Introduction

The global economy experienced extraordinary changes in the nineties that affected the economic prospects of both developed and less developed countries when the decade ended.

One of its alarming features was the widespread and massive borrowing in both groups. In the U.S., the government budget deficit was being energetically brought down during the Clinton administration, but American households and businesses borrowed freely during the unprecedented economic boom of the second half of the decade. Japanese corporate and financial sectors borrowed heavily and invested unwisely in land and real estate, burdening Japanese banks with a mountain of nonperforming loans when the unsustainable expansion of the eighties ended. In that regard, investors in the European Monetary Union (EMU), latecomers on the scene with its formation in 1998, were an exception. They took advantage of the expanded bond market defined in the single currency euro and invested in U.S. industry and financial activities.

Countries of the less developed group did not lag behind as borrowers. In the East Asian cluster of Indonesia, Malaysia, Philippines, South Korea, and Thailand analyzed in this book, government finances were in balance but businesses and banks borrowed on short term in foreign currency and invested long term in dubious domestic assets. Governments in Russia, Brazil, Argentina, and Turkey accumulated a significant foreign debt burden without concern or ability to meet their repayment obligations via export earnings.

A major difference in the borrowing activities of the two groups arose from the decision-making process. Borrowers, public and private, in the three dominating zones—the U.S., the eurozone, and Japan included in this book—were free agents unencumbered by external pressures in their decisions to borrow and pay up their debts. By contrast, the economies in the second group analyzed here invited financial and currency crises from the borrowing binge facilitated by a premature opening up of their capital markets to free entry of short-term, speculative funds. Preferences of developed country lenders, private and institutional, played a role in the hasty liberalization of their economies’ financial and capital account transactions involving foreign exchange.

A difference in the policy responses between the two sets of countries was also apparent when the debt-led expansion came to a halt. It ended
in Japan in 1990 and in the U.S. in mid-2000. The East Asian economies were swept in a capital-outflow led financial and currency crisis that began in Thailand in mid-1997. Currencies tumbled at varying rates in Russia in August 1998, Brazil in January 1999, Turkey in early 2001, and Argentina in December 2001. Policy decisions to promote stable growth in Japan (marked by failure) and the U.S. (significantly on track despite the negative impact of the terrorist attacks of September 11, 2001) were domestically driven. By contrast, the crisis-ridden economies lost their decision-making initiatives under International Monetary Fund (IMF) bailouts, which consisted of extreme monetary and fiscal discipline and unrealistic triple-policy arrangements of floating exchange rates, free capital mobility, and a presumed monetary policy autonomy. The IMF sought to resolve an externally imposed crisis by subjecting these recession-prone economies to severe contractionary regimens, which would have been unthinkable in a developed economy in the midst of an economic downturn. None of these countries were adequately prepared for achieving post-crisis stable growth by implementing independent monetary policy in the midst of unrestricted capital flows and freely floating exchange rates. These triple-policy arrangements, preferred by the IMF, were more suited to the developed economies with flexible markets, robust institutions, and adequate supervision of their banking and financial sectors.

In this chapter, I introduce the book’s theme of the contrasting interaction between the economic challenges and the policy responses of recent years in the developed center of the world economy and the less developed periphery. I begin with the former group.

The Developed Countries: Events and Outcomes

At the start of the new millennium, policy makers in the three dominant economies—the U.S., the eurozone, and Japan—were engaged in maintaining inflation-free, stable growth. The unprecedented expansion of the U.S. economy, marked by the stock market boom, ended in mid-2000, raising policy debates about a stimulus package aimed at arresting the economic slowdown that turned into a recession after the events of 9/11. Twelve of the fifteen European Union countries formed a monetary and economic union in May 1998, and surrendered their monetary policy autonomy to the European Central Bank by discarding their individual currencies and adopting the euro. The end of the Japanese investment boom of the eighties left a massive burden of bad loans with banks that posed formidable policy challenges for Japanese authorities in steering the economy to stable growth.
In 2002, the outcomes of the policy initiatives in each area varied significantly. The U.S. emerged in the first quarter out of a post-9/11 recession, which turned out to be short and shallow. The swift U.S. recovery was aided by the Federal Reserve’s aggressive monetary easing and the government’s budgetary stimulus. Continuing productivity growth added to the prospects of sustained growth in 2002. The eurozone’s economic recovery lagged behind that of the U.S. as the European Central Bank fitfully implemented its mandate of achieving inflation-free growth for the zone in the midst of halting labor market liberalization and corporate sector deregulation reforms in member countries. The worst performer was Japan: a prolonged, on-again, off-again policy mix of monetary easing, tax reform, and clearing of bank debts failed to pull the economy out of the eventual malaise of declining prices. As a result, consumers postponed their spending and companies battled the impact of price deflation on their profitability and delayed capital spending. Japan’s economic stagnation continued into 2002.

