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Globalization and Openness

Lessons from the Recent Crisis in Southeast Asia

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Abstract

Up until the recent crisis, the Southeast Asian region had been regarded as one of the most dynamic regions in the global economy. Their industrial structures have undergone a process of adjustment into more capital-intensive and technologically sophisticated manufacturing sectors. These adjustments created intra-regional flows of foreign direct investment (FDI) followed by the expansion of capital and intermediate goods intra-firm and intra-industry trade among regional economies. The paper argues that globalization and openness are not entirely responsible for the recent Asian crisis. It can be argued, however, that financial and capital-account liberalization was too rapid because domestic institutional capacities were inadequate and unable to cope with the influx of capital. …/…

Keywords: East-Asian crisis, globalization, lessons for other LDCs.

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The broader issues raised by the experience of Southeast Asia pertain to lessons for other countries, and this in turn centres on the fundamental question: has globalization and liberalization gone too far?

Introduction

Up until the recent crisis, the Southeast Asian region had been regarded as one of the most dynamic regions in the global economy. The region comprises 10 tropical countries, now defined as ASEAN[1] with a total population of around 500 million. For more than a decade, these countries displayed impressive growth rates and increases in per capita income, along with rapid industrialization. Singapore is characterized as being in the first wave of Asian NIEs.[2] Since the mid-1980s, the regional pattern of trade and investment has been evolving rapidly, with the strong growth of manufactured exports, especially in the second generation of emerging economies. These include the other three ASEAN countries: Malaysia, Thailand and Indonesia. By the first half of the 1990s the process extended itself to the Philippines, and even the transitional economy of Vietnam. The road towards such an export-oriented requires countries to continuously adapt to changes in comparative and competitive advantage. For example, certain labour-intensive export industries in Malaysia and Thailand have lost competitiveness and have relocated to other economies in the region. Their industrial structures have undergone a process of adjustment into more capital-intensive and technologically sophisticated manufacturing sectors. These adjustments created intra-regional flows of foreign direct investment (FDI) followed by the expansion of capital and intermediate goods intra-firm and intra-industry trade among regional economies.

Globalization and openness are not entirely responsible for the recent Asian crisis. As a matter of fact, the region had done relatively well out of globalization and openness in terms of trade as well as investment inflows before the turmoil. It can be argued, however, that financial and capital-account liberalization was too rapid because domestic institutional capacities were inadequate and unable to cope with the influx of capital. Capital became abundantly available for domestic-oriented activities at the expense of the outwardly oriented trade and investment linkages built earlier. Herding behaviour by foreign banks rushing in to invest in several economies played a major role. The key factor was faith in the maintenance of the fixed exchange rate and the spread on local investment, especially in construction and securities. Eventually worries about deficits in the current account of the balance of payments appeared on the horizon. These were earlier ignored because of capital inflows. Eventually the herding behaviour of Western banks reversed itself and there was a pullout of funds. The fixed exchange rate par values became untenable in the absence of even higher interest rates, and expectations of imminent currency devaluation led to a currency crisis. These speculative attacks finally materialized and there was substantial exchange rate devaluation. Twinned with this were banking crises, especially in Thailand and Indonesia. Most importantly, the East Asian crisis introduced the new phenomenon of *contagion*. This involves the spread of crisis to neighbouring countries and even further afield. Singapore was hit, even though its economic fundamentals were healthy. On the other hand, Taiwan, another country with favourable fundamentals, managed to steer

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1 The Association of Southeast Asian Nations (ASEAN) includes its original five members of the Bangkok Declaration of 1967 (Indonesia, Malaysia, the Philippines, Singapore and Thailand) and five additional members (Brunei, Cambodia, Laos, Myanmar and Vietnam)

2 Asian Newly Industrialized Economies: Singapore, Hong Kong, Korea and Taiwan.

clear of the crisis. Later, there were financial crisis in other ‘emerging’ markets, including Russia in 1998 and Brazil during 1999.

The financial crisis of 1997-98 had adverse implications for the real sector and future growth potential of these countries. It may be seen as an opportunity for the regional economies to put their houses in order. The debate in the region is no longer focused on whether countries should seek to integrate into the global economy. But rather the question now relates to the appropriate terms on which that integration should take place. ASEAN remains open, and is deepening and widening regional integration to poorer countries in the area. There remains a question as to whether ASEAN can adapt its past success into new internal capabilities to cope with newer features of globalization. Crisis challenges consensus, and the recent episodes in East Asia and elsewhere have undermined faith in the ‘Washington Consensus’ set of beliefs regarding the benefits of liberalization, certainly as far as financial markets are concerned (see Stiglitz 1998 for one example). The broader issues raised by the experience of Southeast Asia pertain to lessons for other countries, and this in turn centres on the fundamental question: has globalization and liberalization gone too far?[3]

The rest of the paper is organized as follows: section 1 examines ASEAN economies in a globalized context, section 2 the ASEAN experience of liberalization and also the impact of the crisis, and finally section 3 looks at crisis management and attempts to enumerate lessons for the rest of the developing world.

