

The Asian Financial Crisis in Retrospect

Jeffrey D. Sachs
Center for International Development
Harvard University
jeffrey_sachs@harvard.edu

and

Wing Thye Woo
University of California, Davis
wtwoo@ucdavis.edu

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For a while, in the darkest moments of the Asian financial crisis in 1998, it was widely predicted that East Asia would continue to be deathly sick for the next two to four years. While it is fortunate that the news of the (near) death of the East Asian miracle was greatly exaggerated, this economic earthquake remains a tragic disaster in human terms. The tremendous destruction of wealth and the pushing of a significant proportion of the population in the poorer countries to below the poverty line caused political volcanoes to erupt in several countries. New governments have emerged in Indonesia, South Korea and Thailand; and the political leadership is split in Malaysia. The social after-shocks of this economic earthquake are still being felt in April 2000.

The Crisis in Hindsight

For the economics profession, the Asian financial crisis has been divisive and, for some economists, humbling. The International Monetary Fund (IMF), the financial firefighter of the world, under-predicted the severity of the output collapse in every one of its program countries,¹

¹ Lane, Ghosh, Hamann, Phillips, Schulze-Ghattas and Tsikata (1999), and IMF (1997).

and then went on to under-predict the pace and strength of the economic recovery.² This systematic failure in prediction by the IMF of output behavior in the crisis countries certainly suggests an institution that neither understood the cause of the region-wide crisis nor knew what the optimal rescue package for these countries should have been.

It was in support of this impression of an incompetent IMF that Joseph Stiglitz, the Chief Economist at the World Bank during the crisis, wrote in April 2000:

“IMF experts believe that they are brighter, more educated, and less politically motivated than the economists in the countries they visit. In fact,... the IMF staff...frequently consists of third-rank students from first-rate universities...Quite frankly, a student who turned in the IMF’s answer to the test questions “What should be the fiscal stance of Thailand, facing an economic downturn?” would have gotten an F.”³

The economics profession is certainly divided over the IMF’s performance but not in a clear-cut fashion, however. For example, among the economists who agree with Stiglitz that the first IMF programs that Indonesia, South Korea and Thailand were badly flawed, many would differ importantly both from his reasons for why the IMF made mistakes and from his negative assessment about the analytical capability of the IMF.

The economics profession has shown uncharacteristic humility over its initial judgement of the Asian financial crisis. The well-known economist, Paul Krugman, has conveniently left on his website a well-documented record of his stream of consciousness about the crisis, so we will use his intellectual odyssey as the expository device to capture an important evolution in the view of the economics profession toward the Asian financial crisis.

In March 1998, Paul Krugman opined that:

“Broadly speaking, I would say that there are two approaches to the Asian crisis....One approach – which I would identify mainly with Harvard’s Jeffrey Sachs – regards what happened to Asia as basically

² IMF (1998)

³ Stiglitz (1999)

a modern, high-tech, multicultural version of a good old-fashioned financial panic... The important point to make here is that a panic need not be a punishment for your sins. In principle, at least, an economy can be “fundamentally sound”... and yet be subjected to a devastating run started by nothing more than a self-fulfilling rumor...

“OK, as you may have guessed, I don’t buy that story.. The story I believe...argues that the preconditions for that panic were created by bad policies in the years running up to the crisis. The crisis, in short, was a punishment for Asian crisis, even if the punishment was disproportionate to the crime.

“What were these Asian crises? We hear now about ‘crony capitalism.’ It’s a good phrase, and it certainly captures the spirit of what went on in much of Asia.. The specific spirit that pushed Asia to the brink was the problem of moral hazard in lending – mainly domestic lending.”⁴

Following his crony capitalism analysis of the crisis, Paul Krugman (1998a) went on to deliver a defense of the IMF policies, which had been criticized (by Jeff Sachs, for example) as overly deflationary. He felt that the policies were justified because the IMF was not a true lender-of-last-resort due to its limited financial capital, and because the IMF had little choice (“the Fund must either confront crony capitalism or stay out of the picture altogether”).