As I noted, the early years of the nineties were also marked by capital inflows into developing countries that abolished their capital account controls and liberalized their domestic credit and financial markets.

The Developing Countries: Premature Capital Mobility and Its Consequences

These inflows, pushed by determined Washington policy makers and supported by avid Wall Street financiers, were massively short term, speculative, and destabilizing. The banks and financial institutions of the borrowing countries were poorly supervised and their capital/asset ratios were inadequate. Their lenders and borrowers were linked via special ties and traditional norms of financial practices. Risk management of portfolios was rudimentary. Short-term loans in hard currency were lent long term to domestic borrowers who invested the funds in real estate and businesses of questionable worth. As the highly leveraged borrowers missed debt payments and declared bankruptcies, foreign creditors withdrew funds aggravating the finances of these borrowers and dragging with them the values of the currencies they dumped. The 1997–98 financial crisis that spread from Bangkok to Brazil via Moscow became a currency crisis.

The nineties were thus marked by economic growth followed by severe downturn in several less developed countries of Asia as well. The East Asian economies of Indonesia, Malaysia, South Korea, and Thailand recorded high growth and low inflation rates and balanced government budgets in the decade leading to 1997. During this same period, the Philip-
pine economy also steadily improved in terms of these norms. These five economies were hit by the financial and currency crisis that began with the collapse of the Thai currency in mid-1997 and spread to Russia and Brazil in 1998; they experienced severe recession from the IMF-imposed monetary and fiscal austerity measures calculated to restore currency stability and foreign investor confidence in their systems.

In contrast to the robust macroeconomic indicators in these East Asian economies in the pre-crisis decade, Russia’s economic performance was shaky. The control of inflation from quadruple-digit levels of 1992 to low double-digit numbers thereafter was uncertain, budget deficit at 7 percent of gross domestic product (GDP) remained high, and economic growth in 1997 following a severe contraction of the economy (by half in domestic prices since 1991) was barely visible. In Brazil, the record of successful inflation control and positive economic growth following the adoption of the Real Plan in July 1994 was also handicapped by high budget deficits that spilled into current account deficits. As a latecomer attempting the painful transformation from a command to a market economy, the Russian economy in 1997 was far more deficient in its macroeconomic health than the Brazilian economy. It was also more vulnerable to the crisis contagion that spread from East Asia as foreign investors withdrew their ruble- and real-denominated assets. On August 17, 1998, the Russian authorities declared a unilateral default on the government’s ruble debt, prohibited commercial banks from clearing their foreign liabilities, and devalued the ruble from 6 rubles to a dollar to 26 rubles. In response to a similar withdrawal of assets by nervous foreign investors in the final weeks of 1997, the Brazilian government cut back budget outlays by 2.5 percent of GDP, the central bank pushed up the basic lending rate to 43 1/2 percent, and finally allowed the real to float in January 1999.

