The Promises & Perils of Globalization

By Roman Terrill

Not long ago, the popular conception was that if the 20th century "belonged" to the United States, the 21st century would certainly belong to the countries of Asia. After all, the economies of Asia were growing at a rate that far exceeded growth rates in the United States and Europe. While educational systems in Asia were producing a steady supply of well-trained engineers (who would undoubtedly contribute to future economic success), the United States seemed to produce a great number of lawyers (who would presumably do little more than interfere with economic progress). Furthermore, Asian countries enjoyed huge trade surpluses with the United States, and did not suffer from the large budget deficits that were all too familiar to the U.S. In the late 1980s, U.S. companies sent their managers to Asia to learn and bring home their "secrets."

Much has changed since then. A financial crisis swept much of Asia, leaving the region at an economic, social, and political crossroads. Asian leaders and commentators from around the world questioned whether the "Asian way" is viable in a new world of financial globalization. This debate generated an even broader discussion regarding the benefits of an increasingly global economy. The question being asked with more frequency and greater urgency is: Should we fear or embrace financial globalization?

This section will provide you with information you will need in thinking about possible responses to the question. Part A discusses the promises that financial globalization seems to offer the "borrower" and the "investor." Part B addresses the perceived perils of financial globalization. In Parts C and D you will read about the Asian financial crisis, which will help illustrate both the promises and the perils of "global money." The two parts provide a general overview of the nature of the crisis and a country-by-country analysis. Part E will provide you with a detailed look at the IMF's response to the crisis as it related to one country, Korea. The section will conclude with observations regarding the crisis' impact on development and sovereignty.

As you read the material, keep in mind the ultimate question regarding financial globalization - namely, is it really worth it? Financial globalization legitimately provides countries and communities of the world a chance to prosper at levels otherwise unattainable. It also has its costs. Of course, in life the "good" often comes with the "bad." People must weigh these factors in decisions they make daily. As you will see, the IMF seems to have

already weighed these factors and has decided in favor of further globalization. After you have read this section, tell us what you think.

A. The Promises of Financial Globalization

Like many things in life, financial globalization can be both a blessing and a curse. We will first look at the potential opportunities created for the borrower and the investor.

1. The Borrower's Perspective.

a. Access to a global supply of savings reduces the cost of borrowing.

A borrower pays for the use of other people's savings. The cost of those savings is generally expressed in terms of an interest rate. For example, a potential borrower might go to a bank and ask to borrow $20,000 to start a new business. The bank, which collects the savings of depositors, might agree to lend the borrower $20,000 at a 10% annual interest rate. The bank is charging the borrower $2,000 annually for the use of the savings it has collected from depositors (savers).

To a certain extent, the cost of the loan (the interest rate) the bank will charge the borrower will depend on the amount of savings available to the bank. The law of supply and demand tells us that when the supply of savings is high, the cost of using those savings (the interest rate) will be low. The opposite (low supply of savings means higher interest rates) is also true. This means that borrowers in countries with low savings rates must pay higher interest rates for loans.

One of the promises of financial globalization is that it gives such borrowers access to funds from countries with higher savings rates. The result for the borrower is access to cheaper money in the form of lower interest rates. One such borrower that continues to benefit tremendously from this phenomenon is the United States Government.

b. Financial globalization gives the borrower access to sophisticated products and services.

By accessing the savings of the world, rather than just the savings of its own country, a borrower also accesses the incredible sophistication of the world's financial centers. A company in Costa Rica, for example, that wants to finance the construction of a new plant naturally would want to acquire the needed money at the lowest cost possible. The financial institutions in New York, London, Berlin, Singapore, and Tokyo would likely be more capable than those in Costa Rica of meeting the specific needs of the company,

whether it be by managing risks, offering a wider range of financial instruments, or negotiating among potential lenders. So not only could the Costa Rican company find cheaper financing, it might also get access to better types of financing.

c. Indirectly, globalization will increase the sophistication and efficiency of domestic financial markets.

Borrowers also stand to benefit indirectly from financial globalization. If borrowers are able to access more sophisticated and less expensive capital from abroad, financial institutions and the regulatory structure in the borrower's home country are likely to improve in order to compete with the global players. This will benefit the home country's economy through more efficient transactions between borrowers and savers (what economists call "financial intermediation"). Ultimately, policymakers hope that improved domestic financial markets will lead to sustained economic growth and increased standards of living.

2. The Investor's Perspective.

Borrowers are not the only ones to benefit from financial globalization. The saver, or investor, stands to benefit as well. Recall that a borrower in country A, which has a low savings rate and consequently high interest rates, can acquire capital at a lower cost from country B, which has a relatively high savings rate. An investor in country B, of course, is bound by those same relatively low interest rates in her country. If the investor lends her money to a borrower in country B, she will only be able to charge the market rate for the use of her savings. If she charged more, the borrower could quite easily go to a different investor and acquire capital (someone else's savings) at a cheaper rate. However, if the investor from country B can make her funds available to the borrower in country A, where interest rates are higher, she might be able to charge more for the use of those funds. This benefits the investor in three ways.

a. Financial globalization gives investors access to investments with higher returns and thus greater profits.

Financial globalization provides the investor with greater access to borrowers worldwide, which means more customers and potentially higher returns and profits. Borrowers in countries with low savings rates can provide the high-risk, high-return investments that many investors look for. Investors could put their money in government bonds and/or low-risk stocks and expect a return of six to eight percent on those investments. But many investors will combine low-risk, low-return investments with high-

risk, high-return investments that may generate much higher percentage returns. Thus, globalization provides the investor with a larger pool of high-return investments to select from.

b. Financial globalization helps reduce the risks of investment, such as "country risk" and "currency risk."