However, seven months later, in October 1998, Paul Krugman (1998b) completely reversed his assessment of the crisis in an article entitled “The Confidence Game: How Washington Worsened Asia’s Crash.” In Krugman's new awareness:

"When the Asian crisis struck, .. countries were told to raise to raise interest rates, not cut them, in order to persuade some foreign investors to keep their money in place and thereby limit the exchange-rate plunge... In effect, countries were told to forget about macroeconomic policy; instead of trying to prevent or even alleviate the looming slumps in their economies, they were told to follow policies that would actually deepen those slumps.

“ .. [To understand the perverse macroeconomic policy stance] consider the situation from the point of view of those smart economists

⁴ Krugman (1998a)

who are making policy in Washington. They find themselves dealing with economies whose hold on investor confidence is fragile... The overriding objective of policy must therefore be to mollify market sentiment. But, because crises can be self-fulfilling, sound economic policy is not sufficient to gain market confidence; one must cater to the perceptions, the prejudices, and the whims of the market. Or, rather, one must cater to what one hopes will be the perceptions of the market.

“In short, international economic policy ends up having very little to do with economics. It becomes an exercise in amateur psychology, which the IMF – whose top economist Stanley Fischer, boasts credentials just as impressive as those of Summers and his crew – and the Treasury Department try to convince countries to do things they hope will be perceived by the market as favorable. No wonder the economics textbooks went right out to the window as soon as the crisis hit.

“Unfortunately, the textbook issues do not go away.... The perceived need to play the confidence game supercedes the normal concerns of economic policy. It sounds pretty crazy, and it is.”

What led to Paul Krugman’s startling apostasy? In a retrospective piece in a September 1999 issue of Slate, Krugman (1999) asked:

“Where do I fit in? In the summer of 1998, I began to reconsider my own views about the crisis. The scope of global “contagion” – the rapid spread of the crisis to countries with no real economic links to the original victim – convinced me that IMF critics such as Jeffrey Sachs were right in insisting that this was less a matter of economic fundamentals than it was a case of self-fulfilling prophecy, of market panic that, by causing a collapse of the real economy, ends up validating itself.”

Several papers in the August 2000 issue of the ASEAN Economic Bulletin (AEB-Aug2000) reached the same conclusions as Paul Krugman finally did. Patrick Damien Carleton, Brian Pilapil Rosario, and I in “The Unorthodox Origins of the Asian Financial Crisis: Evidence from Logit Estimations” examined the currency experiences of 57 countries in the 1970-96 period, and found that inflationary macroeconomic policies and small stocks of foreign reserves

were reliable predictors of currency collapses. We found that the individual probability of Indonesia, Malaysia, Philippines, South Korea and Thailand experiencing a currency collapse in 1997 was about 20 percent, which meant that only one of these five countries should have experienced a crisis. Since all five currencies (and economies) collapsed rather than just one as expected, it seems that financial contagion is a better explanation than weak domestic fundamentals.

In “Coping with Accelerated Capital Flows from the Globalization of Financial Markets,” (AEB-Aug2000) I examined the movements of the risk premia levied on Eurobonds issued by East Asia, and came to two conclusions. First, the great increase in capital flows into East Asia during 1994-96 was accompanied by a secular decline in the risk premia. These price-quantity movements indicate a positive shift in the supply of funds to Asia. This verification of the existence of “irrational exuberance”,⁵ implies that the opposite phenomenon, investor panic, must also exist.

Second, the risk premia on Thai Eurobonds increased by 10 basis points following the July 2, 1997 devaluation but it jumped 40 basis points upon the implementation of the IMF program in August 1997. This supports the contention that the IMF program of deflationary macroeconomic policies and abrupt bank closures undermined investor confidence instead of restoring it!

Anwar Nasution in “The Meltdown of the Indonesian Economy: Causes, Responses and Lessons,” (AEB-Aug2000) pointed out that it was important to cleanse the financial system of insolvent banks but the Indonesian way of doing so (in compliance with IMF conditionality) in late 1997 exacerbated the economic crisis. The government should have taken over the running of the insolvent banks in the short-run rather than have closed them down precipitously. This

way, the lines of credit to solvent borrowers would not have been disrupted, and the confidence of the depositors unperturbed.

