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Bitter Medicine for Sick Tigers: The IMF and Asia's Financial Crisis

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This issue of Pacific Rim Report *features an analysis of Asia's financial crisis by Shalendra D. Sharma. The paper presented here is an edited version of a larger study entitled "Risks and Benefits of Globalization: Lessons from the Mexican Peso Crisis of 1994 and the Asian Financial Crisis of 1997" and the outgrowth of a multiyear research project examining policy issues confronting ASEAN, sponsored by the USF Center for the Pacific Rim under the direction of Sharma.*

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In July 1995, during one of their usually sedate summer public forums, senior policy makers at the International Monetary Fund (IMF) dropped a bombshell when they projected the unthinkable: that the high-performing "miracle economies" of Southeast and East Asia were quite vulnerable to the "tequila effect" that ravaged the Mexican peso in December 1994. With calculated precision, they argued that despite the Asian tigers' seemingly sound macroeconomic fundamentals, the disturbing tell-tale signs of a catastrophic macroeconomic disequilibrium loomed on the horizon for a number of the "star performers," in particular, the "ASEAN 4" (Thailand, Indonesia, Malaysia and Philippines) and, to the utter disbelief of many, the world's eleventh largest and the most miraculous of Asia's miracle economies, the Republic of Korea.[1]

The problem, it was argued, could be explained by basic macroeconomics: the existence of an imprudently large and growing current account deficit, financed increasingly by short-term capital inflows; a rapidly rising external debt; deteriorating international competitiveness (in part the result of formal pegging of regional currencies to the rising U.S. dollar); lack of financial transparency in government-private sector financial relations; and an under-regulated, poorly capitalized and over-exposed banking system lacking prudential surveillance. Most troubling, especially in the cases of Thailand and Indonesia and to a lesser extent South Korea, was the rising share of capital investments flowing in highly speculative and overvalued non-traded goods sectors and not in areas aimed to enhance export-promotion in knowledge or value-added manufactures and high-technology industries (the very engine of the region's sustained growth). This was true especially in real estate and property ventures financed largely with unhedged short-term borrowing in foreign currency.

It is now on record that during the latter part of 1995 and throughout 1996, several senior officials from the IMF (including deputy managing director, Stanley Fischer) repeatedly alerted the governments of Thailand, Malaysia, Indonesia and other countries regarding their vulnerability to economic shocks and urged them to implement immediate corrective measures to avert an impending economic crisis.[2]

The Year of Living Dangerously

It is also now on public record that without exception, the Asian governments were impervious to exhortations. Some even publicly scoffed at the IMF's unduly apocalyptic projections and policy prescriptions and adopted at best only minor, and largely cosmetic economic policy reforms.[3] In the case of Thailand, both of the Kingdom's former prime ministers, Banharn Silpa-archa and the wily ex-general, Chavalit Yongchaiyudh (who replaced the latter in November 1996), and their respective advisory nomenclatura never came to terms fully with the country's severe underlying monetary and financial problems. They dismissed Thailand's large external deficits and asset price bubbles in the deceptively prosaic economistic language of "temporary," and the zero export growth as primarily "cyclical" and reflective of potentially reversible factors such as weak demand in the United States, Europe and Japan.

The authorities claimed that the Kingdom's financial sector was "fundamentally sound."[4] They found comfort in Thailand's high savings rate, government budget surplus and dexterity in overcoming the periodic bouts of economic hyper-volatility in global financial markets. They also repeatedly cited the Bank of Thailand's successful defense of the baht against the first wave of the "tequila effect" (between January 9-13, 1995) and Bangkok Bank's unprecedented 30 percent-plus return on equity in 1995-96, which made it Southeast Asia's most profitable financial institution. Chavalit, who continued to promise a "dream team" of economic managers, became a grand master in sending mixed messages to the IMF team in Bangkok who were there at his government's request, and he dithered for months over minor technical policy issues until the crisis broke. In the end he was ignominiously forced out of office.

In the case of Indonesia, while President Suharto (the self-styled bapak pembangunan or the "Father of Development") remained gracefully aloof, the Bank of Indonesia Governor Soedradjat Djiwandono, in keeping with the quintessential Javanese sense of propriety and restraint, informed the IMF that they would seriously consider its recommendation. In the end Jakarta only widened the fluctuation band for the rupiah against the U.S. dollar. While this allowed for a gradual depreciation of the rupiah (by some 4-5 percent per year between mid-1995 to 1997) and prevented the emergence of serious exchange rate distortions, it failed to deal with Indonesia's Achilles heel: lax financial regulation and mushrooming private foreign debt.

Neighboring Malaysia's long time prime minister, the irascible Datuk Seri Mahathir Mohammad, considered the IMF's comparison of his region with Latin America as irresponsible and simplistic ivory-tower punditry. Mahathir claimed that unlike Mexico's current account deficit, which was financed by short-term foreign portfolio investment, Malaysia's deficit was financed by long-term foreign capital inflows used for business investment rather than government or consumer profligacy — hence eliminating the potential for sovereign default risk.

Mahathir conveniently forgot to acknowledge that Malaysia's manufacturing export boom of the 1980s was now facing severe slowdown as the result of falling competitiveness, rising wages (which increased by 11.4 percent in fiscal 1996-97), stagnant productivity (which managed only a 1.4 percent gain) and high ratios of foreign debt to GDP. Moreover, there was Malaysia's ever growing list of extravagant mega-projects designed to facilitate Mahathir's "Vision 2020" goal of industrialized or developed country status by the year 2020. These major projects included the Bakun dam, Asia's largest hydroelectric dam with estimated cost of M$15 billion; Kuala Lumpur's showpiece, "Petronas" or the world's tallest twin towers (M$2 billion); a super-modern airport (M$9 billion); a new administrative capital for the state of Sarawak in Borneo; and the most audacious of all, a M$20 billion national administrative capital near Kuala Lumpur aptly called Putrajaya (or city of kings, to be built as a tribute to Mahathir Mohamed). All of these ambitious projects required heavy imports of capital and technology and inexorably pushed the current account deficit higher.

Thus, while Mahathir correctly pointed out that Mexico's currency crisis was fundamentally a short-term "monetary management problem," he incorrectly attributed the sudden and massive speculative attack on the peso exclusively to Mexico's political instability brought on by the assassination of the presidential candidate, Luis Donaldo Colosio, and by the regime's inability to contain the violent antics of a handful of rag-tag bandits in Chiapas. Mahathir vociferously declared that Mexico held no real lessons for Asia and that the unduly "severe" IMF stabilization prescriptions drawn from the Mexican experience were inappropriate for Malaysia and indeed, for ASEAN as a whole. Yet Mahathir, always a shrewd pragmatist and cognizant of his country's growing current account deficit, deftly announced in September 1995 that the Malaysian government, of its own volition, would implement a series of stabilization measures very much in line with what the IMF had been urging.

In late 1995 the government introduced its home-grown plan, which included the scaling down of some of the government's ambitious mega-projects and a series of anti-speculation measures to cool off the overheated property market. Bank Negara, the Malaysian central bank, was instructed to maintain a tight monetary policy. Under the new tight liquidity the ringgit was allowed to appreciate so as to neutralize the impact of short-term capital inflows and to insulate the economy from imported inflation.[5] In the end, it was these last minute, hastily erected reform measures that enabled Malaysia to weather the crisis of 1997 more effectively.

Paradox of the Asian Miracle: The Price of Success

Arguably, the Asian governments' "denial syndrome" is understandable. Asia's economies have long been viewed as the "miracle economies" with an impeccable performance record and a model for others to emulate. Between 1965 and 1990 the economies of Japan, the four original tigers (Hong Kong, the Republic of Korea, Singapore and Taiwan) and the three emerging tigers (or the newly-industrializing economies of Southeast Asia — Indonesia, Malaysia and Thailand) grew more rapidly and more consistently than any other group of economies in the world. They averaged 7 percent per year growth rates in real terms since the mid-1970s and 9 percent per year in the 1990s. These economies all experienced dramatic increases in real per capita incomes. In South Korea and Singapore, for example, real per capita income grew more than 700 percent between 1965 and 1995. Over the same period Taiwan and Hong Kong logged more than a 400 percent increase, while Malaysia, Thailand and Indonesia each experienced real per capita income growth of over 300 percent.

South Korea's unprecedented growth in per capita GNP (6.9 percent over 1960-81 and 8.5 percent over 1980-94) increased incomes from US$1,700 in 1981 to US$8,260 in 1994. Equally impressively, Indonesia's per capita GNP rose from US$90 in 1972 to US$880 in 1994, Thailand's rose from US$220 to US$2,410 and Malaysia's from US$450 to US$3,480 during the same period. While there are country variations, overall the benefits of this growth have extended across all sectors of society. For example, in Thailand poverty (measured on purchasing power parity) was reduced from over 57 percent in the late 1960s to about 13 percent in 1996, with Thais enjoying dramatic improvements in social welfare such as food security, education, infant mortality and life expectancy. Similarly, in Indonesia the benefits of growth have extended to all of the 27 culturally diverse provinces despite remaining disparities. Between 1970 and 1996 the proportion of population living below the official poverty line declined from 64 percent to an estimated 11 percent. The quality of life for the average Indonesian has improved greatly: infant mortality declined from 145 per 1,000 live births in 1970 to 53 per 1,000 in 1995; life expectancy rose from 46 to 63 during the same period; and the country achieved universal primary education in 1995.

Borrowing abroad to sustain high rates of investment for the domestic economy is a common feature of rapidly growing economies and is generally seen as benign and consistent with external solvency. Market-oriented developing economies often peg their exchange rates (at least for a time), to encourage trade and investment, to maintain a nominal anchor for domestic prices and restrain inflation and to signal their commitment to prudent monetary policies.[6] Indeed, the formal pegging of the Thai baht, Malaysian ringgit, the Philippine peso and other regional currencies to the U.S. dollar had paid dividends by providing a strong impetus to export-led growth.

