What does Joe Stiglitz's Nobel-Prize-winning research have to do with this indictment of the IMF and its banker friends?

No doubt, Stiglitz could come up with something in a flash – he's as quick on his feet as he is passionate about political economy. But this excerpt from *Globalization and its Discontents** stands on its own. ¶ One interesting sub-theme worth noting in Stiglitz's brief career as a policymaker is his role as critic from within the economics establishment. I would put him on a short list of gadflies (along with Jeff Sachs, also of Columbia University) who have resisted the profession's drift to the right on issues of development and international finance. ¶ Is this attack of the multilateral lenders' role in the Asian financial crisis on target? The jury is out. But I'd certainly rather read Stiglitz on the subject than parochial critics of globalization who want to roll back the clock to 1956. – *Peter Passell*

**©2002 Joseph Stiglitz. Reprinted with permission from W.W. Norton & Company*

When the Thai baht collapsed on July 2, 1997, no one knew it was the beginning of the greatest economic crisis since the Great Depression – one that would spread from Asia to Russia and Latin America, and threaten the entire world. For 10 years, the baht had traded at around 25 to the dollar; then overnight it fell by 25 percent. Currency speculation spread and hit Malaysia, South Korea, the Philippines and Indonesia, and by the end of the year what had started as an exchange-rate disaster threatened to take down many of the region's banks, stock markets and even entire economies.

The crisis is over now, but countries like Indonesia will feel its effects for years. Unfortunately, the policies imposed by the International Monetary Fund during this tumultuous time worsened the situation. Since the IMF was founded precisely to avert and deal with crises of this kind, the fact that it failed in so many ways has led to a major rethinking of its role, with many calling for an overhaul of the IMF's policies and the institution itself.

Indeed, in retrospect, it became clear that the IMF not only exacerbated the downturns but also was partially responsible for their onset. Excessively rapid financial- and capital-market liberalization was probably the single most important cause of the crisis, though mistaken policies on the part of the countries themselves played a role as well. Today, the IMF acknowledges many, but not all, of its mistakes. Its officials realize how dangerous, for instance, excessively rapid capital-market liberalization can be. However, the admission comes too late to help the countries afflicted.

Over the preceding three decades, East Asia had not only grown faster and done better at reducing poverty than any other region of the world, but it had been spared the ups and downs that mark all market economies. Indeed, so confident had the IMF been about the region that it reportedly assigned a loyal staff member as director for the region as an easy preretirement posting.

When the crisis broke out, I was surprised at how strongly the IMF and the United States Treasury criticized the countries. According to the IMF, the Asian nations' institutions were rotten, their governments corrupt, and wholesale reform was needed. How, I wondered, if these countries' institutions were so rotten, had they done so well for so long? The difference in perspectives between what I knew about the region and what the IMF and the Treasury alleged made little sense until I recalled the debate that had raged over the East Asia miracle itself.

The IMF and the World Bank had almost consciously avoided studying the region – though it would have seemed natural for them to turn to it for lessons for others. It was only under pressure from the Japanese that the World Bank had undertaken the study of economic growth in East Asia, and then only after the Japanese had offered to pay for it. The reason was obvious: the countries had been successful not only in spite of the fact that they had not followed the dictates of the so-called Washington consensus, but also because they had not. Though the experts' findings were toned down in the final report, the World Bank's Asian Miracle study laid out the important roles that government had played. These were far from the minimalist roles beloved of the Washington consensus.

There were those, not just in the international financial institutions but in academia,

who asked, was there really a miracle? "All" that East Asia had done was to save heavily and invest well! But this view misses the point. No other set of countries around the world had managed to save at such rates and invest the funds well. Government played an important role in enabling East Asia to accomplish both things simultaneously.

When the crisis broke out, it was almost as if many of the region's critics were glad; their perspective had been vindicated. While they were loath to credit the region's governments with any of the successes of the previous quarter century, they were quick to blame the governments for the failings.

Whether one calls it a miracle or not is beside the point: the increases in incomes and the reductions in poverty in East Asia over the last three decades have been unprecedented. No one visiting these countries can fail to marvel at the developmental transformation – the changes not only in the economy but also in society. Thirty years ago, thousands of backbreaking rickshaws were pulled for a pittance; today, they are only a photo opportunity for the camera-snapping tourists flocking to the region.

