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The Southeast Asian Financial Crisis: Malaysia Rejects Economic Orthodoxy

Douglas Sikorski

ABSTRACT

Pinpointing the actual forces at work in the Asian Financial Crisis, especially politics and other non-market factors that contributed substantially to the loss of confidence, has not been easy. The causes of the crisis might be interpreted as either a failure of Asian capitalism, or alternatively a failure of market capitalism. The first interpretation obviously has a great deal of substance, and Malaysian economic institutions and public policy are not blameless – reckless over-expansion and credit growth, a pegged currency, political imbroglios, etc. Obviously, Malaysia needs to restore confidence in its financial institutions and practices. But Prime Minister Dr Mahathir Mohamad has rejected economic orthodoxy in favour of a more radical strategy. His dramatic gambit has some intellectual legitimacy based on a revisionist movement in economics and may well herald what will be the "new architecture" of the international monetary system.

ABSTRAK

Mengenalpasti faktor sebenar disebalik krisis kewangan Asian, khususnya faktor politik dan faktor bukan pasaran lain yang menyebabkan kehilangan keyakinan pelabur bukanlah sesuatu yang mudah. Faktor penyebab krisis boleh ditafsir sebagai sama ada kegagalan kapitalisma Asian atau kegagalan kapitalisma pasaran. Interpretasi pertama mempunyai asas yang kukuh dan institusi ekonomi Malaysia serta dasar awamnya tidak terlepas daripada dipersalahkan – pertumbuhan dan pengembangan kredit yang melampau, regim mata-wang tidak fleksibel, kegawatan politik, dan sebagainya. Tetapi Perdana Menteri Mahathir Mohamad telah menolak ortodoksi ekonomi dengan memihak kepada strategi radikal. Namun, langkah ini mempunyai justifikasi intelektual berasaskan gerakan revisionist dalam ekonomi dan berkemungkinan dianggap sebagai arkitek baru dalam sistem kewangan antarabangsa.

INTRODUCTION

The Southeast Asian currency crisis broke out in Thailand, apparently precipitated by persistent, large current account deficits[1] and a currency pegged to the appreciating US$. The current account measures the net of all short-term international transactions including trade in products and services, and interest. It appears from the Mexican debt crisis of December 1994 that current account deficits in excess of 4% of GDP may signal trouble ahead (Frankel 1998). All of Southeast Asia except Singapore evoked speculative interest on that criterion (Table 1).

TABLE 1. Pre-crisis current account balances (as a % of GDP)

	1990	1991	1992	1993	1994	1995	1996
China	3.02	3.07	1.09	- 2.17	1.17	1.02	- 0.34
Hong Kong	8.40	6.58	5.26	8.14	1.98	- 2.21	0.58
Indonesia	- 4.40	- 4.40	- 2.46	- 0.82	- 1.54	- 4.25	- 3.41
Korea	- 1.24	- 3.16	- 1.70	- 0.16	- 1.45	- 1.91	- 4.89
Malaysia	- 2.27	- 9.08	- 4.06	-10.11	-11.51	-13.45	- 5.99
Philippines	- 6.30	- 2.46	- 3.17	- 6.69	- 3.74	- 5.06	- 5.86
Singapore	9.45	12.36	12.38	8.48	18.12	17.93	16.26
Thailand	- 8.74	- 8.61	- 6.28	- 6.50	- 7.16	- 9.00	- 9.18

Source: Roubini 1998.

Foreign capital began a mass exodus in the summer of 1997. On July 2nd 1997, after weeks of selling pressure from speculators exchanging the baht for US dollars, Thailand announced it was abandoning a 13-year old peg to a basket of currencies dominated by the US$. The Thai currency crisis spread to Indonesia, Malaysia, and the Philippines which also linked their currencies to the US$ and had large current account deficits (Table 1). All of these countries, later followed by South Korea, had to allow their currencies to depreciate precipitously.

Thailand, Indonesia, and South Korea had high ratios of foreign debt to local GDP and lacked sufficient reserves to meet short-term foreign exchange obligations. All required assistance from the International Monetary Fund. The Philippines was already under an IMF programme. All countries were compelled to follow the standard IMF remedy: tight fiscal and monetary policies. In exchange for high bailouts agreed for Thailand, Indonesia and South Korea, the IMF required a long list of

reforms. However, the IMF remedy had very doubtful, even negative results, and the Asian Crisis remained unresolved well into 1999.

Malaysia spurned the direct intervention of the IMF and today claims success for its heresy. Malaysia did 'shadow' the IMF policy with its own macro-economic austerity but only until its dramatic policy gambit in September 1998.