The mid-1980s export boom that began for Thailand and others was driven largely by the depreciation of the U.S. dollar in relation to other countries and by the fact that currencies such as the baht were pegged to it. This made Thailand's labor-intensive exports such as apparel, footwear and toys competitive internationally. It also prompted massive influx of Japanese, Taiwanese and Hong Kong investment into these emerging Asian economies because the former wished to avoid rising labor costs in their own countries.

In the case of Thailand, the terms of trade improved, and the economy recorded a GDP growth rate of 12 percent a year between 1987 and 1990 and 8.6 percent growth between 1991 and 1996. Thailand's exports from the manufacturing sector rose from 35 to 80 percent of total merchandise exports, the largest percentage of any ASEAN country. In fact, between 1994-96, ASEAN and East Asia recorded the highest rates of increases in merchandise trade. The region's imports were up 15.6 percent and reached US$1.01 trillion. Exports rose by 15.2 percent to US$1.1 trillion, and Asia, which controlled only 17 percent of the world's GDP in 1950, saw its share jump to 40 percent by 1997. The World Trade Organization (WTO) pointed out the ascendance of the six most dynamic Asian trading spots: Taiwan, Hong Kong, South Korea, Malaysia, Thailand and Singapore. In these countries exports were up by 18.1 percent to US$418 billion which represents a 9 percent increase over 1993-94.

By early 1996, the Mexican peso crisis was long forgotten and a measure of financial normalcy was restored. A heady mixture of complacency, nostalgia and bravado returned with a vengeance to Asia's state capitals. Caution, it seemed, had been thrown to the wind as governments took solace in the fact that they belonged to that most exclusive of clubs, the "High Performing Asian Economies." A spate of popular books such as Jim Rohwer's Asia Rising: Why America Will Prosper as Asia's Economies Boom and John Naisbitt's bestseller, Megatrends Asia, along with a growing list of unoriginal academic tomes, projected the inexorable shift in power towards the Asia Pacific and showered laudatory praises on the virtues of "East Asian style state-guided capitalism" for emerging economies.

The region's self-styled gurus such as Mahathir Mohamad and Singapore's erudite patriarch, Lee Kuan Yew, found the semiotic imagery of "Asian style capitalism" congenial because it suggested the irresistible hegemony deemed necessary to performance of their leadership role. In a world where these gurus are held in veritable awe and their every utterance is extensively covered, they confidently asserted that Asia had defied doomsayers before and that the region's exuberant growth was destined to continue well into the next millennium.

A growing number of distinguished economists, including Columbia University's Jagdish Bhagwati, concurred with the sanguine assessments. They reasoned that East Asia's economic growth was due to its faithful adherence to the neoliberal or market-friendly script known as "the Washington consensus." Asia was able to build an economy on solid foundations by maintaining prudent, liberalized capital accounts, open trade and foreign investment policies, a single competitive exchange rate, a commitment to the principles of comparative advantage, economic integration and export-led growth. In other words, Asia's economies were based on both the accumulation of factors of production (especially the massive investment in physical capital) and increases in total factor productivity measured in terms of improvements in technology and efficiency.[7]

It is not that the "optimists" were wrong in their overall assessment of the East and Southeast Asian economies; rather, in their exuberance they failed to factor in the IMF's caution that the high-performing Asian economies (like Mexico in 1994) were also vulnerable to severe financial shocks precisely because of their success. What accounted for this paradox? The answer lies in seeing through the present Janus-faced global financial markets and the nature of their linkages with the high-performing emerging economies.

The onset of the debt crisis in 1982 saw a sharp decline in capital inflows to developing countries from $30 billion in 1977-82 to under $9 billion in 1983-89. However, with the liberalization of cross-border financial transactions — specifically the international diversification of rapidly expanding institutional portfolios (mutual funds, insurance companies, pension funds, proprietary trading of banks and securities houses) and the progressive integration of global capital markets in the 1990s — capital inflows witnessed a dramatic revival and expansion to developing countries. Between 1990-94, net capital surges to all developing countries skyrocketed to $524.2 billion. A disproportionate share of the surges went to the Asian economies, which received some $280 billion or roughly 60 percent of all the total capital flows.[8] In fact, the ASEAN 4 experienced rates of growth of money and credit at 25-30 percent a year between 1992 through the end of 1996.[9]

What was significant about the new surge was the sharp rise (in terms of both absolute levels and the share of total inflows) in short-term portfolio capital flows in the form of tradeable bonds and equity shares. For developing countries as a whole, aggregate private portfolio capital flows increased from $6.6 billion from the base years 1983-89, to $218 billion between 1990-94, to an all time high of $167 billion in 1996.[10] There is no doubt that portfolio capital flows consisting of international placements of tradeable bonds, issues of equities in international markets and purchases by foreigners of stocks and money market instruments (in particular, securities and mutual funds) greatly aid the domestic markets of high-performing developing economies by fostering financial integration and improving the returns on investments through knowledge/skills spillover, enhanced competition and market efficiency effects.

However, short-term, yield-sensitive and liquid private capital inflows are not a costless lubricant, especially if the flows are large relative to GDP. Short-term capital inflows that often show up as an expansion in liquid short-maturity bank deposits are highly sensitive to cyclical fluctuations in domestic or international interest rates. They exhibit high levels of volatility, with sudden outflows potentially resulting in balance of payment problems or widespread financial crises. The absence of prudent management can cause surges in capital flows to produce an appreciation of the real exchange rate, an inflationary expansion of domestic money and credit and an unsustainable current account deficit. The unpredictable ebb and flow of international portfolio capital can wreak havoc on an economy that has grown too dependent on it. Given the fact that portfolio investments are usually liquid financial instruments (and, under liberalized foreign exchange controls, easier to move in and out of a country), they constantly chase and demand prohibitively high “enticements,” or high rates of return, and engage in risk diversification.

This process can make emerging market econo-mies highly susceptible to volatility — especially those with limited absorptive capacities, weak fiscal policies, poorly managed banking systems, weak prudential surveillance and distorted domestic markets. This trend was already evident in early 1994, when the U.S. Federal Reserve began to increase interest rates and the unsentimental and footloose international portfolio investors’ appetite for stocks and bonds in emerging markets greatly diminished, contributing in large measure to the Mexican peso crisis. With the exception of Singapore, Taiwan and Hong Kong, the high-performing Asian economies that had liberalized their financial sector, without commensurate strengthening of prudential supervision and regulation, now lay vulnerable and exposed.

Additionally, the increased “dollarization” of these national economies, which enabled nonresident portfolio investors to participate in bond flotations, also carried a built-in credit and exchange rate risk, as did the burgeoning number of domestic banks that borrowed abroad in short-term, dollar-denominated securities and then lent to finance domestic projects based mainly on longer-term projected higher returns.[11] In Thailand and Indonesia authorities permitted the development of serious asset-liability mismatches in the banking sector, which resulted in the proliferation of notoriously under-capitalized and under-regulated banks without the capacity effectively to intermediate capital resources into productive use. These “quasi-banks” or “financial trusts” had every incentive to borrow abroad and lend and “invest” domestically with reckless abandon because they lacked system-wide portfolio diversification and acted as intermediaries for channeling vast sums of foreign capital into the domestic economy. However, by engaging in such practices they exposed themselves to the risk of currency depreciation since the value of such loans would fall relative to the value of their dollar borrowing.

Why then did these financial institutions and intermediaries engage in and get away with such risky practices? First, the sterilization of capital inflows invited such activity. In order to keep their nominal exchange rates from appreciating in response to the large surges of capital inflows, the high-performing Asian economies sterilized the inflows by building up foreign reserves. However, sterilization entailed the imposition of high domestic interest rates, which resulted in severe distortions between the domestic and international interest rate, thus creating added incentives for companies to borrow from abroad.

Second (and as noted earlier), rapid and haphazard financial liberalization without adequate financial regulation or supervision quickly sapped the strength of financial systems. For example, in South Korea, the elimination of many interest rate controls (which removed restrictions on corporate debt financing and cross-border flows) enabled the large conglomerates to depend heavily on debt intermediated or guaranteed by Korean financial institutions. With the slowdown in growth and the emergence of financial difficulties in 1997, non-performing loans increased rapidly and the banks’ access to international capital markets collapsed.

In Thailand and Indonesia, the following factors encouraged over-lending by foreign financial institutions and over-borrowing by domestic firms: the watering-down of rules governing non-bank financial institutions, the arbitrary expansion of permissible capital market activities (such as allowing banks and “trusts” to finance equity purchases on margin) and easy access to off-shore borrowing, implicitly or explicitly backed by government guarantees. In fact, national banks and financial institutions, which had every reason to perceive their operations as “insured” against adverse contingencies by government promises of bailout, had a literal carte blanche to borrow recklessly from abroad and to make excessively risky loans domestically.

And third, many of the “trusts” controlled by the ruling elites and their cronies, which were selected on the basis of byzantine-style nepotistism, factionalism and personal ties (and hence not subject to transparency and creditworthiness rules), provided an avenue for these groups to distort resource allocation directed at real estate and consumption and surreptitiously to appropriate extraordinarily large sums of “easy money” through a complex and pervasive system of elite corruption. For example, if the lending worked for the owners of these “trusts” (and it did for a while), the “bankers” made quick and tidy profits, but if the lending and the repayment of debts failed (as it did with a bang), the depositors and creditors lost money, and some lost their life savings. The unaccountable, and often unidentified bank owners, with little capital tied to the bank, simply walked away without fear of punishment.[12] Under such capricious conditions, even solvent and otherwise healthy banks were vulnerable to liquidity problems, especially when short-term interest rates suddenly rise for a sustained period, and the need to roll over the short-term liabilities can — and did — seriously undermine the income position of these banks.

