I. Introduction

The sequence of events that is still denoted the “Asian” financial crisis has now produced a global economic crisis. It began with the destabilization of several Southeastern Asian currencies in summer 1997. By summer 1998, Wall Street had lost momentum. The IMF’s inability to stop Russia’s mid-summer crisis then turned the cracks in Wall Street’s dizzy consensus concerning the end of history into gaping holes. Traders worldwide ran for safety, leading to spasmodic new rounds of currency and equity-market collapses in Latin America and Asia.

Merely documenting what has happened will fill volumes. We focus here first on the architecture of the crisis as a whole, and then on one case: South Korea. There are several reasons for choosing Korea. First, it occupies the pivotal place in the sequence of events: the tsunami that built up in Southeast Asia hit the Republic of Korea with full force in fall 1997, and lingered there through the spring before assaulting New York, Russia, and Latin America in summer 1998. Second, Korea is perhaps the prototype for the Asian developmental model. Third, we have observed the Korean situation firsthand. In effect, Korea provides us with a lens for viewing the innumerable layers of crisis in the current situation.

Our central point is that the essence of the current crisis is its inherent structural complexity; it cannot be reduced to a single mechanism operating at a single behavioral level, but involves instead a series of interlinked conflicts operating at several levels simultaneously. Understandably, most analysts have focused on one or the other contributing causes in this crisis. Some have tried to identify a flawed microfoundational mechanism of the “Asian model”—for example, Krugman’s (1998) model of perverse borrower-lender relations due to unwise government guarantees. Others have emphasized national policy mistakes—for example, Grabel’s (1998) argument that over-reliance on hard-currency foreign loans without controls over portfolio investment flows triggered
many recent financial crises. Still others have emphasized flaws in the structure of international markets – for example, Paul Davidson’s (1998) view that the Asian crisis reflects liquidity-shortage chickens coming home to roost in the post-Bretton Woods world.

We find much to agree with in these works. But we do not think the crisis in its current form could have resulted only from problematic microeconomic design, flawed national strategy, or a perverse international environment. Rather, the current crisis has arisen simultaneously as a conflict between international and national forces, on one hand, and as localized struggles between capital and labor, on the other.

The crisis is thus inherently international, national, and class-based all at once. In our view, no single behavioral cause or design flow can be identified as having nudged the End-of-History ship toward the iceberg. Instead, this crisis has arisen due to long-term contradictions embedded in the structures and policies of the global Neoliberal regime, political and economic contradictions internal to affected Asian nations, and the destructive short-term dynamics of liberalized global financial markets. The system is broken at so many levels that serious study of the structured complexity of global conflict must precede proposals for institutions and policy changes designed to solve the many problems created by the crisis.

The sections that follow first discuss the transition from the Golden Age system to the global Neoliberal regime, and then the myths and reality of the East Asian economic model. We then provide an overview of the Asian crisis, emphasizing the fundamental structural incompatibility between this model and the Neoliberal regime. After critically evaluating the use of mainstream equilibrium-based models to understand the Asian crisis, we provide a more detailed discussion of the crisis in Korea. We end with some reflections on policy.

II. From the Golden Age to the Global Neoliberal Regime

The so-called Golden Age of modern capitalism, lasting from World War II through the early 1970s, was built on the foundation of state regulation of the economy. In the international financial system, exchange rates were fixed relative to the dollar, which in turn was pegged to gold. Significant barriers to capital mobility were in place. Domestically, governments in the North operated managed capitalist systems. They controlled aggregate demand to meet unemployment and inflation targets; they regulated business and finance, established rights for workers, redistributed income via the tax/transfer system, and underwrote a social safety net. In the workplace, a period of relative labor-capital peace was achieved through widespread adoption of what has been termed the Fordist production model. Economic output was centered on capital-intensive goods manufactured in large-scale facilities by largely unionized workforces. Many workers obtained higher real wages and gains in job security and workplace safety. Admittedly, experience in the countries of the South was extremely varied, in large part because many nations were emerging from neo-colonial domination by European powers. Fueled by high Northern growth rates, much of the South did achieve sustained expansion.

The Golden Age’s increasing prosperity did not, however, create capitalism without conflict. The struggle within each nation among firms and workers over wages, relative prices, and working

1 This concept is introduced and explored in Glyn, Hughes, Lipietz, and Singh (1990).
conditions continued unabated. And economic conflict among nations did not cease. During the Golden Age, the capital-labor class conflict was mediated by gains-sharing contracts that raised real wages; and national-capital conflicts were obviated by the Pax Americana that prevailed with the Bretton Woods system. These resolutions were, to some extent, mutually reinforcing. The top portion of Figure 1 demonstrates this point, using arrows to indicate causal influence. That is, the fixed-exchange rate regime facilitated the pursuit of Keynesian demand management built on redistribution and full employment; this facilitated a political environment in which the public supported these policies, thus reinforcing these policies and enhancing their success. Firms meanwhile engaged in co-respective competition based on (and thus expanding) the use of high-wage, high-productivity labor.

But eventually this solution came undone. The balance of power between domestic governments and stateless money and wealth and corporations swung decisively toward the latter in the 1970s. This in turn legitimized a free-market revolution in economic policy, accomplished most successfully by conservative politicians and economists in the US and the UK in the early 1980s. With the Golden Age in ruins, the Reagan and Thatcher Administrations put the Neoliberal regime into place.

The defining elements of the Neoliberal regime are deregulation, privatization, and liberalization—that is, a contraction of the state’s role in an increasingly integrated global economic system. The hallmark of Neoliberalism is the existence of unregulated markets almost everywhere for almost everything. These economic relations are supported in the ideological realm by the dominance of Neoliberal economic and political theory—even within economics departments in Asian countries.

Guiding the emergence of this order are the G7 nations, especially the G1 (the United States), together with the multinational corporations and banks of the North (and, increasingly, of the South). Supporting these agents are domestic elites, North and South, and a set of four multilateral institutions—the International Monetary Fund (IMF), the World Bank, the World Trade Organization, and the Bank for International Settlements (BIS). The United States has stood at the apex of global economic power both in the Golden Age and in the Neoliberal regime. The hallmark of the Neoliberal order, however, is the power of global rentiers. The past two decades have seen the construction of a globe-girdling network of financial centers and off-shore financial havens. These centers and firms provide an infrastructure for financial speculation; the instability of co-respective exchange rates and interest rates in the Neoliberal regime provide the requisite motivation.

The threat of nearly instantaneous cross-border capital movements triggered by speculative motives in turn has imposed severe constraints on state economic policies. Indeed, managed capitalism has been replaced by laissez-faire capitalism. Monetary policy now aims at lowering inflation, not unemployment; safety-net and social-welfare programs have been cut; the counter cyclical role of government expenditure in sustaining aggregate demand has been virtually eliminated; business has been deregulated; workers’ rights have been restricted. The nations of the South are expected to follow suit if they expect to continue to trade with the North.

Economic conflict in the workplace is also resolved differently than in the Golden Age. The Fordist production model has been largely replaced by the “post-Fordist” model, featuring
substantial use of subcontracting, often with bid-price competition, just-in-time inventory methods, and out-sourcing. Together with the erosion of state protections for workers, and of income-transfer programs, this has led to less gain-sharing by firms; regressive redistribution from labor to capital thus has helped sustain profits just they were being eroded by increased interest payments to rentiers. Many firms have taken advantage of the ease of capital mobility to adopt the global factory model, in which components are manufactured and assembled in multiple off-shore locations.

Advocates of Neoliberal policies have argued that they could yield better national and global economic performance than in the Golden Age: high GDP, employment, and productivity growth. Technology transfers from the North would allow less developed nations to converge to the developed nations’ level of economic performance. Such projections have been wide of the mark. Neoliberal policies has generated higher profits for some multinational firms and banks, and much higher returns for rentiers throughout the world. But for most people, Neoliberalism’s promised benefits have not materialized. In the North, economic growth rates have been slow relative to historical trends. European unemployment has hovered near depression levels for a decade while in the US, median real wages have substantially declined and inequality has risen dramatically since the late 1970s. In much of the South, the situation is even worse. Latin America had its “lost decade” after the Mexican debt default of August 1982. Eastern Europe’s economies have stumbled badly after a widely heralded start.

The most recent Trade and Development Report of (UNCTAD, 1998) points out that global economic growth averaged just 1.9% between 1990 and 1995; it rose to 3.0% in 1996, and further to 3.2% in 1997—largely because the effects of the Asian crisis were not yet felt. But it is projected to fall to 2.0% in 1998, and is now slowing further. In the entire 1990-97 period, the economies of the developed nations have grown more slowly, on average, than the global economy as a whole—an average of 1.7% in the 1990-95 period, 2.5% in 1996, 2.7% in 1997, and 1.8% in 1998 (projected). Only East Asia and the US have sustained growth rates above the global average in the 1990s.

Why is Global Growth Stagnant?