1 Open ASEAN economies in the context of globalization

According to Fukasaku (1992) the developments in the trade and growth patterns for East Asia as a whole reflected a ‘flying geese’ pattern. In other words, it involved lagging economies catching up with more advanced ones. First Northeast Asian nations, South Korea and Taiwan, caught up with Japan; then others in Southeast Asia gradually followed suit. This reflected the heterogeneity among the various economies in the region in terms of population, per-capita incomes, natural and human resource endowments and so on. One would normally expect a degree of inter-industry trade between these disparate Asian economies. But there has been a vast growth of intra-regional trade, a good deal of which is of the intra-industry variety. Several reasons have been put forward for the growth of intra-regional and intra-firm trade. One reason was the appreciation of the Japanese and then the Korean currencies in the wake of the Plaza accords of 1987. This appreciation would have encouraged Japanese and Korean firms to re-locate some of their production activities to lower cost and geographically proximate economies in the region, giving rise to intra-Asian foreign direct investment (FDI). Of course, FDI from other parts of the world has also flowed into the region.

North and Southeast Asian nations were among the first developing countries to embrace globalization because of their early adoption of outward orientation. The degree of trade openness is high, and the measure of openness (the sum of exports and imports as a proportion of GDP) is greater than 100 per cent for the region as a whole. Apart from Singapore, ASEAN economies were primarily resource-based when it came

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3 Originally raised by Dani Rodrik (1997) in the context of groups disadvantaged by the process.

to trade and investment before the 1980s. FDI flows into the ASEAN-4 (Indonesia, Malaysia, The Philippines and Thailand) were largely associated with primary production. Singapore, on the other hand, pursued an open-door policy towards FDI and quickly embarked on export-oriented activities. By contrast, countries in the ASEAN-4 were mostly engaged in import substituting industries until the late 1970s. FDI flows used to be mainly from Western industrialized countries.

One may summarize the present pattern of specialization and comparative advantage in ASEAN utilizing the principle of revealed comparative advantage, due to Balassa (1965). Indonesia's specialization is in the resource-intensive product groups (SITC 0-4).[4] During the last decade newer labour intensive manufactured products are gaining competitive advantage, especially in SITC 6 and 8. Malaysia also specializes in natural resource based products such as crude materials (SITC 2), mineral fuels (SITC 3), and animal and vegetable oils (SITC 4). But after the mid-1980s, the country moved on to a number of capital and technology intensive manufactured exports (SITC 75-77). The Philippines has more recently began exporting labour-intensive manufactures (in SITC 8 and 9), and a few capital and technology intensive items (SITC 76-77). A large share of Singapore's total exports consists of re-exports (APEC Secretariat, 1999), and this share has remained comparatively stable over time. Singapore's specialization includes SITC 7; in particular technologically advanced SITC 75-77 goods. Thailand grew rapidly during the regional economic boom that started in the mid-1980s. Apart from its comparative advantage in some resource-intensive sectors in SITC 0 and SITC 2, Thailand had also specialized in labour-intensive industries (SITC 8), and more recently in some technology-intensive industries (SITC 75-77). These findings are also confirmed in Murshed (1999).

As for investment flows, the region registered a rapid increase in inflows from an annual average of US$ 3.1 billion between 1982-87, to almost US$ 28 billion in 1997; equivalent to around one eighth of FDI inflows to all developing economies (UNCTAD, World Investment Reports). Also, between 1980 and 1997, the stock of inward FDI as a proportion of ASEAN output rose from around 16 per cent to over 37 per cent (see Table 1). This is greater than the world average, which rose from under 5 per cent to more than 10 per cent, over the period 1980-1996; see Nayyar (2000). FDI inflows as a proportion of 6 ASEAN countries' gross fixed capital formation rose rapidly from 6.9 per cent between 1980-84 to 15.9 per cent in 1996 (Table 2). This also represents a higher figure than the world average, which rose from 2 per cent in 1980 to 6 per cent in 1996. Thailand, Indonesia and Malaysia ranked among the top 10 developing countries to benefit from such flows.