To sum up, in hindsight, we can say that:

- a) investor panic was the cause of the Asian financial crisis;⁶
- b) tightening macroeconomic policies (particularly fiscal policy) is an inappropriate response to panic-induced crisis; and
- c) the shutting down of the insolvent banks in Indonesia, South Korea and Thailand should have been carried out in a manner that was sensitive to the possibility of triggering bank runs.

Insights from the Crisis

There are too many valuable insights in the voluminous literature on the Asian financial crisis for us to summarize here.⁷ We have selected two of them for discussion here because of their wide implications for economic management. The first deep insight concerns the natural working of the market mechanism, and the second deep insight concerns the broader context within which the market mechanism operates.

There has long been a tradition of resistance within the economics profession to acknowledge the phenomenon of disorderly market behavior. The most commonly used defense against claims of speculative bubbles is the alternative hypothesis that unstable asset prices reflect unstable government policies. The claim is that observed flip-flop movements in asset prices reflected rational anticipations of changes in government policies that were not realised.

⁵ A term coined by Alan Greenspan in December 1996 to describe the U.S. stock market.

⁶ A point also made by Montes (1998), McKibbin (1998) and Chang (1999).

⁷ See, for example, Delhaise (1999), Eichengreen (1999), Garran (1998), Jomo (1998), McLeod and Garnaut (1998), Woo, Sachs and Schwab (2000) and World Bank (1998).

This defense against the speculative bubble hypothesis is known in the financial literature as the "peso problem."

The truth is that the peso problem hypothesis cannot really be disproved, even in the case where the fundamentals, ex post, were stable for a long period of time. To see the difficulty of disproving it, suppose that agents, after long experiences with government behavior, have concluded that the government is the chief destabilizing force, and adjusted their financial market behavior accordingly. If the government were to now cease being a destabilizing force, the very fact that the behavioral norm of the government had changed fits the definition of a vacillating government! There is just no way of getting around the sophistry of a determined peso problem believer.

The fact that financial contagion has been common in the 1990's cannot be in serious dispute: the European Exchange Rate Mechanism crisis in 1992-93, the Mexican and Latin American financial crisis in 1994-95, the Asian financial crisis in 1997-98, the conversion of the Russian ruble to a ruble in August 1998, and the collapse of the Brazilian real in January 1999 to a more realistic level. It stretches credibility, if not also the imagination, that all these governments coincidentally shifted to destabilizing policies in the same decade. Herein lies the first deep insight from the Asian financial crisis: *occasional excessive price movements in financial markets are normal and should not be labeled 'peso problems' in a knee-jerk fashion.*

The unpleasant truth is that "bad things can happen to good people" and that economic disasters are not necessarily penitence for economic sins. Crony capitalism is bad regardless of where it exists but it was not the cause of the Asian financial crisis. Paul Volcker (1999), former Chairman of the Federal Reserve Board, put it very well when he wrote:

"International financial crises, I might even say domestic financial crises, are built into the human genome. When we map the whole

thing, we will find something there called greed and something called fear and something called hubris. That is all you need to produce international financial crises in the future. I have not seen anything to raise any doubts about that.”

The rejection of the dogmatism of the peso problem approach to interpreting economic phenomenon leads naturally to the rejection of the dogmatism of unreflective market bias. It is with this open-mindedness that Mahani Zainal Abidin assesses the controversy over the use of capital controls in Malaysia in “Implications of the Malaysian Experience on Future International Financial Arrangements” (AEB-Aug2000). To be modest, one can safely say that the capital controls have not rendered the recovery in Malaysia slower than in the other crisis countries. To be less modest, one can point out that the 1998 collapse in Malaysia was smaller than in Thailand and the Philippines, and that the 1999 recovery in Malaysia was faster than in these two countries. Mahani identified the chief virtues of the controls to be the monetary policy independence to reflate the economy, and the breathing room to drastically restructure the financial and corporate sectors. The main cost of the controls was that Malaysia missed most of the international capital that returned to the region beginning 1998:4Q. A possible cost, that is still not yet clear, may come from concerns that a similar policy could be reintroduced prior warning, hence resulting in a higher risk premium in the future for Malaysian-issued Eurobonds.