The East Asian “Crisis Five” and Brazil revived at rates varying from 2 to 3 percent in 2000. More remarkable was the turnaround of the Russian economy at 8 percent, driven by a booming oil sector and the relative price advantage of a substantially devalued ruble in favor of domestic industry. While these economies put the symptoms of a recession behind them, fears arose in late 2000, in unrelated developments, about financial and currency turmoil in debt-ridden Argentina and Turkey. In Argentina, the peso’s link to the strong dollar backed by a currency board type arrangement helped squeeze inflation and promote growth until 1998. Following the devaluation of the Brazilian real in January 1999, however, the link slowed export growth and set in motion a recession that affected tax revenue inflows resulting in persistent budget deficits. These escalating uncertainties raised foreign investor’s fears about a debt default and a peso devaluation, both of which occurred in December 2001. The Turkish lira too came under pressure toward the end of 2000 as a result of endemic
budget deficits and extreme inflation that remained at 60 percent in 2001. In 2002, Argentina's economic uncertainties, defying an early solution, threatened to spill into political chaos as well. Turkey's prospects for a steady, low inflation growth depended on its policy makers' ability to bring its budget deficits under control in the midst of contentious politics which worsened with the dissolution of the parliament in August 2002 and announcement of new elections. In Brazil, too, voters' preference in the public opinion polls in favor of a left-of-center presidential candidate in the October 2002 election raised fears of a reversal of pro-market reforms. The IMF sought to relieve the pressure on the real induced by capital flows with the announcement of a rescue package of $30 billion on August 7.

The performance and policy record of both groups of countries, in bouncing back from economic slowdown or recession following a boom (as in the U.S., Japan, and the East Asian “Crisis Five”) or maintaining steady growth following quadruple-digit inflation (as in Russia, Brazil, and Argentina) or simply achieving stable growth with low inflation without having to overcome the consequences of an economic boom or extreme inflation (as in the eurozone and Turkey), had major differences.

The Differences: Center versus Periphery, and Endogenous versus Exogenous Disturbances

First, among the developed economies of the U.S., the eurozone, and Japan, the U.S. arrangements, despite recent corporate governance scandals, meet the demands of an open market economy. They are least handicapped by structural bottlenecks such as fragmented labor markets, an overly regulated corporate sector, or extravagant welfare benefits. They are endowed with a sophisticated network of financial institutions including commercial banks that are regulated by supervisory agencies. The rapid and extensive adoption of information technology has also kept the U.S. economy ahead in productivity performance. In practice and philosophy, it is relentlessly engaged in the process of Schumpeterian creative destruction, which is encouraged by the resilient responses of households and businesses to policy signals. Despite frequent differences on economic policy issues, the two-party system is committed to the advancement of the free enterprise system. Benefiting from the combined impact of these attributes, the U.S. is better equipped than the eurozone and Japan in overcoming economic fluctuations and maintaining inflation-free, stable growth. It can also readily function under the policy trinity of a floating dollar, free capital mobility, and pursuit of monetary easing or tightening by the independent Federal Reserve.
Second, from a historical perspective, the developed group as a whole (including other member countries of the Organisation for Economic Co-operation & Development) is more advanced than the developing group (and others in that category excluded from this book’s focus) in institutional capabilities, appropriate policy formulation, cohesive political decision making, and technological and managerial adaptability. It also has the maneuverability to battle the competitive pressures of an open global economy. The developed group belongs to the center of the world economic system not only because it has a dominant share of global income but also because it is better equipped to prevent the less developed group in the periphery from enlarging its share of the pie. This uneven playing field raises the issue of the speed with which the peripheral group can adopt the institutions and economic practices of the developed center and integrate with it in order for both to profit from capital flows from the developed center to the developing periphery. Ready or not for such integration, the less developed economies, which have opened their borders to capital flows, are called emerging market economies, a label I adopt for my analysis.

Third, the center-periphery inequitable relationship was brought into sharp focus in the nineties as the fast-paced and premature opening up of several emerging market economies to the free flow of capital threw them into economic turmoil in 1997, beginning with the East Asian crisis. Emerging market policy makers with few exceptions (in China and India) operated in a highly pressured environment in favor of such flows pushed from the advocates, official and private, of the U.S.-led center. The resulting economic and political destabilization in these economies in the nineties was thus imposed from outside, whereas the economic problems and acute challenges in the U.S., the eurozone, and Japan were endogenous.