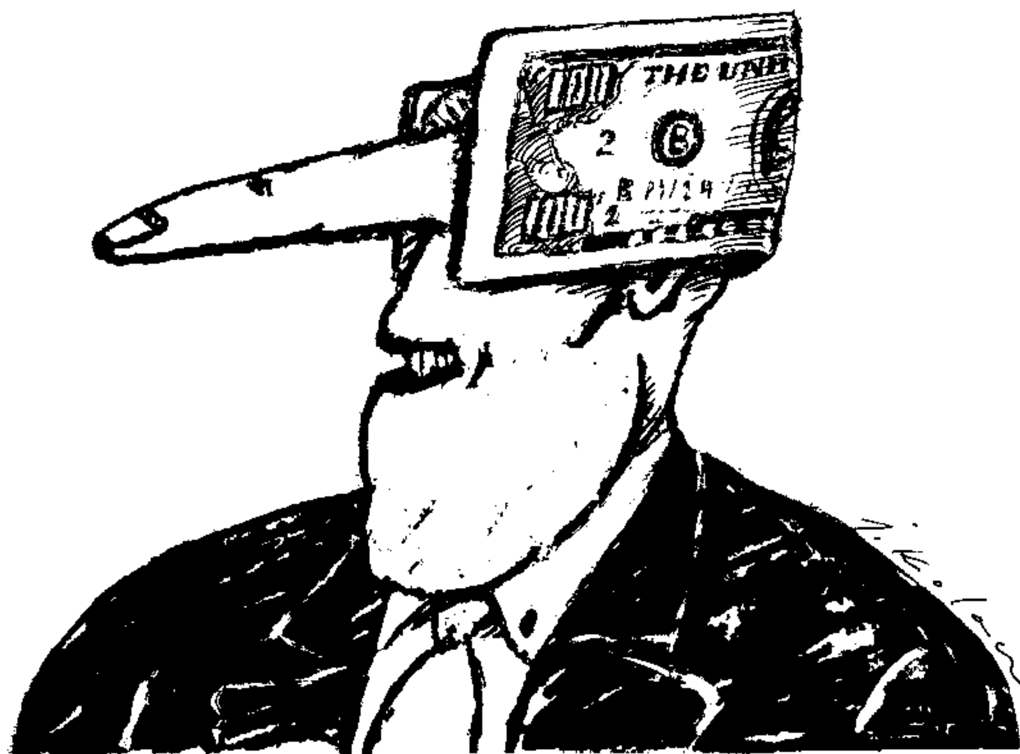
The combination of high savings rates, government investment in education and state-directed industrial policy all served to make the region an economic powerhouse. Growth rates were phenomenal for decades and the standard of living rose enormously for tens of millions of people. The benefits of growth were shared widely. There were problems in the way the Asian economies developed. But overall, the governments had devised a strategy that worked, a strategy that had but one item in common with the Washington consensus' policies: the importance of macro stability.

As in the Washington consensus, trade was important, but the emphasis was on promoting exports, not removing impediments to imports. While the Washington Consensus' policies emphasized rapid financial and capital market liberalization, the East Asian countries liberalized only gradually. Some of the most successful, like China, still have a long way to go.

In the Washington Consensus' view, industrial policies in which governments try to shape the future direction of the economy are a mistake. But the East Asian governments took that as one of their central responsibilities. In particular, they believed that if they were to close the income gap between themselves and the more-developed countries, they had to close the knowledge and technology gap. So they designed education and investment policies to do that. While the Washington Consensus' policies paid little attention to inequality, they believed that such policies were important for maintaining social cohesion, and that social cohesion was necessary to provide a climate favorable to investment and growth.

When the crisis began, those in the West did not realize its severity. Asked about aid for Thailand, President Bill Clinton dismissed the collapse of the baht as "a few glitches in the road" to economic prosperity. Clinton's confidence and imperturbability was shared by other world financial leaders who attended the annual meeting of the IMF and the World Bank in Hong Kong in September 1997. IMF officials were so sure of their advice that they even asked for a change in its charter to allow them to put more pressure on developing countries to liberalize capital markets.

Meanwhile, Asian leaders were terrified. They viewed the hot money that came with liberalized capital markets as the source of their problems. They knew that major trouble was ahead. They feared that IMF policies



would prevent them from taking the actions needed to stave off the crisis, and that the policies the IMF would insist upon should a crisis occur would worsen the impact. But they felt powerless to resist. In the end, only Malaysia was brave enough to risk the wrath of the IMF. And though Prime Minister Mahathir Mohamad's policies – keeping interest rates low, putting brakes on the rapid outflow of speculative money – were attacked from all quarters, Malaysia's downturn was shorter and shallower than that of the other countries.

At the Hong Kong meeting, I suggested to the ministers of the Southeast Asian countries that there were some concerted actions they could take together. If they all imposed capital controls in a coordinated way, they might be able to withstand the pressures that would undoubtedly be brought down upon them by the international financial community, and they could help insulate their economies from the turmoil. They talked about getting together later in the year to map out a plan. But hardly had their bags been unpacked from the trip to Hong Kong than the crisis spread – first to Indonesia, and then, in early December, to South Korea. Meanwhile, countries from Brazil to Hong Kong had been attacked by currency speculators, and withstood the attack at high cost.

There are two familiar patterns to these crises. The first is illustrated by South Korea. As it emerged from the wreckage of the Korean War, South Korea formulated a growth strategy that increased per capita income eightfold in 30 years, reduced poverty dramatically, achieved universal literacy, and

went far in closing the gap in technology between itself and the more advanced countries. By the beginning of the 1990s, South Korea had become one of the world's largest producers of computer chips, and its large conglomerates produced goods known throughout the world.