The second deep insight from the Asian financial crisis is that “getting the institutions right” is just as important as “getting the prices right” if long-term stable growth is to be guaranteed. This insight is shown most clearly in the case of Indonesia. The larger output loss and slower recovery in Indonesia compared with its neighbors should really be seen more as a political failure than as an economic failure.

In the three-decade long rule of Soeharto, he relied upon satisfactory economic growth as the justification for his stewardship of the country. Regularization of the political process was

neglected because Soeharto recognised such regularization as a reduction in his power. So instead of establishing political institutions and channels to resolve important socio-political issues about regime legitimacy, political succession, administrative transparency, regional concerns, ethnic disputes and religious tensions, Soeharto resorted to political manipulation, co-optation, and occasional violence to minimize discussions of these issues. The result is that beneath the façade of stable rule buttressed by support from the armed forces, social dissatisfaction with the Soeharto regime was rising in step with the expansion of the middle and professional classes, and in step with the growth of special economic privileges to Soeharto's children, e.g. subsidised loans from state banks, and monopoly import licenses.

As Soeharto entered into his seventies, and as his health showed signs of decline, the tensions associated with political succession became impossible to contain, and fissures within the army appeared. The fissures multiplied and widened when Soeharto promoted his son-in-law, General Prabowo Subianto, over several more senior generals to be the head of the most powerful military command based in Jakarta (Kostrad) -- the post that Soeharto held when he made his bid for political power in 1965. Soeharto's increasingly tendency toward an "all-in-the-family" approach to economic and political matters discredited him considerably within his core constituencies, the army and the bureaucracy. Once the Asian financial crisis revealed that the aging Soeharto had become an incompetent manager, there was massive withdrawal of political support by the upper and middle classes, and factionalism within the army and the civilian bureaucracy spun out of control. The Indonesians, unlike the Malaysians, the South Koreans and the Thais, did not have the option of expressing their outrage at gross incompetence through the ballot box, and so they expressed their outrage in the only form available to them -- a social explosion that deepened and prolonged the economic meltdown.

The Indonesian experience supports the contention that socio-political development must accompany economic development in order to maintain social stability, a primary prerequisite for continued economic growth. The political transition away from ‘strongman rule’ that had occurred in South Korea and Taiwan must also occur in the remaining authoritarian states in East Asia where democracy has been slighted as a mechanism for resolving social tensions. The case for the expansion of democratic political institutions is based not only on moral ground but also on pragmatic, long-term economic considerations.

Of course, political institutions are only a subset of the institutions that have to be appropriate and in place in order to promote economic growth. The efficient working of the market mechanism necessitates the presence of infrastructural institutions like modern corporate governance; well-defined, transparent bankruptcy procedures; protection of intellectual property rights; and prudential supervision of the financial sector. It must be kept in mind however that democratic political institutions and the infrastructural institutions of the market can work to their full potential only if an efficient, objective legal system is already firmly in place.

The Courage to Have Foresight?

Given our better understanding of what happened in Asia in 1997-98, and of the general nature of currency crises, what can we expect of the future? Because foresight in the sense of prediction is necessarily more speculative, it naturally spans a wide range of possibilities. But one thing that we can be reasonably confident about is that the process of financial market integration will continue, if not accelerate, and this development, *ceteris paribus*, will make currency crises even more common.

If we think of foresight in the sense of making prudent provisions for the future, then, based on the study we conducted for the January 1999 meeting of the World Economic Forum and published as Woo, Sachs, and Schwab (2000), we want to suggest thirty recommendations for global reform in seven areas:

- ❑ the financial and non-financial sectors of developing countries;
- ❑ the International Monetary Fund;
- ❑ the international monetary system;
- ❑ the design of international "rescue" packages;
- ❑ the regulation of international capital markets;
- ❑ short-term Pacific Asian financial management; and
- ❑ long-term Pacific Asian institutional reform.