Risk assessment is a critical feature of any investment decision. The risk associated with the investment—the chance the investor will not receive a good return or will even lose money - will determine the price the investor charges for the use of her funds. When an investor holds different types of investments - a portfolio - she tries to manage the risks associated with the individual investments and the risks associated with the investment portfolio as a whole. One risk to the portfolio that should be managed is "country risk." If an investor has all of her money invested in the United States, then a downturn in the U.S. economy might spell trouble for her entire portfolio. The prudent investor most likely will look for investments in Europe, Asia, Latin America, etc., which can offset losses from U.S. investments in the event those investments lose value. Financial globalization makes accessing these markets and managing this risk easier.

Another broad category of risk that can better be managed through financial globalization is "currency risk." If an investor has all of her investments denominated in yen, a decline in the value of the yen would mean a decline in the value of her entire investment portfolio. A prudent investor wants to spread that risk around, by having investments denominated in other currencies. The investor might purchase, say, German bonds, Asian stock, and Russian certificates of deposit in order to reduce currency risk.

c. Financial globalization gives financial institutions access to new markets.

This benefit applies more to investment banks and other financial institutions than to individual investors. Financial globalization enables highly sophisticated and efficient financial institutions (especially in the U.S. and Europe) to expand business operations throughout the world. Prominent and powerful financial institutions like J.P. Morgan, Citicorp, Chase Manhattan, the Credit Suisse Group, Morgan Grenfell, and Goldman Sachs compete with each other not only in the major financial markets, such as New York and London, but also in emerging markets in China, Mexico, and Thailand. The profits from operations in the emerging markets will help offset weaker profits from the financial institutions' operations elsewhere.

B. The Perils of Globalization

Financial globalization is not without its potential pitfalls. The very characteristics of financial globalization that fuel the expectations of global economic expansion and higher living standards also fuel the concerns about potential negative consequences. One might consider the following questions:

- What happens to financial institutions in the lesser-developed countries that do not have the same amount of capital and cannot provide the same sophisticated financial instruments as foreign institutions?

- What are the economic, social or cultural costs of profound financial restructuring in developing and emerging countries that result from the processes of globalization?

These are complex questions that even experts cannot fully answer. We will describe a few of the concerns relating to these questions.

1. Global Competition for Investment Capital Requires Companies to be "World Class."

The previous section highlighted the promise of a global supply of investment capital (savings). Capital will become more sophisticated in form and function, and at the same time less expensive. This prospect is very enticing to the borrower in country A, where capital is expensive and difficult to obtain. This prospect, however, is also very enticing to borrowers in countries B through Z, where circumstances might be the same. This presents the first peril of globalization for the borrower - the global supply of additional borrowers ready to compete for that investment capital.

To illustrate, try imagining a very promising computer software company in Moscow. Assume the company has performed well for a number of years and needs capital to expand its operations. In a financially globalized world, foreign investors will see investment opportunities not only with the Moscow company but also with similar companies in other parts of the world, such as software firms in Taiwan or India. So even if the performance of the Moscow company exceeded the expectations of investors, it might lose out to a distant and unknown rival. Economists are likely to view this as an example of economic efficiency because scarce capital is being allocated to its highest valued use. But the Moscow company will hardly find that explanation comforting.

Now imagine that the Moscow company outperformed its Taiwanese and Indian rivals. As it happens, it still may have difficulties attracting foreign investors. For instance, what if just before the directors of the Moscow company decided they were going to borrow money in the international capital markets by issuing a debt instrument called a Eurobond, the Russian government began considering legislation to make immediate payment of all the billions of rubles still owed employees of the Russian government? The company's investors might interpret such a proposal as inherently inflationary, especially in Russia. This might fuel the concern that the ruble would be worth less in the future, making it more difficult for companies to service debts denominated in currencies other than the ruble, such as a Eurobond. Potential investors in that Eurobond issue might therefore be reluctant to buy the bonds.

These examples explain why those companies that do raise capital in the international capital markets are frequently labeled "world class companies." They have acquired that reputation by their size, by outperforming their rivals, and by operating in relatively safe domestic circumstances - three factors that investors look for when deciding where to place their savings. Put another way, companies become "world class" by overcoming "country risks." Many companies in developing or emerging economies are unable to reach that status easily. Ironically, this means that companies and countries that are in the greatest need of tapping into the global capital markets may be unable to do so.

2. Borrowers' Ability to Compete Depends on Massive Regulatory Reform and Global Economic Coordination.

In the globalized world of finance, a borrower's performance is but one factor in determining where capital will flow. Other factors, such as interest rate fluctuations around the globe, regional recessions or booms, taxes and regulatory restrictions, all of which are often beyond the control of the borrower, will be as determinative in the fight for investment capital as will the performance of the borrower. In this respect, the borrower's country as well as the individual borrower must become globally competitive.

The adjustments a country must make to become globally competitive can be daunting. Reforming a financial system requires in some circumstances a great deal more than merely tinkering with a few laws or regulations. Opening the borders to sophisticated foreign financial firms is one way of forcing a country to "modernize" its system. But this might result in foreign-firm dominance of the financial system. Moreover, financial systems are often configured in a way that reflects the history, culture and values of a specific

country or region. Just as the French might be concerned that globalization of the movie industry a la "the Americans" will harm French culture, so too might the Koreans argue that organizing an economic and financial system "the American way" would require an unacceptable loss of essential aspects of Korean society. This precise concern was expressed in the aftermath of what is now commonly referred to as the Asian financial crisis.