But whereas in the early days of its transformation Korea had tightly controlled financial markets, under pressure from the United States it had reluctantly allowed its firms to borrow abroad. The firms thus exposed themselves to the vagaries of the international market. In late 1997, rumors flashed through Wall Street that Korea was in trouble. Such rumors can be self-fulfilling prophecies. The banks, which a short time earlier were so eager to lend money to Korean firms, decided not to roll over their loans. Their prophecy thus came true: Korea was in trouble.

Ordinary people as well as many government officials and business people continue to refer to the economic and social storm that hit their nations simply as "the IMF" – the way one would say "the plague" or "the Great Depression."

The second was illustrated by Thailand. There, a speculative attack combined with high short-term indebtedness was to blame. Speculators who believe a currency will devalue try to move out of the currency and into dollars; with free convertibility this can easily be done. But as traders sell the currency, its value is weakened – confirming their prophecy. Alternatively, and more commonly, the government tries to support the currency. It sells dollars from its reserves, buying up the local currency to sustain its value. But eventually the government runs out of hard currency. The currency plummets. The speculators are satisfied. If the crises had a familiar pattern, so too did the IMF's responses: it loaned huge amounts of money so that the countries could sustain their exchange rates. It thought that if the market believed that there was enough money in the coffers, there would be no point in attacking the currency, and thus confidence would be restored.

The money served a second function: enabling the countries whose firms had borrowed from Western bankers to repay the loans. It was thus a bailout to the international banks as much as it was a bailout to the borrowers. And in country after country in which the IMF money was used to sustain the exchange rate temporarily at an unsustainable level, rich people took advantage of the opportunity to convert their money into dollars at the favorable exchange rate and whisk it abroad.

The IMF combined the money with conditions in packages that were supposed to rectify the problems that caused the crisis. It is these other ingredients, as much as the money, that were supposed to persuade markets to roll over their loans, and to persuade speculators to look elsewhere for easy targets. The ingredients typically include higher interest rates – in the case of East Asia, much, much higher rates – and cutbacks in govern-

ment spending and increases in taxes. Additional conditions required countries to make political as well as economic changes – major reforms, including increased openness and transparency, and improved financial-market regulation.

The IMF would claim that imposing these conditions was the responsible thing to do. It was providing billions of dollars; it had a responsibility to make sure that the countries did the right thing to restore their economic health.

The programs failed. Exchange rates continued to fall, with hardly a flicker of recognition by the markets that the IMF had come to the rescue. In each case, an embarrassed IMF charged the country with failing to take reforms seriously. In each case, it announced there were fundamental problems that had to be addressed before a true recovery could take place. Investors, more convinced by the diagnosis of the problems than by the prescriptions, fled. Rather than restoring confidence that would lead to an inflow of capital, IMF criticism exacerbated the stampede of capital out.

Because of this, the perception throughout much of the developing world is that the IMF itself had become a part of the countries' problem rather than part of the solution. Indeed, in several countries in crisis, ordinary people as well as many government officials and business people continue to refer to the economic and social storm that hit their nations simply as "the IMF" – the way one would say "the bubonic plague" or "the Great Depression."

As the crisis progressed, unemployment soared, GDP plummeted and banks closed. In Indonesia, almost 15 percent of males working in 1997 had lost their jobs by August 1998. In South Korea, urban poverty almost tripled. In 1998, GDP in Indonesia fell by 13.1 percent, in Korea by 6.7 percent, and in Thailand by 10.8 percent. Three years later, Indonesia's GDP was still 7.5 percent below what it was before the crisis, Thailand's 2.3 percent lower. The erosion of the middle class, caused by usurious interest rates that threw small businesses into bankruptcy, will have the most enduring effects on the social, political and economic life of the region.

With the slowing of global economic growth, commodity prices fell. From Russia to Nigeria, the many emerging countries that depended on natural resource exports were in deep, deep trouble. As investors who had risked their money in these countries saw their wealth plummeting, and as their bankers called in their loans, they had to cut back their investments in other emerging markets. Brazil, dependent on neither oil nor on trade with the countries in deep trouble, and with economic features far different from these countries, was brought into the unfolding global financial crisis by the generalized fear among foreign investors. Eventually, almost every emerging market was affected.

HOW IMF/U.S. TREASURY POLICIES LED TO THE CRISIS

The disturbances capped a half-decade of an American-led global triumph of market economics following the end of the cold war. Investors saw newly emerging markets, from East Asia to Latin America to Russia to India, as a paradise of high returns and seemingly low risk. Private capital flows from the developed to the less developed countries increased seven-fold in seven years

The IMF and the United States Treasury argued that full capital-account liberalization would help the region grow even faster. The countries in East Asia had no need for additional capital, given their high savings rate, but still capital-account liberalization was

pushed on these countries in the late 80s and early 90s.