THE CURRENCY CRISIS IN MALAYSIA

Currency and stock markets in Malaysia became the target of speculative attack in July 1997, due to fears that country was next in line to the financial crisis then beginning in Thailand. The current account deficit had improved in 1996, but FDI inflows could not fully offset the 1996 deficit, resulting in a basic balance deficit of RM1 billion. FDI outflows of RM6.6 billion further exacerbated the strain in the BOP. Despite this, the central bank increased its foreign exchange reserves by RM6.2 billion due to massive net inflows of short-term capital at RM11.2 billion. However, the danger of relying on such a volatile source to finance the current account deficit was made evident when this capital was withdrawn and the ringgit dropped dramatically. The Malaysian central bank, Bank Negara, attempting initially to defend the value of the ringgit, depleted reserves by 12.5% in a mere span of two weeks. On July 14th the government abandoned defence of the ringgit.

Overall money supply (M3) had been growing at 20%, and growth in bank loans surpassed 30% with high nominal interest rates and low inflation, hence high real interest rates. Loans to the 'unproductive' property and security sectors increased sharply, with more sluggish loan growth to manufacturing.

The large-scale banking failures suffered by Thailand and Indonesia were not expected in Malaysia due to better central bank supervision and regulatory control. Banks were better capitalised, with capital adequacy ratios at 11% (permanent capital 9.5%) at end-September 1997, compared to international guidelines of 8% (permanent capital 4%). Although lending for properties and share-financing was a problem, most borrowings were local which reduced the currency risk of loans. The ratio of non-performing loans was only 3.3% in June 1997 – half the level leading into Malaysia's last major economic crisis in 1986. It reached 9.7% by April 1998.

Government spending plans had long been disparaged by critics as grandiose. Indeed, the clustering of mega projects in the government's 'Vision 2020' concept gave rise to questions of financial feasibility. These projects were expected to have high import content and also divert resources from the traded sector. Nevertheless, the government was running a large budget surplus when the crisis hit.

Malaysia's Prime Minister Mahathir Mohamad has been criticised for contributing to the lack of confidence by his verbal assaults on those disinvesting from Malaysian currency or shares, calling them manipulators, saboteurs, and even racists out to wreck the country's economy. Dr Mahathir warned that for developing countries "the fight for independence will have to begin all over again for the present market rules will surely result in a new imperialism more noxious and debilitating than the old". His comments were associated with curbs on foreign exchange and stock trading imposed in late-August 1997. The crowning measure was announced on September 3rd, a RM60 billion fund (equal to roughly 43% of Malaysia's GDP) to prop up the depressed stock market. This effectively would create a two-tier market, opening the opportunity for foreign investors to sell shares to domestic players who could then pass them on to the government fund at a premium. In response to such designs, investors dumped both their shares and the ringgit. The policies were soon rescinded when they failed to prop up the markets.

On 17th October 1997 the government presented a belt-tightening budget, followed by tight monetary policy. A target of 7% GDP growth was pronounced unrealistic by market pundits, and the markets responded negatively. Finally on 5th December, the then Deputy Prime Minister Anwar Ibrahim introduced a "self-imposed IMF programme" which was better received in the markets.

Several events, towards the end of 1997, seemed like more meddling by the government and resulted in the currency and stock markets taking another beating. Two government-linked companies shuffled their assets in what appeared to be a bailout for influential investors: the country's largest construction firm UEM transferred cash to its debt-laden parent Renong in exchange for approximately one-third of its parent's shares. The deal provoked challenges of 'cronyism' and for lacking transparency.

Later that same week a government takeover of the deferred Bakun dam project precipitated renewed selling on the markets. The government explained that the main contractor withdrew from the project since it

had been deferred. Markets nevertheless suspected bailout conspiracies, and the stock market declined 11%, hitting a 7-year low which meant the Kuala Lumpur Stock Exchange, Southeast Asia's largest, emerged as the world's worst performing market for 1997.

During 1998 the tight macro-economic policies contributed to a worsening recession. Second-quarter GDP declined 6.8% (1st quarter: –1.8%). As a new wave of speculative pressures hit currency and stock markets from Asia to Russia to Latin America, the Malaysian government imposed capital controls and fixed the ringgit at 3.80 to the dollar (about 10% above the currency's prevailing levels).

Given that Malaysia's economy was so dependent on trade and FDI (more so than any other Southeast Asian country except Singapore), leakage would be hard to avoid. Exports could be under-invoiced, and imports over-invoiced, to park foreign exchange offshore. Long-term investment might be put off by higher costs, potential corruption, or simply annoyance at new bureaucratic red tape. There was even talk of capital flight. However, low external debt and miniscule foreign liabilities in the banking system reduced the potential for leakage.

Capital controls allowed the government to loosen fiscal and monetary policy without sending the ringgit through the floor. On 23rd October 1998, Dr Mahathir announced a high budget deficit for 1999. Given the apparent success[3] so far of Malaysia's daring policy shift, other nations were expected to follow.

DIFFERING INTERPRETATIONS OF THE ASIAN CRISIS

THE CAUSES

Marcus Noland (1998) identified 'four principal causes' of the Asian financial crisis: *exchange rate misalignment*, *export slowdown*, *weak financial institutions*, and *moral hazard*. We develop our initial analysis around these points.