C. The Asian Financial Crisis: Background

Before we explain how the Asian financial crisis occurred, we will provide you with important background - set the stage, so to speak, for a country-by-country explanation.

1. Asia's Economic Success in the 1980s Illustrates the Promise of Financial Globalization: Asia's Market-Oriented Economies Attracted Foreign Investors Whose Capital Fueled Economic Expansion.

The Asian crisis vividly illustrated both the promises and perils of financial globalization. On the one hand, financial globalization has helped fuel Asia's remarkable economic performance in the last few decades. During the 1980s and early 1990s, investors from around the world poured investment capital into Asia as a result of the region's pursuit of export-oriented, market friendly policies. Foreign portfolio investors were undoubtedly attracted to the impressive growth rates in the region, which averaged around 7% to 9% annually. The impressive performance of the region's stock markets produced the high returns these investors cherish. And foreign commercial banks from Europe, the United States and elsewhere engaged in profitable transactions by lending to Asian banks and companies. The Asian economies built on their own successes—they already enjoyed high domestic savings rates - by investing the capital these investors provided.

2. Asian Governments Pegged their Exchange Rates to Promote Confidence.

The challenge to governments in Asia in the midst of their rapid economic expansion was to ensure that economic growth continued at a manageable pace. One way of "stabilizing" financial flows and investment is to maintain a stable exchange rate by "pegging" (or fixing) the value of domestic currency, say, the Indonesian rupiah, to a currency or currencies used widely throughout the world. When exchange rates are stable, investors worry less about sudden currency fluctuations that may negatively affect their investments. They are therefore less likely to suddenly pull their money out of a country because of speculative calculations of the future value of the currency. Consequently, Asian countries, like many other developing countries, opted for fixed exchange rate regimes

rather than "floating" rates. In fact, even after all of the relevant Asian countries had tried to adopt more flexible regimes by 1980, the policies of the central banks effectively created a de facto single currency peg regime hinged on the U.S. dollar leading up to the crisis.

A more detailed example may help you fully appreciate at least one reason for adopting a fixed exchange rate system. Imagine a U.S. investor who wants to purchase Thai stock for 100 baht, which is Thailand's currency. Assuming a baht to U.S. dollar exchange rate of 10 baht:1 U.S. dollar, the U.S. investor would have to exchange 10 U.S. dollars for 100 baht in order to purchase this stock. Assume the investor feels confident that the stock will increase in value to 125 baht by the end of the year. If the baht:U.S. dollar rate remains the same at the end of the year, and his prediction for the performance of the stock is accurate, the investor will make 25 baht, or 2.5 U.S. dollars. If, however, the investor thinks the baht: U.S. dollar rate will fall to 13 baht: 1 U.S. dollar, he will not even purchase the stock. In this case, if the U.S. investor did invest in the stock, the growth in the value of the stock would still yield 125, but that 125 baht would not be enough to repurchase the 10 U.S. dollars he invested in the first place (he would need 130 baht to purchase 10 U.S. dollars).

Exchange rate instability was a big concern for Asian governments because of the relatively small size of some of the Asian economies and because their economies were growing so rapidly. If investors lost confidence in both the long- and short-term stability of exchange rates in the region, the flow of foreign investment might become increasingly erratic. Hence the peg to "hard" currencies, like the dollar and yen, which tended to remain very stable.

In Thailand, for example, the baht was essentially pegged to the U.S. dollar, although the actual fixed-rate calculation was a bit more complex. The Central Bank of Thailand pegged the value of the baht at around 20 baht to 1 dollar. As a result, anyone (Thai citizens, Thai banks, foreign investors) could exchange their baht for dollars at the pegged rate. The baht was allowed to fluctuate in a very narrow band with the dollar, but holders of baht and baht denominated investments could remain confident that the baht they held would not lose a significant amount of value.

3. By Adopting Pegged Exchange Rates, Host Countries Promised Everyone They Would Defend the Declared Value of the Currency, a Promise They Eventually Had to Break.

When Thailand pegged the baht to the U.S. dollar, it made a promise to any and all

who held baht that they could exchange baht for a set amount of dollars at any time. Of course, in order to fulfill this promise, the Thai Central Bank had to maintain an adequate level of dollars on hand so that it could make the required exchanges. Consequently, the amount of "foreign reserves" the Thai Central Bank had was an essential issue to all those who held baht. If baht holders feared or predicted that the Thai Central Bank would not have adequate foreign reserves to exchange for baht, the currency would not really be "worth" the fixed rate of dollars. You can see, then, that maintaining an adequate level of foreign reserves would become a critical issue for foreign investors. Ultimately, the Thai Central Bank nearly ran out of its dollar reserves, and could no longer defend the declared dollar value of the baht.

4. The Steep Devaluations of the Regional Currencies Caused Great Economic and Social Pain.

The Asian economies hit hardest by the crisis had at least one thing in common: the collapse of pegged exchange rate regimes established in part to maintain foreign investor confidence. Holders of the currencies in question lost confidence in the government's ability to maintain the pegged rate. Foreign investors, as well as domestic players, such as corporations, investors and citizens, hurriedly exchanged their domestic currencies for hard currency, mainly dollars, until the central banks depleted their foreign reserves and were forced to abandon the pegged system. The currencies were then allowed to "float," that is, their values were set mainly by market forces. By 1997, all the affected countries had adopted floating rate regimes.