Financial reforms within developing countries

First, and foremost, the financial markets in developing countries require root-and-branch reform in many cases. The institutional weaknesses of domestic corporations (both financial and non-financial) render them susceptible to creditor panic. In order to increase the resilience of the financial sector and the non-financial corporate sector to external creditor shocks, and to enable these sectors to recover rapidly after the occurrence of such shocks, the research team proposes eight reform measures in this area:

Proposal 1: Financial institutions should more quickly adopt internationally accepted accounting standards. Major international accounting firms should work together with the international agencies to increase the standardization of accounting practices in the emerging markets.

Proposal 2: The supervision of financial institutions must be enhanced and BIS-style⁸ prudential ratios must be enforced on the financial institutions. As part of this process of improved supervision, there should be:

- much wider membership of developing countries in the Bank for International Settlements;
- an intensive international effort to upgrade the technical capacity of banking supervisors; and
- new BIS standards that are appropriate for the volatile conditions of emerging markets. The capital adequacy ratio should take into account that the bank's capital may be denominated in the home currency but a significant part of its loan portfolio may be denominated in another currency.

Proposal 3: The ownership structure of the banking sector in emerging economies should be diversified to include foreign ownership, in order to reduce the risks of systemic banking collapse, and to generate demonstration effects to the domestic banks regarding efficient operations and prudent risk management.

Proposal 4: The development of the non-bank financial sector (e.g. equity and bond markets) should be promoted because the over-reliance on bank credit in many developing countries has made them excessively vulnerable to financial panics.

Proposal 5: The legal underpinnings of corporate governance should be clarified, especially to protect minority shareholders. Part of the vulnerability to financial panic arises from the lack of clarity of property rights within the emerging market economies.

Proposal 6: Modern bankruptcy law should be introduced in order to forestall creditor panics (or "grab races") in the event of financial distress.

Proposal 7: Financial institutions should be required to file more frequent reports on their portfolios and their exposure to sectoral and currency risks, in order to allow better oversight by shareholders and the regulatory bodies.

Proposal 8: Short-term foreign borrowing by domestic banks should be tightly limited as a matter of prudential policy. Excessive short-term foreign debts of Asian, Russian, and Brazilian banks contributed to the onset of financial crises in all of these economies.

Reform of the International Monetary Fund

Grave flaws in the IMF's procedures and policy recommendations have become apparent in the course of the crisis. Each of the IMF's major packages in the past two years has failed to meet its targets, and many of the programs (for example, Korea, Russia, and Brazil) have

⁸ BIS = Bank International Settlement.

collapsed within weeks of their approval. The performance of the International Monetary Fund (IMF) has left much to be desired. External supervision of the IMF must be increased and improved, and this requires the decision-making process within the IMF to be more transparent, and more democratized to include a larger number of developing countries. We propose four reform measures to improve international management of future crises, and to renew legitimacy of the international financial system itself:

Proposal 9: The international community should establish an IMF External Review Commission to review the functioning of the IMF in various of its major recent activities: its handling of the international financial crisis; its policy advising to developing countries; and the IMF's structural adjustment programs in the poorest countries.

Proposal 10: Archived IMF materials should be made public to allow outside surveillance of the institution.

Proposal 11: IMF voting powers should be reformed in order to give greater representation to developing countries, which, after all, constitute eighty-five percent of the world's population, and which bear the burden of failed IMF strategies.

Proposal 12: The functioning of the IMF Executive Board should be over-hauled, including: public hearings; opportunities for outside parties to submit evidence to the Board; and solicitations of professional opinions by the Executive Board from beyond the IMF staff.

Reforms of the international monetary system

The third set of reform recommendations arises from the deep instabilities in the international financial system. The events in East Asia, Russia, and Brazil, demonstrate the instability of short-term capital flows, and their tendency to oscillate between waves of euphoria and waves of panic. These instabilities have been exacerbated by systems of pegged exchange rates, as were used in Thailand, Korea, Russia, and Brazil. As the IMF can not, and should not, be either the international lender of last resort or the international deposit insurance agency, we recommend three main reform measures in this area:

Proposal 13: In general, countries should pursue flexible exchange rate arrangements (e.g. wide crawling bands, open floats). In every case of serious financial crisis -- including Mexico in 1994, Argentina in 1995, Korea and Thailand in 1997, Russia in 1998, and Brazil in 1999 – the country pursued a fixed exchange rate policy in the years leading up to the crisis, and the system of fixed rates clearly contributed to the onset of the crisis.