While the US dollar was generally depreciating from 1985-95, pegging currencies to the dollar improved export competitiveness vis-a-vis other countries – notably with Japan and Europe – while also assuring stability in trade and investment relationships with the USA. However, after reaching a low point of 80 yen in the spring of 1995, the tide turned as the US$ commenced a long-term upswing. Asian currencies tied to the dollar appreciated along with it, which dampened their export competitiveness.

Several regional developments also affected Asian exports. In 1994 China unified its official and swap markets for currency conversion, effectively devaluing the renmindi by one-third and leading to a boom in Chinese exports largely at the expense of exporters in Southeast Asia. Then during 1995-96 world demand slumped for a key Asian product, semiconductors, which significantly dampened Asian export growth. Finally, continuing economic stagnation in Japan affected trade and investment well beyond the Asian region.

Concerning Asia's 'weak financial institutions', poor supervisory arrangements had allowed banks to finance long-term domestic lending with short-term foreign borrowing. In many countries, equity markets were relatively less developed and debt financing relied upon too much, often involving lending directed by governments. Or worse, as was commonly alleged: "financial decisions were strongly influenced by non-economic considerations, including outright corruption" (Noland 1998).

Moral hazard refers to expectations of bailouts for investors or recipients of capital. It prevails in countries that favour particular investors or classes. Domestic banks (and depositors) and corporations hoped their governments would come to the rescue of national institutions (and savers). Moral hazard also is evident in the international arena. Foreign banks were expecting the IMF to force debtor countries to pay up. All parties seemed to be right.

The economic causes have been well developed in the literature by Noland and many others. Causes of a political and social nature are less easily established, but certainly the perception of political risk in the region was crucial. One part of the problem is Asian political processes, which we now denigrate with such expressions as 'cronyism'. Another aspect is the political economy of the IMF rescue attempt and the long-standing inability of the United States – and American bankers – to countenance any policies that might give some credence to undemocratic or socialist political cultures or solutions to the crisis that were otherwise contrary to the 'American way'. There seems a need for all concerned (the Clinton administration, Asian leaders, even financiers and other market players) to be 'politically correct'.

Singapore's Senior Minister Lee Kuan Yew, attributed the crisis to a loss in investor confidence caused by over-spending, made possible because of poor supervision of banking systems and arguably exacerbated by corruption and cronyism (*Straits Times*, 8 Feb. 1998). But the key source of the problem, according to LKY, was political. Governments were too preoccupied with political difficulties to take action on war-

ning signals from the market. Thailand had six governments in five years. Indonesia was dominated by a ruling family that refused to allow political options to itself. South Korea started with a 'lame duck' president and ended with a coalition government.

Lee Kuan Yew was too diplomatic to criticise regional leaders; nor would he question prevailing liberal ideology at such a sensitive time for his country. But a tacit point Lee could well have in mind is that not only can governments misjudge markets, markets also misjudge governments. Lee has always believed, in the fashion of Asian paternalists, that markets function better with appropriate government guidance. Globally integrated markets are beyond this kind of oversight however. Global market players only vaguely understood Asian political developments and are quite uncertain about the merits of 'Asian capitalism'. The International Monetary Fund, lamenting the failure of its policies in Asia, noted that once the crisis started the success of any policy hinged on how markets reacted, and there were perhaps deficiencies in the way the substance of the programmes was communicated to the markets. (IMF 1999) It is possible that short-term market reaction to, say, reform in Indonesia reflected misapprehension about the incumbent administration. This put the country 'between a rock and a hard place': the country seemed destined to total collapse with Suharto or without Suharto.

Psychology, the most important factor in the great economic crises in history, is the least assessable of all market forces. Perceptions of risk had altered, and market players viewed economic policy through an ideology-tainted lense that gave a dim picture of Asian ways of doing things.

It was indeed a crisis of confidence. Those administrations that earned the proper liberal credentials or made the 'right' kind of public utterances got a better press. This may help to reassure the global financial community – which adhered to the liberal market perspective of the US government and bankers. Of course, respecting the prescriptions of the International Monetary Fund was also prerequisite to being 'politically correct', and many would argue that only disciplined compliance with IMF 'conditionality' would enable countries to gradually rise above their vicissitudes. Dr Mahathir had little faith in IMF programmes and placed blame squarely on market speculators.

EXCHANGE RATE MISALIGNMENT AND CURRENCY RUNS

Exchange rate misalignment led to market imbalances, inviting speculation that wreaked havoc. Market manipulation by speculators in Hong Kong and elsewhere stems in part from a lending syndrome that appears when exchange rates are fixed yet interest rates vary markedly from country to country. In East Asia, the opportunity arose for international banks to borrow hard currency at low interest rates, and re-lend the money at significantly higher rates for short periods to banks in, say, Malaysia or Thailand, which then re-lent the money at still higher rates to local companies. The foreign banks rolled over the yen or dollar loans as they expired, until the borrower's currency, such as the Malaysian ringgit or the Thai baht, lost value. The foreign loans suddenly became more expensive to repay, and the borrowers could not repay fast enough. The lenders, alarmed, refused to roll over the short-term debt, and a credit crisis emerged.