In Thailand, Indonesia, Malaysia and to a lesser extent in the Philippines, the situation was further exacerbated by lack of investor confidence. This is not surprising in view of the almost total lack of transparency in banking operations, which included lax to non-existent loan classification and provisioning practices; the maintenance of an overvalued real exchange rate; and the channeling of foreign capital inflows into overvalued non-tradeable sectors, particularly real estate. Meanwhile, the tradeable sectors that are necessary to provide the resources for the future servicing of debts were generally bypassed. Under these extremely deleterious economic circumstances, the Thai government’s insistence on maintaining a pegged currency regime (instead of a devaluation-immune, fixed exchange rate) in the face of large external imbalances and appreciating real exchange rates was an invitation to a speculative currency attack. This happened to the European Rate

Mechanism (1992 and 1993), Mexico (1994) and the Czech Republic in 1997. And this also happened to the high-performing Asian economies in summer 1997.

Summer 1997: The Deluge

In early 1997 it was rumored that Thailand's revered constitutional monarch, King Bhumibol Adulyadej, had a nightmarish dream and that he was "sick with worry" about the future of his people and country. Perhaps the IMF already knew what the venerable king dreamt. The failure of Samprasong Land after it missed payments due on its foreign debt in early February signaled the precipitous collapse in property markets and the beginning of the end for the financial companies which had lent heavily to real estate and land development companies.**13** By April 1997 Thailand's economy stood precariously at the edge of the precipice as export growth slowed markedly, not only in the primary commodities and labor-intensive sectors such as apparel and textiles, but also in the electronics sector where labor costs were three times higher than those in similar plants in Shanghai. While the slowdown was a result of increased competition from new entrants with lower-wage and production costs, such as China and Vietnam, it was also due to the built-in inefficiencies in these economies.

However, the real culprit behind the sudden slowdown in export growth was the imprudent retention to the pegged exchange rate regime. This encouraged heavy external borrowing which resulted in excessive exposure to foreign exchange risk by domestic financial institutions. Under this system, capital inflows to purchase Thai securities or to expand manufacturing capacity in Malaysia or Indonesia required that their central banks buy dollars and supply the needed baht, ringgit or rupiahs, creating a glut in money supply. The central banks' efforts to offset these flows (most commonly by selling government securities) raised domestic interest rates and fueled further capital inflows, eventually making exports from these countries relatively costly on world markets.

The situation was compounded further by the 50 percent nominal devaluation of the yuan (renminbi) in 1994, a move which made China more competitive in relation to its neighbors and caused the the U.S. dollar to appreciate against the yen (a 56 percent rise from 1995 to mid-1997). The European currencies inadvertently made the U.S. dollar-pegged Thai baht and other Southeast Asian currencies artificially strong, which in turn made exports from these countries more expensive and less competitive.**14** Since the Thai authorities adamantly refused to let the baht adjust to the dollar rise, the only way the government could maintain its ten year stable peg (of 25.6 baht per dollar) was to raise domestic interest rates to unsustainably high levels. This decision had an immediate negative impact in the real estate and banking sectors because property developers and others who had borrowed in short-term, dollar-denominated foreign loans (without protecting themselves from the possibility of a decline in the baht's value) could no longer repay their dollar-denominated loans.

The many unregulated banks that had engaged in bad lending (or what is known in the region as "self-dealing") were stuck with fast growing, non-performing loans; and they also witnessed a sharp deflation in the value of their assets.**15** Not surprisingly, by April 1997 Thailand's real exchange rate had considerably appreciated, and the equity prices literally plummeted. The current account deficit, running at an abnormally high 8.5 percent of GDP and financed increasingly by short-term inflows, began to compound severely the gross external debt of US$70 billion (of which US$40 billion was short-term loans), or approximately 50 percent of GDP. These problems exposed other weaknesses in the economy, including substantial unhedged foreign borrowing by the private sector, an unsustainable domestic consumption, a grossly inflated real estate and stock market and weak and over-exposed financial institutions, many of whose very solvency was now in question. In early May 1997, the attempt to save Finance One, Thailand's largest finance company, by means of a merger failed, and the company became formally bankrupt. It was now a matter of time before the
deluge hit the Kingdom.

During May 14-17, 1997 the Thai baht came under relentless speculative pressure as financial markets (in particular, currency speculators) correctly concluded that Thailand's pegged exchange rate was unsustainable in light of its large current account deficit, high short-term foreign debt and declining competitiveness. The desperate efforts of the Thai authorities to maintain a fixed exchange rate for the baht via capital and exchange controls and interest rate hikes proved futile and exacerbated the costs to the treasury. Within weeks volatile speculation consumed most of the country's hard-earned and once large and healthy reserve of foreign exchange — from US$37.7 billion in December 1996 to under US$10 billion in August 14, 1997. On July 2 the Bank of Thailand bowed to the inevitable and introduced a more flexible exchange rate regime. It floated the beleaguered baht, thereby replacing a basket of currencies which depended heavily on the US dollar.**16** Almost immediately the baht depreciated by a cumulative 20 percent (plummeting to a record low of 28.80 to the dollar), as investors (including domestic corporations) scrambled to buy foreign exchange.**17** By the end of July, the baht had fallen by 25 percent (relative to January 1997). In August, the baht had dropped to 38 baht to the U.S. dollar (a fall of 34 percent), and by the end of September it was 42 percent below its start 1997 level.

The Thai government's appallingly indecisive and desperate policy responses shook market confidence. Even amid evidence of growing financial disintermediation, the authorities were reluctance to close insolvent financial institutions and tighten monetary conditions. The rapid reverberations of the financial contagion (or the "Mai-Thai hangover") to Malaysia, Indonesia, the Philippines, Hong Kong and South Korea further compounded the loss of investor confidence. The reverberations also moderately weakened the mighty Singapore and the New Taiwan dollar and caused increasing panic in the already jittery market. Domestic investors seeking to hedge their foreign currency exposures were now forced to take a closer look at the region's underlying economic problems.

More importantly, international commercial and investment banks, mutual fund managers, securities firms, stock brokers, portfolio investors, currency traders and others in competitive marketing-sales were also now forced to take another look at the region's underlying economic problems. This included institutions that had long suffered from what Charles Kindleberger has termed "disaster myopia" and whose jaundiced view of Asia and excessive dependence on glossy annual reports and voracious appetite for commissions had led them to oversell

Asia's emerging economies enthusiastically.

What the investors saw — to different degrees in different economies — were many of the same problems. When it became apparent to foreign creditors that Thailand (and maybe others) had more short-term foreign debts than the remaining short-term foreign reserves, a "stampede" — to borrow Jeffrey Sachs's apt metaphor — ensued. Instinctively risk averse with low tolerance for uncertainty, the fickle international financial markets and their managers did what they had done in Mexico in 1994. In a world of integrated and electronically linked capital markets, they fled Thailand and the region as fast as they had entered it to seek safer and more stable havens.

Caught in the rapid downdraft of an unforgiving global market, the Thai government was reduced to a helpless, passive spectator of the unfolding drama. Thai financial institutions were suddenly pushed to the brink of default, and the "meltdown" began. Long deluded by their invincibility, Thailand and her neighbors had ignored the IMF's advice at their peril. They learned a painful lesson about economic globalization the hard way: that nations with basically sound macroeconomic fundamentals can succumb to overvalued currencies and poorly managed financial institutions.

To the Thai government's consternation, its urgent appeals for Japanese assistance were rebuffed despite Japan's huge financial stake in the country, and it was finally forced to ask the IMF for technical assistance on July 28 in order to forestall a balance of payment crisis. A stand-by adjustment program with the IMF was agreed to in early August 1997, which provided the basis for a $17.2 billion emergency international financial "bailout" package with Japan's premier EXIM bank pledging SDR 3 billion or US $4 billion. For their part, the Thai authorities agreed to swallow the IMF's "bitter medicine" and quietly unveiled an austerity plan, or the 1997-2000 Program, that immediately suspended 48 finance firms and provided a blueprint for the complete restructuring of the financial sector.

At the core of the 1997-2000 Program are the so-called "second generation" reforms designed to reestablish domestic and external confidence in Thailand's financial system by requiring that surviving banks meet tough new reserve and prudential supervision requirements. These requirements include a tight monetary policy to stop authorities from printing money in order to rescue failed or failing financial and property companies. This procedure was to be complemented by an array of the usual IMF fiscal belt-tightening measures such as expenditure cuts, shifts in domestic savings-investment balances to reduce the external current account deficit to a more sustainable level (5 percent of GDP in 1997 and 3 percent in 1998) and the capping of year-end inflation at 9.5 percent in 1997 and 5 percent in 1998. Also, state enterprises were required to maintain their overall financial balance by phasing out low-priority investments and seeking private sector participation in infrastructure programs, and the government was virtually ordered to reduce its budget deficit by 1998 through an increase in the rate of the value-added tax (VAT) from 7 to 10 percent, as well as to make cuts in fiscal spending by 100 million baht.

The IMF's bailout of Thailand failed to stop the spread of the financial contagion. This state of affairs reflected rational market behavior. Since the depreciation of the baht would inevitably erode the competitiveness of Thailand's trade competitors and put downward pressure on their currencies, few believed in the viability of exchange rate arrangements in neighboring countries. However, it was the stubborn denial — the refusal of Thailand's neighbors to admit to the problem — that added fuel to the rapidly expanding contagion.

For example, the usually stoic Singapore Prime Minister, Goh Chok Tong, dismissed the unfolding crisis as "merely a hiccup." President Suharto repeatedly made public statements implying that Indonesia had already decided to reject financial assistance from the IMF despite the fact that a high-powered IMF team was already in Jakarta and locked in the final stages of negotiating a package for Indonesia. Instead, Suharto claimed that Indonesia would accept a US$10 billion assistance package from "friendly neighboring Singapore." Mahathir alleged that a western conspiracy was undermining developing countries. The chief culprit was US financier George Soros, whom he called a moron. He further declared that "the free exchange of currencies is unnecessary, unproductive and immoral" and "should be made illegal." These statements served drastically to undermine investor confidence. The net result was a four percent fall of the ringgit in less than two hours to a low of M$3.4080 to the U.S. dollar.[18] By mid-October, the cumulative declines of the ASEAN-4 currencies against the American dollar exceeded 30 percent for Indonesia and Thailand and 20 percent for Malaysia and the Philippines.

