators need an open position denominated in the currency they want to attack, i.e. they need substantial debt denominated in that currency. Without that debt, which is easier to repay after a devaluation, the motive for an attack on the currency disappears. Today we see exactly that happening in Hong Kong: the local banks there are (deliberately) restricting Hong Kong dollar denominated loans to foreign borrowers. They are able to do so because the number of large banks that could lend sufficient amounts of money to foreigners is limited, and the banks in Hong Kong have no incentive to reduce the value of their own assets by encouraging devaluation.

3.2 Avoiding unwanted short-term capital inflows

The inflow of "hot money" can be restricted. The best known example is Chile, which required a 30 per cent deposit with the Chilean Central Bank for all foreign loans. That deposit (*encaje*) had to remain with the Central Bank for one year and did not attract interest payments. Long-term loans are not excluded, but that measure represents a declining burden for long-term loans: the longer the maturity period of the loans, the lower is the additional cost of the deposit.[11]

The basic idea, regardless of the exact construction of the instrument, is always similar. By making domestic loans cheaper relative to foreign loans and encouraging domestic borrowing, the risk of a sudden withdrawal of foreign capital is reduced. None of these instruments will be perfect, but they offer increased stability of the financial sector without losing too much efficiency.

11 Due to a decline of capital flows in the aftermath of the Asian crisis, Chile had to abandon the *encaje*. These developments, however, are no big surprise, since investors have deserted virtually all emerging markets.

3.3 Other capital controls

Some observers have advocated more capita left governments are in power in Europe's three leading countries. Taking the views of the British and the French governments during the recent World Bank/IMF Annual Meeting in Washington into consideration, we could see a European effort to reshape the IMF.

It could also be argued that three regional funds (Asian, American, European with joint competence for Africa) would be a better solution. It is difficult to justify the existence of an inefficient bureaucracy in Washington that claims responsibility for the world economy, but clearly is overburdened with that task. During the Asian crisis, many incidents have been reported that underline the lack of knowledge in the IMF with regard to the economic and political situation in the countries visited by the IMF. Regional funds, which could be better prepared to monitor economic development, would strengthen the regional element that is already today characterising economic cooperation.

Furthermore, one seriously has to ask whether an institution like the IMF, which takes pride in being a fortress of blunt neoliberal economic thinking, is able to revise its strategies in the direction of a more regulated world financial market.

The current IMF, which characterised itself during the Asian crisis as "a confidential economic adviser as well as a watchdog for the international community" could also be privatised, since that role of a "Super-Moody's" is not one for a publicly financed institution.

4.2 A new currency regime?

A new currency regime seems more necessary than ever. We need more stable exchange rates, which are, as the experience of the last 20 years has shown, difficult to achieve with floating exchange rates. One option could be a currency regime built around a stable Dollar-Euro exchange rate. In the medium term it could be developed into a tripolar currency regime, with a yet to be found Asian currency as a third pillar. A world currency council could be the institution implementing that regime; both the American and the European central bank would have to participate as well as the reformed (regionalised?) IMF (cf. Dieter 1998a).

At this stage, the inclusion of the Japanese Yen certainly would not make sense. The Japanese monetary policy is not very transparent and it is clearly subordinated to political goals. For the same reasons, an Asian Monetary Union is a rather distant prospect.

As an alternative to a world currency regime based on a Euro-Dollar regime, one could imagine a set of regional schemes. I doubt, however, whether such a scheme would provide a substantial improvement over today's system. Even today, we find regional links between currencies, in particular between the Dollar and Latin American currencies and the German Mark and East European currencies. These links have, whichever form they took, provided increased stability, but they did not have an influence on the occasionally dramatic swings between the major world currencies.

Having suggested a new currency regime, however, it seems necessary to stress that the realisation of such a scheme is not very likely. European policy makers might find the concept of fixed exchange rates attractive and have voiced their sympathy for it, such as the new German Minister of Finance, Oskar Lafontaine. But it is unrealistic to expect any substantial support for fixed exchange rates in the US, at least at this stage. Things may change, however, when the current boom of the US economy finally bottoms out and, at the same time, imports will continue to rise. Although even a trade deficit of US$ 400 billion, as Fred Bergsten expects for 1999, is technically not a problem, politically it might still be regarded to be one, in particular in the forthcoming election year 2000.

4.3 The need for a "World Financial Organisation" (WFO)

For the stabilisation of credit relations the introduction of a World Financial Organization WFO should be considered seriously. Just like we have a World Trade Organisation, a similar institution for organising financial relations is needed. The Bank for International Settlements (BIS) in Basle is not able to shoulder that task. As an organisation of central banks, the BIS cannot provide an internationally binding framework. That will have to be negotiated by governments and will also have to be controlled by governments.

The WFO should provide the framework for private agents to work in. In contrast to today's system, where the exporters and importers of goods have to comply with regulations, the exporters and importers of capital work in an environment characterised by the absence of effective regulation. The rather few recommendations of the BIS point in the right direction, but are too limited in scope.

5 Conclusions

The Asian crisis has produced a crisis of the concept of globalisation, understood as a set of ideas promoting unregulated free flow of capital, further global integration and further reduction of the influence of governments on economic policy making. Although mistakes were also made in the affected countries, the more important causes of the crisis were the flow of "hot money" into Southeast Asia, the sudden withdrawal of capital and the speculation against the currencies.

The world financial system we see today, which is largely based on the neoliberal dogma of the universal superiority of market solutions, has failed to provide both adequate warning signals as well as solutions once the Asian crisis developed. The answer thus is a more regulated, though not state-centred, organisation of world financial markets.

Whether this consequence, a re-regulation of the world financial system, will be implemented remains to be seen. As long as the US-Congress is more preoccupied with other matters, it might not be very realistic to expect a shift in emphasis. No major player has suffered enough to come forward with a new blueprint for the organisation of the world economy in general and financial markets in particular, and those in Asia that have endured hardship have no voice in the reconstruction of the world economic order.

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