Weak global growth rates in the Neoliberal regime can be traced to two mutually reinforcing, fundamental problems: (1) chronically insufficient growth in aggregate demand; and its flip-side, (2) chronic excess aggregate supply.

Here we identify five interconnected roots of weak global aggregate demand deeply embedded in the structures of the Neoliberal regime. First are a series of forces holding down wages and mass consumption. These include the threat of capital mobility (which, in the case of FDI, is underestimated by the measured volume of capital mobility); rising import competition; and chronic job “churning,” which can be traced both to technical change and to new corporate strategies of downsizing and re-engineering. In effect, changes in laws and technology made it feasible for multinational corporations to substitute low-wage Southern labor for equally-skilled but higher-paid Northern labor. It bears emphasis that these anti-worker corporate policies were made possible by

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2 The importance of international capital mobility has sometimes been downplayed, in part because of peculiarities in tests designed to measure it. See Crotty, Epstein, and Kelly (1997), on which this section draws heavily.

3 Another factor depressing global wages was the entry of workers from China, the former Soviet
two prior shifts in government policy: the erosion of support for unions and regulated labor-capital bargaining; and the slow deconstruction of social safety nets, which made workers’ exit option less attractive.

The second factor depressing global growth rates is the high real interest rate regime created by independent central banks and reinforced by global rentiers. This monetary-policy shift coincided with the elections of Reagan and Thatcher, who helped create a secular increase in the reserve army of the unemployed and thus forced the costs of the global crisis of the 1970s and early 1980s onto workers. This shift in monetary policy also was reinforced by the rising power of global rentiers in the 1980s in the wake of financial deregulation. The rentiers were able to punish countries that used policy to pursue growth and employment rather than low inflation.

A third factor was the emergence of restrictive fiscal policy. The high interest-rate regime played a role: rising interest payments eat up larger shares of public spending, all else equal. But more important, lower taxes and a shrinking social safety net have been the political order of the day. The importance given to austere fiscal policy was recognized explicitly in the criteria established under the Maastricht treaty. Further, rentiers and independent central banks together punished countries that ran excessive deficits.

A fourth factor was the level and character of global investment. Investment spending in the Neoliberal regime has been, on average, low, due to high real interest rates and sluggish aggregate-demand growth. But beyond this, much investment was labor-saving rather than capacity-expanding: thus, the increased aggregate demand created by investment spending has often been counteracted by cuts in worker consumption caused by the job and wage losses associated with this investment.

The final factor explaining low aggregate demand is the role of the IMF. As more developing countries experienced national insolvency, the IMF has increasingly played a new role—lender of last resort to countries with inadequate foreign exchange reserves. The IMF has invariably mandated austerity macroeconomic policies plus Neoliberal restructuring in return for its money. The growth of IMF austerity programs around the developing world (not to mention the self imposed macro-economic austerity programs adopted by countries like Brazil to avoid falling under the control of the IMF) has left global aggregate demand even more constrained.

Why hasn’t supply adapted to reduced demand growth? In the Neoliberal regime, demand problems have generated destructive competitive processes which, in turn, have aggravated demand deficiencies. The Neoliberal regime has replaced the “co-respective competition” (to use Schumpeter’s phrase) among large firms in the Golden Age—characterized by long-term planning horizons, restrained capital-labor conflict, and avoidance of those dimensions of competition that undercut industry-wide profitability, with “coercive competition” based on predatory pricing, overinvestment, waves of technological innovation that render recently constructed capital goods obsolete (and the debt used to finance them potentially unpayable), and aggressive regimes of labor policy. The key is to understand why the Neoliberal regime has forced competition into a coercive and destructive mode.

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4 See Crotty (1993) on the importance of this shift in competitive regimes.
The modern global economy has a discrete number of key manufacturing, service and financial industries that dominate international trade and investment—such as banking, insurance, autos, airplanes, computers, semiconductors, electric appliances, steel, and machine tools. Mature industrialized countries have large multinational corporations that desire to maintain their traditional domination of these key industries. In addition, however, developing countries moving up the technology/productivity/value-added ladder—such as Japan, Korea and Taiwan — must establish footholds, followed by strongholds, in many of these same industries. So each new wave of entrants, like the countries of South East Asia in recent decades, further crowds these global markets. If global and Northern aggregate-demand growth was strong, this problem would be contained to some degree. But, as we have seen, it is not; the Neoliberal regime severely constrains the growth of demand. In the absence of exit by established players, waves of new entrants leads to chronic overcapacity, low profits for many firms (except at cyclical peaks), fierce competition, and a deflationary bias in global commodity markets.

Given the centrality of these markets and the sunk costs required to enter them, most competitors try to stay in the game even as competition mounts, hoping to survive current struggles so they can reap the high profits expected to emerge when the losers are eventually forced out. Consequently, they tend to over-invest, building plants in areas with cheaper labor and/or putting cutting-edge technology in place. In markets such as semiconductors and airplanes, best-practice technology requires huge investment. Ironically, investment aimed at insuring competitive strength simultaneously generates risk. Over-investment in a period of low profit rates and high interest commitments requires many firms to use high leverage. While high leverage is a well-known feature of Asia’s economies, rising leverage occurs in any system with high investment levels, falling profits, and high interest burdens.

In neoclassical textbook models, the downward pressure on profits, capacity utilization, and prices is soon eliminated by the exit of firms to industries with higher profits. But in the Neoliberal regime, it is reproduced, because entry is not matched by exit. The more these pressures develop, the more they force firms to cut wages, smash unions, move to areas of cheaper labor, and push for tax cuts and other government policies which restrict aggregate demand—one of the major causes of the excessive competitive pressures in the first place. The elements causing slow aggregate-demand growth and excess aggregate supply thus reinforce one another in a vicious circle.

The pattern of excess supply leading to coercive competition in the real sector is repeated in the financial sector. In the wake of continuing financial deregulation, removal of capital controls, and technical change, large banks are forced to compete globally for up-scale customers. Accompanying this trend is a shift in these banks’ revenue generation from traditional intermediation (lending to hold) to fee-based income (lending to sell). This shift reflects both the premium placed on liquidity in the uncertain economic climate of the Neoliberal order, and also banks’ reluctance to absorb default and other risks in this climate. However, in shifting away from intermediation and toward fee-based activities, banks are moving into heightened competition both with investment and brokerage firms and with one another. Increasingly, high profits can be obtained in the financial sector only in two ways: by opening up new lending venues and enjoying a scarcity rent on funds lent; or by taking on highly-leveraged excessive risks. Events in recent

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months have made it clear that the bets these players take can jeopardize the stability of the entire global financial system.

In sum, the step-by-step dismantling of Keynesian policies from the mid-1970s onward and the freeing of capital movement have pushed the world’s economies deeper into a Neoliberal economic trap which increasingly shuts in on itself. As the bottom portion of Figure 1 illustrates, Pax Americana and the exchange-rate regime no longer set the tone for global economic policy, as in the Golden Age; multinational firms and mobile capital do. Restrictions on state action reduce the scope for redistributive policies and hence erode mass support for lift-all-boats efforts. This in turn eliminates Keynesian employment-based demand management and leaves states with price stability targets, contributing to a global deflationary bias. The Golden Age political consensus in favor of Keynesian demand management, market regulation, and income redistribution now appears to be an exercise in hopeless utopianism; replacing this consensus is a global sense of pessimism on the part of national electorates, whose erstwhile leaders have conditioned them to expect nothing and hope for nothing.

III. The East Asian Model: Myths and Reality

This brings us to the East Asian model itself. The shock-waves emanating from this region's current crisis should not cause us to forget East Asia's immense long-term achievements. The prototype was Japan in the 1950s “income doubling” period, while from 1961 through 1996, South Korea’s average annual rate of growth of real per capita GDP and real wages averaged about 7% per year. Though East and South East Asia constitute about 25% of global GDP, in the 1990s about half of the growth of world GDP has originated in this area. Ajit Singh recently observed that: “It is no exaggeration to say that the post-World War II development of East Asia (including Japan) is the most successful story of sustained economic expansion in the history of mankind.” (Singh, 1996)

This economic success has been achieved through a structure of state-led growth originated in Japan, refined in the four “Tigers” (South Korea, Taiwan, Singapore, and Hong Kong), and subsequently adapted for use in South East Asia, China, and elsewhere. The beginning of wisdom about the East Asian model is the recognition that it has differed substantially from one country to another, and within countries from one period to another. This variability has allowed analysts to explain the elements behind East Asia’s brilliant economic very differently. Marcus Noland has remarked in private correspondence that East Asia has been a mirror, in which many analysts have seen the reflections of their own preconceived ideas. For example, some economists have attempted to attribute the success of Taiwan, and East Asian economies more generally, to their pursuit of policies that a market-oriented economic approach would have dictated anyway—despite voluminous evidence to the contrary (Wade, 1990).