Fourth, the exogenous-endogenous difference also extended to the policy measures that the crisis-swept economies were inevitably driven to implement under IMF rescue, which they sought. By contrast, the success (in the U.S.), the paralysis (in Japan), and the slowness (in the eurozone) resulted from policies that were domestically formulated and implemented. The countries that sought IMF bailout (with the sole exception of Malaysia which instead imposed capital account controls to moderate capital outflows) did not “own” their programs. The IMF fiscal and monetary austerity measures aimed at restoring investor confidence and arresting currency declines were severe because the financial support was inadequate to fill the liquidity crunch that resulted from the sudden and massive outflows of speculative funds. The IMF was also ideologically opposed to the adoption of market-based capital account controls in crisis-swept economies that sought its support, although such measures could have reduced the necessary funding. Again, the IMF failed to initiate timely and
comprehensive debt restructuring for highly indebted recipients, such as Argentina, without which its budget deficit targets became irrelevant and its monetary tightening recipe ceased to be credible. Occasionally the size, timing, and frequency of support were influenced by the non-economic considerations signaled by the U.S.-led center. Far from being an objective and adequate lender of the last resort for emerging markets in financial crisis, the IMF in effect operated as a G-7–led institution, aggressively extending a mandate of irreversible capital mobility in inadequately prepared and therefore financially vulnerable emerging markets.

Based on these arguments, I adopt a comparative, center-periphery framework in this book. I lift the analysis beyond the narrow focus of crises origins, the contagion which may or may not spread, the factors leading to the relatively speedy revival of some emerging market economies in contrast to others, and the failure of IMF policy prescriptions. Some of this has been done before although I combine systematic empirical underpinning and analytical rigor in my comparative framework in order to reach policy judgments.

The Comparative Perspective

My broader, panoramic theme centers on four propositions. First, some economies even among the developed group are more geared toward bouncing back from a slowdown or a recession or a banking crisis than others. The U.S., for example, weathers economic ups and downs more resiliently and rapidly than other countries. Second, irrespective of the impact and duration, the economic malaise of the nineties in the developed center was homegrown and its resolution domestically driven. By contrast, the financial crises in the periphery were planted from outside. Third, the premature opening of peripheral economies to capital flows from the advanced center was based on the assumption that they were similar in their absorptive capacity to the robust performers in the center. The capital market globalizers overlooked the fact that the countries in the periphery lacked the necessary institutions and corporate practices enabling investors and borrowers to gain from capital flows. Finally, the IMF preference for capital flows into emerging markets, its standard prescriptions of fiscal and monetary austerity in crisis-swept economies, its lack of flexibility in initiating country-specific policy responses, such as preemptive debt restructuring, and its insistence on the triple arrangements of a floating exchange rate, free capital mobility, and monetary policy independence, create a less than benign view of its policy agenda with respect to capital account liberalization in emerging market economies. Specifically, this no-pain no-gain approach means that the recurring
Crises of recent years are the inevitable costs of the extension of financial globalization that the peripheral economies must undergo in order to reap financial globalization’s eventual benefits.

The lack of institutional and structural readiness of the borrowing economies in the periphery for absorbing capital inflows can best be contrasted by examining the preparedness of the economies in the center for voluntarily attracting these flows and maintaining stable economic growth.

Policies and Performance in the Developed Center: The Contrasts

Of the three dominant global economies of the center, the U.S. (discussed in chapter 2) is more adept in overcoming economic fluctuations of internal origin via an interplay between institutional and structural underpinning and policy signals than the eurozone (discussed in chapter 3) and Japan (discussed in chapter 4). The U.S. free enterprise model, supported by the strength of its institutions and its technological innovativeness, and marked by the resilient responses of its businesses and households to appropriate policy signals, has been hard to implant in the eurozone and in Japan, even though both are market systems with institutional capabilities and open economy adaptability. In particular, the Federal Reserve has been more successful in implementing the policy trinity, also adopted by Japan and the eurozone, of a floating dollar, capital mobility, and monetary policy autonomy with a view to achieving inflation-free growth. Despite the continuing debates about the effectiveness of Federal Reserve policies, their timing and the lags, the conflicting signals about the economy’s prospects of bouncing back in 2002 from the slowdown of early 2001 followed by the post-9/11 recession, the model’s resilience backed by its upbeat productivity performance is incontrovertible. By contrast, the European Central Bank, reined in by a less integrated and deregulated eurozone and lower productivity growth, has continued battling the dilemma of economic growth and inflation control. EMU members have lagged behind in forging a unified free enterprise area, marked by reduced pension benefits and low budget deficits, unregulated labor markets, and low corporate taxes that can propel their corporations into high-productivity trajectories.