The post-1980 flows of FDI have been directed to export-oriented manufacturing, and hence changed the pattern of trade in ASEAN-4. By the early 1990s, foreign firms accounted for more than half the manufactured exports from the Philippines and Thailand and over 80 per cent from Singapore and Malaysia (Dowling 1994; Lim and Pang 1991). It has also encouraged intra-regional flows of investment in recent years towards Malaysia, Thailand and Indonesia. Evidence shows that flows of FDI into ASEAN has played a significant role in developing world class manufacturing, resulting

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4 SITC stands for Standard International Trade Classification. Sections 5-8 cover manufactures. The most technologically advanced manufactures fall within SITC 7, and labour intensive manufactures usually fall within 6 and 8. See Murshed (1999) and Fukasaku (1992) for details.

in knowledge transfer and the industrial modernization of these countries. This has been evident most for electronics but also the automobile industry. Some other industries like steel and petrochemical industries could join this bandwagon in the near future.

Table 1
Inward and Outward FDI Stocks in ASEAN
As a percentage of GDP, 1980-1998

	1980	1985	1990	1994	1995	1996	1997	1998
Cambodia								
Inward	n.a.	n.a.	n.a.	7.8	18.0	36.3	32.8	35.5
Outward	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Indonesia								
Inward	14.2	28.6	36.6	26.5	25.6	25.0	28.6	65.0
Outward	n.a.	0.1	n.a.	0.1	0.7	0.8	1.0	2.2
Laos								
Inward	0.4	n.a.	1.6	12.1	12.0	20.1	24.3	47.1
Outward	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Malaysia								
Inward	21.1	23.7	24.1	46.2	31.8	48.6	38.1	60.0
Outward	1.7	4.4	6.2	8.9	13.1	14.8	13.0	20.3
Myanmar								
Inward	0.1	0.1	0.7	-	0.9	0.9	0.6	0.1
Outward	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Philippines								
Inward	3.8	8.5	7.4	8.3	8.2	10.4	10.2	15.6
Outward	0.5	0.6	0.4	0.2	1.6	1.3	1.9	3.8
Singapore								
Inward	52.9	73.6	76.3	72.8	71.2	72.4	81.6	102.2
Outward	66.6	44.1	21.4	16.0	41.9	39.9	46.2	56.7
Thailand								
Inward	3.0	5.1	9.6	10.1	10.5	11.6	8.5	17.8
Outward	-	-	0.5	1.0	1.3	1.9	1.3	1.8
Vietnam								
Inward	0.1	0.6	4.5	1.9	27.3	40.2	55.8	47.8
Outward	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Inward FDI stock in ASEAN-6	**15.9**	**23.4**	**26.4**	**27.6**	**29.1**	**34.7**	**37.1**	**51.4**

Source: UNCTAD, *World Investment Report* (various years), Geneva.

(-) indicates that the item is equal to zero or its values are negligible.
n.a. means non available data

Table 2
FDI Inflows into selected countries as a percentage of Gross Domestic Capital Formation (GDFC), 1980-1998

	1980-84	1985-89	1990	1991	1992	1993	1994	1995	1996	1997
Indonesia	0.9	1.8	3.1	4.1	4.7	3.8	3.5	5.8	8.9	5.3
Malaysia	11.5	9.3	16.3	23.7	25.6	22.7	15.9	16.8	18.9	16.7
Philippines	0.4	6.2	5.0	5.9	2.0	9.5	10.3	8.9	7.0	7.4
Singapore	18.9	29.3	38.7	30.4	12.2	21.3	36.1	29.6	27.8	30.9
Thailand	2.9	4.5	6.9	4.8	4.7	3.6	2.3	2.9	4.7	12.7
Vietnam	n.a.	0.1	1.9	2.2	1.4	11.4	16.4	25.4	28.2	n.a.
ASEAN-5	**6.9**	**8.7**	**12.0**	**11.9**	**8.4**	**12.1**	**14.1**	**14.9**	**15.9**	**14.6**

Source: UNCTAD, *World Investment Report* (various years), Geneva.
Average from Indonesia, Malaysia, the Philippines, Singapore and Thailand.

A remarkable development in intra-regional trade in ASEAN is the rapid expansion of investment in cross-border production operations and the network in vertically integrated industries, particularly in electronics and motor vehicles, by US and Japanese multi-national companies (MNCs), and more recently by MNCs from Asian NIEs. As shown by Petri (1994), growth, trade and FDI in the region have reinforced each other to make the region known for its 'trade-investment nexus'. The formation of the ASEAN Free Trade Area (AFTA) will increase FDI flows and trade in the region (Athukorala and Menon 1997). These interlinkages are important as trade policy affects FDI flows, and FDI policies affect trade flows via intra-firm trade.

An APEC (1999) study focussed on how trade might influence growth. For Thailand openness did not necessarily raise total factor productivity (TFP), rather a more open economy stimulated faster capital accumulation, see Young (1994, 1995). Singapore has a huge central provident fund. Investment is therefore influenced more by the mandatory saving rate rather than by international trade. In the Philippines there were distortion creating trade and investment policies. In Indonesia openness in trade raised both investment and TFP.