I believe that capital-account liberalization was the single most important factor leading to the crisis. It has also become increasingly clear that all too often capital-account liberalization represents risk without a reward. Even when countries have strong banks, a mature stock market, and other institutions that many of the Asian countries did not have, it can impose enormous risks.

Probably no country could have withstood the sudden change in investor sentiment that reversed the huge inflow of capital. In the case of Thailand, this reversal amounted to 7.9 percent of GDP in 1997, 12.3 percent of GDP in 1998, and 7 percent of GDP in the first half of 1999. While developing countries' ability to withstand the reversal was weak, so, too, was their ability to cope with the consequences of a major downturn.

Their remarkable economic performance meant that the East Asian countries had not developed unemployment insurance plans. But even had they turned their mind to the task, it would not have been easy. Even in the United States, unemployment insurance for those who are self-employed in agriculture is far from adequate, and this is precisely the sector that dominates economies in the developing world.

The complaint against the IMF, however, runs deeper; it is not just that it pushed the liberalization policies that led to the crisis, but in addition that it pushed these policies even though there was little evidence that they promoted growth and there was ample evidence that they imposed huge risks.

In October 1997, the IMF was advocating the expansion of precisely those polices that underlay the increasing frequency of crises. As an academic, I was shocked that the IMF and the U.S. Treasury would push this agenda with such force in the face of a virtual absence of theory and evidence suggesting that it was in the economic interests of either the developing countries or global economic stability. Surely, one might have argued, there must be some basis for their position beyond serving the naked self-interest of lenders and investment bankers.

The advocates of capital-market liberalization came up with an argument that even at the time I thought was unconvincing, but in retrospect looks particularly strange – namely, that it would enhance the countries' economic stability! This was to be achieved by allowing greater diversification of sources of funding.

It is hard to believe that these advocates had not seen the data that showed that capital flows were procyclical – capital flows out of a country in a recession, precisely when the country needs it most, and flows in during a boom, exacerbating inflationary pressures. Sure enough, just at the time the countries needed outside funds the bankers asked for their money back.

There was a second, hardly more credible argument put forward by the advocates of capital-market liberalization. They contended that capital market controls impeded economic efficiency and that, as a result, countries would grow faster without these controls.

Before liberalization, Thailand had severe limitations on the extent to which banks could lend for speculative real estate. It had imposed these limits because it believed that investing the country's scarce capital in manufacturing would both create jobs and enhance growth. It also knew that throughout the world, speculative real estate lending gives rise to bubbles. These bubbles always burst, and when they do, the economy crashes.

The IMF, however, contended that the kinds of restraints Thailand had imposed to

prevent a crisis interfered with efficient market allocation. If the market says build office buildings, commercial construction must be the highest-return activity. While Thailand was desperate for more public investment to strengthen its infrastructure and relatively weak secondary and university education systems, billions were squandered on commercial real estate. These buildings remain empty today, sad testimony to the risks posed by excessive market exuberance and the pervasive market failures that can arise in the presence of inadequate regulation of financial institutions.

THE FIRST ROUND OF MISTAKES

There is little doubt that IMF and U.S. Treasury policies contributed to an environment that enhanced the likelihood of a crisis by encouraging – in some cases insisting on – rapid financial and capital-market liberalization. However, the IMF and Treasury made their most profound mistakes in their initial response to the crisis.

At the onset, the IMF seemed to have misdiagnosed the problem. It had handled crises in Latin America that were caused by profligate government spending and loose monetary policies, which led to huge deficits and high inflation. And while it may not have handled those crises well – the region experienced a decade of stagnation after IMF intervention – it at least had a game plan with some coherency. East Asia was vastly different from Latin America; governments ran surpluses and economies enjoyed low inflation,

but corporations were deeply indebted.

The diagnosis made a difference for two reasons. First, in East Asia the problem was not excess demand for goods and services but insufficient demand. Thus dampening demand could only make matters worse. Second, if firms have a low level of indebtedness, high interest rates can be absorbed. But with high levels of indebtedness, imposing high interest rates is like signing a death warrant for many firms – and for the economy.

While the Asian economies did have some weaknesses that needed to be addressed, they were no worse than those in many other countries – and surely nowhere near as bad as the IMF suggested. Indeed, the rapid recovery of South Korea and Malaysia showed that, in large measure, the downturns were not unlike the dozens of recessions that have plagued market economies in the advanced industrial countries in 200 years of capitalism. If East Asia was vulnerable, it was largely the result of the financial-market liberalization for which the IMF was itself partly culpable.

Hooverite Contractionary Policies: An Anomaly in the Modern World

For more than 70 years, there has been a standard recipe for a country facing a severe economic downturn. The government must stimulate aggregate demand by cutting taxes, increasing expenditures, or loosening monetary policy. The crisis economies of East Asia were clearly threatened with a major downturn and needed stimulation. The IMF pursued the opposite course, with predictable consequences.