Despite this contrast, the economies in the center created their economic problems and “owned” their remedies. Emerging markets, on the other hand, experienced financial and currency turmoil associated with externally pressured opening up of their economies to short-term capital inflows and underwent IMF policy prescriptions that produced severe recessions.
Financial Crisis and Contagion

I analyze nine Asian borrowers (in chapter 5) from the perspective of their exposure to financial destabilization arising from short-term capital inflows. I divide them into three groups of crisis-prone (Indonesia, Malaysia, Philippines, South Korea, and Thailand), crisis-immune (China, Hong Kong, and Taiwan) and crisis-safe (Singapore). These three groups were similar in having strong macroeconomic fundamentals of high growth and low inflation rates, high saving and investment rates, and low to nil budget and current account deficits in the years before the onset of the crisis. The first group however was engulfed in the financial and currency turmoil of 1997–98 (which I narrate in chapter 6), precisely because its short-term capital inflows in relation to foreign exchange earnings were massive and resulted in excessive loans to domestic borrowers and money supply growth. The related collapse of the Russian ruble in August 1998 (discussed in chapter 7) and the sharp decline of the Brazilian real in January 1999 (discussed in chapter 8) also resulted from the panic-driven withdrawal of short-term funds, although the Brazilian economy’s short-term exposure to foreign borrowing in relation to long-term foreign investment was less precarious.

The financial and currency problems of Turkey and Argentina (discussed in Chapter 9), that gathered speed toward the end of 2000, were unrelated to the Asian malaise, and provide a contrast to the problems relating to crisis management and post-crisis recovery. The emerging market economies of this book from Asia to Latin America had weak institutions, regulatory underpinning, and structural handicaps. However, the fundamentally strong Asian Crisis Five during the pre-crisis years had a greater potential for rapid economic recovery than Turkey, which was fiscally mismanaged and ran high double-digit inflation, and Argentina, which was burdened with the policy albatross of the peso’s link with the strong dollar long after the arrangement had successfully squeezed quadruple-digit inflation from the economy. The declining Argentine economy in the end was left without resources for meeting its debt obligations or credible policy choices for initiating a quick recovery.

The 1997–99 contagion (analyzed in chapter 10), spreading from Bangkok to Brazil, was financial in its transmission mechanism, unlike the trade-linked contagion of the earlier decades. Such a financially transmitted global contagion did not transpire from the Argentine and Turkish crises of 2000–01 because quality-conscious, common lenders had kept away from investing in emerging markets except in China and Mexico, and had expected and adjusted to the Argentine debt default. The juxta-
position of these two contrasting contagion scenarios again highlights the role of short-term financial capital in triggering global contagion.

Having failed to plug capital outflows and stabilize their currencies, policy makers in the financially troubled economies, who turned to the IMF with a view to be ‘rescued’ or ‘bailed out’ from a desperate predicament, could not expect to ‘own’ the policy prescriptions. The lone exception was Malaysia, which resorted to capital account controls. The IMF imposed strict monetary control and fiscal discipline, and worked up detailed programs for structural and institutional reforms (as I discuss in chapter 11). Its funding was occasionally supplemented by bilateral credits and bolstered by intrusive performance criteria. The conditions required higher interest rates to stem capital outflows, sharp budget cuts and fiscal discipline to restore investor confidence, and a switch from fixed to floating exchange rates. (An exception to this occurred in Argentina until December 2001, when Argentine authorities were forced to free the peso from its link with the dollar in reaction to the IMF’s refusal to extend a credit tranche.) The programs created severe recessions in most cases and intensified political uncertainties (in Indonesia) and investor nervousness about the prospective success of IMF bailout (in Russia and Argentina, and subsequently in Brazil in 2002).

The IMF to the Rescue: How Did It Fare?