It is thus important to be clear on the essential features of the Asian model—what this model is and is not. A common misimpression regards the Asian model as controlled by a giant predatory


7 For example, Korea’s industrial strategy was made over substantially in the 1970s, and again in the early 1980s, both to correct policy mistakes and to respond to an evolving international environment; see E.M Kim (1997).
state which monopolizes national output and builds wealth by running aggressive trade surpluses, and devalues its currency aggressively to maintain its edge in global markets. Reality is far more complex. First, the government accounts for no larger a share of output in East Asia than elsewhere. Further, East Asian countries do not uniformly run trade surpluses. Figure 2 shows that Korea and Thailand have more often run trade deficits than surpluses. In the 1990s Korea has consistently had trade deficits with both the US and Japan. As for chronic currency devaluations, Figure 3 shows that throughout the 1980s and 1990s, two of five East Asian currencies (the Japanese yen and Taiwanese dollar) have risen substantially against the US dollar, while the other three held their value against the dollar until the 1997 crisis period.

What then are the points of commonality in the East Asian model? First is the shared structural circumstances and historical legacy of nations in this portion of the world. Of special importance is the relative paucity of mineral resources and oil, which helps explain the centrality of trade considerations in these nations’ policies. Second, and most important, is the fact of heavy state involvement in the allocation of resources. This has been referred to in the literature as the developmental state (Johnson, 1995) or late industrialization (Amsden, 1989). For example, until the recent crisis period, the Korean government provided temporary import protection for domestic markets introducing new products or technologies, channeled the development of high tech production capabilities to a small number of diversified companies (called chaebol), allocated credit toward priority industries and technologies, and tightly regulated the cross border movement of money. At the same time, the government selectively opened markets to import competition and imposed export performance criteria in return for government aid to insure that key industries achieved world-class efficiency. Such heavy involvement in investment and savings flows is present even when the apparent level of government involvement is relatively slight, as in Taiwan. Such strong government guidance is, of course, antithetical to Neoliberalism, but it did lead to high investment levels, as Figure 4 illustrates. The US investment share of GDP hovers just under 20%; Taiwan’s share has trended downward to about 25%; but Japan’s share has remained at about 30%. Investment shares in the other three East Asian countries shown, including Korea, climbed as high as 50% in the 1990s.

The Asian model are tightly integrated. This close relationship is demonstrated in Figure 5. The US GDP growth rate is relatively independent of the East Asian rates, which instead vary closely with Japan’s cyclical growth rate. In 1996, about 52% of Asian exports, and 54% of its imports, were intra-regional (UNCTAD, 1998, page 27). The apparent pattern of dependence on Japan is not surprising given the sheer scale of the Japanese economy, whose GDP is about 12 times as large as Korea’s. That the Korean economy was, until the 1997 crisis, the eleventh largest in the world, makes this mismatch all the more remarkable.

Another theme of East Asian development has been deferred gratification for consumers. Tight constraints have been imposed on the domestic consumer goods market in order to free up resources for investment and exports. Current consumption has been sacrificed for high rates of capital accumulation, and thus for future consumption. The guiding idea has been that household needs would be met by the sheer pace of growth.  

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8 This aspect of East Asian economies has gradually changed. Government expenditures on social welfare and housing have risen rapidly in most countries, albeit from a low base.
Finally, East Asia has been understood to be reasonably free from the overt capital-labor conflict that has often characterized Western labor markets and labor processes. The exchange of the security of lifetime employment for worker loyalty and pursuit of company objectives is often seen as key components of the Japanese and Korean ‘miracles’.

But the deferred-gratification/low-conflict features of the Asian model should not be exaggerated or romanticized. Rapid growth, relatively flat pay scales, and flexible supervisory methods have often kept capital-labor conflict in the background. But political repression including the destruction of independent, democratic and militant unions has played a crucial role as well--and continues to do so in the restructuring processes imposed by the IMF after the crisis began. Further, the avoidance of overt capital-labor conflict is due in part to the heavy industrial use of female labor in the context of long-standing gender-based oppression. But the case of Japan shows that the long-term price of playing the gender card in industrial development is the ‘revolt’ of women, which can jeopardize the reproduction of social relations in several ways (see Naff 1994). Further, housing remains inadequate, especially for lower-income people (Ha, 1995; and W.J. Kim, 1997). And democratic participation has been restricted--at times outlawed, encouraging the entrenchment of powerful economic and political elites (E.M Kim, 1997).  

IV. The Emergence of the East Asian Crisis: An Overview

In this section we make two arguments. First, that the fundamental structural incompatibility between the Neoliberal regime and the East Asian model guaranteed that the Asian economic miracle would inevitably be disrupted at some time, in some way. Second, that the financial liberalization imposed on Asia by external and internal elites, in the context of the global financial regime, set the stage for the timing and character--the conjunctural and contingent characteristics--of the Asian crisis of late 1997. We see these two arguments as addressing, respectively, the ultimate and proximate causes of the crisis.

Structural Incompatibility

It is not just a coincidence that Japan, Korea and Taiwan created and consolidated their East Asian models during the Golden Age. Northern growth was rapid and the demand for imports grew even faster. Since only a few Asian countries were vying for shares of Northern import markets, and were starting from a small base, their success posed no immediate threat to host countries. Cold War politics made the US hesitant to treat these countries too harshly; on the contrary, it provided substantial grants and loans to assist their development. Plus, the US pumped money into Asian countries in the course of prosecuting the wars in Korea and Vietnam. Finally, note that for much of the period, the movement of financial capital across national borders was slow, and controlled by national governments.

But the rise of the Neoliberal regime has created multidimensional tensions with developing countries that have adopted the Asian model. For one thing, East Asia's success offered proof that an intelligent and flexible combination of state regulation and market forces could achieve a combination of economic growth, productivity, technological progress, and income equality superior

9 Of course, the US and its European OECD partners hardly have clean hands when it comes to the eradication of social inequality, gender oppression, and the coddling of entrenched elites.
to anything Neoliberalism could offer. Until 1997, the unparalleled success of the Asian model was seen by many as proof that the idea embodied in the “Washington consensus” that “there is no alternative” to Neoliberalism was just an ideological slogan, not a fact. For another, it was true even in the Golden Age that export-led growth in the South could never be a permanently successful strategy for every developing country given limits to the growth of low to mid-tech global export markets. But the evolution of the Neoliberal regime with its chronically inadequate aggregate demand growth and structurally determined excess supply made these limits bind earlier and bite harder than otherwise would have been the case. Asian countries could not continue forever to increase exports at 8% a year in a global economy whose developed economies were growing at 2% a year. These constraints meant that sometime, somewhere, export-led developing countries were likely to experience severe problems.

As a result of conflicts between the structure of the East Asian models and the ideological and material interests of the G-7 nations and multilateral institutions, enormous pressure was applied to East Asian countries in the late 1980s and 1990s to deconstruct key components of their economic systems. Northern powers pressed with special vigor for liberalization of both domestic and international financial markets, and elimination of trade management and investment oversight. This pressure arose in part because the profits that firms, banks, and rentiers outside East Asia could earn from its economic miracle was severely restricted by Asian governments’ controls and regulations. Beyond this, Asia’s government-directed economies represented the last significant obstacle to the consolidation of global Neoliberalism. Western interests believed that they were in a “war” with East Asia over what kind of capitalism would dominate the early twenty-first century--US capitalism or East Asian capitalism; and they intended to win. Though they used many weapons in this war, financial liberalization was clearly central to their battle plans.

Financial Liberalization, Short-Term Capital Flows, and the Outbreak of Crisis

That the sought after financial liberalization was in fact achieved is demonstrated by the surge of capital inflows to East Asia in the 1990s. Figures 6 and 7 provide figures on yearly inflows of short-term and long-term capital in four East Asian economies. These economies all experienced a substantial rise in short-term capital inflows in the 1990s. Long-term capital inflows rose in three of the four countries as well. It is important to emphasize the shift toward short-term lending, depicted in Figure 8. The short-term character of much of this capital reflects global lenders’ perceived need to maximize their liquidity—the ability to unwind any position quickly and with minimum loss, and created the potential for a lightning-fast bout of capital outflow. These short-term financial inflows created the preconditions for Minsky crises, especially in the South East Asian countries such as Malaysia and Indonesia that lack deep financial markets, adequate regulation, and lender of last resort institutions. The inflow of so much money in such a short time to so many different East Asian countries created the possibility of region-wide panics, contagions, and financial crises.

Moreover, by opening Asia to unregulated domestic use of these short-term capital inflows prior to undertaking other changes that would make these models consistent with financial deregulation, a time bomb was planted. The East Asian model is an integrated and coherent whole.

