EDDY LEE The Debate on the Causes of the Asian Crisis: Crony Capitalism Versus International System Failure

Cince July 1997 several South-East and East Asian Countries have experienced an economic shock of unprecedented severity after decades of uninterrupted high growth. The enormity of the shock is captured by the fact that in the worst-affected countries real GDP growth has turned abruptly from over 7 per cent per annum to negative. In Thailand growth fell from 6 per cent in 1996 to almost zero in 1997, with all the decline concentrated in the second half of that year, and has fallen by at least a further 5 per cent in 1998. In Indonesia the corresponding swing is from 8 per cent growth up to the third quarter of 1997 to an absolute decline of 15 per cent in 1998. Such shifts in GDP in relation to what it would have been according to long-standing trends are very severe indeed.

These huge aggregate income shifts were the result of a financial crisis reflected in precipitous currency devaluations and falls in equity prices. Currencies depreciated by up to 80 per cent in the worst case (the Indonesian rupiah) while equity and other asset prices fell by 50 per cent or more in the worst-affected countries. The key factor behind this currency and stock market collapse was a massive reversal of foreign capital flows. It has been estimated that for Indonesia, the Republic of Korea, Thailand, Malaysia and the Philippines net private inflows dropped from US\$ 93 billion to 12 billion – a swing of 11 per cent of GDP between the end of 1996 and the end of 1997. This swing in foreign capital flows has continued into 1998.

Nature of the Crisis

What caused this sudden and massive financial crisis in countries that had for decades been heralded as economic miracles? To many observers, there appeared to have been new and unprecedented elements of the crisis which did not fit standard models of currency and financial crises and which could not easily be understood by reference to recent experiences such as the Mexican crisis in 1995. Taking this view, some of these new elements, such as the sudden and massive shift in sentiments towards these countries on the part of international financial markets, the relative ineffectiveness of efforts so far to stabilize markets, and the general failure on the part of governments, international organizations and markets to anticipate the crisis, pose new and difficult problems for analysis. They also raise critical issues of national and international public policy in the context of growing globalization of financial markets.

Some economists have, however, argued that none of the main elements of the crisis are new or unprecedented.¹ They point out that the bursting of asset bubbles (real estate and stock markets) has been a common feature in economic history. Similarly, the fact that there were no warning signals is also typical of financial crises. They see these features as manifestations of the severe imperfections that characterize financial markets. Foremost among these imperfections is that there is a large problem of asymmetric information in international lending wherein international lenders have limited and poor information about local borrowers. This leads lenders to over-extend credit, including to unsound local banks and com-

I. See in particular Wyplosz, C.: *Globalized financial markets and financial crises*, paper presented at the Conference on Coping with Financial Crises in Developing Countries: Regulatory and Supervisory Challenges in a New Era of Global Finance, Amsterdam, 16-17 March 1998 (Forum on Debt and Development). On Website: http://heiwww.unige.ch/~wyplosz/ fondad.pdf. Retrieved on 16 September 1998. See also Stiglitz, J.E.: »More instruments and broader goals: Moving towards the post-Washington consensus«, 1998 WIDER Annual Lecture (Helsinki, Finland), 7 January and »Bad private-sector decisions«, in *Wall Street Journal*, 4 February 1998. panies. Perceptions that there are implicit guarantees by governments to maintain fixed exchange rates and to bail out local borrowers reinforce this process. At the same time, borrowers are also encouraged by the same perceptions with respect to the fixedness of the exchange rate and government bail-outs. These market failures thus increase the riskiness of international lending and hence the vulnerability to periodic crises. In such a context it becomes a rational response for individual international lenders to follow the herd when danger signs of a crisis emerge. This »herding« phenomenon generates self-fulfilling panic that leads to large market overreactions that are not warranted by economic fundamentals.

To proponents of these arguments, the current Asian crisis, instead of constituting a new phenomenon, has in fact merely provided confirmation of their view of international financial markets. There had clearly been extremely rapid growth of foreign capital inflows in the past few years before the onset of the crisis. With hindsight it is also clear that this was overdone, with prudential limits of risk accumulation being exceeded. There was also the uniform failure of credit-rating agencies and others to foresee the impending crisis. The spread on loans to the crisis-affected countries remained very low until the crisis broke. Most importantly, the swift and massive outflow of capital once the crisis broke in Thailand is seen as a classic illustration of self-fulfilling financial panic.