The result of allowing the currencies to float was that Asian currencies lost much of their value, a process known as devaluation. This created rampant inflation, followed by a sharp increase in interest rates, and a steep decline in the regional stock markets. Moreover, the devaluations created crushing debt burdens for Asian companies and banks, which had borrowed heavily in dollars from foreign banks and converted the dollars to local currency. The devaluations meant they had to use much more local currency to repay the loans than they otherwise would have under the fixed rate. Asian banks and companies in this predicament faced the risk of defaulting on their loans; bankruptcies were widespread.

5. Many Factors Contributed to the Crisis; Experts Disputed Over the Main Sources.

The collapse of the pegged exchange rate systems is what precipitated the economic crisis in Asian countries. During the crisis, economists and policymakers disputed over

what the precise origin of the forces that led to the devaluations were. Some claim that the government-directed market economies of Asia created economic distortions that eventually led to the devaluations. Proponents of this position, which included the IMF, said that fundamental structural defects in the Asian economies made the pegged rates unsustainable. In essence, the claim was that the crisis of confidence in the pegged currencies was just a natural "market correction" of the governments' mismanaged economies and exchange rate regimes. Even domestic companies knew a correction was imminent when they started entering into contracts to exchange local currencies for dollars ("hedging"), a development that put additional downward pressure on local currencies.

Others tended to blame foreign players for the crisis. Malaysia's Prime Minister blamed so-called hedge funds for attacking the local currencies - i.e., institutional investors who make money by betting that a currency will be devalued. Others said that portfolio investors in the stock markets overreacted to concerns about the perceived fundamental weaknesses in Asian economies and pulled their money out too quickly for fear of losing high returns on their investments. This caused a crisis of confidence that ultimately led to the collapse of the peg. Another culprit was the foreign commercial bank, which over-lent to domestic borrowers.

Still other commentators said that the IMF was to blame by remaining essentially silent about the viability of the pegged rates until they had already collapsed. The IMF had, after all, claimed that it had been privately warning Asian governments of the weakness of the pegged rates. This raised the concern that perhaps the IMF should have done more to prevent these incredibly destructive devaluations.

What follows is a chronological explanation of the crisis based largely on financial publications of the world.

D. The Asian Financial Crisis: A Country-by-Country Analysis

1. The Crisis First Emerged in Thailand.

The crisis erupted in Thailand in the summer of 1997. Starting in 1996, weaknesses in the Thai economy began to emerge that until then had been overshadowed by high rates of growth and a relatively stable currency resulting from the peg of the Thai baht to the U.S. dollar. Ironically, Thailand's difficulties resulted from its earlier economic successes. Its strong growth and generally prudent economic management attracted large capital inflows. These inflows quickly turned into outflows when the economic outlook in Thailand

weakened.

a. Financial globalization enabled increased foreign investment in Thailand, which led to overvaluation of the baht.

Because of the peg, the large and steady inflow of foreign capital into Thailand did not seriously affect the dollar-baht exchange rate. In other words, despite the fact that more and more money was coming to Thailand, where it was converted to baht and then circulated in the economy, the stated value of the baht remained largely unchanged against the dollar. In countries that do not peg their currencies, an increase in the supply of money usually leads to a decrease in the value of the currency.

In Thailand, the exchange rate did not adjust sufficiently to reflect the inflationary effects of large capital inflows. Thai banks, which had more money as a result of the foreign capital inflows and the overall growth of the economy, expanded their lending rapidly, often in increasingly risky investments. Thai banks, operating under a model made popular in Japan, were allowed to report loans (a bank's principal asset) that were not being repaid on a timely basis, if at all, at their projected values. This is widely believed to have fueled overinvestment in certain assets, particularly commercial and residential real estate. Because investors saw nothing but success from banks lending in this area, investors lined up to lend to developers. The resulting unrealistic increases in asset prices were not sustainable and the "real-estate bubble" eventually burst once the investments were judged on their actual, not projected, performance.

All of these developments led to the overvaluation of the baht. Simultaneously, Thailand's financial system was weaker than the banks' balance sheets indicated. Perhaps the Thai government's past success fueled unrealistic confidence in the sustainability of these policies and conditions. However, the Thai government failed to recognize that at least one critical aspect of its past success, its current account surplus, was no longer present.

b. The overvalued baht led to a worsening of the current account balance, a speculative assault on the currency, and a devastating devaluation.

For years, Thailand ran a current account surplus, largely as a consequence of its successful export-led industrialization strategy. But in recent years those surpluses turned into deficits. The large inflow of capital fueled an economic expansion that in turn heated up demand for imports. In a relatively short period of time, Thailand began to import more goods and services than it exported. This resulted in dangerously high current account deficits. The ratio of the current account deficit to GDP was 8.3% in 1995; 7.9% in 1996;

and an estimated 7.5% in 1997 even before the devaluation. Among most economists, a ratio of current account deficit to GDP over 5% is considered "dangerous."

With its banks lending money at a frantic pace, and with imports outstripping its exports, Thailand's dollar-baht peg was put under considerable pressure. Put quite simply, Thai banks were increasing the supply of baht in the economy by issuing easy credit. At the same time, Thai consumers and corporations were demanding greater amounts of foreign exchange to satisfy their demand for imports. Not surprisingly, the real value of the baht began to fall against the dollar. The policy measures necessary to maintain the credibility of the peg (increased interest rates, increased reserve requirements, or a fiscal austerity program (decreased spending or increased taxes)) never materialized. This led to a classic speculative assault on the baht-to-dollar peg.