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Its impressive successes were the result of all key components working together. Breaking down some parts of the system while leaving others intact courted disaster. In particular, the deregulation of domestic and international financial markets and the elimination of state investment coordination in the context of traditional corporate and bank leverage ratios was a recipe for crisis. Corporate debt equity ratios of three or four are inherently vulnerable to profit or interest or exchange rate shocks.\textsuperscript{11}

The huge and variable capital inflows to Asia set up a Catch-22 dilemma for Asian exchange rate regimes, which raised yet higher the likelihood of crisis. As Figure 3 shows, most East Asian countries adopted de facto fixed exchange rate regimes in the 1990s. This insured foreign investors against exchange rate losses. Fixed rates also required that national authorities control inflation and limit budget deficits—policies favored by foreign rentiers; they thus helped generate glowing evaluations by the IMF and World Bank as to the soundness of these economies, which only accelerated the speed of capital inflows. However, de facto fixed exchange rates made it impossible to eliminate current-account deficits. So when deficits did arise, governments had to use their limited reserves to defend the exchange rate. When investors began to withdraw funds because current account deficits threatened the exchange rate regime in 1997, governments were forced to use their exchange reserves even faster. When the exchange rate pegs were finally abandoned in the heat of the crisis, remaining reserves were too small to cover foreign debt repayment commitments. Default or IMF supervision were then the only remaining options.\textsuperscript{12}

Under speculative bursts of capital inflows and outflows, however, flexible exchange rate regimes can lead to devastating exchange rate instability. Inflows raise exchange rates, causing current account deficits and domestic credit explosions; large outflows make it impossible for domestic firms and banks to repay foreign denominated debt. No small, trade-dependent country can tolerate the extreme exchange-rate volatility inherent in the Neoliberal regime in the absence of capital controls.

Thus, once Neoliberal forces had successfully orchestrated the liberalization of domestic financial markets and international capital flows, and weakened the structures of trade management and investment coordination, the Asian countries were placed in deep jeopardy no matter which exchange rate regime they adopted. It was only a matter of time until crisis came.

We will flesh out the dynamics of the Asian crisis and present a more detailed explanation of its causes, with special focus on the case of Korea, in section VI. But first, we look at the strengths and weaknesses of the explanations of the crisis offered by mainstream economists.

V. A Critical Evaluation of Neoclassical Theories of the Asian Economic Crisis

\textsuperscript{11} See Wade and Veneroso (1998). The high debt ratios of the Asian model follow logically from the fact that profits are low, while household savings and capital investment are high. High corporate debt levels are the inevitable result of using a banking system to transfer large volumes of household savings to the corporate sector to finance investment.

\textsuperscript{12} The \textit{Wall Street Journal} of October 16, 1998 makes the same argument about the untenability (hence Catch-22 aspect) of both fixed and flexible exchange rates, nothing that “misalignments and currency crashes are equally likely under pegged and flexible exchange rate regimes. In the 116 instances between 1976 and 1996 when currencies plunged 25% or more, half were operating with flexible exchange rate systems” (while obviously the other half were fixed or pegged).
Most analyses of the Asian crisis have focused on the cycle of short-term capital flows into and out of the recently liberalized Asian financial markets. Outstanding treatments of theory and facts surrounding this financial cycle can be found in the work of non-mainstream scholars such as Wade (1998), Wade and Veneroso (1998), Akyuz (1998), Chang, Park and Yoon (1998), Grabel (1998), MacLean, Bowles and Croci (1998), and UNCTAD (1998). Of course, many mainstream economists have also presented theories to explain the Asian financial crisis. Before we present a more detailed view of the crisis via an analysis of the course of events in Korea, it will be useful to briefly review the debate within mainstream economics about the causes of Asian crisis. We preface this review by recalling a typology developed by Radelet and Sachs (1998). These authors argue that financial crises can have any of five causes: deteriorating macroeconomic fundamentals; moral hazard in loan markets; financial panic; asset bubbles; and disorderly workouts. Most economists’ writings on the Asian financial crisis incorporate some combination of these elements; indeed, the debate is shaped along these lines. The IMF, for example, emphasizes the first two factors: they trace foreign-exchange and asset-market pressure to either inappropriate macroeconomic policies or flawed systems of financial intermediation and regulation. This coincidence is not surprising in that this list encompasses the research interests of most economists using the core conceptual categories of mainstream macroeconomics. In order, these five causes correspond to: models of efficient markets; asymmetric information models; models with multiple equilibria, especially the Diamond-Dybvig model of bank runs; models of sunspot equilibria and self-fulfilling prophesies; and “political economy” models with rent-seeking government officials.

There is something here for almost every Neoclassical economist. Indeed, there is something exhilarating, almost titillating for economists about the Asian crisis; for the opinions of a sizable band of economists revered in academia—Joseph Stiglitz, Jeffrey Sachs, Paul Krugman, Lawrence Summers, Martin Feldstein, Stanley Fischer, and so on—have been analyzed in excruciating detail in leading journals of world opinion. Political professionals like to say about careers in their field that “you find a horse and you ride him.” Things are little different for economists interested in making their mark on Noriel Rubini’s instantly famous Asian crisis homepage—you find a theoretical take and you ride it.  

13 The most extreme example of this is perhaps the empirical sub-literature on whether banking and financial collapses (like those in Asia) have generally been foreshadowed by deteriorating macroeconomic or structural fundamentals. The one-time character of any given occurrence of financial crisis leaves too few degrees of freedom for a reliable test. Some enterprising economists have tried to overcome this constraint by building up a panel of different occurrences of banking and financial crisis in contemporary economic experience; by stretching the definition of crisis and the allowable range of countries, they are able to generate 50 or more events. This in turn makes it possible to use a multinomial probit model to test whether a number of macroeconomic and financial variables collected for these various events are useful indicators of banking crises. For example, Hardy and Pazarbasioğlu (1998) build a model of this sort, then apply the parameters they obtain to the case of East Asia. They find that variables capturing the vulnerability of the banking and corporate sector predict the subsequent crises, but macroeconomic variables do not. One problem with this exercise is that it requires the assumption that, say, the US savings and loan crisis of the 1980s, the Japanese banking crisis of the early 1990s, and numerous bank runs in smaller countries around the globe in the past 20 years can be put into a uniform data set and manipulated using models that require a high degree of statistical regularity.
The fundamental problem with most of this literature is, not surprisingly, the problem one finds in mainstream macroeconomics debates between New Keynesians and New Classicals (and the shades in-between): this debate is conducted using as a point of reference the perfectly coordinated, mistake-free Walrasian general equilibrium model. There is certainly nothing wrong with comparing outcomes in one’s model of choice with the Walrasian case. The problem goes deeper, however, to an ingrained habit of contemporary debate in mainstream theory: the idea that the implications of a given idea can be understood—and thus accepted as important—only with respect to the deviations they introduce from Walrasian equilibrium. Models for which the Walrasian case is simply not applicable thus cannot be understood.

The debate over the Asian model has quickly taken on this sort of flavor: the focus is on the mechanism that drives one away from the efficient equilibrium assumed to be the natural resting place of the system. A good example of this approach is a recent paper by Chang and Velasco (1998). These authors adapt the Diamond-Dybvig model (1983) to show that a shortage of global liquidity combined with a shock that adversely affects borrower countries in the presence of short-term capital inflows can generate recessions driven in part by a debt-deflation multiplier. Clearly, these authors have generated a framework capturing many aspects of recent events in a clever and concise way.

The question is, where does an analysis of this sort go next? One move would be to attempt to add in additional realistic features based on stylized characteristics of Asian economies—a labor process, taxation and a government sector, a household sector, and so on. But this is asking the Diamond-Dybvig framework to carry a lot more weight than it was designed to bear, given its origin as a simple demonstration of the possibility of bank runs. Not only would such realistic features conflict with the simplifying assumptions required to generate a closed-form equilibrium; but adding them would lead to confusion on the part of mainstream economists as to which realistic feature is generating what amount of inefficiency in the resulting second-best equilibrium. To pertain more fully to the unfolding crisis in Asia, this (and other) framework(s) must be stretched this way; but to do so takes them quickly beyond the formal limits that generated their explanatory force in the first place. The problem derives, at root, from theoretical economists’ insistence on assuming that the Walrasian maintained hypothesis is meaningful—that in the absence of whatever mechanism is emphasized, the economy would be at (or near) an efficient economic outcome. It is possible to ask, “what else is missing?” only within the straitjacket imposed by whatever formalism underlies an author’s results. To insist on bringing in factors that require loosening that straitjacket invites the suggestion that one doesn’t understand the rules of this game.

Another problem is empirical. One would like to move toward an empirical implementation of an idea like Chang and Velasco’s. However, the formal restrictions required to generate equilibrium in their model do not permit the construction of a set of empirical propositions. A reduced form must be used, one that presumably includes the list of variables that could shift the parameters of central interest in this formulation. However, this reduced form will be almost indistinguishable from those generated by models based on very different premises—in this particular case, from the Hardy and Pazarbasioglu (1998) model discussed in footnote 13, which assumes efficient markets (and does not bother with the information asymmetry at the root of the Chang/Velasco framework). Suppose one found that variables representing structural features of the banking system, as Hardy and Pazarbasioglu do, matter empirically? It is unclear whether one is showing: à la Chang and Velasco, that the banking system has malfunctioned because of
international liquidity shortages: à la Hardy and Pazarbasioglu, that lack of regulatory oversight and other structural problems in domestic banking systems are to blame; or something else altogether. Still, the sheer difficulty of getting significant coefficients with small time-series/cross-section samples poses a barrier, even if one swallows the objections raised in footnote 15.