As noted earlier, Indonesia weathered the initial wave of currency turmoil reasonably well because its adoption of a wider fluctuation trading band for the rupiah from 8 to 12 percent against the U.S. dollar allowed for a more gradual depreciation of the rupiah. It also prevented the emergence of serious exchange rate distortions and saved the foreign reserves necessary to cover imports and short-term foreign debt. Some concluded, therefore, that the contagion effect on Indonesia would be minimal. But the rupiah could not escape the second wave of currency attacks in late July, and it dropped 6 percent in a day to 2,510 rupiah to the U.S. dollar.

Despite Bank Indonesia's valiant efforts to curb a possible currency and stock market meltdown by cutting interest rates by 50 basis point on August 8 and by 100 basis point on August 13, which included selling an estimated US$200 million of its foreign reserves, it could not stop the currency attack or the continued fall of the rupiah. By August 13 the rupiah stood below the 2,682 rupiah to the U.S. dollar floor of the intervention band. On August 14 Bank Indonesia finally abolished the system of managing the exchange rate through the use of the currency band and let the rupiah float freely. This, moreover, triggered an immediate plunge in the rupiah to 2,830 rupiah to the U.S. dollar (settling at 2,960 rupiah to U.S. dollar on August 31), and stocks fell from the 720 point mark in early July to below the 600 threshold by August 20.

The downward spiral of the rupiah cannot be attributed simply to regional contagion. Instead, currency and stock traders, including Indonesian corporations (now desperately selling rupiah and buying U.S. dollars), could no longer ignore the long overlooked yet open secret about the Indonesian economy: the pervasive corruption and mismanagement. The government's accounting irregularities and unauthorized expenditures, the widespread misappropriation of public funds by the politically well-connected and pervasive mismanagement of the economy by Suharto's family and cronies created uncertainty about the nature and extent of the country's private foreign debt. Even Bank Indonesia lacked the regulatory powers to force the politically well-connected banks and "financial trusts" to disclose details about their operations, including levels of their off-shore debts.

Not surprisingly, while Bank Indonesia placed the country's private foreign debt at around US$55 billion, financial market analysts placed the debt-burden at over US$100 billion claiming that short-term, off-shore borrowing and roughly US$44 billion in offshore bond borrowing were not included in the official government figures. Much of the debt was unhedged in that borrowers failed to protect themselves against a possible fall in the rupiah's exchange rate. As the rupiah fell against the U.S. dollar, the unhedged, dollar-denominated loans now cost over 30 percent more to service in rupiah terms. This development effectively bankrupted many Indonesian firms and financial institutions which previously were thought to be sound. The loss of investor confidence (exemplified by the refusal of international investors even to accept letters of credit from Indonesian banks) only intensified the attack on the rupiah which fell to about 3,850 rupiah to the U.S. dollar by late September — a 34 percent decline since August.

On October 8, the Indonesian government approached the IMF and the World Bank for assistance, and on October 31 when Indonesia signed its first IMF program, the rupiah immediately strengthened as a result of large, concerted interventions by Japan and Singapore. On November 5, 1997, the IMF along with the World Bank and the Asian Develop-ment Bank approved a $23 billion multilateral financial assistance package for Indonesia to restore confidence and stabilize the rupiah. Indonesia's veteran technocrat, Widjojo Nitisastro, on behalf of his government, accepted the IMF's "bitter medicine" and agreed to maintain tight fiscal and monetary policies designed to stabilize financial conditions and to reduce the current account deficit.

The government also agreed to immediately close 16 unviable banks (and did), while weak but viable banks were required quickly to formulate and to implement rehabilitation plans. In addition, Indonesia was required to adopt measures to strengthen the legal and regulatory environment and to establish a strong enforcement mechanism and clear exit policy. The latter included implementing a broad range of structural reforms such as the liberalization of foreign trade and investment, dismantling inefficient domestic monopolies, expanding deregulation and privatization and allowing greater private sector participation in the provision of infrastructure.

The Financial Contagion: Why the Mighty Korea, Inc.?

By early November the contagion had spread to South Korea. The simmering turmoil in South Korea's financial markets boiled over in early January 1997 with the bankruptcy of Hanbo Steel, the 14th largest chaebol with US$6 billion in debts.[19] This scenario was repeated in quick succession by the bankruptcy of Sammi Steel (the main firm of Korea's 26th largest conglomerate) and of Ssangyong Motor (Korea's fourth largest car maker and sixth largest chaebol). In July the Kia group, the eighth largest conglomerate, failed to pay $370 million worth of liabilities and was put under protection. This action was followed by the collapse of important, but less well-known chaebol such as Hanwha and Hanjin. With South Korea's estimated combined debt now standing at $55 billion, a series of foreign press reports predicted that South Korea could become the next Thailand.

During the first two weeks of November downward pressure on the Korean won intensified (despite Bank of Korea's repeated defense of the won by selling dollars and widening the daily fluctuation band),[20] and equity and stock prices plummeted. These developments reflected lack of confidence about prospects for an orderly workout of the corporate debt overhang and growing difficulties encountered by the financial sector in rolling over South Korea's short-term external debt which was estimated at more than $100 billion (70 to 80 percent of which was short-term liabilities maturing within a year).

On November 17 South Korea finally abandoned its defense of the battered won, which sent the currency crashing through the psychologically disturbing 1,000/dollar level. Shock waves hit the baht, the rupiah, the ringgit and other regional currencies which fell even further relative to the dollar. Referring to the problem as a "temporary funding shortage" and the "idea of IMF aid as unthinkable," the affable new Finance and Economy Minister, Lim Chang-Yuel, announced that the government would form an emergency economic presidential advisory committee to solve the nation's financial problems, and on November 19 he unveiled an emergency bailout package. Seen as "too little to late," the measure failed to restore market confidence, and on November 20 the won fell by another 10 percent to 1,139 won per dollar.

Following marathon all-night negotiations with the IMF team, the weary and somber Finance Minister reluctantly announced in a nationally televised press conference on November 21 that Korea would seek emergency financial assistance from the IMF. After some two weeks of tense negotiations, Michel Camdessus, Managing Director of the IMF, announced on December 4 that the IMF and the South Korean government had signed a three-year stand-by arrangement according to which the IMF had agreed to provide a record-breaking $57 billion rescue package to South Korea. Seoul would receive the first payment of $5.6 billion immediately; the second tranche would be forthcoming only after December 18, following review of Korea's adherence to the comprehensive economic reform program underpinning the loan. While then President Kim Young Sam publicly conceded that "we have lost our economic sovereignty," he nevertheless stated with unusual candor that his government would honor the stringent IMF conditionality and asked the nation to endure humiliating and "bone-carving pain."

The Korean government agreed to a fundamental overhaul of its economy and a contractionary macroeconomic policy of higher taxes, reduced spending and higher interest rates. Specifically, it agreed to (a) immediately suspend some 15 of the country's 30 "ailing" merchant banks with huge non-performing loans, while the surviving ones were required to submit rehabilitation plans regarding capitalization, liquidity and management; (b) provide more transparent financial data by requiring independent external auditors to oversee the bookkeeping practices of the financial ministry and the major conglomerates, including banning chaebol from making debt guarantees for affiliates, as well as forcing the government to disclose all data relating to foreign-exchange reserves, bank capitalization and chaebol ownership in consolidated financial statements; (c) open its financial markets by liberalizing capital account transactions and increasing foreign access to domestic money market instruments, corporate bond markets and direct investment; (d) increase the ceiling for foreign ownership of listed shares from 26 to 50 percent by the end of 1997 and to 55 percent by the end of 1988; (e) end its restrictive trade practices, including providing trade-related subsidies to promote exports and the elimination of import licensing; and (f) raise taxes and tighten monetary policy, which included facilitating labor market restructuring by easing layoff and dismissal restrictions under mergers, acquisitions and corporate downsizing — the most "bitter medicine" of all for most Koreans.

Despite the magnitude of the South Korean crisis, the IMF and most analysts agree that the crisis in South Korea is fundamentally a financial sector problem rather than a crisis of the "real economy." Some maintain that the contagion reflects nothing more than market overreaction. That is, even while Korea shares some of the basic underlying economic problems plaguing Thailand and Indonesia, in many respects it is structurally different from the latter two countries in that the problem is one of liquidity rather than insolvency. Korea is only temporarily unable to pay current foreign obligations, they say, but is not permanently unable to earn foreign currency to repay debts. South Korean chaebol such as Hyundai, Samsung, Lucky-Goldstar, Daewoo and Sunkyong are competitive globally and were the major beneficiaries of the soaring yen in the period from 1995 to mid-1996.

On the eve of the crisis the South Korean economy was performing well as real GDP grew at 8 percent per year through the 1980s and 1990s, and the current account deficit was slightly over 3 percent of GDP compared to 8 percent in Thailand and 10 percent in Mexico. Also, the bulk of foreign loans was used to finance investments in the export sector rather than real estate developments or imports of consumer goods as was the case in Southeast Asia and in Mexico. Finally, South Korea's gross public debt amounted to only 3 percent of GDP; little inflationary pressure was present in the economy; and in June 1995 the country's seasonally adjusted unemployment rate stood at 2.1 percent (the lowest in the country's history). It seems that South Korea was doing the "right things." How do we account then for the financial calamity?