The result was equally classic. The foreign currency markets began to "short-sell" the baht, and, despite the Thai government's attempt to defend it, the peg gave way to the insurmountable pressure to devalue. On July 2, 1997, the Central Bank allowed the baht to float against the dollar on the foreign currency markets. In essence, the Thai government gave up trying to assign a dollar value to the baht through its peg, and instead allowed the foreign currency markets to make their own determination of the baht's real value. The baht immediately lost nearly 15-20% of its value against the dollar. Since then it has lost nearly a third of its pegged value.

The consequences for Thailand were immediate. Prices instantly soared as companies quickly ascertained that if the baht lost 20% of its value, they would have to charge 20% more baht for their goods and services. Interest rates shot up as a guard against inflation. Sensing the inevitable economic slow down and perhaps the recession that the increase in interest rates would bring, the stock market plunged. Abandoning the peg thus triggered a severe economic crisis in Thailand.

c. Thailand's financial crisis could not easily be contained in a globalized economy.

The double-edged sword of globalization was evident at this early stage in the Asian crisis. Thailand's impressive economic performance had attracted enormous flows of capital supplied by foreign entities that were eager to take part in a fast-growing economy. The massive capital inflow, aided by some questionable macroeconomic polices and possibly some financial sector mismanagement, altered the economic landscape of Thailand. Credit was easier to come by because there was a lot more of it. Imports were cheaper because the

peg kept the baht's value unrealistically high against the dollar. The inflow of "global" capital created a boom. However, when Thai fortunes turned for the worse and the economy began to show weaknesses, the foreign capital fled just as quickly as it had entered. The resulting bust was likely far greater than any cyclical downturn would have produced had it not been for the effect of global capital.

The crisis was not limited to Thailand. Developments there prompted investors to take a much closer look at similar risks in other countries. Many of the factors that led to the crisis in Thailand seemed to be present in Malaysia, Indonesia, Korea, and even in countries as far away as Brazil and Russia. Moreover, companies and individuals in these other countries began to question the future stability of their currencies and the soundness of the domestic financial systems. Finally, government policymakers were suddenly faced with the threat of a Thai crisis repeating itself elsewhere. Their ability to prevent the spread of the crisis, or the so-called "Asian contagion," was probably limited. In some cases, their resolve to prevent the spread was even more limited.

2. The Crisis Spread to the Philippines But Had a Limited Impact on the Country's Economy.

The Philippines was affected almost immediately by the events in Thailand. On the same day the Thai baht was devalued, the Philippine central bank intervened heavily in the currency markets to defend its currency, the peso. Shortly thereafter, the central bank continued its strategy of increasing interest rates to stem a speculative assault. Perhaps sensing the futility of defending its peg on its own, the Philippine government quickly looked to the IMF for assistance.

On July 11, 1997, the Philippine central bank heeded the advice of the IMF and allowed the peso to float within a wider band against the dollar. In exchange, the Fund pledged over a billion dollars of support to the Philippine government. The IMF and the Philippines had been in close cooperation well before the crisis began. This arguably helped to restore more quickly domestic and foreign confidence in the stability of the Philippine economy.

3. The Crisis Spread to Malaysia, Which Implemented Structural Reforms without an IMF Program.

Like the Philippines, Malaysia intervened in the foreign exchange markets to defend the ringgit, which was tied to the U.S. dollar. The strategy helped, but it was costly - so costly that it prompted the Prime Minister of Malaysia, Mahathir Mohammed, to condemn

speculators and their activities as "immoral." The Prime Minister argued that the country's foreign currency reserves, and indeed all of Asia's remarkable successes over the last three decades, were being squandered by defending currencies from speculative assaults by foreigners such as George Soros. Over the course of the next several months, Malaysia saw its currency lose nearly a third of its value.

Prime Minister Mahathir's rebuke of George Soros received global attention. Some claimed that he wrongly blamed his country's economic plight on foreign actors, such as speculators that acted rationally upon developments in Malaysia's economy. Others have argued that at the very least Mahathir's comments provided a much needed response to the prevailing "Western" view that Malaysia and other Asian countries were in trouble because they had been run by corrupt "crony-capitalists" who needed to be "disciplined by the markets."

Without the assistance of the IMF, Malaysia adopted a tough structural reform package to prevent future crises. The measures included a commitment to higher interest rates, improved banking and corporate regulation, and reduced government spending. Despite Mahathir's claim that speculators ruined an otherwise healthy economy, he has since conceded implicitly that the markets reacted initially to genuine weaknesses in the Malaysian economy.

4. The Crisis Hit Indonesia Severely, Causing Food Riots and Ethnic Tensions.

As the crisis unfolded in Malaysia, Indonesia began to see similar sell-offs of its currency, the rupiah. Investors, both foreign and domestic, concluded that Indonesia's financial system and currency peg bore considerable resemblance to the countries beset by the contagion. High levels of short-term foreign debt, a troubled banking sector, and inflationary pressures added to Indonesia's problems. Consequently, investors, domestic companies, and others began selling rupiah for dollars, hoping to make the exchange before their rupiah lost value.