At the onset of the crisis, East Asia was in rough macro balance, with low inflationary pressures and government budgets in balance or having a surplus. This had two obvious implications. First, the collapse of the exchange rate and the stock markets, the breaking of the real estate bubbles, accompanied by falling investment and consumption, would send it into a recession. Second, the economic collapse would result in collapsing tax revenues, and leave a budget gap. Not since Herbert Hoover's administration have responsible economists argued that one should focus on the actual deficit rather than the structural deficit – that is, the deficit that would have been there had the economy been operating at full employment. Yet this is precisely what the IMF advocated.

Today, the IMF admits that the fiscal policy it recommended was excessively austere. During the crisis, however, Stanley Fischer, the IMF's first deputy managing director, defended the IMF's policies, writing, in effect, that all the IMF was asking of the countries was to balance their budgets! Not for 60 years have respectable economists believed that an economy going into a recession should balance its budget.

Beggar-Thyself Policies

Of all the mistakes the IMF committed as the East Asian crisis spread in 1997 and 1998, one of the hardest to fathom was its failure to recognize the important interactions among the policies pursued in the different countries. By continuing to advocate contractionary policies, the IMF exacerbated the spread of the downturn from one country to the next.

The beggar-thy-neighbor policies of the 1930s are generally thought to have played an important role in the spread of the Great Depression. Each country tried to bolster its own economy by cutting back on imports and thus shifting consumer demand to its own products. However, as each country cut back on imports, it succeeded in exporting the economic downturn to its neighbors.

The IMF devised a strategy whose effect was even worse. Countries were told that

when facing a downturn, they must cut their trade deficits, and even build surpluses. The IMF also inveighed strongly against further devaluation. Indeed, the whole point of the bailouts was to prevent a further decrease in the exchange rate. This itself might seem peculiar, given the IMF's faith in markets. Why not let market mechanisms determine exchange rates, just as they determine other prices? But intellectual consistency has never been the hallmark of the IMF, and its single-minded worries about inflation being set off by devaluation have always prevailed.

With tariffs and devaluations ruled out, there were but two ways to build a trade surplus. One was to increase exports. But this is not easy when the economies of your major trading partners are weak and your own financial markets are in disarray, which means that exporters cannot obtain capital with which to expand. The other was to reduce imports by cutting domestic demand – that is, by inducing a recession. Unfortunately this is what happened in East Asia in the late 1990s. Contractionary fiscal and monetary policies combined with misguided financial policies led to massive economic downturns, which led to huge trade surpluses and gave the countries the resources to pay back foreign creditors.

If one's objective was to increase the size of reserves, the policy was a success. But at what expense to the people in the country, and their neighbors! The consequence for any country's trading partners was exactly the same as if beggar-thy-neighbor policies had actually been pursued. Each country's imports were cut back, which is the same as other countries' exports being cut. From the neighbors' perspectives, they couldn't care less why exports were cut; what they saw was the consequence – a reduction of sales abroad.

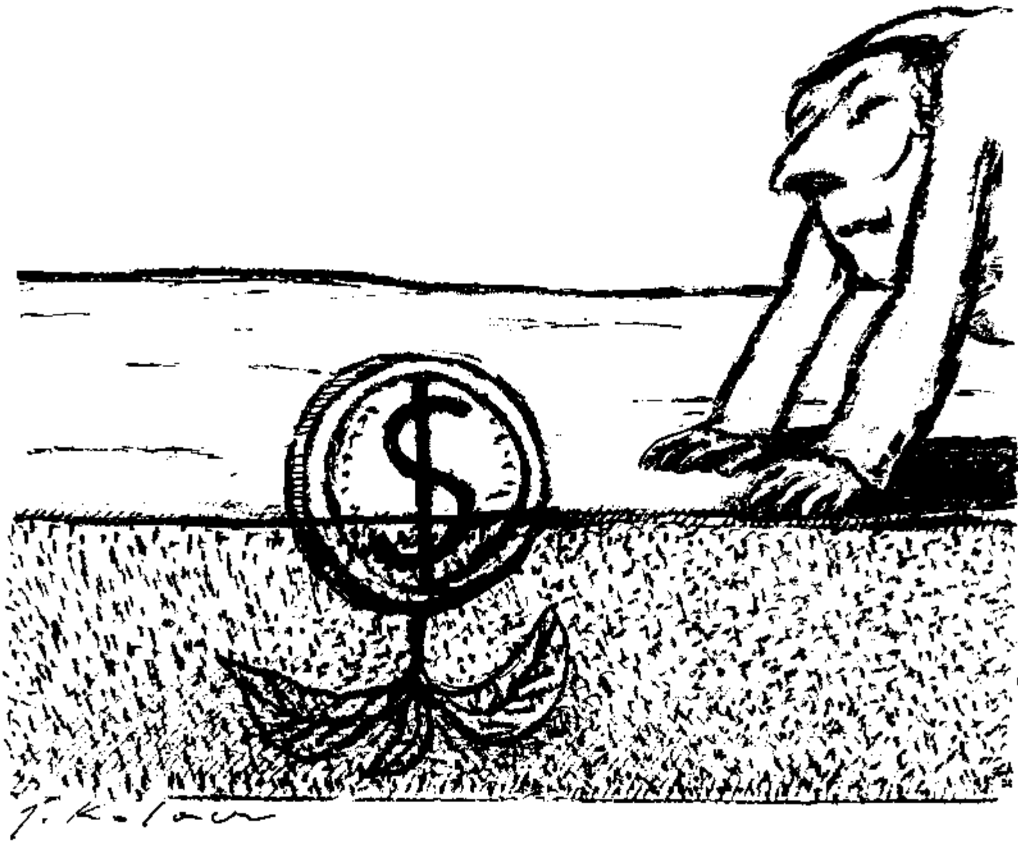
In focusing on protecting investors, it had forgotten about those in the countries it was supposed to be helping.