Proposal 14: Because the IMF is not (and can not) be a true international lender of last resort, there is no justification for the monopoly position of the IMF as the sole international arbiter of monetary affairs. Regional monetary bodies, for example within Pacific Asia, or within other emerging market regions, could provide mutual support in the event of a financial crisis hitting one or another member country.

Proposal 15: An international bankruptcy system should be established in order to accelerate an orderly workout of international debts when a developing country falls into an extreme indebtedness crisis. As an interim measure, the writing of contracts for Eurobonds should be amended to create “standing committees of creditors”, and to introduce some of the standard bankruptcy procedures e.g. the automatic stay provision (to prevent grabbing of assets before resolution of bankruptcy in domestic court), and the debtor in possession provision (to enable the firm to continue to obtain working credit while the domestic bankruptcy process takes place).

Reforming international "rescue" packages

The IMF has launched five major “rescue” packages in the past two years: Thailand (August 1997), Indonesia (November 1997), Korea (December 1997), Russia (July 1998), and Brazil (December 1998). None of these packages succeeded in re-establishing market confidence, or in reducing the adverse macroeconomic effects of international financial panic. Indeed, all of these packages quickly collapsed and required renegotiation. This clearly suggests that there have been major flaws in the design and implementation of these policy packages. Among other things, standard features of domestic bankruptcy procedures should be part of international rescue packages; and IMF funds should certainly not be used to defend overvalued exchange rates. We have identified at least three areas of needed change:

Proposal 16: Debt relief often needs to be an integral component of "rescue" packages in order to encourage creditor-debtor bargains to stretch out loans, convert debts to equity, and occasionally a permanent write down of claims.

Proposal 17: IMF programs must not be designed to defend pegged exchange rates (as in the Brazil and Russia programs) because, at best, such IMF programs promote sharp recessions, and at worst (as in Russia and Brazil) the currency collapses anyway.

Proposal 18: Rescue packages should “bail in” (rather than “bail out”) the international private investors by insisting that the private creditors bear the major burden for renegotiating the timing and repayment terms on existing debts when a financial crisis emerges. For example, the private creditors may be called upon to roll over existing claims, as occurred in the case of Korea in December 1997.

Regulatory reforms of international capital markets

The fifth set of reform recommendations addresses the dangers of premature capital account liberalization in emerging markets before the necessary supervisory and regulatory standards are in place. The regulation and monitoring of international capital markets should be stricter and internationally coordinated. We recommend the following four reform measures to prevent short-term capital movements from destabilizing an economy, and forcing the government into an expensive financial bailout of the banking system:

Proposal 19: Controls on short-term capital inflows into emerging markets can help to maintain macroeconomic and financial stability. But while controls on short-term capital inflows may be advisable in many countries, controls on capital *outflows* should almost always be avoided, since controls on outflows tend to undermine government credibility and provide an inducement towards irresponsible policies.

Proposal 20: While short-term capital inflows should be discouraged, long-term capital inflows (especially foreign direct investment) should be promoted. There are still major strides to be taken in many developing countries (e.g. in areas of telecoms, banking, and other modern services) in allowing foreign investors to gain ownership over domestic enterprises.

Proposal 21: There should be informative and timely disclosure of hedge funds, cross-border lending, and derivatives transactions to enable policy makers in the developed and developing countries to know the external financial exposures of their national financial institutions.

Proposal 22: There should be greatly enhanced regulation of highly speculative activities such as highly leveraged hedge funds.

Proposal 23: The international community should immediately constitute a working group on international capital flows, including representatives of the developed countries, the developing countries, the major international institutions (IMF, BIS, WTO, UNDP, WB, and others)⁹, as well as private-sector observers, to report to the respective international institutions within one year on improvements in the oversight and regulation of cross-border capital flows.