The Indonesian central bank eventually succumbed to speculative pressure and allowed the rupiah to float on August 14, 1997. One month earlier, the rupiah to dollar exchange was around 2500:1. As of January 22, 1998, one dollar bought almost 15,000 rupiah. The Indonesian government, headed at the time by President Suharto and several members of his family, has faced mounting political and social unrest because of the crisis. Food riots hit the capital city of Jakarta as prices soared and ethnic tensions were rekindled.

Indonesia, it is fair to say, faced the most serious threat of nationwide chaos as a result of the Asian financial crisis.

It was tempting to conclude that foreigners who withdrew their investment from Indonesia were responsible for devastating the Indonesian economy. The evidence suggested, however, that Indonesian companies may have helped trigger the crisis by entering into contracts to buy dollars for rupiah to hedge against the loss in value of the local currency. This activity, along with the actions of global investors, placed tremendous downward pressure on the rupiah.

5. Korea Became the Contagion's Next Victim.

Countries with financial systems and macroeconomic fundamentals much stronger than Indonesia's also fell victim to the contagion. Korea, once the model of the Asian economic miracle, began to see its stock market fall as investors expressed similar concerns about the inherent weakness of its financial system. In Korea, concern focused on the financial weakness of its massive conglomerates, or "chaebols." These chaebols are powerful networks of manufacturing and financial corporations that coordinate their operations to achieve sectoral or regional dominance in Korea. Having been alerted to the instability caused by similar corporate and financial arrangements in other countries, investors began to take a closer look at the viability of the Korean chaebols.

Like other banking sectors in the region, the Korean banks that were tied to the conglomerates had accumulated enormous levels of underperforming or non-performing assets. The chaebol system allowed, and perhaps encouraged, lending to valued partners without the usual concerns for asset performance and collateralization (acquiring an ownership interest in a debtor's assets in the event of default). Analysts believed the banks and companies were using the chaebol structure to mask dangerously high debt burdens. The risk that these massive conglomerates might face insolvency in the event of a downturn seemed quite plausible. Consequently, investors began to pull out of the Korean stock market.

Heavy short-term borrowing from abroad added to the crisis. Confident that the won-to-dollar exchange rate would remain stable, chaebols had secured large, short-term loans from commercial banks all over the world. These loans were denominated in a foreign currency, usually U.S. dollars. When the Korean stock market began to tumble, and the Korean won began to lose value, Korean debtors faced a serious liquidity crisis.

The Korean legislature unsuccessfully grappled with a financial reform package. As the won continued its slide, the Korean government contemplated calling upon the IMF for assistance. Bankers in New York and London, who saw their Korean borrowers earning won of ever-declining value, began to fear that the debtors would be unable to repay the loans. All of this led to a rescue effort that dwarfed the measures adopted after the Mexican crisis of 1995.

E. The IMF's Response to the Crisis: The Example of Korea

In the wake of the devastation brought about by the currency devaluations in Asia, the IMF, the World Bank, and the governments of individual countries assembled economic rescue packages of unprecedented size and scope. The total amount of financial assistance committed to Asian countries from these institutions and governments reached a staggering $100 billion by 1997. The amount and form of the assistance differed significantly from country to country. Some of the broader characteristics of the rescue effort, however, are worth mentioning.

First, in each country beset by the crisis, the initial task of the rescue packages was to help restore confidence in the short-term stability of the economy. With this objective in mind the IMF, the World Bank, and the Asian Development Bank issued credit to Asian governments so that they could meet their immediate financial obligations. This assistance was necessary to calm the fears of global market participants that the countries in question were facing imminent economic collapse.

The next objective was to restore investor confidence in the longer-term health of the economy. After all, both foreign and domestic investors would certainly be reluctant to commit money to fundamentally flawed economies that were destined to sink repeatedly into economic crises. Consequently, the funds made available to Thailand, Indonesia, and South Korea were conditioned upon the countries' adoption and implementation of comprehensive economic reforms designed to remedy the supposedly inherent flaws in Asian economies that "caused" the crises in the first place - this is the "conditionality" mechanism described in another part of the e-book.

In addition to the assistance promised by the IMF and the World Bank, governments from individual countries pledged assistance as a "second line of defense." In other words, governments from around the world agreed to provide Asian countries with additional funds if the IMF/World Bank/Asian Development Bank assistance proved

insufficient. This additional support was needed to convince investors and the financial markets of the stability of Asian economies and, in particular, Asian investments. The strategy was labeled "second line" in part to establish that the United States would not participate in the "first line of defense," as it did in the Mexican financial crisis.

By far the most expensive assistance package was the one designed for Korea. The following description of the IMF-led response to the crisis in Korea illustrates both the incredible scope of the reforms required by the IMF and the limited ability of the IMF to fully resolve financial crises in the global economy.

1. The Korean Government Initially Attempted to Solve the Crisis on its Own.

The Korean government, like most governments of the region, had pegged its currency to a basket of foreign currencies, which included the U.S. dollar. As domestic and foreign investors began selling their won for dollars, the won steadily lost value against the dollar. To neutralize the decline of the won against the dollar, the Korean government intervened in the currency markets by buying won. This resulted in a classic showdown between the Korean government, convinced that it could maintain its peg, and the international currency markets, equally confident that the won was overvalued and in need of substantial devaluation.