2 Asean responses to globalization through economic liberalization

2.1 Trade liberalization and regional integration

ASEAN countries had conducted a series of structural adjustments in domestic policy through liberalization and deregulation. Deregulation began with trade. An observable trend of liberalizing investment regimes followed suit.

The liberalization moves were further intensified with the advent of the ASEAN Free Trade Area (AFTA). The original AFTA schedule called for tariffs to be reduced to 0-5 per cent within 15 years and non-tariff barriers to be eliminated within 8 years beginning 1 January 1993. In 1994, this timetable was brought forward so that the fast track reduction would be completed by 2000, and the normal track by 2003. Thus most intra-ASEAN trade, except for new members, will have a maximum of 5 per cent import duty by 2003. The AFTA tariff cuts are linked to the Common Effective Preferential Tariff (CEPT) formula, based on sectors, and hence has very comprehensive product coverage. It is estimated that by 2000 tariffs would be down to 0-5 per cent for at least 90 per cent of tariff lines. Although there is a time lag allowed for newer members, the schedule has been accelerated for them also. This means that, for the six older ASEAN members, AFTA should be substantially completed by 2000. In order to bring down barriers to trade in services, members have made commitments to liberalize seven service sectors: air transport, business services, construction, financial services, maritime transport, telecommunications and tourism.

There are still some contentious issues in AFTA implementation, although the region's leaders have revealed themselves to be committed to AFTA. The tariff elimination by 2003 may not fully be realized as some members may delay their efforts. The car industry is a case in point, where import tariffs on cars and car parts are scheduled to be subject to a ceiling of 5 per cent. Thailand seems on schedule with regard to its tariff cuts. The country looks as though it would gain from a liberalized trading environment with an emerging status as a car-production hub in the region.[5] Malaysia, on the other hand, is seeking to delay its tariff liberalization. Its national carmakers like Proton and Perodua, seem unprepared to withstand the increased competition that would result.[6] Japanese car makers are likely to cut into the domestic share of these car makers so they are unlikely to make gains in export markets such as Indonesia and the Philippines, where the Japanese are better positioned. For the moment, there is a danger that AFTA will end up producing only a series of interim deals, including bilateral tariff agreements

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5 *Bangkok Post*, 2 May 2000.

6 Malaysia decided to protect its car industry from November 1999 irritating Thailand which has threatened to protect its palm oil industry from Malaysia imports, Legawie, Jochen (2000) *Far Eastern Economic Review*, May, p. 32.

and quotas. This means that ASEAN needs to deepen its own regional integration but make it effective in implementation.

The small size of intra-regional trade as a proportion of total trade suggests that an inward-looking, European Union style, economic grouping is not desirable. In the short-run, the crisis had reduced purchasing power in member countries diminishing intra-regional trade and investment. Once confidence in the region is restored, intra-regional activities should recover. With the presence of MNCs in the region and the volume of intra-firm trade thus generated, a significant part of intra-ASEAN trade is guaranteed.

2.2 Liberalization of investment regimes

Investment regimes are an important component of economic policy and strategy within the ASEAN region. The present reality is quite different from period before the mid-1980s, when ASEAN countries still showed marked differences in policies and attitudes towards FDI (Chia 1998). After the mid-1980s, other governments embarked on unilateral liberalization, deregulation and privatization, resulting in a more open regime that promoted manufacturing for export. Singapore had always maintained a very open economy with free capital flows. This later spread to the ASEAN-4, where governments pursued a more active policy, using investment incentives and investment promotion policies to attract foreign investors. The exception was the Philippines where political uncertainties prevailed.

Most ASEAN countries provide investment incentives to attract and control FDI. They include tax holidays, accelerated depreciation and investment allowances, export incentives, preferential loans, and subsidies. These incentives are often offered in conjunction with performance requirements. Competition for FDI, however, has resulted in incentives being shifted from local firms to MNCs. There was an eventual convergence of FDI policies with regard to both the level and range of investment incentives offered, and the relaxation of performance requirements and other restrictive regulations (Chia 1997; Konan 1996). The convergence of FDI policies has meant that host countries have paid greater attention to other factors that maintain or secure a competitive edge. But it also raises questions about the extent to which ASEAN governments compete for investment amongst each other. With the recent crisis, many countries have become even more FDI dependent.

Full repatriation of profits is allowed for most investments in almost all ASEAN countries. Fiscal investment incentives are broadly similar within the region. Administration of FDI has been streamlined towards more efficient investment approval procedures and a greater transparency and consistency in applying investment incentives and performance requirements. The liberalizing trend is towards a clear national treatment in policy formulation for both foreign and domestic investors. A favourable investment environment exists in terms of access to land and infrastructural facilities. Most countries, however, restrict foreign equity participation in some areas. For these and other reasons several countries in the region have entered into bilateral investment agreements with a growing number of FDI home countries. Such agreements usually have the scope for right of establishment and national treatment, rights to repatriate capital and income without restriction, assurances that expropriation of foreign-own assets is allowable only under well-defined conditions with fair and prompt compensation, and avoidance of double taxation.