Pegged currencies encouraged the risk-taking. The lending opportunity should disappear if exchange rates and interest rates are both market determined because the two rates move in relationship to each other (according to the 'interest rate parity' theorem). But speculators can create imbalances even when interest and exchange rates are in equilibrium, due to the immense liquidity in the foreign exchange market.

Peter Drucker (1997) dubbed this liquidity "virtual money" – it "has no existence" outside global money markets; it "has no economic function"; and it "fits none of the traditional definitions of money, whether standard of measurement, storage of value, or medium of exchange." But its gross volume far surpasses the money involved in conventional economic activities such as investment and trade that such "world money" was created to support. "And because it serves no economic function and finances nothing, this money also does not follow economic logic or rationality. It is volatile and easily panicked ...". And it brings economic collapse in its wake.

Do speculators deliberately promote economic collapse and cheer as currencies and stock markets plummet? The multi-billion dollar hedge funds certainly thrive on market activity, and it matters not which way the market is moving, only that they can get on the bandwagon. First, the hedge funds borrow heavily in the very currency they are betting against. When they start selling the currency, interest rates can increase dramatically, enabling the funds to win in the money market even if they fail to bring the currency down. Thus, if they bet wrong they can

still win, according to a commentator in Singapore (Wee 1997): "Sources say the big funds entered the money market a month ago to borrow Hong Kong dollars at around 7%; they are now on-lending these dollars at … as much as 250%". With high interest rates, the whole economy suffers so before the funds launch their currency attack, they short-sell the stock market too. The general market collapse "frightens genuine foreign investors into selling out too … . That's how it all snowballs".

SHOULD THE IMF CHANGE ITS STRIPES?

Currency runs thus lead to market panic. The International Monetary Fund provides the major bulwark against adverse market pressures, but there is a perception that the IMF has not been effective in the Asian Crisis so far.[2]

If the crisis was primarily one of panic, then the goal of the IMF should be to control unstable markets, implying the provision of more defence funds or creating new rules of the game. Some Asian governments ascribed to this latter view and one attempt to overcome the panic was an Asian Monetary Fund, ardently advocated by Dr Mahathir. However, the idea of a separate fund outside the control of the IMF was not favourably received by the US and the IMF.[3] Another reaction is a feeling of regret and resentment for having liberalised financial markets in the first place. Some of the most open economies suffered most, while China, Taiwan, India and other countries that restrain capital flows were spared the worst of the crisis.

Allowing free markets for currency exchange on the capital account (debt and equity transactions, effectively including those cash transactions not related to trade in goods and services) is seen by many policy-makers as the key source of difficulties. Taiwan's central bank, the Central Bank of China, has tightened up its monitoring of currency trading, and Taiwan is expected to delay the abolition of all cross-border capital controls planned for 2000. Until the crisis hit, China had been promising to allow free capital movement (its currency was internationally convertible on current account only); now the Chinese government is reluctant to take this step.

Asia's problems lay in the private sector, and thus IMF prescriptions calling for fiscal austerity among countries with low sovereign debt levels and high savings rates were not just inappropriate, but damaging. Tight monetary and fiscal policy quickly strangled all remaining strength in the healthy part of Asian economies, worsening

matters rather than resolving them. Conspiracy theorists (see Shintaro 1998) argue that macro-economic restraint is precisely the IMF's intent, choking off escape routes until recalcitrant Asian governments gave way to free market reforms. There is an ideological contest going on between the free market system and another type of capitalism, and Asian governments have long been pressured by liberal opinion to accept the ideologies of the West on faith. There is no conspiracy – only a necessity to be 'politically correct'.

ASIAN CAPITALISM IN THE AFTERMATH OF THE CRISIS

IS IT TIME TO GET RADICAL?

According to *The Economist* (1998), the causes of the Asian Financial Crisis might be interpreted in two ways: 1) a failure of Asian capitalism, or 2) a failure of market capitalism that led to a loss of confidence in Asian capitalism. Both these categories of causes have considerable basis. The first obviously was fundamental – weak financial institutions, government-business cronyism, etc. But Malaysia's faith in the international financial system is also quite shaken and its commitment to financial liberalisation very much in doubt.

The most obvious and remediable need is sound financial practices and better information – reform seems appropriate for Asian governments, companies and banks (and also the IMF). But the Asian financial community was experiencing considerable progress and development even before the crisis (see later). The World Bank (1993) credited Asian "policies to increase the integrity of the banking system" and "creating effective and secure financial systems" as prime causes of the East Asian "miracle" (Page 1994:2,3). John Page was team leader for the 1993 World Bank study.