»Crony« capitalism and the failure of the Asian model

The basic divide in the debate over the causes of the crisis is between those who attribute blame to the malfunctioning of international financial markets and those who see domestic factors as the primary cause. For the latter, the crisis is best understood as the consequence of a defective Asian model of development that deviated from the principles of free market economics. Although the crisis-affected countries had pursued open economic policies and had pursued macroeconomic policies in line with the prescriptions of the »Washington Consensus« there were serious failings in other respects that turned out to have grave consequences. These failings have been encapsulated in the term »crony capitalism«. A key element of this is widespread political interference with market processes. This covered several sins such as give-away privatizations to the relatives and cronies of the political leadership, the granting of artificial monopoly rights, government direction of credit towards political allies and government bail-outs of politically connected enterprises. These practices all amount to a supplanting of free and open competitive market processes by corrupt rent-seeking behaviour. A side effect of such a system is the creation of moral hazard in the form of expectations of government guarantees to politically connected lending. All this invariably resulted in a misallocation of investment, falling returns to investment and growing fragility in the financial system.² It will be noticed that this version of the failings of the Asian model focuses on corruption and the consequential lack of transparency in economic management.

A related critique blames corruption but puts the stress on dirigiste policies per se. This relates to features of the Asian development model such as the role of government in the selective promotion of industries and in the coordination of investment, and control over the allocation of credit and capital account transactions.³ These deviations from laissez-faire are seen as having high costs in terms of reduced economic efficiency.

International capital markets

Those who argue that the crisis has largely been caused by the malfunctioning of international capital markets have strongly questioned the validity of

^{2.} Krugman, P.: *What happened to Asia?* On Website: http://web.mit.edu/krugman/www/. Retrieved on 12 January 1998. Also: *Asia: What went wrong.* On Website: http://web.mit.edu/krugman/www/. Retrieved on 19 February 1998.

^{3.} Greenspan, A.: Testimony of Chairman Alan Greenspan before the Committee on Banking and Financial Services, US House of Representatives, 30 January 1998, on Website: http://www.bog.frb.fed.us/boarddocs/ testimony/19980130.htm. Retrieved on 4 February 1998. Also: Remarks by Chairman Alan Greenspan before the Annual Convention of the Independent Bankers Association of America, Honolulu, Hawaii, 3 March 1998, on Website:http://www.bog.frb.fed.us/boarddocs/speeches/. Retrieved on 5 March 1998.

this »crony capitalism« explanation. A basic counter-argument is that an adequate explanation for the crisis can be provided without the need to invoke crony capitalism. Similar currency and financial crises have occurred in countries which have been free of these presumed Asian vices.⁴ A recent case in point was the financial crisis in Scandinavia in the early 1990s. A related counter-argument is that crony capitalism and dirigiste policies cannot constitute a sufficient explanation for the crisis.⁵ One element of this is that while there is no denving the existence of corruption and cronvism in the crisis-affected Asian countries, it is no worse than in emerging market economies elsewhere. The rates of return on investment in South-East and East Asian economies were significantly higher than in other developing regions in the pre-crisis period, even after the decline observed in the immediate pre-crisis years. It is thus difficult to make the case that these were uniquely Asian weaknesses that led to the onset of the crisis. Another, and related, difficulty with the »crony capitalism« and over-interventionist explanation is the question of timing. In order for this to have been the cause of the crisis it is necessary to show that the extent of these failings has increased in the years leading up to the crisis. If these failings had always been present and compatible with high growth in the pre-crisis period, then it needs to be explained why, other things being equal, they should have provoked the crisis. In fact there is no clear evidence that there had been an increase in the extent of cronvism or interventionism in the years immediately prior to the crisis.