A confluence of domestic and external shocks reveal some fundamental weaknesses in the Korean economy. The slowdown in international trade in semiconductors (especially the memory chips market), office automation equipment and consumer electronics (which began to slow down imperceptibly in 1995, but reached crisis proportions by early 1997) severely hurt the Korean economy which had invested heavily in these markets. The price of the 16-megabit memory chip (which accounted for approximately 20 percent of Korean exports) tumbled from a high of more than $50 to under $7 by mid-1997 due to a world-wide glut, declining demand and the entrance of new competitors (mainly Taiwan and Singapore) in the marketplace.[21]

The chaebol (unlike the Japanese keiretsu) do not have their own financial institutions, and they financed the construction and expansion of costly multibillion dollar chip-fabrication factories, known as "fabs," with massive doses of short-term, dollar-denominated loans. The situation was compounded by weakening profitability associated with cyclical downturns in sectors such as steel, autos, shipbuilding and labor intensive textiles. They now faced an impending financial disaster as the huge losses in this critical sector greatly constrained the chaebol to cross-subsidize their investments. Beginning with Hanbo Steel in January 1997, over a dozen highly leveraged chaebol out of the top 30, along with several poorly managed merchant banks, moved into bankruptcy by early November 1997. The bankruptcies in turn severely weakened the financial system, in particular the lending merchant banks which were burdened with sharply rising non-performing loans (which in mid-1997 were equivalent to 7.5 percent of GDP).

It is useful to remember that a vast body of scholarship, building on Chalmers Johnson's seminal but flawed *MITI and the Japanese Miracle*, has long attributed South Korea's phenomenal export-led economic modernization that began in early 1960 under the authoritarian Park Chong Hee regime to the collaborative relationship, or "pragmatic synergy," between a highly centralized, interventionist and fortuitous "developmental state" and the large private conglomerates known as chaebol it created. The state nurtured the chaebol with generous subsidies and protection from competition in return for utilitarian performance standards necessary to meet the stringent requirements of export-oriented industrialization. The state-chaebol alliance became indispensable to South Korean development. Working together, the state and chaebol were seen as formidable partners with an uncanny ability to follow market signals, preemptively respond to externalities and broker relations with foreign investors and creditors. How did the state-chaebol alliance, the very symbol of Korea, Inc. and the much touted "East Asian Development Model," come to be the root cause of South Korea's financial crisis?

In retrospect, the merits of the state-chaebol alliance were grossly overstated. While the system served a useful purpose in the early phase of Korea's ambitious and ultimately successful drive to export-led industrialization, by the early 1980s it had become obsolescent and riddled with corruption. As noted earlier, Korea's strong developmental state enjoyed substantial powers over resource allocation, and the chaebol were dependent on the state for providing them with low-interest credit, subsidies, preferential tax breaks and government approvals to operate and expand their many operations. Over time, state-chaebol relations degenerated into a crudely instrumental neo-patrimonial alliance based on Confucian piety, patronage, nepotism and corruption. The result was the loss of bureaucratic-administrative elan and coherent and judicious economic management. The recent cases against two former presidents — Chun Doo Hwan (1981-87) and Roh Tae Woo (1988-92) — revealed unprecedented levels of racketeering, extortion and downright self-aggrandizement as politicians and political parties collected huge sums of money (Hwan received over $900 million and Woo about $600 million) from the chaebol in return for easy credit, loan guarantees, protection from global competition and other privileges.

The election of Kim Young Sam, the first directly elected civilian head of state in more than 30 years, as Korea's president in December 1992 brought hope for reform of the old paternalistic networks and corrupt state-chaebol nexus. Indeed, Kim had made financial deregulation and "clean government" a top priority during his campaign. However, during its roller-coaster five year term and after much foot-dragging, his government was able to introduce only limited "half-measures" that had the paradoxical effect of further entrenching and changing the state-chaebol-private sector nexus, which had negative implications for the national economy. Under the new government's financial liberalization program, a host of patronage-dispensing politicians and chaebol were able to borrow huge sums of funds without any constraints or caution. This was facilitated by the fact that politically connected private sector financial institutions (including the proliferating merchant banks) were able to borrow huge sums of funds in the name of further solidifying the country's bid for the prestigious OECD membership and rapidly transforming South Korea into a world-class industrial and technological power.

While careful not to repeat the Mexican government's costly mistake of luring foreign capital by issuing short-term and high-yielding dollar-indexed bonds (the infamous tesobonos), the Korean government made a different, but equally costly error: its new financial liberalization policy gave a virtual carte blanche to the chaebol and commercial and merchant banks (who worked either as teams, individually or both) to borrow huge sums of money without any prudential supervision from both domestic depositors and from abroad. An orgy of imprudent borrowing followed — mostly unhedged, short-term, dollar-denominated loans from eager international banks which totaled over $70 billion. This sum was then quickly plowed into expanding the capacities and performance of chaebol industries like automobiles, shipbuilding, telecommunications, electronics, petrochemicals, aeronautics, steel and semiconductors and also into overinflated pork-barrel construction and real estate projects. The latter included lucrative built-in kickback schemes for influential politicians, including the president's own son.[22] Moreover, the absence of proper coordination of investment decisions coupled with the virtual abdication of prudential regulation and supervision of dealing in the chaebol and banking sector, resulted in excessive capacity creation in almost all sectors.

The problem was compounded in early 1997 when export prices dropped sharply with resultant loss of market share. The conglomerates could no longer meet their debt obligation because they had permitted leverage (the ratio of debt to equity) to rise. As a consequence, they now faced bankruptcy, and banks and other creditors were stuck with billions of dollars in non-performing loans (estimated at over $33 billion) and faced insolvency. The rapid buildup of the short-term, dollar-denominated external debt totaled a staggering $100 billion, $40 billion of which was due by the end of March 1998 and the remainder by the end of 1998. Moreover, the sustained appreciation of the won and the fact that debts, borrowed in dollars to be repaid in dollars, simply doubled over time led some to conclude the real South Korean foreign debt is over $150 billion. Faced with such daunting financial problems, the old certitudes crumbled. South Korea swallowed its pride and turned to the IMF for assistance.

The IMF: Savior or Villain?

Asia's financial crisis has dragged a relatively obscure multilateral institution, the IMF, into the global spotlight, subjecting it to intense public scrutiny and scathing criticism. While some of the criticism is valid, much is disingenuous and stems from a lack of understanding of the role of the Fund and what it can and cannot do under its mandate as outlined in the charter of rights and obligations contained in its constitution, or "Articles of Agreement."

Under the institution's Articles of Agreement, the current 182 member countries (signatories to the charter) have made a committment to promote global trade and deepen economic integration by maintaining a stable international monetary system. This goal is to be achieved by maintaining orderly exchange arrangements among members, by avoiding competitive exchange depreciation and by allowing individual national currencies to be exchanged for foreign currencies in the marketplace without restriction (currently only 117 members have agreed to the full convertibility of their currencies). Member countries are obligated to keep the IMF informed of any changes in their financial and monetary policies that may adversely affect economies of fellow members and to expeditiously modify or reform national policies on the advice of the IMF in order to facilitate international trade. The Fund operates much like a credit union for the member countries and serves as a manager of their common pool of financial resources, which were estimated to be over $215 billion in 1997.

This resource base allows the Fund to establish a stable value for each currency and to extend confidence to members by making the general resources temporarily available to them, thus providing them with the opportunity to correct maladjustments in their balance of payments without having to resort to measures destructive to national or international growth. The Fund's capital comes almost entirely from "quota subscriptions" or membership fees assessed on the basis of member countries. The United States, the world's largest economy, contributed about 18 percent (approximately $38 billion in 1997) of the total quota, followed by Japan and Germany which contributed 5.67 percent each. Quotas are reviewed every five years. This practice allows member countries either to increase or lower their contributions. The size of quotas determines the voting power of the member country, and larger quotas allow it to borrow more in time of need.

Contrary to popular perception, the IMF cannot decide or dictate what economic policies its members should pursue. It is an advisory body that can exert only moral pressure and encourage member countries to respect the rules and regulations they have freely agreed to observe. In the wake of the Mexico's peso crisis, the member countries vested the IMF with greater authority by strengthening its powers of "surveillance." This move enables the Fund to scrutinize more closely members' financial and banking systems and periodically to monitor and review each member's monetary exchange policies to assure that they meet transparency requirements. When necessary, the Fund provides members with expert technical and operational assistance in designing macroeconomic policies and in setting up agencies to collect and publish economic data. The Fund's surveillance activities are carried out through annual consultations with senior finance ministry officials in the member country, and by "independently" reviewing the official data on exports and imports, wages, prices, employment rates, interest rates, investments, tax revenues, budgetary expenditures and other variables that impact the relative or exchange value of currencies.[23] If the IMF is provided with accurate and timely economic data, its supervision can provide an early warning system or an opportunity to spot in advance any potential exchange rate or balance of payment problems. Since the Fund has no effective authority over the domestic macroeconomic policies of its members, it is up to each member country to accept or adopt IMF suggestions.

While each member country has the right to borrow from the Fund, in practice the IMF generally lends money to members facing a balance of payment problem. If a member borrows more than the initial 25 percent of its quota, it must, under the rules of the "Articles of Agreement," fully disclose information on its monetary and fiscal policies and demonstrate to the IMF's 24 executive directors how it intends to resolve the underlying fiscal problem. Only when the executive directors are satisfied can the IMF disburse loans in installments — usually under the "stand-by" or "extended" arrangement system.[24] The IMF is also authorized to provide members with additional liquidity by issuing SDRs (or special drawing rights), a fiduciary asset that can be retained by members as part of their monetary reserves or to be used in place of national currencies in transactions with other members.[25]

The IMF is therefore not an all-powerful, imperious Leviathan. On the contrary, it acts as an intermediary between the will of the majority of the membership and the individual member country. The Fund cannot arbitrarily make rules, nor can it dictate economic policies to members who are not seeking its help. Rather, its powers of compulsion come too late — only after members formally seek its assistance. Several points are pertinent here.