When some governments, especially Malaysia, Indonesia, the Philippines and Thailand, embarked on export-oriented industrialization, the direction and emphasis of investment policies changed to promote exports. The agencies promoting investment had encouraged domestic and foreign investors to exploit incentives offered for investment.[7] Several countries in ASEAN had notified the WTO of their local content and/or trade balancing programmes under the 1998 trade-related investment measures (TRIMs) agreement.[8] As a consequence many ASEAN countries are able to maintain local content requirements as well as trade balancing stipulations and the 100 per cent export requirement of export processing zones, both of which are forms of export promotion.

In almost all ASEAN countries the direction of industrial policy has been shaped and set by trade and investment policies. As most of them are outwardly oriented, the industrialization that has taken place is influenced by the external contact each country has had with foreign countries. For Malaysia and Indonesia, industrial policy can be characterized by a big-push and government intervention to stimulate industrial growth; the emphasis towards measures that deal directly with increasing efficiency and competition are less evident. The manner in which trade patterns impact on industrial policy can be seen in a changing global trading environment. Malaysia and Thailand, as indicated above, are losing competitive advantage in labour-intensive activities and have to shift to a second-stage of export-oriented industrialization based on the export of technology and knowledge-intensive products like Singapore. Such a transformation will require a consistent industrial policy based on targeting some industries with R&D capacities and an adequate pool of skilled workers with support from public and private infrastructure.

The Southeast Asian corporate culture and governance mechanisms have come under increased scrutiny since the onset of the recent crisis. Government and business relations give privileges to big conglomerates in Malaysia, Indonesia and Thailand.[9] The limited progress in dismantling these kinds of government business relations diminishes the Southeast Asian ability to enforce new policies, and also leads to the erosion of the strength of the region's business management.

2.3 Liberalization of capital-account transactions and the 1997-98 crisis

In most ASEAN countries, exchange rate stability was part of government policy. The choice of exchange rate regime and the degree of financial openness are crucial for the rest of the economy. However, these countries chose mainly to fix their exchange rates

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7 Malaysian investment policies including two principal acts-the Promotion of Investment Act (1986) and the Income Tax Act (1967). Thailand's Investment Promotion Act was applied back in 1977.

8 Including Indonesia (selected products), Malaysia (automotive industry) and Thailand (selected products). See UNCTAD (1999).

9 Many big financial and industrial conglomerates in Malaysia are under the protection of the Prime Minister Mahathir, including his own project of Supercorridor Multimedia. Indonesian authorities, during the Suharto era, routinely dispensed favours to his family and friends.

while capital controls had been relaxed or liberalized allowing international interest rate arbitrage flows to complicate the sustainability of domestic policies.

Positive factors such as high growth rates, relative currency stability and substantial interest rate differentials, all contributed to attracting international lenders after capital account liberalization. Following the rapid liberalization of domestic financial sectors the form of bank lending altered from lending by individual banks to syndicated bank loans (World Bank 1999), and from sovereign bonds to portfolio flows and back to bank lending (UNCTAD 1998). Krugman (1999) points out that their was a revival in private capital flows to developing countries after 1990, rising from US$ 42 billion to a pre-crisis level of US$ 256 billion in 1997. Most of this went to selected Latin American economies and East Asian countries. Eventually, these large capital inflows led to rapid credit expansion in the context of a liberalized financial sector, without adequate prudential regulation.

One could have argued that the pre-crisis opening to international capital markets would quickly eliminate most of the visible imperfections of domestic financial institutions. Unfortunately, this proved to be an overly simplistic view. This is because financial liberalization requires effective prudential regulation and supervision to ensure the safety and soundness of the financial system. This had not been followed. Financial liberalization had not encouraged domestic financial reforms and corporate governance.

A sharp increase in capital inflows in to the region since the early 1990s was mainly in the form of short-term lending to both banks and firms. This lending was supposed to finance investment with a capacity to generate export earnings. Just before the crisis became obvious, total lending for ASEAN was quite substantial both for banks and the non-bank private sector (Table 3) with negligible sovereign borrowing. In contrast to the Asian NIEs, the ASEAN-4 had borrowed more from the foreign non-bank private sector. Much of this lending was on short maturity (Table 3, column 1, figures in parenthesis). The increasing size of these capital flows consisted of short-term arbitrage funds seeking to profit from the interest rate differentials, rather than funds seeking long-term returns on productive investment. There were strong herding tendencies.