Recent work on the Republic of Korea has also challenged the empirical validity of the crony capitalism argument.⁶ It has been argued that two key elements of the crony capitalism argument did not apply. First, it was untrue to say that there had been government guarantees to banks and corporations which created the problem of moral hazard with respect to foreign loans. Several large enterprises, including the tenth largest »chaebol« (conglomerate), had been allowed to go under in the immediate pre-crisis period. Second, contrary to the picture painted by the moral hazard story, most of the foreign borrowing went into the tradable sector and not into fuelling asset bubbles in the non-tradable sector. As for the claim that over-interventionist policies were at the root of the crisis, it has been argued that inappropriate deregulation was a more plausible cause. This included the abandonment of investment coordination which led to over-capacity in several industries; the ending of rule-based state-business relationships which opened the way for less transparent relationships; and the failure to put in place adequate regulation of the newly liberalized financial sector.

In sum, the core of the case against the crony capitalism explanation is that there has been no rigorous proof that this has indeed been the main explanation. It smacks too much of wisdom after the fact, involving the identification of new sources of weaknesses in the Asian model that had been barely raised earlier. There is also the impression that much of the argument has been ideologically driven, seeking to make the point that the US version of capitalism is the only viable one nowadays.

Financial liberalization and fragility

Those who argue that the malfunctioning of capital markets was the cause also make the point that it was unwise for the crisis-affected countries to have embarked on premature and ill-prepared financial liberalization. They thus needlessly exposed themselves to the risk of a financial crisis in exchange for the dubious benefits flowing from integration into global financial markets.

The latter point links this debate on the causes of the Asian crisis to the larger debate that has been provoked on the desirability of intensifying financial globalization. The view that is being pushed by what critics have dubbed the »Wall Street Treasury complex« is that it is imperative for all countries to push ahead with capital account liberalization in order to reap the full benefits of

^{4.} See Wyplosz, 1998 as above.

^{5.} Stiglitz, J.E.: »More instruments and broader goals: Moving towards the post-Washington consensus«, 1998 WIDER Annual Lecture (Helsinki, Finland), 7 January 1998 and »Bad private-sector decisions«, in *Wall Street Journal*, 4 February 1998.

^{6.} Chang, H-J.: »Korea: The misunderstood crisis«, in *World Development*, Vol. 26, No. 8, August 1998. See also Park, H-J.; Yoo, C.G.: »Interpreting the Korean crisis: Financial liberalisation, industrial policy and corporate governance«, in *Cambridge Journal of Economics*, Vol. 22, No. 6, November 1998.

globalization. The benefits from participating in financial globalization are depicted as being analogous to the benefits from free trade. »Free movement allocates capital to its most productive uses across countries and allows residents of different countries to engage in welfare-improving intertemporal consumption smoothing. In a competitive model with perfect foresight and complete markets, the welfare benefit from intertemporal trade is identical to the welfare benefit from international trade in goods and services.«⁷

Opponents of this view of course dispute the depiction of international capital markets as being essentially the same as markets for goods and services.⁸ As pointed out earlier, they see endemic problems of asymmetric information in international financial markets that lead to periodic crises. Taking this view, therefore, the putative benefits from capital account liberalization have to be set against the large economic and social costs of financial crises which countries with open capital accounts become vulnerable to. In this context it has been pointed out that the effects of financial crises can be not only devastating when they hit but also long-lasting in retarding growth.

The benefits of capital account liberalization have also been questioned. A recent study,⁹ comparing the growth performance of countries that have liberalized capital accounts and those that have not, has found no evidence that the former group performed better. In addition, there have been many cases in recent economic history of countries having enjoyed high growth without liberalized capital accounts. This was true of Japan in the 1950s and 1960s, of the Republic of Korea until recently, and is true of China today. There are thus no proven benefits from capital account liberalization while, at the same time, there are significant examples of it not being essential for achieving high growth.

Another major difference between the opposing positions is over the extent to which domestic policies can protect countries with open capital accounts from the risk of financial crisis. Advocates of liberalization maintain that such good domestic policies as sound macroeconomic policies, adhering to transparent market-based policies and maintaining a well-regulated financial system can effectively ward off the risk of financial crisis. This would then permit the enjoyment of the benefits of liberalization without incurring any of the risks.