First, the criticism that the Fund failed to anticipate the crisis is untenable. As discussed in detail in earlier sections, the IMF's early warning system did work. It not only foresaw the crisis as early as mid-1995, but senior IMF officials continually warned respective governments that the combination of pegged exchange rates, poor bank supervision, and the buildup of short-term, unhedged debt could prove disastrous. In fact, with regard to the Article IV consultations, the 1997 Annual Report contains summaries of IMF Executive Board discussions on Indonesia, South Korea and Thailand that took place during the second half of 1996.

The IMF Executive Board explicitly warned Thailand, South Korea and Indonesia that they might not be able to sustain large current account deficits over the long-term and suggested the need to reduce trade deficits so as to minimize the risk of serious balance of payment problems in the future. Further, the IMF recommended: (1) improved banking sector supervision; (2) more flexible exchange rates; (3) tightened fiscal policy; and (4) increased transparency and openness to capital flows.

The IMF did not anticipate the sheer magnitude of the crisis, nor did it predict when the crisis was likely to occur. The latter task is impossible, and the former proved difficult, given lack of transparency, lax banking regulations and the patrimonial corporate culture and business practices in the countries in crisis. But, this response also begs the question: since it is the Fund's task to monitor financial transparency, did it fail in its responsibility? As noted earlier, surveillance is based on consultation and collaboration between the IMF and the member country. In hindsight, while the IMF should have more closely scrutinized the economy and demanded greater transparency, there were obvious limits to what it could do. Member country governments not only ignored warning signs, they also failed to provide timely and reliable data. For example, there was inadequate reporting of data on the maturity and currency composition of external debt and official reserves, especially with regard to forward obligations, swaps, liabilities and the usability of reserves.

The above situation prevented the Fund from making a more comprehensive analysis of the problem and proposing a possible recovery plan. In fact, the reluctance of Asian governments to tighten monetary policy and to close insolvent financial institutions (even in the face of an impending crisis) greatly added to the financial meltdown. Asia's financial problems are based largely on the mis-allocation of investment, unhedged, short-term borrowing and in the case of Korea, on very high debt-to-equity ratio. These problems are rooted in the poorly regulated financial markets in the private sector and are beyond the IMF's immediate purview.

Second, critics such as Harvard economist Jeffrey Sachs have repeatedly asserted that the IMF's unimaginative, if not routine prescriptions have "actually made Asia's financial turmoil worse."[26] According to Sachs, while the weaknesses in the Asian economies were significant, they were "far from fatal." That is, the deeper strengths of the economies (including high rates of savings, budget surpluses, flexible labor markets and low taxation) remain in place and auger well for long-term recovery. How-ever, the Fund's overdose of bitter medicine — notably, pressing beleaguered governments to raise the existing budget surpluses still higher and to tighten domestic bank credit by increasing interest rates including the imprudent closing down of several weak (but still viable banks) — only served to prolong asset-price deflation in real estate and further erode investor confidence. The bitter medicine administered thus resulted in a "stampede mentality," and the consequent capital flight and further economic contraction.

While the IMF has admitted that it initially erred in requiring the Indonesian government to implement tough budget tightening measures (overlooking the fact that the budget was not the root of the problem), the Fund has, nevertheless, compellingly argued that the rest of its reform prescriptions have been "basically sound," not only for Indonesia, but also for Thailand and for South Korea. For example, while it is true that in the short-term, the tightening of monetary policy may exacerbate the problems inherent in weak financial systems, a period of tight money was necessary to restore exchange rate stability. Evidence from other national experiences has shown that an easy monetary policy, which allows the domestic currency to continue depreciating, might undermine confidence and fuel rapid inflation. If anything, the Mexican crisis of 1994-95 and the more recent experiences of the Czech Republic and Hong Kong have clearly shown that once confidence in a currency has been eroded, a period of sufficiently tight money is necessary, either to defend the currency peg or to stabilize a flexible exchange rate.[27]

Although the IMF failed to arrest the currency decline, the argument that the very IMF prescriptions contributed to the sharp fall in regional currencies is not convincing. The baht's decline had more to do with the erratic nature of investor confidence and spreading regional contagion than with the Fund's financial reform and austerity measures. Malaysia, which is not under any IMF assistance program, saw the ringgit drop to a new historical low of 4.0600 against the dollar (between January 5-6 1998) after new figures from the Bank of International Settlement (BIS) revealed that Malaysia's short-term debt was actually 56 percent of total borrowing from foreign banks rather than the earlier 30 percent estimate. Similarly, the wild rollercoaster swings of the rupiah — from a low of 2,400 to the U.S. dollar in July 1997 to 6,750 to the dollar on January 5, 1998, to 7,700 to the dollar on January 6 and 9,500 to the dollar on January 8 — were a sweeping indictment by the market following Suharto's tabling on January 6 of an expansionary and "totally unrealistic" 1998/99 national budget.

The budget was a complete abrogation of what the Suharto regime had negotiated and signed under the IMF's November 5, 1997 Stand-By and subsequent stabilization agreements, totaling some $43 billion in loan guarantees, and failed to shore up the banking system and curb inflation to make cuts to costly high-profile government projects. It also failed to dismantle inefficient and profligate monopolies with close links to the Suharto family's vast financial empire. In fact, it was only after Suharto reluctantly signed the letter of intent with the IMF on January 15 and agreed to abide by the terms of the agreement that a measure of financial stability was restored, and the rupiah stabilized at 8,200 to the dollar. But on January 20 the rupiah once again plunged to over the 9,500 mark, took a nosedive to 12,000 to the dollar on January 21, and then reached an all-time low of 17,100 to the dollar on January 23 before recovering to 11,400 to the dollar on January 27.

Contrary to the opinions of critics, the rupiah's rapid downward spiral was not a reflection of the Fund's misguided policies. Instead, the markets were responding negatively to the discretionary delays by the Suharto regime to implement the IMF programs and to the widely perceived blatant act of defiance by Suharto in choosing his long-time friend and big-spending Technology Minister, Jusuf Habibie, as his vice-presidential candidate (and presumed successor) in the March polls. The markets rightly concurred with the IMF and the Clinton administration's view that Habibie, who has a major financial stake in almost every business activity in Indonesia, epitomizes the unscrupulous crony capitalism and the perverse business subculture responsible for the crisis. As a pugnacious critic of the IMF and the so-called "foreign interests," Habibie would simply rubber-stamp, if not clandestinely promote Suharto's pattern of double-entendres and half-measures on the agreed IMF reforms.

Perhaps nothing reveals the Suharto regime's obscurantism more than its plans to create a fixed exchange rate system for the volatile rupiah through a currency board in direct opposition to the IMF, the United States, the European Community, Japan and other donor governments. While rumors that Indonesia might adopt a currency board had circulated for weeks, by mid-February Jakarta began to send implicit messages that it would establish a currency board unilaterally unless the Fund came up with a better alternative for strengthening the rupiah. Following the appointment on February 17 of U.S. trained economist, Sjahril Sabirin, as the new Bank Indonesia Governor, the Indonesian government embarked on a media blitz to make its case for a currency board regime. Jakarta's strategy seemed to have worked as a number of prominent academics, including Jeffrey Sachs and John Hopkins University professor Steve Hanke (who was also named adviser to President Suharto's economic council), claimed that unlike an ordinary exchange-rate peg, the predictability and rule-based nature of a currency board would impose strict discipline on profligate governments and prevent them from abusing the central bank's printing presses to fund large deficits.

Using the example of the Hong Kong dollar (which has been officially fixed at HK$7.80 per American dollar since the board was introduced in 1983 and has weathered the crisis reasonably well), supporters argued that since the currency board holds extremely low-risk interest-bearing bonds and other assets denominated in the anchor currency, it not only encourages arbitrage, but also offers an effective barrier against speculative attacks and rapid currency appreciations. Proponents of currency boards claim that they provide stability to the banking and financial system by maintaining market-adjusted interest rates and prudentially controlling destabilizing international capital flows.

It is important to note here that the IMF, in principle, is not necessarily opposed to the establishment of currency boards by emerging economies. It strongly opposed the Indonesian plan (threatening to withhold further tranches under the bailout package) because it felt that a quick-fix was ultimately an unsustainable solution and that it was important for Indonesia to implement the basic agreed upon reforms before establishing a currency board. This position was based on sound economic reasoning. A currency board arrangement can work effectively only if the banking system has the capacity to tolerate significant movements in domestic interest rates. Otherwise the currency board arrangement will induce a conversion of deposits into foreign exchange, further shrink the monetary base and greatly increase interest rates. Also, since a currency board must hold reserves of foreign exchange (or gold or some other liquid asset) equal at the fixed rate of exchange to at least 100 percent of the domestic currency issued, the IMF appropriately concluded that Indonesia's US$12 billion in disclosed foreign exchange reserves (as of March 20, 1998) — and a foreign debt of $130 billion — was simply inadequate to back the estimated 24 trillion rupiah in circulation and would drain the reserves in a few weeks.

The Fund had every reason to suspect that the Suharto regime would dip into the IMF loans to support the currency board because it was already injecting massive doses of liquidity (akin to printing money) to bail out the country's weak banking system. The Fund also found the Hong Kong example to be spurious. In Hong Kong, the Exchange Fund is committed to 100 percent foreign currency backing for Hong Kong dollar bank notes, and the Hong Kong Monetary Authority (HKMA) has an explicit mandate to act as an official lender of last resort; it has been involved in open market operations since 1990.

Hong Kong (unlike Indonesia) has formidable foreign reserves totaling over US$85 billion to cover the currency in circulation plus demand deposits. This gives the HKMA tremendous autonomy to raise short-term interest rates to make it expensive for speculators to obtain Hong Kong dollar credit. And Hong Kong's well regulated and capitalized banks with very low levels of non-performing loans can cope with the increases in short-term interest rates that might be needed to defend the currency board.