Short-term financial measures to restore growth in Pacific Asia

The most serious immediate problem of the Asian crisis countries is the tremendous amount of bad debts in the banking and corporate sectors. The bad debts are paralyzing the credit system and inhibiting investment. The answer to the bad debt problems must be a series of negotiations between creditors and debtors to restructure the debts. At the same time, a large-scale infusion of public money to recapitalize the banking systems in Asia is also unavoidable.

We make four recommendations for financial workouts in Asia:

Proposal 24: The re-capitalization of banks in Pacific Asia should be accelerated, through a combination of public money, foreign investors, and contributions by existing owners.

Proposal 25: The government should replace the non-performing loans (NPLs) of the banking system with government bonds, and in return the bank owners should agree to repay the government bonds over a set period, or to convert the government bonds into bank equity if the banks can not service the bonds.

Proposal 26: Having acquired the banks' NPLs at a discount, the government should give debt relief to the firms based on their capacity to pay, and specifically:

- debt relief should be concentrated on small and medium-sized firms because they have been hit the hardest by the credit crunch; and
- debt write-downs for the larger corporations should be conditional on debt-equity swaps, in which the government gains some equity share in the corporations. This equity share would later be auctioned as a form of "re-privatization" of the government's stakes.

Proposal 27: The barriers to entry by foreign banks should be lowered to provide the competition that is needed to prevent domestic banks from imposing wide spreads between deposit and lending rates in order to earn their way out of the crisis, but at disastrous costs to domestic corporations.

⁹ WTO = World Trade Organization; UNDP = United Nations Development Program; and WB = World Bank.

Long-term measures to enhance Asian competitiveness

In our opinion, the greatest long-term challenges to Pacific Asia lie not in financial regulation, macroeconomic stability or exchange rate management but in “social software,” such as the quality of education, the overhaul of public institutions, the enhancement of science and technology, and increasing the democratization of political structures. There is a serious mismatch in Pacific Asia, particularly in most of Southeast Asia, between investment in physical hardware – factories and machinery – and investment in the social software – scientific research centers, administrative and judiciary systems, and growth of civil society. The annual *Global Competitiveness Report* (GCR) gives some clear and quantifiable evidence of the shortcomings in these areas. While the Asian manufacturing countries (China, Indonesia, Japan, Korea, Taiwan, Malaysia, Thailand and the Philippines) achieved an average overall ranking of 21st out of 53 countries in the 1998 GCR rankings, and a particularly high ranking of 9th on fiscal management, these countries scored a surprisingly low rank of 30th in technology, and 34th in quality of governmental institutions.

While it is now increasingly recognised that the enrichment of the domestic scientific base is crucial for sustaining high economic growth, it is less recognised that Asia’s flawed social infrastructure and inadequate political institutions – which have allowed for too much corruption and mismanagement – are a cause for serious concern. In a world of growing international competitiveness, when foreign direct investors are courted not just by Asia but Central Europe and Latin America, the concerns over governance are bound to grow, and to weigh increasingly heavily on the unreformed countries of Asia. We make three very general recommendations to address fundamental problems of harnessing technology and skilled manpower, and establishing adequate social infrastructure for sustained economic development.

Proposal 28: The Southeast Asian countries should make a determined effort to raise the standards of science and technology within their societies. Among other steps, this will require much greater support for higher education, as well as encouragement of much closer links between universities and the private sector, such as the collaborative relationships found especially in the high-tech areas of the U.S. economy (such as information technology and biotechnology).

Proposal 29: In enhancing the quality of public institutions, appointments and promotions should be based primarily on merit and not on, say, ethnic identity or ideology.

Proposal 30: Pacific Asia must launch a concerted effort to upgrade its public institutions particularly its civil service and its judiciary system. For example, according to the 1998 GCR, Indonesia was ranked 53rd out of 53 countries regarding the independence of the judiciary, with Malaysia, Thailand, Korea, China, Taiwan, and the Philippines all ranked worse than 30th.

In our opinion, it is hard to over-emphasise that the long-term competitiveness of Asia rests as much on “getting the institutions right” as on “getting the prices right.”

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