To critics, however, this is easier said than done. They point to several inherent difficulties in managing an economy with open capital accounts.¹⁰ A basic one is that there are virtually no effective instruments for dealing with a large surge in capital inflows such as that which occurred in the past few years before the crisis in Asia. Short of reintroducing capital controls, the main instrument available is to sterilize part of the capital inflow. But this is costly and not sustainable for long. It is costly because it typically involves the selling of domestic bonds by the government (in order to acquire part of the inflow of foreign currency) on which a higher rate of interest has to be paid than the returns available on its holdings of foreign reserves. Bearing this cost of sterilization, in itself, creates problems of sustainability. In addition, however, sterilization will also prevent the differential between domestic and foreign interest rates from narrowing and hence will do little to reduce continued inflows of foreign capital. It will also raise domestic public debt that undermines policy credibility if sterilization is pursued for too long. Other forms of control through bank regulation and the raising of reserve requirements also have costs and cannot be pursued for too long before being circumvented. Such measures, of course, also go against the very logic of financial liberalization.

^{7.} Dooley, M.P.: "The Tobin tax: Good theory, weak evidence, questionable policy", in M. ul Haq, I. Kaul and I. Grunberg (eds.): *The Tobin tax* (New York and Oxford, Oxford University Press, 1998).

^{8.} Bhagwati, J.: "The capital myth: The difference between trade in widgets and dollars", in *Foreign Affairs*, May-June 1998.

^{9.} Rodrik, D.: Who needs capital-account convertibility?, Harvard University, February 1998, paper written as contribution to a symposium edited by Peter Kenen (to be published as part of a »Princeton Essay in International Finance«) On Website: http://www. nber.org/~drodrik/essay.PDF. Retrieved on 16 September 1998.

^{10.} Calvo, G.A.; Mendoza, E.G. Rational herd behaviour and the globalization of securities markets, on Website: http://www.econ.duke.edu/Papers/Abstract97 /abstract.97.26.html. Retrieved on 15 September 1998. See also Leiderman, L.; Reinhart, C.M.: »Inflows of capital to developing countries in the 1990s«, in *Journal* of *Economic Perspectives*, Vol. 10, No. 2, Spring 1996.

Critics of financial liberalization also point out that increased fragility in the financial system is a usual concomitant of financial liberalization and is difficult to prevent. One result of freeing entry into the financial sector is the lowering of the franchise value of banks and other financial institutions. This has the result of encouraging more risky behaviour on their part, since less is now at stake. Another factor making for greater financial fragility is that the social costs of increased foreign borrowing is not internalized by private borrowers, leading to excessive borrowing in the aggregate. These effects can, of course, be attenuated by stronger regulation of the newly liberalized financial system but this is often difficult to achieve quickly. Building up the necessary skills in risk management and loan management is a slow process involving an extended period of »learning by doing«.

These inherent difficulties are of great significance to opponents of capital account liberalization since they also take the view that large surges of capital inflows are not a rare occurrence. The reason is that such surges reflect an unavoidable once-off adjustment. With good economic performance such as high growth and low inflation, governments and the private sector acquire an improved capacity to borrow internationally. When this is permitted by financial liberalization, »corporations and authorities alike then face higher borrowing ceilings. As they move from one level of external borrowing to a higher level, the resulting once-off stock effect translates into a sudden increase in capital flows. The surge is transitory in nature, which presents the recipient country with a severe trade-off.«11 Given the limited availability of effective policy instruments available for dealing with the surge of inflows, it is common for this to lead to increased financial fragility and other sources of vulnerability and then to a currency and financial crisis. This, together with the susceptibility of international financial markets to self-fulfilling panic at the first signs of trouble, makes »a sudden shift from boom to bust«12 more likely than a gradual adjustment that ensures a »soft landing«.13

Domestic policy failures

The foregoing debate has shown how difficult it is to arrive at a pat conclusion on what caused the crisis. There are clearly persuasive arguments on both sides but it would be wrong, in my view, to end on a purely agnostic note.

Let us concede that there was such a major malfunctioning of international capital markets such that crony capitalism alone is an insufficient cause of the crisis. Let us further concede that crony capitalism is not a uniquely Asian vice. In addition, let us also accept that the international financial system placed severe constraints on the scope for domestic policy. Does it then follow that we can entirely absolve domestic policy failures?