By the time Malaysia had imposed capital controls in the autumn of 1998, intellectual acceptance of the need for such policies was spreading. This represents a sea change in economic thinking. Among economic theorists, the belief that free capital movement increases efficiency has been as much an article of faith as the traditional belief in the gains from free trade. However, a revisionist view has emerged as a result of the Asian Financial Crisis. Revisionists (see Bhagwati 1998) argue that the case for capital mobility is much weaker than the case for free trade. Markets for goods and services are reasonably stable; yet in financial markets, bubbles and crashes are endemic. Revisionists also

question the assumption that capital mobility has been a source of economic benefit – least of all for Asia. China, Taiwan and others (Japan in the early days) enjoyed economic success without allowing capital mobility.

Taking in the notion that market forces may be less than economically beneficial and rational is hard for the 'politically correct' to swallow. George Soros espouses his 'reflexivity' phenomenon to explain what motivates market players like himself. Reflexivity means supply and demand are not independent but are structured through perceptions of market possibilities, which perceptions in turn influence the possibilities. Essentially, the valuation of financial assets depends less on economic fundamentals than on investor expectations of the behaviour of other investors. Soros therefore questions the viability of free capital markets: "As I said, there is a question whether we can live with this knowledge of reflexivity, because when you have that knowledge, and everybody else in the market has that knowledge, markets become inherently unstable … . I'm afraid that the prevailing view, which is one of extending the market mechanism to all domains, has the potential of destroying society …" (*The Business Time*, 1 November 1997, p. 3).

Western *laissez faire* market theory is a conceptual heritage of the 18th century Enlightenment. According to Ayres (1998), the liberal quest of creating free "globalized markets" for everything represents a "victory of academic theory over common sense". This represented to Ayres the latest and probably the final utopian project inspired by the Enlightenment, driven "by the world's last great Enlightenment regime", the United States. Of course, free market ideology is always questioned when market forces seem beyond control, but the global capital meltdown of 1997-9 exacted too high a price in social dislocation and economic and political instability for our faith in the liberal vision of utopian society to endure. Complaints are mounting as, for example, debt to international banks is prioritised over public provision of education, health and other services.

'ASIAN CAPITALISM' REVISITED: RESULTS RATHER THAN FREE-MARKET PRINCIPLES

The currency crisis has been a watershed event in East Asia's development. In 1993 the World Bank praised Asian governments for their market-friendly public policy, and particularly for an effective govern-

ment role in achieving what the Bank called "stable and secure financial systems" and "macro-economic stability". This macro-economic stability was largely based on stable exchange rates linked to the US$. Now the formula for the East Asian Miracle has become a recipe for collapse.

Asian economic growth and the associated expansion of intra-Asian direct investment was largely predicated on a rather fortuitous circumstance that prevailed among exchange rates in the region, which promoted the "flying-geese pattern"[4] of trade and investment. The strength of the Japanese yen relative to the dollar since 1985 facilitated Japanese foreign direct investment into Asian countries (whose currencies followed the US$). Yen investments in turn created greater economic growth in the region, which spurred more trade and investment. This virtuous cycle was interrupted when the US$ instead appreciated. The US$ began to slowly turn around after hitting a low of 80 yen in the spring of 1995, and by the summer of 1997 the US$ was appreciating rapidly against virtually every major currency in the world.

Is macro-economic stability, which was credited so much for Asia-Pacific success since the mid-1980s, gone forever? Stable exchange rates linked to the US$ contributed to the East Asian economic 'miracle', as yen appreciation since 1985 led to a surge of Japanese investment in the region, an export boom, and considerable technology transfer and industrial upgrading. Foreign investment came to Southeast Asia both for purposes of 'outsourcing', or offshore production to export to the world market, and for purposes of market access to the growing purchasing power of regional consumers. Now the boom in regional markets has come to an abrupt end. Exporters to America and Europe expected to benefit from currency devaluation; but high import content keeps some export prices up, or low commodity prices keep returns down. One analyst argues that the historical experience in economic crises indicates that despite devaluation exports are almost never the source of recovery (Koh 1998). Throughout the first year of the Asian Crisis, currency volatility, high interest rates, and high inflation discouraged potential investment in export industries.

The recessionary trap of tight money hand-in-hand with a weak currency was finally thwarted by the sudden market interventions in autumn 1998 in Hong Kong and Malaysia. These dramatic strategies reflected the growing sentiment and conviction that stability must be reinstated, at the expense of some freedom in the flow of money.

Southeast Asian countries may wish to return once again to the old 'managed float' regime or some other formula for regulating their currencies to control volatility and maintain an appropriate purchasing power. However, government intervention in foreign exchange markets was largely discredited by the crisis. The defenses the region put in place in response to the attack on the Mexican peso (repurchase agreements between central banks to provide mutual support of regional currencies) were not successfully employed to stem speculation. In the early days of the Southeast Asian currency debacle, there was fruitless talk of creating an Asian Monetary Fund, an IMF-type institution to be funded and operated by Asian countries.