By November 6, 1997, the won had fallen to 973.65 won:1 dollar from an average of about 900:1 dollar in August. The IMF's first response to the emerging problem in Korea was to offer a qualified dismissal of the potential for a Korean crisis of the proportions seen in Indonesia and elsewhere. After all, Korea was not exhibiting the traditional signs of an impending economic crisis. It was enjoying a 6% growth in GDP in the first three quarters of 1997; inflation was low at around 4%; its current account deficit was a manageable 3% of GDP; and the government was running only a slight fiscal deficit. The IMF's Managing Director, Michel Camdessus, expressed confidence that the Korean government's handling of the situation would be sufficient to prevent a repeat of an Indonesian-style crisis.

Investors did not share Mr. Camdessus' confidence in the stability of Korea's financial situation. On November 7, foreign investors began pulling out of Korea by selling off their Korean stock holdings in record numbers. That day the Korean stock market lost nearly 7% of its value, followed by another decline of nearly 4% the next day. Foreign investors sold $71 million worth of Korean shares, while they purchased only $6.4 million. The South Korean government blamed the sell-off on "speculative foreign press articles,"

which indicated that Korea was at risk of becoming the next victim of the regional financial crisis. The government claimed that its financial system was sound and that warnings of its instability were grossly overstated.

Even the Korean government was not entirely convinced of the soundness of its financial system, however. The following week, the government announced a major financial reform package that included a consolidated regulatory agency and new rules that would allow weaker financial institutions to be merged with stronger ones. However, the package of reforms failed to receive legislative approval and subsequently the won fell below the 1000:1 level with the dollar. The inability of the Korean government to act and the psychologically significant fall of the won below the 1000:1 barrier with the dollar essentially ended any hope that the Korean government could manage the crisis on its own. By November 21, the government announced that it would actively seek IMF assistance to stem the growing crisis.

2. Korea Eventually Agreed to an IMF-Led Rescue Package Intended to Restore Investor Confidence.

The IMF's principal role in the Korean crisis was to restore confidence in the Korean financial system. Its response was divided into two interrelated phases: the stabilization phase and the structural adjustment phase. The stabilization phase was designed to stop the panic selling of the won in exchange for the dollar. Nervous investors, companies and individual citizens saw the won losing value, and naturally feared further depreciation. They reacted by selling their won for dollars. This caused the won to lose still more of its value against the dollar. This sparked more fears of depreciation, and the cycle repeated itself.

To calm nervous investors, the government needed to demonstrate (1) that it had sufficient reserves of foreign exchange to back up the won, and (2) that it was committed to reforming the aspects of the Korean economy that contributed to the investors' fears about the instability of the financial system in the first place. In order to accomplish these twin aims, the IMF and the Korean government designed a massive financial restructuring program for the Korean financial sector and announced major new macroeconomic initiatives, such as an immediate rise in short-term interest rates. In exchange for its acceptance of this potentially painful structural adjustment, the IMF would extend Korea the "credit" it needed to demonstrate its short-term financial stability.

On December 5, the IMF accepted the Korean government's request for a three-year

stand-by facility equivalent to SDR 15.5 billion (about $22 billion) in support of the government's economic and financial program. The credit was to be made available in installments, with each installment conditioned on compliance with performance targets and program reviews. In essence, the IMF only agreed to extend the funds Korea needed for its short-term financial stability on the condition that the Korean government continue to implement a long-term structural adjustment program that the Fund had in large part designed. The World Bank and the Asian Development Bank agreed to provide another $13 billion. And, if that was insufficient, individual foreign governments (the so-called "second line of defense") pledged another $22 billion worth of support for Korea, bringing the total package to about $57 billion dollars.

The announcement of the rescue package had the desired effect on investor confidence. On December 4, the Korean stock market rose a record 7% on the news that the IMF and the Korean government had reached an agreement. At the end of trading that day, the won posted its first significant gain against the dollar in weeks, finishing at 1,170:1, from the previous day's 1,190:1. Foreign investors were particularly pleased with one specific aspect of the restructuring: they would now be allowed to own up to 50% of a Korean stock, up from a maximum of 26%. However, not everyone in Korea was pleased with the reform package.

3. Korea Agreed to Make Profound Structural Changes in Return for Financial Assistance.

The Korean government committed itself to immediate increases in interest rates, various tax increases, and renewed budget cuts. These measures were not only likely to reduce employment and economic growth; instead, they were designed to do so in light of the inflationary pressures caused by the depreciation of the won and the general need to demonstrate the government's willingness to take "tough measures." Moreover, the government committed itself to a fundamental restructuring of the financial system that was certain to have far–reaching effects on the Korean economy and society. Here, we will describe three measures.

a. The government agreed to allow Korean banks to fail.

Under the Korean regulatory system, the government-ensured Korean financial institutions (and their depositors) would remain solvent. In exchange, Korean banks adhered to the "guidance" of Korean regulators. The guidance was usually in the form of an informal set of reserve requirements, lending procedures, and reporting requirements

designed by both the regulators and the banks themselves. This informal style of regulation was a fundamental part of the Korean financial system, and was once lauded as one of the strengths of the economy.

The agreement reached with the IMF called for the guarantee to end by the year 2000. It was to be replaced with a more Western-style approach to financial regulation, namely a deposit-insurance system, new disclosure and auditing requirements, and a new and powerful regulatory agency to oversee the entire financial system. In connection with the end of the guarantee, the Korean government agreed to suspend the licenses of insolvent commercial banks, and of all those banks that could not submit appropriate restructuring programs.

b. Korea agreed to reduce or eliminate extensive labor protections.