Finally, with justifiable reason the Fund remained highly suspicious of the Suharto plan, under which the rupiah's rate would be set at 5,000 to the dollar, or about twice as strong as the current rate. Since a currency board is committed to exchanging foreign currency and local currency on bank reserves at a pre-announced exchange rate, senior Fund officials felt that the currency board was a ploy to allow Suharto's children and cronies to retrench the discretionary and egregious rent-seeking structures and quickly change their substantial rupiah holdings into dollars at an artificially high rate to move it into offshore accounts. It should be noted that if capital outflows are sufficiently large, a currency board could collapse because of a shortage of foreign assets. In Indonesia, where the government cannot even provide complete cover for the domestic currency, the currency board would simply wipe out its remaining foreign currency reserves before the entire domestic currency stock had been converted.

Third, Sachs is only partly correct in noting that lower interest rates would ease access to credit and keep more companies and jobs afloat. However, prudence indicates that under conditions when market confidence has yet to be reestablished, capital outflows persist and currencies continue to depreciate. High real interest rates on a short-term basis are necessary then. In other words, a relaxation of monetary policy would lead only to further currency depreciations. High interest rates are required to attract foreign investment to keep currency speculators at bay and inflation under control and to provide incentives for the corporate sector to restructure its financing away from debt and towards equity. Without the security of higher interest rates, it was theoretically possible for the weak currencies to free-fall, increasing the debt burden in domestic currency and severely hurting borrowers who must pay off their foreign currency obligations. The Fund also had little choice other than to close down insolvent banks, including at least one controlled by a son of President Suharto. Contrary to what the critics suggest, the closures were not arbitrary. A number of weak, but viable banks were allowed to operate only after their rehabilitation plans were approved by the national central banks and the Fund. It is also important to note that the shareholders of the closed banks will not be compensated; small depositors have been compensated by the government in Indonesia.

Fourth, Sachs and other critics have argued that the Fund's massive financial rescue packages, beginning with the one extended to Mexico in 1995, have exacerbated what economists call "moral hazard." Moral hazard refers to a situation where one reaps the rewards from actions when things go well, but does not suffer the full consequences when things go badly. Thus, investors do not necessarily have to exercise due diligence since they could expect a bailout in the case of default, or for that matter, debtor countries can choose to pursue risky economic policies with the expectation that they will not have to pay the full costs of their debts and investors will not lose the full amount invested if a financial crisis occurs.

In the Asian context, it is argued, the IMF only encourages reckless behavior in the future by cushioning the losses of imprudent lenders and borrowers with generous bailout packages. While the logic of this argument is irrefutable, it is extremely difficult to measure the degree of moral hazard present in a given situation and the effect on moral hazard of providing financial assistance in a given crisis. After all, what may look like moral hazard may be in reality the case of mortal lenders and investors simply reading the markets wrong. Also, the IMF's shareholders, the 182 member countries, recognized that the Fund had little choice except to intervene in a sovereign financial crisis to contain and/or minimize the spreading of a global systemic financial crisis, thereby creating the potential for "moral hazard." While some large creditors of banks have no doubt been protected more than they should have been, the hard fact that equity prices have plunged by 30 to 50 percent since the onset of the crisis has meant that equity and bond investors and owners of other publicly traded instruments have experienced significant losses in the value of their investments.

Additionally, a number of international banks have recorded losses (some significant), especially against their exposure to corporations. Contrary to critical opinion, there are no provisions in IMF-supported programs for public sector guarantees, subsidies or support for nonfinancial institutions, and no special treatment is provided for shareholders of institutions that have lost their capital. According to U.S. Federal Reserve Chairman, Alan Greenspan, "Asian equity losses, excluding Japan, since June 1977 worldwide are estimated to have exceeded $700 billion of which more than $30 billion has been lost by U.S. investors. Substantial further losses have been recorded in bonds and real estate."**28**

Some Concluding Reflections

Suharto, Indonesia's former presidential monarch who enjoyed personalized and discretionary control over broad realms of public life and whose personal prerogatives often eclipsed the authority of laws, was unanimously re-elected by a largely appointed People's Consultative Assembly to a seventh-term as president on March 10, 1998. Normally this routine act (what the Indonesians call wayang or shadow puppet theater) would go unnoticed. But Suharto used the occasion to declare that the IMF mandated reforms would be abandoned since they contravene Indonesia's constitution. Convinced that Suharto and his newly appointed cabinet, aptly dubbed the 3K's for korupsi, kolusi, and keluarga (or corruption, collusion and family connection), was not serious about implementing economic reforms, the IMF and key donor governments responded by withholding its $3 billion aid tranche and postponing the review of the aid package until mid-April.

Caught in this debilitating game of brinkmanship, the rupiah fell past the 10,000 to the dollar level, and total foreign debts climbed to over $166 billion with severe reverberations in the economy. For example, the cost of living has increased at an annualized rate of over 200 percent. The price of essential foodstuffs such as rice rose by 25 percent in February 1998 (leading to food riots in East Java), and the price of baby formula and powdered milk has risen by 400 percent since the crisis began. The World Bank projects that the sharp increases in unemployment will increase poverty levels — almost doubling the number of poor from 23 to 40 million. It soon became clear that the consummate dalang (master puppeteer) had sadly lost his midas touch. Reluctant to challenge the privileges of his family, cronies and the powerful traditional constituencies (such as the military establishment), Suharto further jeapordized the furture of his vast and ethnically varied archipelago empire.

Although the crisis is far from over and the evidence remains somewhat equivocal, there is a growing sense that the IMF's bitter medicine is gradually resuscitating the original sickest patients, Thailand and South Korea. Bangkok's close adherence to the IMF prescriptions is starting to pay off. For example, in December 1997, the Thai government permanently closed 56 of the 58 suspended finance companies (i.e. non-bank depository institutions) in accordance with its original agreement with the IMF. The state-owned Radhanasin Bank assumed temporary control of the higher-quality assets earmarked for subsequent privatization, while the two failing banks that did not submit acceptable recapitalization plans (the First Bangkok City Bank and Siam City Bank) were nationalized and are now open to foreign investors willing to acquire them.

The Thai government has also strengthened loan classification rules in line with international standards, and all banks will be required to implement them fully by 2000. These important reform measures, combined with the IMF's vote of confidence, greatly contributed to the rally in the stock market in late January. This development was followed soon after by a much needed “morale booster” as several major American, Japanese and European banks agreed to roll over the debts for several of Thailand’s stronger private sector banks and financial companies. Indeed, fears of a debt moratorium have receded with an improvement in Thailand’s current account, which recorded a surplus of $800 million for the last three months of 1997, and is expected to top over $18 billion in 1998. This shift of the external current account into surplus also means that two critical monetary objectives, exchange rate stability and the maintenance of adequate foreign exchange reserves, can now be met.

Similarly, it was the confidence generated by the $60 billion in IMF guarantees and the Kim Dae Jung administration’s commitment to reform that helped the Korean won recover nearly a third of its value against the dollar by mid-January 1998. The IMF’s sustained pressure and the introduction of its new Supplemental Reserve Facility, combined with more aggressive prodding by the U.S. Federal Reserve and the Bank of Japan, prompted several major American, European and Japanese banks to reschedule the servicing of some $24 billion in short-term debts by converting bank debts into more manageable government-issued bonds with flexible (or longer term) maturities. The threat of a national debt moratorium has also receded in South Korea.

It seems that Jeffrey Sachs is correct on only one score: the currently sick Asian tigers have the wherewithal to rebound back. Their secret of success — enterprise, hard work, discipline, high savings, prudent investment in education, relatively egalitarian distribution of income, low taxation and a market guided economy commited to export promotion — is still there. Earlier the latter would have been regarded as sufficient conditions for the sick tigers to make a quick recovery. Not anymore. The demands of the emerging globalized economy require deeper market integration, rigorous economic transparency and efficacious management. The crisis has also decisively exploded the myth about the merits of “developmental dictatorships.” The records of Thailand’s austere Chuan Leekpai and South Korea’s Kim Dae Jung (one-time political prisoner, dissident, human rights activist and now President) illustrate that democratic and accountable government based on the rule of law is a necessary condition for Asia’s recovery.

Postscript

On April 8, 1998, in their third agreement in six months, the Indonesian government and the IMF signed a new “memorandum of understanding.” It is yet another effort to get Indonesia to comply with the conditions before the IMF’s second tranche of $3 billion can be released. However, to assure compliance, the IMF Executive Board, along with the World Bank and the Asian Development Bank, will carry out joint daily monitoring. The IMF financial aid is to be released gradually and only after Indonesia undertakes substantive reforms. Although the new agreement reiterates many of the earlier IMF prescriptions, both parties have made important concessions. For its part, the IMF has agreed to allow Jakarta to continue to subsidize the import of food, fuel and feed-meal for livestock until October 1998; this includes preferential exchange rates to be enjoyed by private firms helping in the distribution of basic commodities. The Indonesian government, in turn, has agreed to accelerate bank restructuring by closing all insolvent banks (i.e. banks controlled by Suharto’s family and cronies), by tightening money supply and by developing a comprehensive arrangement with foreign creditors to restore trade financing and to resolve the problem of interbank credit and corporate debt. Regardless of who leads the Indonesian government, the crisis has clearly shown that meaningful economic and political reforms are a necessity for the country.