We can sum up this discussion by generalizing a remark that Jeffrey Sachs made about IMF economists in his Financial Times article of December 13, 1997, “it defies logic to believe that the small group of 1,000 economists on 19th Street in Washington”—or for that matter a self-conscious academic elite not afraid to substitute a simplifying assumption for an institutional investigation—“should dictate the economic conditions of life to 75 developing countries with around 1.4 billion people”—or that their own debating conventions should dictate the terms on which matters of such importance must be understood.

Following every nuance of the burgeoning economic literature would be exhausting, if not impossible, in the manner of a cat chasing its own tail. The remainder of this section identifies the three central threads along which debate has flowed.

**The Asian Model on Trial: The Neoliberal/Neoclassical Perspective**

The Neoliberal view of the Asian crisis is espoused by economists at the IMF and World Bank, by business economists, and by conservative, largely US-trained academic economists, including many in elite universities in Asia and Latin America. Neoliberal economic theory is the official ideology of the Neoliberal regime. This view finds the roots of the Asian crisis in the inherent incompatibility of the external (Neoliberal) global environment and most Asian nations’ internal economic structures and policies. This incompatibility is traced in part to self-dealing and rent-seeking, “crony capitalism,” which the March 1998 issue of Finance and Development sees, *inter alia*, as the root of the crisis in Southeast Asia (see Grey and Kaufman, 1998). In countries where corruption is not present, the IMF position is that something must be wrong with either macroeconomic management or institutions. Since Asia’s afflicted economies generally had strong macroeconomic fundamentals prior to the crisis, blame focuses on “weaknesses in financial systems and, to a lesser extent, governance.” (IMF, 1998).

This approach asserts that market fundamentals should drive observed outcomes, and government intervention can only worsen outcomes. Since only the Neoliberal approach fully embodies this view, "there is no alternative" to Neoliberalism. No East Asian model of centralized control over capital movements and investment can be permanently sustained because its costs--price distortions, misallocated resources and restricted access to Northern goods and financial instruments--will eventually become too large to bear. The crisis is thus not attributable to external forces such as currency speculation, but to the cumulation of internal inefficiencies. Any transition

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14 This argument trips over itself. The governments in crisis are blamed both for permitting weaknesses to emerge in financial systems (through the aforementioned over-regulation of flows) and for their inadequate financial supervision. The contradiction herein is resolved if one considers that it refers to financial systems already in transition from government-directed to market-based methods of allocation. Interestingly, a paper produced independently by economists at the IMF (Demirguc-Kunt and Detragiache, 1998) summarizes some empirical tests which conclude that financial liberalization increases the probability of banking crisis.
from government-controlled allocation to decentralized market allocation will, it is admitted, impose temporary costs of adjustment, but in the Neoliberal view, the permanent costs of not opening capital and product markets clearly exceed the one-time costs of transition.

The Asian Model on Trial: Economic Theory Weighs In

As already mentioned, economists have begun to apply theoretical models to stylized representations of the Asian crisis. Broadly speaking, contemporary theoretical models can be divided into those with unique and those with multiple equilibria. The unique-equilibrium models invariably describe efficient outcomes along steady-state growth paths; the multiple-equilibrium models permit deviations from efficient outcomes for reasons ranging from missing information, to perverse parameters, to asymmetric information, and so on. Models of the second type, which as already mentioned encompass almost the entire research agenda of applied microeconomists and macroeconomists using mainstream methods, are being widely and variously applied to the Asian crisis. The apparent facts of the case fit well with the notion of a good equilibrium which is replaced by a bad one.

Models of this type have been used to identify problems in Asia. For ease, we consider just one strand within this stream--microfoundational models in which bubbles emerge due to incentive problems under asymmetric information. The fundamental problem is incentive incompatibility between a well-informed loan applicant and a less-informed lender: in finite-horizon games in which loan applicants pay interest and keep residual returns, applicants have an incentive to undertake riskier projects than lenders want to underwrite. The potential for overlending and/or a bubble then arises if lenders do not exercise adequate vigilance. Banking systems in which risks are guaranteed are especially likely to fall prey to this sort of moral hazard problem. This general approach has been used to indict deposit insurance as the culprit in the 1980s US savings and loan crisis and the Latin American debt crisis.15

Paul Krugman’s web-published January 1998 paper proposes a moral-hazard theory of the East and Southeast Asian financial crisis incorporating these elements. Specifically, he argues that each nation has a class of assets--especially land--that is fixed in quantity but has a variable return. Suppose the return to land can be either high or low with a given probability. Then under risk neutrality a fair price for this land is, (Probability of high return) x (Value of high return) + (Probability of low return) x (Value of low return). Krugman argues that a bubble in land values emerges when one set of bidders on these assets discards the low return, and thus bids their price up to the high-return value. The culprit is the domestic banking system, which supports this bidding-up because it is backed by implicit governmental guarantees against failure. The asset bubble then bursts when low returns occur, generating losses for banks that governments are unable to absorb. This sets off a contagion effect when depositors at banks holding overvalued assets of this sort realize that they stand to lose the next time a low-return outcome is drawn.16

15 The standard asymmetric-information models of the LDC debt crisis are Sachs (1984) and Eaton, Gersovitz, and Stiglitz (1986). These models advance the proposition that the debt crisis arose because the penalty for non-payment was too low and contractual terms could not be enforced. The recurrence of two currently prominent names from this earlier discussion gives pause. As Yogi Berra put it, “It’s deja vu all over again.”
16 A macroeconomic approach building on the same factors as Krugman’s microfoundational model
Second Thoughts about the Neoliberal Regime: Economic Theory Changes its Mind

But what economic theory gives, it also takes away. The same asymmetric-information framework used by Krugman to demonstrate weak points in the Asian model has been deployed to defend it and cast suspicion back on the Neoliberal regime itself as the possible culprit. This counter-offensive draws strength from the fact that neither of the aforementioned attacks on the Asian model fit the facts very comfortably. Vis-à-vis the IMF’s two-level attack, note that some countries affected in the current crisis have succeeded because of state-directed, interventionist macroeconomic and microeconomic policies, not despite them. Further, the spread of the Asian crisis to Latin America has hit hardest countries such as Brazil and Mexico that have made sustained efforts to rebuild their economies after the debt-crisis years using precisely the orthodox policies championed by the IMF. If the IMF was right, Latin America should have stayed clear of the Asian meltdown of 1997-98. Further, while Krugman’s asset-bubble argument may apply to some features of recent Southeast Asian experience, it doesn’t fit the situation of Korea at all, not to mention Latin America. As Dymski (1998b) observes, Korea’s land and stock market bubble peaked nearly a decade ago; a variety of policy steps had reined in the worst excesses of that bubble before this crisis broke out.

This general line of attack is set out in a March 12 speech by Joseph Stiglitz, now Chief Economist at the World Bank, in Manila (Stiglitz, 1998). According to Stiglitz, “Curiously many of the factors identified as contributors to East Asian economies’ current problems are strikingly similar to the explanations previously put forward for their success.” Here Stiglitz is referring to core results from applications of the asymmetric-information framework to the developing-country case, a method he pioneered. Stiglitz argues that because asymmetric information and incentive incompatibility are fundamental features of unregulated credit markets, those markets are prone to market failure. East Asia has defended against market failure in several ways—government coordination of resource flows, limited scope for interest-rate movements, and close instead of arms-length relationships between borrowers and lenders. The success of these measures contributed to the rapid development of these economies. Indeed, he points out that the East Asian solution to credit-market failure permitted Asian governments to channel a remarkably high proportion of national output as savings into capital accumulation without chronic market instability. Stiglitz admits that there was some misallocation of credit in East Asia. But macroeconomic fundamentals is McKinnon’s “overborrowing syndrome” model, which focuses on the inadequate regulation of domestic banks with access to overseas financial borrowing. This approach was operationalized empirically by Kaminsky and Reinhart (1996), a paper which has now provided a launching point for many applied papers on the Asian crisis.