Now Malaysia's and Hong Kong's new interventionism signals another test of governments versus markets. Dr Mahathir, an ardent advocate of the AMF, was probably justified in avoiding IMF help for his country, if he still believes in the Malaysian government's developmentalist capacity. Mahathir's reasoning in calling for an AMF represented a wish (probably futile) to have Asians solve their own problems, since Asians may be more likely to retain some features of their 'Asian capitalism'. The IMF is, after all, a bureaucracy domiciled in Washington DC – effectively a state-owned enterprise ('owned' by member countries of the IMF) subject to all the failures of government interventions in markets. The IMF's claim to represent the values of market liberalism is only indicative of the ideological bent of its administrators.

Do the new interventions by the Malaysian government and others indicate a recasting of public policy in Asia, away from laissez faire? The current generation of politicians has been taught to keep their hands off the marketplace. However, the original character of Asian capitalism was never entirely lost. Asian capitalism still manifests a pervasive government role, with paternalistic leaders often taking on the responsibility to manipulate market forces in favour of the government's social, political or economic objectives.

There is room for doubt about how much will really change in Asia. Few Asians wholly embrace a reform process (largely based on the mold of modern American capitalism and the broadest extension of free markets) with the inherent message that Asian capitalism was wrong.

Much of East Asia's financial market liberalisation only occurred in the last decade, especially in Indonesia and Thailand. Liberalisation at first brought dramatic economic success, but today governments realise they must focus on rescuing the real economy of production and consumption from the ravages of their failed experiment in free financial

markets and banking systems. Despite the clamour for political change in so many Asian countries, there is ample evidence of a return to the old reliance on government to solve a nation's ills. A few examples follow:

- Bank restructuring in Japan, as well as South Korea, Malaysia and Indonesia is extending government ownership and control in the financial sector. Japan's $500 billion rescue package for its banks will result in subscribing banks agreeing to stringent government monitoring and even nationalisation.
- Hong Kong's Chief Executive Tung Chee Hwa seems to be reversing the island's colonial legacy of laissez faire, for example with measures to support the property market. This resulted in a subsequent surge in property sales that fueled the October 1998 stock market rally. Hong Kong's market ploy to buy off hedge funds dumping local currency and stocks was (perhaps only luckily) successful in the near term, lifting the Hang Seng stock index by the end of October 1998 nearly 50% from its pre-intervention lows in mid-summer.
- Malaysia's first desperate attempt at currency controls in 1997 failed badly, but their September 1998 policy was more carefully conceived. Besides this device, billion-dollar rescues of banks and companies are being mooted. Government-run trusts have reportedly bought stocks heavily. The government has been undeterred by its many detractors.
- With IMF blessing, the Indonesian government has nationalised nearly all formerly private banks, including the largest, Bank Central Asia. The state food monopoly Bulog is still in business (again with IMF approval) despite the IMF's initial insistence that food distribution be privatised.
- The Thai government now runs 6 of the nation's 15 banks and nearly all of its 60-odd finance companies.
- In South Korea, state-guaranteed bonds are being used to raise $35 billion for the government's Korea Asset Management Corporation to buy dud loans.

Throughout Asia, the need to enforce restructuring – and higher standards of corporate behaviour – is bringing the governments in. As nationalised banks swap bad debts for equity in firms, governments will own more corporate assets as well. Their involvement in most cases will be long-term.

Nevertheless, in the longer term the East-Asian governments are not likely to wrest control of their destinies from global markets and financial institutions – whether or not Malaysia's daring gambit with capital controls succeeds in the near term. It will be necessary, as Dr Mahathir must learn to his chagrin, to respect the values of the global economy – to be 'politically correct'. The secret to a renewed Asian "miracle" will be to once again become an attractive place to put money.

THE ROAD TO RECOVERY

To better understand the potential for recovery, in this section we explore the main markets for debt and equity financing: commercial banks, bond and stockmarkets.

Asian finance boomed in the 1990s, until the Financial Crisis. Three forces propelled financial development in Asia (excluding Japan):

1. The demand for capital was immense for emerging economies in Asia, most notably for infrastructural development. Power blackouts in the Philippines, traffic jams in Bangkok, impassible roads in China, long waiting lists for telephones in India, all attest the poor infrastructure in developing Asia that needs urgent attention. The Asian Development Bank estimated that developing Asian countries would need $1 trillion in new investment in infrastructure for the 1990s – 35% for China alone. That forecast was coming to fruition until the crisis hit. Latent demand remains to be satisfied.
2. Capital flowed in as private equity rather than simply government budget allocations, commercial loans and foreign aid. An advantage of private investors is that they often manage their own financing – thus they promoted development of domestic capital markets. But private firms need confidence that domestic markets will provide liquidity and good prices for their flotations. Portfolio flows will have to grow once again. Indeed, this reveals the folly of capital controls once recovery starts.
3. National governments were well aware even before the crisis of a need to revamp banking services and capital markets. New stock exchanges were being opened and banks deregulated. Expanded financial markets meet the demand for capital by attracting more sustainable flows of domestic savings and foreign investment.