Table 3
Lending by BIS Reporting Banks to Selected Asian Economies, by Sector, End June 1997

	All sectors (US$ million)	Banks	Non-bank Private sector	Public sector
		(Percentage)		
Indonesia (59%)	58,726	21.1	67.7	11.1
Malaysia (56.4%)	28,820	36.4	57.1	6.4
Philippines (58.8%)	14,115	38.9	48.0	13.1
Singapore (93.1%)	211,192	82.8	16.6	0.5
Thailand (65.7%)	69,382	37.6	59.5	2.8
Hong Kong (82.4%)	222,289	64.8	33.9	0.5
South Korea (67.9%)	103,432	65.1	30.6	4.2
Taiwan (87.3%)	25,163	61.6	36.8	1.6

Source: UNCTAD (1998), *Trade and Development Report*, Geneva, p. 60. Figures in parenthesis indicate the percentage of loans with a maturity of less than 1 year.

The high growth era in East Asia drove firms to expand capacity, which increased the ratio of investment to GDP from already high levels (Table 4), facilitated by the availability of relatively low-cost foreign funding. This capacity expansion occurred at the time when growth rates in the region started to decelerate. The return on equity in Indonesia, Malaysia and Thailand between 1992 and 1996 fell below domestic short-term interest rates. Apart from the over capacity in manufacturing production, construction and property also contributed to the crisis. Real estate loans reached a high of between 25-40 per cent of bank lending in Thailand, Malaysia and the Philippines in 1998 funded to a large extent by short-term foreign borrowing (Chirathivat 1999). These sharp increases in property prices, together with rising equity prices of property development companies, led to speculation in the stock market. The expected increases in asset prices put banks and property businesses in an extremely vulnerable position before the crisis.

There were other problems too. For example, the Malaysian National Economic Recovery Plan following the crisis highlights the sharp fall in productivity growth from the high level in the late 1980s. Investment was more than two-fifths of Malaysian GDP between 1995 and 1997, with a limited increase in output because of the large share of the property sector and other capital intensive projects with expected long-run returns (Mody 1999). Then there were the current account deficits. The decline of ASEAN competitiveness in trade was caused by the adverse movements in the dollar-yen rate, together with an adjustment of the Chinese remmenbi currency, which posed a direct threat to the exports of ASEAN countries. Loss of export earnings continued, and as the situation turned from bad to worse, banks and firms were left with increasing foreign exchange risk exposures.

Table 4
Investment as a Percentage of GDP in Selected Countries, 1986-1995

(Annual average)

Country	1986-1990	1991-1995
Indonesia	26.3	27.2
Malaysia	23.4	39.1
Philippines	19.0	22.2
Singapore	32.4	34.1
Thailand	33.0	41.1
China	27.8	35.3
South Korea	31.9	37.4

Source: UNCTAD (1998), *Trade and Development Report*, Geneva, p. 61

3 Crisis, its aftermath and lessons for other developing countries

3.1 Crisis management in ASEAN

A great deal has been written about the economic and financial crisis in the region. It is mainly argued that the vulnerability was created by fixed exchange rates, along with capital account and financial sector liberalization in the presence of a bank-based financial regime with an implicit promise of a bail out. The collapse was due to the fact that currency depreciation led to a worsening of the financial crisis due to massive unhedged borrowing in foreign currency. This in turn triggered fears of sovereign insolvency, which turned capital outflows into a currency collapse (World Bank 1999).

Each country's policy response was tailored to domestic political considerations. Malaysia opted for a fixed exchange rate along with capital controls in September 1998. Thailand floated after July 1997, and the Baht fluctuated before finding its new level against major currencies. Indonesia considered a currency board, then abandoned this idea and allowed the rupiah to float. Vietnam, on the other hand, chose to devalue its currency and adopted a fixed exchange rate. The manner in which each ASEAN country selected its currency regime right after the crisis was very much in response to cross-border capital movements. The role of central bank policy intervention was crucial and in Malaysia capital controls were implemented to deter currency speculators. The country was reluctant to accept the IMF prescription, as this was at variance with national economic policy objectives. Its foreign debt exposure was rather more limited than in Thailand and Indonesia (Ariff and Abubakar 1999), and this helped to fend off the IMF.