17For example, Stiglitz and Uy argue that, “Several characteristics of financial sector interventions in East Asia stand out: they incorporated design features that improved the chances of success and reduced opportunities for abuse; interventions that did not work out were dropped unhesitatingly; and policies were adapted to reflect changing economic conditions.” (Stiglitz and Uy, 1996: 249) They go on to argue, in opposition to Krugman’s emphasis on moral hazard and government intervention in financial crises, that: “financial crises occur with remarkable frequency in the absence of government intervention. Private monitoring apparently does not suffice to prevent a financial crisis. Moreover, no single financial institution will exercise sufficient care on its own to avoid financial distress.”
there were strong, and these credit-misallocation problems do not prove that these systems are fundamentally flawed. Instead “the buildup of short-term, unhedged debt left East Asia’s economies vulnerable to a sudden collapse of confidence.” Thus, it was financial deregulation followed by excessive short-term capital inflows, not corruption or credit misallocation attributable to government guarantees or regulatory laxity, that plunged East Asia into crisis.

Clearly, then, mainstream theories of the Asian crisis are inherently incapable of explaining either the successes or the failure of the Asian model. They are thus an inadequate foundation on which to build policies for reconstructing prosperity in Asia and the rest of the world.

VI. The Triple Crisis: Korea, Asia and the Neoliberal Regime

We focus our analysis of the Asian crisis in this section on events in South Korea, by far the largest of the most affected Asian economies. Highly diversified, family-owned conglomerates, called chaebol, dominate Korea’s key export markets as well as many of its essential domestic markets. The chaebol were the vehicles used by governments over the past decades to build Korea’s technological, productivity and growth ‘miracle’. Indeed, one might say that the Korean ‘model’ consisted of state regulation of the creation and evolution of the chaebol, largely, though not exclusively, through its control of credit flows.

In the 1990s many of the chaebols’ key export markets--including semiconductor, autos, ship building, steel, petrochemicals, construction, capital goods, and electronic equipment--suffered from the chronic excess supply and secular deflationary pressure discussed above. Chaebol efforts to maintain or even increase market share thus faced fierce competition. At the same time, Korea’s long period of tight labor markets, together with political changes since the ‘revolution’ of 1987, strengthened the labor movement and put steady upward pressure on real wages. Caught between rising labor costs and downward price pressure in product markets, the chaebol sought relief by achieving high rates of productivity growth in their domestic operations and by moving lower-tech operations to the cheap labor pools of South East Asia--just as Japan had done some years earlier. Pursuing both objectives required high rates of capital investment. The chaebol undertook this investment, despite—indeed, because of--the restraints on profit rates in these industries generated by the coercive global competition.

Meanwhile, the global pool of short-term financial capital available to pursue short-term returns had increased with the expansion of Neoliberalism to gargantuan proportions: by 1997, $1.5 trillion was moving through the foreign exchange markets every day. Given the dearth of opportunities for high returns in Northern markets in the early 1990s, an increasing proportion of hot money shifted toward Asia. Global bankers and investment fund managers engaged in heated competition for the best opportunities that East Asia, South East Asia and China could offer. Loan “pushing” became the order of the day, just as in the halcyon 1970s’ buildup of Latin American debt. By 1996, over $300 billion of foreign capital was flowing into developing economies per annum, of which over $90 billion flowed to the five Asian nations that would be hardest hit by the 1997 crisis.

Of course, Korean markets would not have been open to the inflow of hot money if the traditional tight control of cross-border capital flows associated with the East Asian model had been kept intact. But powerful global agents—the G7, the OECD, the IMF, the World Bank, and
multinational banks and firms—had exerted enormous economic and political pressure on Korea and other Asian countries to deregulate domestic financial markets and capital flows, and to reduce barriers to imports and FDI. Those who resisted this pressure were threatened with hostile treatment from international agencies and restricted access to Northern goods and financial markets. Especially after the Cold War ended in the 1990s, external Neoliberal agents bullied the countries of the South without restraint.

Many of the East Asian banks, firms, and elite families that had prospered and grown powerful during the long “miracle” period came to view their future economic interests as tied more closely to developments in global than in domestic markets. Personal prosperity for many associated with these sectors increasingly depended less on national well being than on unrestricted access to foreign markets. However, this access would only be fully available if East Asian governments gave in to external pressures to liberalize domestic markets. In effect, these agents built up an increasing internal demand for liberalization, which reinforced the external pressures faced by area governments.

In Korea, the internal pressure for liberalization came primarily from the families that owned the chaebol. As noted, the chaebol felt they had to increase investment spending to survive the coercive competition they faced in their primary export markets. But their motives for undertaking this investment expansion went deeper than this. The long history of success in finding footholds in growing global markets led chaebol leaders to believe they could become even bigger global players. In the early 1990s the chaebol developed excessively ambitious plans to compete seriously with the most powerful Northern multinational corporations, challenging them market by market throughout the globe both through exports and through foreign direct investment. The rising value of the yen after 1993, which the chaebol believed to reflect a long-term trend, may have contributed to their ambitions. So both defensive and offensive motivations—the pressure to survive and the ambition to become more powerful—combined, inducing the chaebol to undertake huge mid-1990s investments in new capacity in Asia and new technology at home.

Though gross chaebol profit rates were modest, contrary to popular belief, they were not much different than their foreign competitors’ (see Chang 1998, Table 2). However, the chaebols’ high debt/equity ratios generated oppressive interest burdens, forcing net profit rates well below average. As a result, the chaebol needed substantial new credit to finance this investment program. Toward this end, they allied themselves with external Neoliberal forces to pressure the government to accelerate the pace of domestic financial market deregulation. In response, the government of Kim Young Sam permitted the establishment of 9 new merchant banks in 1994 and 15 more in 1996. Most of these were started by people who had made their fortunes in the informal curb market and had little experience in standard commercial banking. According to sources in the banking industry, the government exercised little regulatory control over these banks, and even failed to monitor them; it had little idea of these banks’ asset commitments or liabilities. This lack of banking oversight constituted a dramatic break with established East Asian practices. The chaebol took significant ownership positions in many of the new merchant banks and borrowed extensively from them, mostly short-term. Thus, the chaebol became even more indebted to domestic institutions than was usual in the high debt-to-equity tradition of the Korean and Japanese models.

The chaebol and the newly-minted merchant banks also wanted unlimited access to foreign credit markets, in part because global interest rates were up to 50% lower than those in the semi-
controlled Korean market. In particular, they pressured the government to liberalize short-term inward capital flows; that is, bank loans and portfolio capital. Liberalization of the capital account was also a requirement for membership in the OECD, which the chaebol sought in order to guarantee themselves access without discrimination to Northern goods and investment markets (Amsden and Yoon, 1997). But the Korean government, under strong pressure from the chaebol, liberalized capital flows even faster than the terms of the OECD agreement required.

In considering this aspect of Korea’s economic dynamics in the mid-1990s, it is useful to recall a central argument of some of the non-mainstream scholars cited at the beginning of section V: that the preconditions for the Korean crisis were created not by too much government interference in the private sector, or too much ‘cronyism,’ but by the government’s failure to maintain its established practices of monitoring and controlling economic activity in the national interest. Our argument here complements and extends this view; in effect, we are arguing that this government failure can be traced, in part, to Korea’s internal contradictions; the tensions set out here are among the causes of its excessive financial liberalization. In effect, external Neoliberal forces may be the main villains in this sad story, but they are not the only villains.

In any event, the classic warning signs of a financial boom-and-bust pattern were emerging in several countries of East Asia, including Korea. Global financial markets flush with money seeking to move into Asia’s ‘hot’ markets just as these governments were tearing down the barriers that had previously prevented their free entry. Fed by the euphoric glow of the East Asian boom, global investors demonstrated their usual herd behavior, trying to beat their competitors to the action.

Short-term foreign funds, mostly in the form of bank loans, poured into Korea. Some of these loans were made directly to the chaebol, but most were made to Korean banks, which in turn relented much of their loan proceeds to the chaebol. Merchant banks are believed to have used a significant portion of their foreign borrowings to speculate in financial assets elsewhere in Asia. Foreign bank debt doubled between 1994 and 1997, from approximately $60 billion to $120 billion (excluding any debt accrued by Korean banks’ foreign branches). Even so, total foreign debt was not grossly out of line with that in other countries; the key problem was that over 60% of this debt was short-term and hence due within one year or less.

As a result of this surge of capital inflows, the chaebol thus financed an ambitious and risky long-term capital investment boom primarily with short-term loans, many of which were owed to foreign lenders and therefore due in foreign currency. And the government, which had previously regulated and restrained the chaebol in the nation’s interest, helped them do it.

It was not so much the expansion program itself that was the main source of danger, though it was risky and probably excessively ambitious. After all, in response to the same competitive

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18 The difference between US and, especially, Japanese interest rates led to a wave of so-called “carry trades” in which multinational banks would borrow in Japan or the US at low rates, then re lend the money to Korean firms or banks at rates that were high enough to create attractive margins, yet were still well below domestic rates in Korea.