Robust investment in Asia's emerging financial markets was a driving force behind the region's accumulation of large foreign exchange

reserves. Combined reserves held by central banks in Asia were reported at $609 billion (the European Union had only $343 billion), with the Bank of Japan having far the largest share at over $200 billion. *The Economist* (1995) reported the top ten holdings, which included six Asian countries: Japan (1st, with as much reserves as the 2nd and 3rd places combined); Taiwan (2nd); China (4th); Singapore (5th); Hong Kong (6th); Thailand (10th, Thailand depleted its reserves drastically during the summer of 1997).

Reserves are finally being replenished again, due to current account surpluses. In the malfunctioning markets of the crisis era, governments can have a substantial role to 'recycle' the surpluses now being generated in virtually every crisis-hit country. A noble (yet controversial) purpose might be to rejuvenate capital markets: tap liquidity in the economy through bond issues for example (see later), and put money back into national markets as Malaysia is attempting to do.

DEBT FINANCING – BANKS AND BOND MARKETS

Asian banks had been growing very successfully and making profits through the mid-1990s, largely due to the immense pool of funds made available by high domestic savings rates. Relative dominance by banks facilitated government-directed financing in the early years. Furthermore, governments intervened in support of their domestic banking industry by owning banks or by guaranteeing loans made in compliance with industrial policy. Today, governments from Japan to Indonesia have to nationalise banks in the name of reform. However, local banks, whether state-owned or private, face new competitive pressures from many quarters: foreign competition, other domestic markets, and the growing variety of ways to raise capital.

Concerning the variety of ways to raise capital, disintermediation has been a growing phenomenon in Asia. Instead of employing banks as intermediaries to obtain their loans, borrowers go straight to capital markets to issue their own debt instruments. Now there is a need to securitise bad debts at substantial discounts. To raise money in the current credit crunch, enterprises can repackage into marketable securities anything on their balance sheet that provides a regular income stream.

Similarly, investors are putting their money in other domestic markets instead of only investing in bank accounts. For example, in India mutual funds are gaining on the banks as a receptable of funds. In this way the raising of capital revolves less and less around traditional

bank lending and increasingly around the capital markets – particularly bond securities.

In the fledgling bond markets of Asia, governments may have relatively more room for bond issues due to very low sovereign debt (Basu 1998). Fiscal stimulus requires financing which might be raised in bond markets. A Malaysian banker remarked: "I believe that we will increasingly see restructuring schemes involving the swapping of future cash flows [for current bad debts]. Here the government can have a substantial role to play. In the domestic market, the government can enhance the creditworthiness of any bond issue arising from such swaps" (Phuah 1998). In Singapore, large state-owned firms and statutory boards, which used to rely on borrowing from the postal and savings banks, are now actively encouraged to raise money through bond markets.

Financial liberalisation and the restructuring of domestic banks is allowing foreign banks to enter the competition. Thus, the Asian banking community is under pressure; but most banks were doing well until the crisis. Their success was due to the entrance of new savers and new borrowers still demanding their services. Peasants from the countryside were becoming newly rich, and they tend to save in the traditional way, in local banks. Small and medium-sized enterprises were emerging in great numbers to meet the opportunities in Asia's dynamic economies, and these firms are not sophisticated or reputable enough to float new securities themselves.

Liberalisation has allowed local banks to diversify and compete freely in new businesses. The theoretical benefits of liberalisation come into play, ie, the bracing winds of competition force local banks to modernise and compete with the best banks in the global industry and with the capital markets. The big commercial banks in Malaysia and Singapore were developing investment-banking and stock-broking expertise before the crisis. Thus banks have growing interests in capital markets.

EQUITY MARKETS

Stockmarket capitalisation in Asia (excluding Japan) increased from $195 billion in 1987 to $1000 billion in 1994, just before the Mexico crisis. Asia's share of the global equity market was rising to match its big share of the world economy. The largest markets as of September 1994 were in Hong Kong, Malaysia, Taiwan, South Korea, Thailand, Singapore, India, China, and Indonesia in that order. (In terms of number of companies listed, India is far the biggest – India under British rule

established its first stockmarket in the 19th century). Ironically, the largest two markets are now basing recovery upon interventionist policies – a rejection of economic orthodoxy!

The year 1993 was a watershed – it was the year international investment funds flocked to Asia (besides being a bull-market year). American outflows to foreign stockmarkets increased by four times. But 1997 marked a changing of the tide; and in autumn 1998 capital was withdrawn from emerging markets worldwide.