In my view, no, for two reasons: first, one cannot be morally neutral about crony capitalism. At heart, it involves corruption, the subversion of democracy and the rule of law, and social injustice. It is therefore deplorable in and of itself, irrespective of its role in provoking the crisis. Second, the existence of strong external constraints emanating from international financial markets does not make domestic policies immune from judgement. On the particular hazards of integration into global financial markets, it is apposite to recall that »that which is ineffectual in stopping a line of development altogether is not, on that account, altogether ineffectual. The rate of change is often of no less importance than the direction of change itself; but while the latter frequently does not depend upon our volition, it is the rate at which we allow change to take place which may well depend upon us.«14

There can be little doubt that elements of crony capitalism played a role in provoking the crisis, even though not the predominant one some have ascribed to it. Especially in Indonesia, Malaysia and Thailand, connections between politicians in power and certain private enterprises created a moral hazard problem whereby these enterprises were seen as carrying an implicit guarantee against insolvency. There was thus a strong incentive for financial institutions to lend to these enterprises, regardless of the soundness of their operations.

^{11.} Wyplosz, as above, p. 7.

^{12.} ibid., p. 8.

^{13.} ibid., p. 8.

^{14.} Polanyi, K.: *The Great Transformation* (Boston, Beacon Press, 1957). pp. 36-37.

The moral hazard problem arose even more directly when banks and finance companies themselves had close political connections. In some cases these problems were made worse by direct political interference in the allocation of credit and in creating monopolies in certain activities. These types of political interference in the operation of markets are likely to have contributed to the problem of excessive and misallocated investment and a consequent lowering of the rate of return on capital.

From the standpoint of overall development strategy it could also be argued that it was unwise to persist in pursuing exceptionally high growth through increasing reliance on foreign borrowing. Unlike the typical developing country, these Asian economies had exceptionally high rates of domestic saving of over 30 per cent of GDP. There was thus little need or justification to seek to augment these investable resources through foreign borrowing. Pushing up investment rates to 40 per cent or more through foreign borrowing could only contribute to a lowering of the rate of return from investment. As it turned out much of the excess investment (except in the case of the Republic of Korea) went into financing asset price inflation and the growth of non-tradable activities with relatively low returns.

There were also inadequacies in the handling of the impact of the huge surge in capital inflows in the years immediately preceding the crisis. These inflows were very large, amounting up to 12.7 per cent of GDP in Thailand in 1995. Several features of the policy regimes supported these large inflows. The first was the policy of pegging exchange rates to the dollar in the case of Thailand and Malaysia. This signalled a guarantee against exchange rate loss which encouraged both domestic borrowers and foreign lenders to increase the flow of funds. The second was the creation of incentives to foreign borrowing by maintaining domestic interest rates that were significantly higher than the world market rate. While it can be argued that this was largely unavoidable, being in part the result of attempts to sterilize some of the capital inflow, this should have signalled the need to look for additional instruments to deal with the foreign capital inflow problem.

Another basic shortcoming was the failure to ensure that financial liberalization was accompanied by the development of a commensurate capacity to monitor and regulate the newly liberated financial system. There were several dimensions to this problem. One was an information gap. Financial liberalization meant the privatization and decentralization of foreign borrowing, although no adequate systems were put in place to monitor the extent of borrowing and its term structure. As a consequence, the growing problem of overleveraged, unhedged, short-term borrowing was not perceived early enough. This created, in turn, a policy »blind spot« which ruled out the consideration of pre-emptive countervailing action.

This was linked to the problem of inadequate regulation of the domestic operations of the banking system. Weaknesses in accounting systems and disclosure rules meant that there was a lack of transparency about the operations and the soundness of banks. This was compounded by weak prudential regulation of the banking system, especially with respect to capital adequacy requirements. A related problem was the weakness of the project evaluation capacity in banks in the face of increased competition to lend in the context of financial liberalization. This, together with the removal of controls over the allocation of credit, increased the probability of a flow of funds into the fuelling of asset bubbles. In addition, there were parallel weaknesses in the non-bank corporate sector: a lack of transparency, the poor quality of governance and the maintenance of high debtto-equity ratios. All these weaknesses created the preconditions for growing systemic fragility in the financial and non-bank corporate sectors. This was not taken into account in deciding on the timing and pace of financial liberalization.

This set of policy lapses coalesced into a critical mass of economic fragility, which contributed to the massive loss of confidence in international financial markets when the seeds of doubt were first sowed with the onset of the Thai currency crisis. It also greatly compromised the ability of these economies to withstand the shock of the large-scale outflow of foreign capital.