19 Asian economies whose governments did not choose rapid financial liberalization, such as Taiwan and China, stayed relatively insulated from the subsequent financial crisis.
pressures confronting the chaebol, major Northern MNCs were engaged in similar programs of capacity expansion across the globe in industries such as autos, steel and semiconductors, all of which were plagued by excess capacity. This is an era in which huge oligopolies are engaged in a competitive struggle to determine who will dominate global markets. The big question is: which firms will be left standing when the excess capacity created in this struggle is destroyed by deep recession, mass insolvency and bankruptcy. General Motors was expanding more or less in the same way as the Korean chaebol. The key difference in the Korean case was in the short term and foreign mode of finance of the investment boom.

Despite the fact that both the IMF and the World Bank certified the sound condition of the Korean economy in mid 1997, the stage was now set for a domestic and external financial crisis. Any of a large number of not-unlikely developments would now trigger both kinds of crisis: a devaluation of the won (which would increase the won required to repay a given dollar or yen debt), an over-valuation of the yen (which could erode export markets), increasing foreign interest rates, domestic recession, slower growth in key export markets, or any other developments affecting chaebol profit levels adversely.

Under such conditions, domestic financial turmoil could quickly induce a foreign exchange crisis, while any problem in external markets would tip the razor’s edge balance of the domestic economy. Whenever overseas banks begin to fear that borrowers in a given country may default on their short-term loans, they know that those banks that withdraw their funds first will be the least likely to suffer. The same logic holds for portfolio investors who fear a devaluation of the currency of a nation in which they have an investment position. This logic of competitive fear now held Korea in its grip. If the chaebol had trouble servicing their domestic loans, foreign banks and portfolio investors were likely to consider their own investments to be at risk and pull their money out. The situation was thus ripe for a panic or contagion which could quickly accelerate into a collapse in the won and thus force the mass defaults that investors had begun to fear. The inadequate volume of foreign reserves maintained by the Korean government, an amount equal to just three months of imports, only made the situation more precarious.

Events in the mid 1990s built toward a crisis. Devaluation of the Chinese yuan in 1994 and the Japanese yen after 1995, along with falling demand in key export markets such as semiconductors, steel, and autos, affected the current account. In 1995 the current-account deficit rose slightly to about 2% of GDP; but it reached nearly 5% of GDP, $24 billion, in 1996. In the past the government had typically responded to deterioration in the current account by devaluing quickly; but despite evidence that the won was overvalued by approximately 10%, several factors blocked such action at this time. For one thing, the huge inflow of foreign capital in this period maintained upward pressure on the won, which sterilization could not easily offset. Further, foreign investors had come to expect relative exchange rate stability in Asia; a sharp devaluation might spook them. Finally, the government feared that a falling exchange rate would make it harder for Korean firms and banks to pay back their rising foreign debt.

Korea’s current account problems did not last long; the country moved back toward balance by mid-1997. Unfortunately, they lasted just long enough to tip the country into crisis. Stagnant exports led to falling profits and increasing excess capacity for the now highly-leveraged chaebols; this resulted in some key loan defaults and an increase in domestic nonperforming bank loans in the first half of 1997. Whether Korea would have weathered this disturbance in the absence of further
problems will never be known, because in July 1997 the sharp devaluation of the previously fixed-rate Thai baht triggered financial panic across Asia. In any event, if Korea’s mid-1997 debt problems had been exclusively domestic, the economic collapse that began later that year would not have occurred. Korea would have experienced slower growth and financial difficulties, but not a depression and loss of economic sovereignty.

When the Asian crisis erupted there was a general flight of investor capital from Asian markets and currencies. Foreign banks now refused to roll the loans over. Real and financial asset prices plummeted around the region, and exchange rates went into free-fall. After losing reserves in a futile attempt to support exchange rates, countries raised interest rates to try to stop the panic. The initial declines in asset prices in turn induced further “forced” asset sales by investors unable to meet their interest payments.

The destructive Neoliberal financial infrastructure within which Asia was now embedded meant that the onset of financial crisis in any Asian country would pull down the strong as well as the weak. The won lost 20% of its value by early December, when the IMF made its deal with Korea. Firms and banks with large dollar or yen debt were pushed toward bankruptcy, their desperate efforts to acquire these currencies keeping downward pressure on the won. Interest rates rose in response to sharp rising risk; banks, pushed to the brink of default, refused to extend credit to smaller businesses. Economic growth slowed and unemployment, almost unknown in post-war Korea, rose from 2% in November to almost 3% in December. A self-reinforcing cycle of declining growth, falling profits, rising unemployment, rising interest rates, falling interest coverage ratios, and rising bankruptcies was now well under way.

As the world watched in amazement and fear, a number of Asian countries were turned from economic miracles to economic disasters in a matter of weeks! The New York Times (November 22, 1997) pointed to “the transformation of South Korea from industrial giant to industrial pauper.” Neo-liberal economists, who had previously insisted that the East Asian miracles had been generated by free market policy, not by state-led industrial policy, now claimed that the crisis was due to the same powerful but inefficient state industrial policies whose existence they had previously denied. With many banks and corporations unable to meet foreign bankers’ repayment demands, and the prospect of mass private-sector defaults on foreign debt looming, the Korean government accepted a virtual takeover of their economy by the US-controlled IMF in late December.

Pouring Fuel on the Fire: The Agreement between Korea and the US-IMF

We have argued that the evolution of the global Neoliberal regime made the eruption of a financial crisis in Asia at some time virtually inevitable. But the main agents of the Neoliberal regime did not intentionally create the Asian crisis. The crisis was the unintended outcome of its laws of motion, not the conscious objective of some international conspiracy. However, an examination of the core elements of the IMF agreement will make clear that the forces of the Neoliberal regime did consciously use the opportunity presented by the crisis to try to permanently defeat the Asian alternative to Anglo-American capitalism and open Asia to the fullest exploitation by external economic interests. Paradoxically, the consequences of the victory of the Neoliberal regime over Asian-style capitalism have fueled a global firestorm that is likely to scorch the Neoliberal regime itself as well as its constituent elites before it dies out.
The IMF agreements in Asia mandated institutional and policy changes which are unprecedented in their breadth and severity. The key elements of the IMF agreement with Korea were as follows:

- Austerity macroeconomic policies, including high interest rates and restrictive budget or fiscal policy;
- Independence of the Korean Central Bank from the rest of the government;
- Stringent banking regulations, requiring Korean banks to take immediate steps to meet the minimum capital/asset ratios specified in the 1986 Basle Accord;
- Labor law reforms allowing firms operating in Korea to fire workers at will;
- The removal of restrictions on imports, including Korea’s virtual prohibition of the importation of Japanese autos;
- The removal of restrictions of foreign ownership of Korean banks and firms;
- The elimination of all forms of government influence over both domestic and international capital flows—including short-term capital inflows, which had triggered the immediate crisis.

The imposition of sky-high interest rates (including short rates as high as 30% at the beginning in December and January), restrictive fiscal policy, and tough new banking standards devastated output, employment and financial resiliency. Korean banks have always operated with lower equity/asset ratios (higher debt/equity ratios) than are permitted by the free-market oriented Basle standards. When the loan defaults of the crisis left them near insolvency, the imposition of the Basle standards forced banks to drastically cut loans, especially to small and medium size businesses. The resulting credit crunch then forced more firms into loan default, leaving banks even further away from compliance with the Basle standards. Together these policies created an ever-deteriorating cycle of bankruptcies, bank failures, declining production and rising unemployment. The vastly understated official unemployment rate has approached 8%, the highest rate in decades, and may climb above 10%—this in a country without a social safety net.

While devastating to the Korean economy, this wave of destruction created advantages for external forces and, to some extent, the chaebol. The collapse of the Korean economy has led to a large current account surplus—perhaps $35 billion in 1998, gained solely through a massive collapse of imports. This surplus will provide the dollars needed to repay the foreign banks and the IMF. And the depressed stock market and undervalued won associated with the crisis make it possible for foreigners to buy Korean firms and banks at rock bottom prices. Labor law "reform," in turn, has already severely weakened the Korean labor movement, and in so doing, has begun to create the labor market “flexibility” demanded both by the chaebol and by foreign multinationals wishing to buy Korean firms.20 The independent Bank of Korea, as expected, has pursued the objectives of domestic and foreign rentiers rather than those of the Korean people. It maintained high interest rates

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20The struggle in Korea in the aftermath of the IMF agreements is described in Crotty and Dymski, 1998a, 1998b, and 1998c. These articles pay particular attention to the attempt by the Korean Confederation of Trade Unions, the more independent, democratic and militant of the two major Korean union federations, to prevent the implementation of radical Neoliberal restructuring in Korea.
right through mid-summer, even as the credit crunch worsened and the economy collapsed. And, of course, the IMF dollars that came with the agreement were recycled to foreign lenders, thus avoiding, at least temporarily, a severe crisis of the global banking system.

The last three elements of the agreement open the Korean economy to unrestricted foreign exploitation. The US had been trying for decades to penetrate the Korean economy with only moderate success: it looks like the IMF will finally get the job done. Note that at present, about 99% of cars purchased in Korea are made by Korean firms. This will change dramatically when Toyota and Honda have unrestricted access to the market next year.