Thus, the downturn was exported around the region. Slower growth in the region led to a collapse in commodity prices, and the collapse in those prices wrought havoc in oil-producing countries like Russia.

Of all the failures of the IMF this is perhaps the saddest because it represented the greatest betrayal of its raison d'être. More generally, the IMF's performance as market psychologist left something to be desired. Creating deep recessions with massive bankruptcies and/or pointing out deep-seated problems in the best-performing region of the emerging markets are policies hardly designed to restore confidence. In focusing on protecting investors, it had forgotten about those in the countries it was supposed to be helping; in focusing on financial variables like exchange rates, it had almost forgotten about the real side of the economy. The IMF had lost sight of its original mission.

Strangling an Economy with High Interest Rates

Today, the IMF agrees that the fiscal policies it pushed were excessively contractionary, but it does not own up to its mistakes in monetary



policy. When the IMF entered East Asia, it forced countries to raise interest rates to what, in conventional terms, would be considered astronomical levels. I remember meetings where President Clinton was frustrated that the Federal Reserve Bank was about to raise interest rates one-quarter or one-half percentage point. Yet in East Asia, IMF bureaucrats, who were even less politically accountable, forced interest rate increases not 10 but 50 times greater – interest rate increases of more than 25 percentage points.

The reasoning behind these policies was simple, if not simplistic. If a country raised interest rates, it would make it more attractive for capital to flow into that country. Capital flows into the country would help support the exchange rate and thus stabilize the currency. End of argument.

At first glance, this appears logical. However, recall that in South Korea the crisis was started by foreign banks refusing to roll over their short-term loans because they worried about South Korean firms' ability to repay. Bankruptcy – default – was at the center of the discussion. But in the IMF model, bankruptcy plays no role. To discuss monetary policy and finance without bankruptcy is like Hamlet without the Prince of Denmark. Many of the firms in East Asia were highly indebted, and had huge debt-to-equity ratios. Indeed, even the IMF had repeatedly cited the excessive leverage as one of South Korea's weaknesses. At very high interest rate levels, a highly leveraged company goes bankrupt quickly.

In defending its policies, the IMF said they would help restore market confidence. But

clearly, deep recessions do not inspire confidence. On the contrary, the higher rates made the recession worse and actually drove capital out of the country.

The IMF came up with another defense of no more validity. It argued that if interest rates were not greatly increased, the exchange rate would collapse and those with dollar-denominated debts would not be able to repay them. But raising interest rates did not stabilize the currencies. Moreover, the IMF never bothered to look at the details of what was going on inside the countries. In Thailand, for instance, it was the already-bankrupt real estate firms and those that lent to them that had the most foreign-denominated debt. Further devaluations would not have made these firms any more dead. In effect, the IMF made the small businesses and other innocent bystanders pay for those who had engaged in excessive dollar borrowing – and to no avail.

In Indonesia, an estimated 75 percent of all businesses were put into distress, while in Thailand close to 50 percent of bank loans became nonperforming loans. Unfortunately, it is far easier to destroy a firm than to create a new one. Lowering interest rates would not unbankrupt a firm that had been forced into bankruptcy; its net worth would still have been wiped out. The IMF's mistakes were costly, and slow to reverse.

Naive geopolitical reasoning, vestiges of Kissinger-style realpolitik, compounded the consequences of these mistakes. In 1997, Japan offered $100 billion to help create an Asian Monetary Fund to finance the required stimulative actions. But the U.S. Treasury did everything it could to squelch the idea. The IMF joined in.

The reason was clear: while the IMF was a strong advocate of competition in markets, it did not want competition in its own domain, and the Asian Monetary Fund would have provided that. The U.S. Treasury's motivations were similar. As the only shareholder of the IMF with veto power, the United States had considerable say in IMF policies. It was widely known that Japan disagreed strongly with the IMF's actions – I had repeated meetings with senior Japanese officials in which they expressed misgivings that were almost identical to my own. With Japan, and possibly China, as the likely major contributors to the Asian Monetary Fund, their voices would predominate, providing a real challenge to American leadership – and control.