Investment in capital markets in Asia may be set to recover strongly, once the crisis in confidence is over. With large privatisation flotations, stock markets can continue to expand and mature. The privatisation of Singapore Telecoms in 1993 increased market capitalisation by 20%. Issues for major infrastructure are planned for the future. Indeed, privatisation will be demanded once again by the IMF. Now governments are enlarging their portfolios to salvage impaired national assets, but much of this will eventually be re-privatised. Thus, there will be no shortage of investment opportunities. And as Asia's rumour-driven equity markets broaden and mature, they will lose some of their notorious volatility.

Risk of market volatility should be reduced by portfolio diversification into Asia where market movements have not correlated with New York. But did portfolio diversification actually reduce risk, as it is supposed to? High-flying global markets tended to be risky even before the Asian Financial Crisis of 1997-8. The Taiwan market fell by 80% in the early 1990s. Shenzhen's B share market (for foreign investors) lost 50% in the first half of 1994, and Shanghai's A market (for local investors) crashed 40% in two days in October 1994. The Mexico blow-out at the end of 1994 had much wider international repercussions that certainly burned a few fingers. Indeed, emerging markets are more volatile, for legitimate reasons:

1. Investors are still groping for fair values. Market prices anywhere, after all, have no binding rules of value; and emerging markets have an insufficient track record to legitimise given price levels.
2. Small investors and syndicates are relatively dominant, rather than professional investment houses that should be more rational and more stable in their investment behaviour.
3. Regulation is generally weak, and manipulation more possible. In thinly traded markets, major players can control the market to an alarming degree.

In the early 1990s Thailand, Malaysia, India, and China established 'securities and exchange commissions' in the model of the American SEC. Singapore is attempting to develop institutional investor organisations, which helps stability. Now the urgency of reform is top priority, to reinforce supervision and improve transparency in markets.

From our examination of the main sources of financing – commercial banks, bond and stockmarkets – it is evident that the financial institutions are not standing still and are potential means for mobilising debt and equity, once capital inflows return. Investor interest is finally reviving, initially in South Korea and Thailand. In the long term, East Asia's markets will once again attract private investment.

CONCLUSION

East Asian governments seek a rebirth for their countries, but in their own image – upon their own social, economic, and political foundations. Asians are in the process of reappraisal of, for example, the relationship between government and business and proper standards of conduct and disclosure. Western-style responses will not always be appropriate. The challenge is to resurrect Asian capitalism, renewing the values and institutions that led to the Asian "miracle" and jettisoning the elements that led to the Asian 'crisis'.

Today's dominant political-economic doctrines rule out an interpretation of the crisis, or solutions to it, that impute blame on the effects of the ideology of free global markets. No East Asian country, not even Malaysia, wants to withdraw from the global economy, but their faith in the international financial system and even global capitalism has taken a blow.

At this late stage in the crisis, we are still left with more questions than answers. The key is perhaps to ask the right questions. It may be appropriate to ask: How can Asian capitalism adjust to the challenge of global integration; also, how can the international financial regime accommodate such different, legitimate forms of national capitalism and allow all elements of the system to coexist peacefully?

There appears a need for a two-pronged approach: to reform national financial systems but also create smoother transitions in global systems. As if to demonstrate self-confidence that their "Asian capitalism" does not deserve its bad press, Asian governments are now stepping in to solve their own problems in their own ways. Even so, selective govern-

ment interventions should be expected to be market-friendly. This will be essential to make Asian financial markets attractive to investors as the region finally recovers.

NOTES

1. James W Dean synthesizes recent arguments by himself, Paul Krugman and others that large current account deficits were sustainable as long as capital account surpluses were well invested. But unrestricted, cheap foreign capital led to excessive monetary growth and asset inflation. Because banks dominated financial intermediation in the economies worst-hit by the Crisis, banks in effect controlled the countries' money supply. By this account, the Asian Crisis was precipitated by asset deflation and the first failures of financial intermediaries in Thailand (Dean, forthcoming).
2. In its self-assessment published in 1999, the IMF asserted that their policies should have restored investor confidence. But for only vaguely understood reasons -including perhaps the increasingly negative perceptions of global market players about Asian political developments and Asian capitalism generally – capital continued to exit. Market reaction, apart from the policies themselves, was a crucial variable.
3. The United States has the biggest say in IMF affairs, with an 18% voting share on the board, and top American policymakers are consulted closely.
4. The flying-geese model has been used to depict the shift of industries from more advanced countries to less-developed ones (and the dynamic change in capital and trade flows), motivated by technological progress and the search for lower production costs. It was particularly applicable to describe economic development in Asia spurred by Japanese investment (Akamatsu 1962; Kwan, 1996).

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Department of Business Policy
Faculty of Business Administration
National University of Singapore
Kent Ridge Crescent, Singapore 119260