Taken together, the full implementation of these provisions would dismantle the structures and policy tools used by successive Korean governments to regulate business in the national interest—and hence to create the Korean economic “miracle”. For example, these conditions eliminate the government's ability to allocate domestic credit flows and regulate cross-border capital flows—the cornerstone of the Korean development model. If these agreements are permanently implemented, Korea will lack the tools needed to reconstruct a non-Neoliberal, East Asian style system. Korea will then end up Neoliberalized—like Mexico, Argentina, and Brazil before it. Elite families and some powerful banks and firms may prosper; but the labor movement will deteriorate and two-thirds of the Korean population will face persistent economic insecurity and falling wages.

**Internal and External Elites in Come Together in Asia: Why the Korea Government Accepted the IMF Agreement**

Most Koreans believe that the government had no choice but to accept whatever demands the US and IMF made, no matter how harmful to Korea’s sovereignty and its economic future, because the costs of debt default or even a temporary debt moratorium would have been more catastrophic.

But it is quite likely that Korea could have held out for a less destructive agreement. To succeed at this, the government would have had to make a credible threat to proceed without an agreement if IMF and US demands became excessively destructive. For example, the government could have threatened to let Korean banks and firms default on their foreign bank loans. Alternatively, the government could have imposed a temporary moratorium on principal repayments (such as the one later imposed by Russia). The crucial point is that Korea did not need a “good” fallback position in order to credibly threaten to reject the devastating agreement offered by the IMF. In a bargaining situation, a threat whose enactment would severely damage its maker can be effective if it is sufficiently dangerous to the other participants as well. Prospective large-scale Korean defaults did pose a severe threat to other parties directly and indirectly involved in the negotiations. The risk was not just to Japanese, European and American banks: the international financial system itself could have been thrown into crisis if investors lost confidence in the IMF's

21Interestingly, in June 1998, when it had become clear that the economic collapse per se was not leading to a spontaneous economic restructuring of the sort the Neoliberals had in mind, the government stepped in and took direct administrative control of the restructuring process. We thus see once again that the Neoliberal commitment to free markets and disapproval of government interference in economic activity apparently evaporates when the interests of its constituent agents are not being well served by market processes alone.
ability to organize and lead an all-powerful global creditors' cartel. In sum, it would have been irrational for the IMF to refuse to aid Korea and risk a global financial crisis just because the government would accept some, but not all of its demands. The costs of a collapse of negotiations to the IMF and its backers would have exceeded the benefits from holding out for the disputed demands.

Why then did the government accept this remarkably onerous agreement? Answering this question again takes us back to the evolution of the Neoliberal regime. By the 1990s, internal and external elites had, to a significant degree, adopted similar beliefs concerning economic policies and structures. Powerful internal forces in Korea wanted much of the IMF deal for their own interests.

Discussions we held in March with representatives of the chaebol and with government officials established, to our surprise, that the chaebol were generally positive about the IMF agreement—though they were not at all happy with the imperious mode of its design and implementation. While they objected to some elements of the agreement, especially the dangerously high interest rates and the opening of the Korean economy to unrestricted Japanese imports, they believed the IMF deal would help them accomplish two key domestic economic and political objectives. First, the agreement would permanently undermine the power of the labor movement, paving the way for falling wages, labor market flexibility, and permanent job insecurity. Second, the agreement would give the chaebol complete independence from government regulation. If fully implemented, the agreement would create freedom for the chaebol to pursue company profits and owning-family financial interests inside Korea or around the globe, no matter what effect their decisions might have on the majority of the Korean people. So with the most powerful force in Korea now ready to substantially align itself with IMF objectives, a credible government threat of default or debt moratorium failed to emerge.

An analysis of the Korean side of the negotiations leading to the IMF agreement reinforces a key point made earlier. The evolution of the Neoliberal regime helped create economic and political elites in Asia that eventually saw their material interests as being aligned more closely with external Neoliberal agents than with the workers and citizens of their own countries. They became a domestic fifth column, working to destroy the foundations of the traditional Asian models from within.

The Asian IMF Agreements and the Future of the Neoliberal Regime

The IMF agreements in Asia were clearly understood in the West to signal the final defeat of Asian-style capitalism in the war between the systems. Former US Secretary of State Henry Kissinger commented that “what we are trying to engineer in some of these countries is clearly a revolution,” while Federal Reserve Chairman Alan Greenspan proclaimed that “one of the most fundamental effects of the Asian crisis was ‘a worldwide move toward the Western form of free market capitalism’ instead of the competing Asian approach that only a few years ago looked like an attractive alternative model for nations around the world” (NY Times, 2/13/98). This triumphalism was summed up nicely by a Wall Street Journal headline which simply stated, “We Won”.

But our analysis suggests that this will turn out to be a Pyrrhic victory. The ultimate cause of the Asian crisis lies in the contradictions of the global Neoliberal regime itself, most fundamentally in its chronic deficiency of aggregate demand. The policies of the IMF constitute one of the system’s many sources of demand restraint. In response to the outbreak of the financial crises built into the
structure of the Neoliberal regime, the IMF has imposed austerity policies on scores of developing countries. Indeed, Asia has been the only high-growth area in the world over the past twenty years. In the 1990s about half the growth in global GDP has taken place in East and South East Asia, even though only about 25% of global production originates there. By ‘conquering’ Asia and forcing it into deep recession and perhaps depression, the IMF has increased global demand deficiency qualitatively. This cannot help but accelerate the ferocity of predatory and destructive competition sweeping global markets, creating even more severe problems of profitability, excess capacity, financial instability, banking crises, and commodity price deflation.

Current estimates of the expected rate of decline of real GDP in Asia in 1998 include: 2.5% in Japan, 15% to 20% in Indonesia, 7% in Malaysia, 8% in Thailand, 5% in Hong Kong, and 8% in Korea (New York Times, October 2, 1998). The impact of this economic collapse and the massive capital flight accompanying it has already spread to Russia, Latin America, and to US financial markets. Forecasts of a mild US recession in 1999 are now commonplace. With 40% of global GDP generated by countries already in recession, the end of growth in Europe and the US would quite likely lead to a global depression and deflation of historic proportions. In the end, even the global elites who created the Neoliberal regime and have received disproportionate shares of its booty will be unable to insulate themselves from the destructive dynamics they have unleashed.

VII. Policy Implications

Our analysis of the Korean crisis puts substantial emphasis on the large flows of short-term foreign capital that flooded the recently liberalized Korean economy in the mid 1990s. Such emphasis is consistent with the focus placed on large, volatile short-term capital movements in most mainstream and heterodox writings on the Asian crisis. Clearly the $105 change in net capital flows to Korea, Malaysia, Indonesia, Thailand and the Philippines—from a $93 billion net inflow in 1996 to a $12 billion outflow in 1997—an amount equal to more than 10% of the area’s pre-crisis GDP, played a major role in triggering the problems under review. This would be equivalent to a change in net capital flows of about $850 billion in the US economy, which would create an unimaginable degree of instability in US financial markets.

However, we have also attempted to look beneath unstable cross-border financial flows to the structure of the global economic regime within which these financial dynamics were taking place. A complete understanding of the causes and consequences of the Asian crisis, encompassing ultimate as well as proximate causes, requires an investigation of the basic contradictions of the global Neoliberal regime. But we stress the importance of a theory of the Neoliberal regime not just because it helps us better understand the current crisis, but also because it creates a policy perspective quite different from the one associated with most mainstream and heterodox crisis studies.

Neoclassical economists who acknowledge the existence of flaws in global capital markets have proposed that developing countries that experience foreign exchange problems be permitted to utilize certain kinds of temporary controls on inward, but not outward, short-term capital movements. Many heterodox economists go further. They support the use of permanent capital controls as part of the reconstruction of new versions of the East Asian model, ones better suited to current economic conditions and based on more genuine democratic control of the state than were their predecessors. See, for example, Chang (1998).
But our analysis of the crisis suggests that neither of these policy positions is fully adequate, either to repair the damage caused by the current global economic crisis, or to guide the creation of a global economic environment within which long-term, sustainable, egalitarian, high-employment growth is possible in both the North and the South. If we are correct, no new Golden Age era will be possible unless and until the fundamental structures and policies of the global Neoliberal regime are destroyed and replaced by institutions that support buoyant global aggregate demand, facilitate egalitarian national public and private sector institutions and rules-of-the-game, and tolerate different national paths to economic development. Of course, our argument does not suggest that pursuit of objectives short of a reconstitution of the structures of the global economic system are not of the utmost importance. On the contrary, the reimposition of national capital controls in pursuit of the reconstruction of effective and progressive national industrial policies are quite likely preconditions for success in the larger project. The key point is this: if we do not create global institutions that support such progressive national programs, it is far less likely that anyone will be able to successfully construct and maintain them.

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Journal of Economics 22(6), August.