Korea's labor unions were large and politically powerful. They reacted negatively to the announcement that part of the IMF-brokered agreement included the easing of restrictions on layoffs, such as abolishing court approval of layoffs resulting from mergers. This change was significant, considering that mergers are likely to accelerate significantly as bankrupt companies are joined with stronger ones. The Korean labor unions undoubtedly saw these restrictions as the product of decades' worth of struggle for job security. Union leaders promised to wage nation-wide strikes if companies announced substantial layoffs as a result of the IMF agreement.

c. Korea agreed to greater economic transparency.

The chaebol system relied on close networks of banks, corporations, and other firms to coordinate activities and decisions for the benefit of the chaebol as a whole. The IMF proposed new "transparency" requirements that require all the individual members of the chaebols to disclose audited balance sheets and income statements, preventing chaebol networks from "hiding" the performance of weaker firms. At a press conference immediately following the announcement of the IMF package in Seoul, the first question put to Stanley Fischer, First Deputy Managing Director of the IMF, regarded the future of the chaebols. Mr. Fischer indicated that given the new transparency requirements, the chaebols' future was uncertain.

4. In the Meantime, Korea Restructured Short-term Foreign Debt Owed to Major International Commercial Banks.

Foreign commercial banks also played a major role in the Asian crisis. In Korea's

case, several of its major corporations held short-term debt obligations to foreign commercial banks. The debt was denominated in dollars and marks. With the won plummeting from 900:1 dollar to around 1200:1 dollar (and later as low as 1750:1), these obligations became very difficult, if not impossible, to pay.

On December 8, a leading Korean newspaper published a confidential IMF document reporting that Korea's short-term debt was nearly $100 billion. Hundreds of companies began to file for bankruptcy. Several banks inched closer to insolvency. The government took over two major banks, Korea First and Seoul Bank, to prevent their closure. Policymakers feared the international markets would conclude that Korean companies and banks would be unable to service their debt to foreign creditors.

Major international commercial banks began a series of meetings in New York with Korean officials to discuss the possibility of rolling over the debt payments of Korean companies and banks. The banks proposed several alternatives, such as the "J.P. Morgan approach," named after the bank that authored the proposal. This approach would have delayed Korean debt payments to foreign creditors until March 31 and converted the debt into Korean government bonds. Specifically, the Korean government would offer 3, 5, 10 and 20-year bonds to foreign creditors, who would then "purchase" the bonds by selling to the Korean government the debt owed to them by Korean companies. In essence, the government would assume the debt of Korean companies owed to foreign creditors - i.e., private Korean debt would be socialized. Korean officials eventually rejected this proposal, which would have been costly for Korea but profitable for the banks managing the bond issue.

The Korean government preferred a different approach, an approach that would preserve the relationships between the foreign commercial banks and the Korean banks and companies whose debt would be removed from their balance sheets under the J.P. Morgan approach. So the government proposed to guarantee payments on debts whose maturities were extended. Additionally, the government proposed securing a large syndicated bank loan and issuing bonds to replenish their depleted foreign reserves.

The banks eventually agreed to roll over most of the Korean debt until March 31, 1997. The J.P. Morgan approach was adopted on a much smaller scale, and the Korean government's plan was implemented with the assistance of Goldman Sachs and major Japanese and German banks.

F. Development, Globalization, and the Asian Financial Crisis

The devastation caused by the crisis in Asia is difficult to comprehend in the abstract. The effects are best understood in context. For individuals and communities in Indonesia, for example, the rupiah they earned purchased only one fifth what it did prior to the crisis. The standard of living people once enjoyed and the future they looked forward to were undoubtedly overtaken by the daily effort to survive. In Korea, where the labor movement had struggled for decades to win wage increases and laws guaranteeing job security, the rules were rewritten to make large-scale layoffs easier. The IMF claims that these were "needed" to create a "more flexible labor market." It is not an overstatement to suggest that the crisis, and the IMF-led effort to resolve it, changed the economic and political landscape of the affected countries and communities.

The consequences for the future of economic development could be equally profound. The IMF remains theoretically committed to goals of equitable income growth and promoting labor rights in developing and emerging economies. However, its response to the Asian crisis illustrated that if countries' efforts to protect these same values conflict with the operation of the free market, the IMF will not hesitate to require their removal. The IMF holds the view that equitably distributed income growth and enhanced standards of living will be achieved (and must be achieved) within the framework of a free-market economy. For countries seeking IMF assistance in their development efforts, the adoption of the free-market model may be their only choice.

The prospects for economic sovereignty must also be questioned in the aftermath of the Asian crisis. While it is true that each government that instituted economic restructuring formally authored its own reform package, it is common knowledge that the IMF developed many of the individual plans. It is also true that the IMF is a voluntary organization and that member countries can refuse to accept its conditions. However, when governments are on the brink of financial collapse, it is difficult to argue that they have the option of refusing IMF assistance and the conditions that come with it. It is not an overstatement to suggest that governments that signed the IMF charter in order to contribute to and benefit from a more stable global financial system have also agreed to adopt the free-market economic model if and when they require IMF assistance.

In the end, this convergence of countries adopting the free-market approach to economic and social organization is the by-product of financial globalization. People can legitimately debate whether this is a positive or negative phenomenon. For the countries of

Asia, this debate is especially significant. However, it is equally significant for you. The IMF is not an omnipotent institution that operates in a political vacuum. Without the annual contributions of member governments, and without their almost daily cooperation, the Fund would cease to function. The concerns voiced by individuals and communities about the consequences of financial globalization have become the concerns of the IMF. As a result, your concerns and comments will matter once they are voiced.

Jane Ro, a UICIFD staff member, contributed to the 2007 update.