Eventually, Secretary of the Treasury Lawrence Summers and Stanley Fischer at the IMF could not ignore the depression. Japan once again made a generous offer to help under the Miyazawa Initiative, named after Japan's finance minister. This time, the offer was scaled down to $30 billion, and was accepted. But even then, the United States argued that the money should be spent not to stimulate the economy through fiscal expansion, but for corporate and financial restructuring – effectively, to bail out American and other foreign banks and other creditors.

The squashing of the Asian Monetary Fund is still resented in Asia and many officials have spoken to me angrily about the incident. Three years after the crisis, the countries of East Asia finally got together to begin, quietly, the creation of a more modest version of the Asian Monetary Fund, under the innocuous name of the Chiang Mai Initiative.

THE SECOND ROUND OF MISTAKES: BUMBLING RESTRUCTURING

As the crisis worsened, the need for restructuring became the IMF's new mantra. Banks that had bad loans on their books should be shut down, while companies that owed money should be closed or taken over by their

creditors. The IMF focused on this rather than simply performing the role it was supposed to fill – providing liquidity to finance needed expenditures. Alas, even this focus on restructuring failed, and much of what the IMF did helped push the sinking economies down further.

Financial Systems

The East Asia crisis was, first and foremost, a crisis of the financial system. The financial system can be compared to the brain of the economy. It allocates scarce capital among competing uses by trying to direct it to where it is most effective – in other words, where it yields the highest returns. If the financial system breaks down, firms cannot get the working capital they need to continue existing levels of production, let alone finance expansion through new investment.

A crisis can give rise to a vicious circle wherein banks cut back credit, leading firms to cut back on their production – which in turn leads to lower output and lower incomes. As output and incomes plummet, profits fall and some firms are forced into bankruptcy. When firms declare bankruptcy, banks' balance sheets become weaker and the banks cut back lending even further, exacerbating the economic downturn.

If enough firms fail to repay their loans, banks may even collapse. A collapse of even a single large bank can have disastrous consequences. Financial institutions determine creditworthiness. This information is highly specific, cannot easily be transmitted, and is embedded in the records and institutional memory of the bank. When a bank goes out of business much of the creditworthiness information it has on its borrowers is destroyed, and that information is expensive to recreate.

Even in more advanced countries, a typical small- or medium-sized enterprise may obtain credit from at most two or three banks. When a bank goes out of business, many of its customers have difficulty finding an alternative supplier of credit overnight. In developing countries, finding a new source of funds may be nearly impossible.

Fears of this vicious circle have induced governments to strengthen their financial systems through prudent regulation. Repeatedly, free marketers have bridled against these regulations. When their voices have been heeded the consequences have been disastrous – whether in Chile in 1982 and 1983, in which gross domestic product fell by 13.7 percent and one in five workers was unemployed, or the United States in the Reagan era, where deregulation led to the $200 billion savings and loan debacle.

Recognition of the importance of maintaining credit flows has similarly guided policymakers in trying to deal with the problems of financial restructuring. Fears about the adverse effects of this destruction of informational capital partially explain why the United States closed down very few banks outright during the savings and loan debacle. Even so, that crisis was an important contributing factor to the 1991 recession.

Inducing a Bank Run

Although financial-system weaknesses were pervasive in East Asia and the IMF's rhetoric focused on these weaknesses, the IMF failed to understand how financial markets work and how they affect the rest of the economy. Its crude macro models never embraced a broad picture of financial markets at the aggregate level, but were even more deficient at the firm level, never adequately taking into account the corporate and financial distress to which its so-called stabilization policies contributed so strongly.

IMF teams in East Asia focused on shutting weak banks. There was some basis for their position. Elsewhere, allowing weak banks to continue to operate without tight supervision resulted in their making highly risky loans. All too often, such risky loans turn out to be bad loans, and when the day of reckoning comes, the government faces an even bigger bailout than if the bank had been shut earlier. But the IMF overlooked another critical lesson of the United States savings and loan crisis: the importance of keeping credit flowing.

Its strategy for financial restructuring involved triage – separating the really sick banks from the healthy banks and the ones that were sick but reparable. Banks are required to have a certain ratio of capital to their outstanding loans and other assets; this ratio is termed the capital adequacy ratio. The IMF insisted that banks either shut down or quickly meet this capital adequacy ratio. But this exacerbated the downturn.

When only one bank has a problem, insisting on it meeting its capital adequacy standards makes sense. But when many banks are in trouble, that policy can be disastrous. There are two ways of increasing the ratio of capital to loans: increasing capital or reducing loans. In the midst of a downturn, especially of the magnitude of that in East Asia, it is hard to raise new capital. The alternative is to reduce outstanding loans. But as each bank calls in its loans, more and more firms are put into distress. Without adequate working capital, they are forced to cut back on their production, cutting into the demand for products from other firms. And with more firms in distress, the capital adequacy ratio of banks can even be worsened.