Notes

1 Unless noted otherwise, data used in this paper are drawn from International Monetary Fund, *World Economic Outlook: An Interim Assessment* (Washington, DC: IMF, 1997). South Korea’s inclusion was a surprise since its economy was performing so well, growing by 9 percent, with employment at an all time low of 2.1 percent. BACK TO TEXT
2 These measures included the classic IMF demands such as deep budgetary cuts, tax hikes and greater transparency in economic relations. BACK TO TEXT
3 Because these countries relied heavily on private capital inflows, the IMF had only limited influence over them. However, it is worth noting that several high-placed Thai and Indonesian policy makers told me that the IMF failed to give them adequate information or advance warning. Is it possible that because no one had foretold the breadth and depth of the crisis, no one really pushed for what had to be done? BACK TO TEXT
4 Even knowledgeable individuals such as Bandid Nijathaworn, the deputy director of the Bank of Thailand’s economic research department, conveniently ignored Thailand’s 10 billion-baht balance of payment deficit in the first quarter of 1995 when he stated that the current account deficit would shrink rapidly as investment reached its cyclical peak and started to slow down. See “Thailand” in *The Far Eastern Economic Review: Asia 1996 Yearbook* (Hong Kong: Review Publishing Company, Ltd., 1997) 217-18. BACK TO TEXT
5 The Malaysian ringgit (RM: ringgit Malaysia) is based on a bundle of international currencies, with an implicit peg to the US dollar. Before the 1970s it was pegged at RM3: US$1. Since the adoption of the flexible exchange rates in the early 1970s, the ringgit has moved in the range of RM2.4-2.7 to the US dollar. It is important to note that the Bank actively bought the ringgit to prevent the currency from breaching M$2.25 to the dollar, seen as a “psychological barrier.” BACK TO TEXT
6 Under the monetary policy known as a “pegged exchange rate regime,” central banks such as the Bank of Thailand attempt to manage domestic money supply growth in order to maintain a fixed exchange rate with another currency (i.e. the U.S. dollar) and simultaneously to control domestic inflation. Yet the paradox was that these countries did not need to restrain inflation. Prior to the adoption of pegged exchange rates, the high-performing East Asian economies had relatively low inflation. For a good discussion see World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (New York: Oxford University Press, 1993). BACK TO TEXT
7 The lone dissenter was iconoclastic MIT economist Paul Krugman. In a provocative article published in 1994, he argued that Asian growth, impressive as it was, could be explained by basic economic factors such as high savings rates, investment in education and job creation. In other words, it was growth in output, the result of working harder, not smarter — or what Krugman calls “perspiration rather than inspiration.”

However, Krugman's model predicted "diminishing returns," or a gradual loss of economic momentum, rather than a crash. See Paul Krugman, "The Myth of Asia's Miracle," *Foreign Affairs* (November/December, 1994). BACK TO TEXT

8 Data drawn from International Monetary Fund, *International Capital Markets: Developments, Prospects and Policy Issues* (Washington, DC: IMF, 1995) 2-4. BACK TO TEXT

9 For details see IMF, *International Capital Markets and World Bank, Private Capital Flows to Developing Countries: The Road to Financial Integration* (Washington, D.C.: The World Bank, 1997). BACK TO TEXT

10 For example, Malaysia reported a total capital inflow equivalent to 20 percent of its GDP in 1994 while Thailand's external capital inflow peaked at 12.5 percent of GDP in 1995. Some 95 percent of these inflows consisted of portfolio and equity placements. The1996 data are from World Bank, *Global Economic Prospects and the Developing Countries* (Washington, D.C.: The World Bank, 1996) 11-12. All other data are from IMF, *International Capital Markets*, pp. 2-4 BACK TO TEXT

11 The gross foreign liabilities of commercial banks have expanded rapidly in many capital importing countries. In Malaysia, foreign liabilities as a percentage of GDP increased from 7 percent to 19 percent between 1990 and 1993. In Indonesia, the external liabilities of banks increased from 2 percent of GDP in 1989 to 6 percent the following year. The same ratio increased from 8 percent in 1991 to 13 percent in 1994. In Thailand it increased from 4 percent in 1988 to 20 percent in 1994. BACK TO TEXT

12 Jeffrey Sachs aptly notes that "Banks and near-banks — such as Thailand's now notorious financial trusts — became intermediaries for channeling foreign capital into the domestic economy. The trouble is that the newly liberalized banks and near-banks often operate under highly distorted incentives. Under-capitalized banks have incentives to borrow abroad and invest domestically with reckless abandon. If the lending works out, the bankers make money. If the lending fails, the depositors and creditors stand to lose money, but the bank's owners bear little risk themselves because they have little capital tied up in the bank." See Jeffrey Sachs, "Personal View," *Financial Times* (July 30, 1997). BACK TO TEXT

13 Somprasong was the first Thai Company to miss payments on its foreign debt. Why did such a premier company collapse so suddenly? In large part because property loans appear safe only because the values of the loan collateral keep rising. But, these property prices are rising only because of the reckless lending itself, thus creating an asset bubble. When the bubble bursts, the loans cannot be repaid from selling the collateral, which is already plummeting in value. BACK TO TEXT

14 While countries formally peg their exchange rate to a basket of currencies, in the case of Asia, the effective weight of the US dollar in the basket was so high that their policies could be characterized as an implicit peg to the US currency. Since the dollar was on a downward nominal trend relative to the yen and mark between 1991 and 1995 and reached a low of 80 yen per dollar in the first quarter of 1995, the Asian currencies pegged to the dollar experienced a real depreciation relative to the Japanese and European currencies. By mid-April 1995, the dollar started rapidly to appreciate relative to the other major currencies (the yen/dollar rate went from 80 in 1995 to over 125 in the summer of 1997, a 56 percent appreciation). This trend meant that the ASEAN 4 and South Korean currencies, which were tied in nominal terms to the dollar, experienced a significant appreciation of their real exchange rates. Because the financing of these deficits took the form primarily of short-term borrowing in foreign currency, by the summer 1997 they had accumulated large structural current account foreign liabilities. BACK TO TEXT

15 By the end of May 1997 finance companies had liabilities of 1.39 trillion baht, outstanding foreign loans worth 111 billion baht and outstanding promissory notes worth 912 billion baht. Also, about 12 percent of bank loans and 20 percent of finance company loans were non-performing and involved a total of about 1 trillion baht or 20 percent of GDP. For details see The Economist Intelligence Unit, *Country Report: Thailand*, 3rd Quarter 1997 (London: EIU, 1997) 22. BACK TO TEXT

16 As noted earlier, unlike the basket of currencies which depends heavily on the US dollar, the managed float system means the value of the baht would be set by market forces. BACK TO TEXT

17 As domestic corporations who had borrowed heavily in foreign currencies realized that the peg might not hold and that their debt service costs might rise, they did everything possible to sell domestic currency and thus extended the currency free-fall. BACK TO TEXT

18 The reassuring words of Malaysia's Deputy Prime Minister and Finance Minister, Datuk Seri Anwar Ibrahim, calmed the markets in the end. Quotes are from The Far Eastern Economic Review (October 2, 1997): 70; "Southeast Asia in Denial," *The Economist* (October 18, 1997): 14, 39-40; and "Indonesia: No Thanks IMF," *The Economist* (November 1, 1997): 43-44. BACK TO TEXT

19 Created by the authoritarian Park Chung Hee regime (1963-79), chaebol are conglomerates of many companies grouped around one holding or parent company. The parent company is usually controlled by one family. In 1988 the top 40 chaebol grouped a total of 671 separate companies. The top four super chaebol (Samsung, Daewoo, Hyundai and Lucky-Goldstar) have sales which account for roughly 40 to 45 percent of South Korea's GDP. Chaebol, however, do not own or control financial institutions (since South Korean banks were nationalized until the mid- 1970s), making them highly dependent on, if not vulnerable to government policies and predilections. BACK TO TEXT

20 Unlike the Southeast Asian currencies, the Korean won is not pegged to any currency. In early November 1997, the government allowed the value of its currency to fluctuate up to 10 percent per day to revive the foreign exchange market and draw dollar deposits. Despite this widening of the fluctuation band, the won continued to fall throughout 1997. BACK TO TEXT

21 See "Semiconductors: Chips on their Shoulders," *The Economist* (November 1, 1997): 62 and IMF, "IMF Approves SDR 15.5 Billion Stand-By Credit for Korea," Press Release No. 97/55 (December 4, 1997). BACK TO TEXT

22 As the collapse of the Hanbo chaebol unfolded, a huge scandal involving the president's own son was uncovered. Later investigation suggested that the president himself may have been involved. BACK TO TEXT

23 The IMF makes two types of public assessments: (a) overall market forecasts and (b) country assessments that are contained in the reports of Executive Board discussions of Article IV consultations with member countries. The overall market results are published twice a year in the IMF's *World Economic Outlook* and in the annual *International Capital Markets* report. BACK TO TEXT

24 The diversity of the IMF's membership and the problems they confront has led the Fund to establish a complex array of programs and facilities via which it can provide financial assistance. In addition to the "stand-by arrangements" that are usually one to two year support programs designed to correct short-term balance of payments problems, the "extended fund facility" arrangements are usually three to four year programs designed to allow countries to reorganize their financial and monetary system. The "enhanced structural adjustment facility" also finances longer-term programs, but at a concessional interest rate for low-income countries. In December 1997, the new "supplemental

reserve facility" was created to assist emerging market economies. The first borrower under this new program was South Korea. BACK TO TEXT

25 An artificial value, based on the average worth of the world's five major currencies, is assigned to the SDR. Currently there are 21.4 billion SDRs in existence, worth approximately $29 billion and accounting for about 2 percent of all reserves. BACK TO TEXT

26 Jeffrey Sachs, "The Wrong Medicine for Asia," New York Times (November 3, 1997). For a similar, albeit more nuanced criticism of the IMF policies in Asia, see Martin Feldstein, "Refocusing the IMF," *Foreign Affairs* (March/April, 1998). BACK TO TEXT

27 Of course, the question of how tight monetary policy should be varies from country to country. Given its history of macroeconomic instability and high inflation, in Mexico, the authorities had to allow nominal interest rates on 28-day cetes (peso-denominated government obligations) to climb to 70-80 percent for a few weeks. The tightening of fiscal policy also enabled them to reduce current account deficits, bolster investor confidence and ensure the availability of funds to cover the costs of restructuring their financial sectors. BACK TO TEXT

28 "Testimony of Chairman Alan Greenspan Before the Committee on Banking and Financial Services," U.S. House of Representatives Transcript, US Federal Reserve Board (January 30, 1998). BACK TO TEXT