Capital mobility and capital controls such as those implemented in Chile in 1991 and Malaysia in 1998 have been discussed extensively in the wake of the Asian crisis (Edwards 1999). Malaysia's capital controls were wide-ranging. Some of these measures included the forced liquidation of offshore ringgit accounts by residents and non-residents, a ban on the provision of credit facilities to non-residents, and the one-year holding period requirement prior to the sale of Malaysian securities. These capital controls were relaxed in early February 1999 when the strictly back-in rule was replaced by a kind of capital gains tax. Foreign funds are subject to a withdrawal tax on a sliding scale. However, a different system applies for investments entering the country after mid-February 1999. The benefits of capital controls must be weighed against the costs. The major cost involves the country's credibility because it is viewed as a departure from the usual rules of the game. Other costs include the usual rent seeking and other unproductive activities associated with such a policy, Rajan (1998). It remains to be seen whether the time gained due to capital controls will be exploited to implement the required structural policy reforms. If there is a tendency towards complacency induced by a temporary recovery, it may delay required policy reforms.

In Thailand and Indonesia interest rates were raised sharply in order to restore stability to foreign exchange markets. The inflows of official financing from the IMF helped to limit the extent of further currency depreciation. Once confidence was restored interest rates were reduced. The decline in GDP and substantial exchange rate depreciation helped to bring about trade and current account surpluses in all ASEAN economies except Singapore.

Since 1999, however, there has been a degree of economic recovery in East Asia. Thailand and Indonesia adopted the IMF package of reforms. Thailand is due to grow at a rate of 4 per cent in 2000 and 2001, and Indonesia is expected to achieve growth rates of 3 per cent in 2000 and 3.5 per cent in 2001.[10] Malaysia, with its unique approach to problem solving and its rejection of the IMF prescriptions, seems to be growing well with forecast of at least 4 per cent growth in 2000 and 2001. Singapore, least hit by the crisis, posted growth of 5.4 per cent in 1999 and that pace is expected to rise to 5.9 per cent in 2000 and 6 per cent in 2001.

Post-crisis foreign direct investment has become mainly involved in mergers and acquisitions for all sorts of business including banking, real estate, retailing and manufacturing takeovers. The crisis paradoxically encouraged new opportunities for investment, and these could continue to be present as long as the region is open and improves its investment environment for foreign investors. The crisis will reverse the income effect driving intra-regional trade and investment. Malaysia, Thailand and Indonesia, for example, have had to cut back their investment outflows to the region. This, however, is likely to be temporary.

3.2 Post-crisis policy implications

First and foremost, the crisis produced a collapse in living standards. In 1998, per capita GDP fell 57 per cent in Indonesia, 29 per cent in Malaysia, 26 per cent in Thailand and 22 per cent in the Philippines. In 1999, income per capita recovered 48 per cent in Indonesia, 9 per cent in Malaysia, 14 per cent in the Philippines and 11 per cent in Thailand. These figures raise the question about the public provision of social safety networks for those hardest hit by the crisis.

Secondly, the crisis highlighted the need for comprehensive financial sector reform and prudential regulation in this area. Prior to the crisis there was rapid financial sector liberalization in Indonesia and Thailand, causing the number of financial institutions to mushroom. These institutions borrowed short from foreign banks in dollars and lent long to domestic borrowers. This process has been described as ‘mismatch funding’. As indicated earlier, a lot of these loans were used to finance construction and the purchase of securities. After the onset of the crisis in July 1997 there was a good deal of debt default related to non-performing loans, especially in Indonesia and Thailand. This suggests the presence of moral hazard, a familiar refrain raised after every financial crisis. In other words, there is an implicit guarantee of government rescue if the financial sector runs into serious difficulties. The moral hazard problem is even greater when informal social networks operate to the extent that the owners or managers of financial institutions are close to the government. Furthermore, it would be unfair to ignore the moral hazard that exists in the Western banking system who are protected by implicit and explicit guarantees from national and international financial institutions (IMF). Herding behaviour[11] on the part of Western banks, who kept on increasing their exposure in East Asia, despite the fundamentals, played no small part in engendering

[10] These and other GDP growth forecasts are based on the IMF World Economic Outlook, 2000.

[11] This implies a justification of reckless behaviour based on safety in numbers. Thus, if everyone behaves recklessly the probability of serious punishment is low.

the crisis. Issues pertaining to prudential regulation and banking/currency crises are examined in Murshed and Subagjo (2000).

Thirdly, there are macroeconomic policy issues. These include concerns about the appropriate exchange rate regime. Flexible exchange rates in developing countries are deemed inappropriate, as they do not exhibit a sufficient anti-inflation commitment, thereby deterring inward investment. Fixed exchange rates run the risk of becoming incompatible with the macroeconomic environment, which in turn induces a currency crisis. The matter of the appropriate exchange rate regime is, therefore, an unresolved issue. Another macroeconomic issue concerns fiscal policy. Unlike during the Latin American debt crisis of the 1980s, the countries affected by the East Asian crisis did not have unsustainable deficits, nor was there problematic lending to the state. Therefore, expansionary fiscal policy could have been used to lessen the negative output impact of the crisis. But this would have been an anathema to the IMF. Also there are dangers associated with high interest rates used to prop up exchange rates after a currency crisis. These higher interest rates have harmful effects at a time when the economy is already in recession (Stiglitz 1998).