The IMF’s rescue packages were inadequate to meet the liquidity needs of recipients; its macroeconomic targets of budget deficits and inflation control failed to distinguish between feasible and desirable possibilities; and its role became increasingly controversial. A firm believer in global capital markets, it rejected policy deviations from its arsenal such as temporary, market-based controls on capital outflows that could soften the need for excessive fiscal and monetary austerity on a crisis-ridden economy. It also did not consider implementing timely and orderly debt restructuring, for example, in Argentina, with a view to equitably distribute the costs of such arrangements on foreign lenders, domestic borrowers, and local citizenry and pave the way for the removal of the fixed peg of the peso to the strong dollar. Requiring extensive restructuring of institutions and practices in borrowing members as part of its bailout, the IMF itself remained largely unreconstructed. Having encouraged capital flows in economies unprepared for absorbing them successfully, it failed to monitor the extravagant borrowing of some members. Emerging market borrowers were badly hurt, their policy makers were removed from their jobs, advanced country
lenders lost their shirts, but the IMF decision makers, in a business-as-usual mode, have stuck to their rigid, worn-out orthodoxy.

The IMF thus sought to resolve financial crises by imposing fiscal and monetary austerity in the troubled economies in order to stem capital outflows, exchange rate collapses, and inflation spirals. Over time, it drifted from its original mission of supporting members in temporary balance of payments difficulties and floated bailouts to pull them from financial collapses that resulted from the destabilizing capital inflows that it promoted. The recurring crises prompted calls for reforming the global financial arrangements (which I discuss in chapter 12).

Financial Architecture Reforms

These proposals ranged from the choice of an ideal exchange rate regime to stabilize currencies to the adoption of internationally sanctioned bankruptcy provisions for suspending debt payments by heavily indebted countries, and inclusion of collective action clauses in bond contracts to facilitate debt resolution. It is doubtful if the IMF’s preference for the adoption of freely floating exchange rates (or hard pegs) in the midst of unrestricted capital flows will endow emerging market economies with monetary policy autonomy. The inclusion of bankruptcy-type provisions and collective action clauses in bond contracts will deter potential lenders from stepping into emerging markets. From the perspective of these economies, the proposals are directed at stabilizing the world financial system rather than providing them with stable long-term capital flows. As an alternative to its one-rule-fits-all-situations approach, the IMF would be better off applying its surveillance procedures vigilantly, ensuring that the borrowers’ financial needs are met by long-term flows, encouraging market-based measures for the purpose, and stepping in with debt-restructuring initiatives on a case-by-case basis when the need arises. Such a middle-of-the-road, hands-on approach can convert the IMF into an effective lender of limited resort; otherwise its ideologically driven commitment to free capital mobility and floating exchange rates will confine it to the current controversial role of crisis management, large bailouts, intrusive conditionalities, and continuing criticism.

The misplaced zeal of the advanced market economy center policy aficionados in favor of free capital mobility in the unprepared emerging market periphery not only imposed massive recessionary costs on the affected economies, but also raised doubts about the long-run allocative efficiency of global financial markets in raising collective gains for borrowers and lenders. It damaged the prospects for the adoption of Anglo-
American–style institutions and corporate practices by emerging market economies. The resulting financial turmoil raised controversies over the wisdom of subjecting them to the free flow of capital. At the same time, it created interest among policy makers and analysts in a variety of conceptual and empirical issues which I address in the book.

Conceptual Conundrums and Empirical Issues in Financial Crisis

For example, what are fundamentals and what are structural problems? Was the Asian crisis an episode of over-investment or of unregulated, premature capital flows? Has Japan been a victimizer in East Asia? Did investors assume that the IMF would bail them out if their Asian investments went sour? In other words, did moral hazard calculations prompt investors to stretch their risk taking or were they driven by a herd instinct? Does corruption affect economic growth? How does one measure it? Can the Chilean inflow tax direct capital flows into long-term placements? How did India and China, two major mavericks of the East, only gradually liberalize their economies en route to full capital mobility while maintaining high growth rates exceeding 6 percent in the nineties and policy autonomy as sovereign states? I address these questions with a heavy dose of skepticism so that interested readers might critically assess the continuing financial crises in emerging market economies and form reasonable judgments about containing them in the future. Financial globalization is a complex process in which the animal spirits of risk-prone, return-savvy investors from the developed market economies with global, electronic reach collide with the weak financial institutions, traditional corporate practices, and vulnerable political arrangements of emerging market economies with disastrous consequences for the latter. A sensible approach with alternative possibilities is in order.