Fourthly, there are matters related to institutional capacity. The discussion above regarding imperfectly functioning financial institutions highlighted this inadequacy in the government and its associated agencies. In addition, the state is intimately linked to the private sector via powerful and resilient informal social networks. This makes solutions to moral hazard and adverse selection problems in policy formulation all the more difficult to achieve. A related matter concerns infrastructural bottlenecks. In Indonesia and Thailand, for example, there were several bottlenecks in the delivery of infrastructural services because of the corruption of politicians and bureaucrats.

Finally, the role of proposed regional institutions such as an AMF (Asian Monetary Fund) aimed at preventing and lessening the impact of future financial crises in the region. This would avoid the need to necessarily seek assistance from the IMF. It took quite some time before Asian countries discussing this proposal were even able to agree on a common framework, and the feeble response of Japan, the only country in Asia with real economic power, effectively sealed the fate of this idea.

3.3 Lessons for other developing economies

Southeast Asia has come to be regarded as the model for development. This is in sharp contrast to a generation ago when there was considerable pessimism regarding its potential (Myrdal 1968). The most marginalized region of the developing world at present is sub-Saharan Africa. A variety of explanations, some to do with tropical location (Bloom and Sachs 1998), have been forwarded.[12] According to this view, tropical Asia is in a more favourable position. Other reasons for the problems in Africa are said to be its high, and potentially conflict producing, ethno-linguistic diversity.

12 Tropical Africa is meant to be disadvantaged by lower agricultural productivity, a higher disease burden and greater distance from the sea than any other region of the world.

Another argument put forward for the lack of development in general, and the absence of industrialization in particular, is substantial natural resource endowment (for example, Auty and Gelb 2000). A high bounty from nature, and the reliance on exports of such products, is said to make an economy inefficient, inward looking, less adaptable to change, and corrupt due to the scramble for natural resource rents. Also when the resources are more concentrated (point sourced as in the case of minerals) it makes for greater income inequality, autocracy and low levels of human capital accumulation, all of which impact negatively on growth. Also, concentrated natural resource rents can produce civil conflict, which is often a struggle for the control of these revenues (Addison et al. 2000). It has been argued, that Northeast Asia, in particular, was blessed with propitious circumstances for growth and the drive towards industrialization: low natural resource endowments, and an egalitarian income distribution. It has to be pointed out that several countries in Southeast Asia: Malaysia, Thailand and Indonesia are resource rich. But they overcame the problems associated with resource abundance, including a timely departure from policies associated with import substituting industrialization, and the broad resolution of ethnic conflict (except Indonesia). Policy, therefore, can make all the difference. Many African and several Latin American economies can be cited as examples of resource abundant economies where policy error has persisted and conflicts have not ceased. So the most important broad policy lesson from successful parts of East Asia is to be open and adaptable to the changing pattern of the world economy, as well as achieve a lasting resolution to domestic conflict.

One of the more specific lessons from the experience of Southeast Asia concerns FDI. Very few developing countries receive meaningful quantities of FDI inflows. Yet it is central to their avowed development policy goals. The experience of Southeast Asia suggests that piecemeal measures, such as the odd tax concession to attract FDI are not good enough. Countries will be judged in terms of the overall climate for investment, which include infrastructure and institutional quality. A genuine commitment to open trade and investment regimes is a pre-condition for success. Clamouring for special and differential treatment in trade can be counterproductive and convey the wrong signal. Southeast Asia also demonstrates that there might be contagion effects in FDI. A country's location in a thriving (or declining) region can determine success in attracting investment.

A second specific policy lesson concerns bank regulation. Prudential regulation is important for even the poorest and small economies. One reason is the prevalence of non-performing loans that can be avoided through prudential regulation. Also, capital flight (outflows) following a currency crisis can occur in small and vulnerable economies even where capital inflows are insignificant. Prudential regulation is only coherent when sound macroeconomic policies regarding inflation and exchange rates are being pursued. In other words, sound macroeconomic policies and prudential bank regulation are complements.

The East Asian crisis brought out the phenomenon of financial contagion. It further called into question the Washington consensus, or at least its naive version. Blind faith in the efficacy of markets is no longer accepted at least when it comes to capital account and financial sector liberalization. A more cautious approach to liberalization is now fashionable. This should not, however, be used as an excuse to postpone reform or to strengthen the power of rent seeking groups seeking protection and special treatment. Policy makers are now more cautious about the wider (general equilibrium) effects of policy reforms.

Good institutions and institutional capacity relate to all the factors mentioned above. Attempts to reform institutions are fraught with difficulties, not least because of the opportunism associated with political processes.

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