Although financial system weaknesses were pervasive in East Asia and the IMF's rhetoric focused on these weaknesses, it failed to understand how financial markets work and how they affect the rest of the economy.

With a large number of banks shut down, and with those managing to survive unwilling to take on new customers, more businesses found themselves without access to credit. The depreciation of the region's currencies meant that exports should have boomed, as the goods from the region became cheaper by 30 percent or more. But while export volumes increased, they did not increase nearly as much as expected, and for a simple reason: as banks cut back on their lending, firms could not get the working capital required to expand production.

Nowhere was the IMF's lack of understanding of financial markets as evident as in its policies in Indonesia. There, some 16 private banks were closed, and notice was given that other banks might be subsequently shut as well; but depositors, except for those with very small accounts, would be left without a means to recover their assets. Not surprisingly this engendered a run on the remaining

private banks, and deposits were quickly shifted to state banks, which were thought to be protected by an implicit government guarantee. The effects were disastrous, compounding the mistakes in fiscal and monetary policy already discussed, and almost sealing that country's fate.

In contrast, South Korea ignored outside advice, and recapitalized its two largest banks, rather than closing them down. This is part of why Korea recovered relatively quickly.

Riots do not restore business confidence. They drive capital out of a country; they do not attract capital into a country.

Corporate Restructuring

While attention focused on financial restructuring, it was clear that the problems in the financial sector could not be resolved unless the problems in the corporate sector were effectively addressed. With 75 percent of the firms in Indonesia in distress and half of the loans in Thailand classified as nonperforming, the corporate sector was entering a stage of paralysis. Firms facing bankruptcy are in a state of limbo: it is not clear who really owns them, the current owners or the creditors. But without clear owners, there is always a temptation for current management and the old owners to strip assets.

When companies go into bankruptcy in the United States, trustees are appointed by the courts to prevent this. But in Asia there were neither the legal frameworks nor the personnel to implement trusteeships. It was thus imperative that bankruptcies and corporate distress be resolved quickly, before stripping could occur. Unfortunately, the IMF's misguided economics conspired with ideology and special interests to dampen the pace of restructuring.

The IMF's strategy for corporate restructuring was no more successful than its strategy for restructuring banks. It confused financial restructuring with real restructuring – the nuts-and-bolts decisions about what the firm should produce and how. In a massive economic downturn like this one, there were real macro benefits from rapid financial restructuring. It was thus imperative that the government do whatever it could to facilitate a quick resolution.

I took the view that the government should play an active role in pushing this financial restructuring, ensuring that there were real owners at the helm. Once ownership issues were resolved, the new owners could set about the task of deciding the issues of real restructuring. The IMF took the opposite view, saying that the government should not play an active role in financial restructuring, but push for real restructuring – selling assets, for example, to reduce the apparent excess capacity in computer chips in South Korea and bringing in outside (typically foreign) management. I saw no reason to believe that international bureaucrats, trained in macro management, had any special insight into corporate restructuring in general, or the chip industry in particular.

The governments of South Korea and Malaysia took an active role and succeeded in completing the financial restructuring of a

remarkably large fraction of the firms in distress in two years. Restructuring in Thailand, which followed the IMF strategy, languished.

THE MOST GRIEVOUS MISTAKES: RISKING SOCIAL AND POLITICAL TURMOIL

The social and political consequences of mishandling the Asian crisis may never be measured fully. While the IMF had provided some $23 billion to Indonesia to stabilize the exchange rate and bail out creditors, the far, far smaller sums required to help the poor were not forthcoming. The day after food and fuel subsidies for the poor in Indonesia were drastically cut back, riots exploded. As had happened 30 years earlier, Indonesian business executives and their families became the victims. Even if one cared little for those who faced starvation, it was simply bad economics. Riots do not restore business confidence. They drive capital out of a country; they do not attract capital into a country.

After the riots in Indonesia, food subsidies were restored. But again, the IMF showed that it had not learned the lesson of irreversibility. Just as a firm that was bankrupted by the high interest rates does not become unbankrupted when interest rates are lowered, a society that is rendered asunder by cutting out food subsidies is not brought together when the food subsidies are restored. Indeed, in some quarters, the bitterness is all the greater: if the food subsidies could have been afforded, why were they taken away in the first place?

RECOVERY: VINDICATION OF IMF POLICIES?

As this book goes to press many Asian countries are growing again, their recoveries only slightly stalled by the global slowdown that began in 2000. But although some at the IMF believe their interventions were successful, it is widely agreed that serious mistakes were made. The Asian crisis was more severe than it should have been, recovery took longer than it needed to, and prospects for future growth are not what they should be.

There is no true recovery until workers return to their jobs and wages are restored to precrisis levels. Today, incomes in the countries of East Asia affected by the crisis are still 20 percent below what they would have been had their growth continued at the pace of the previous decade. In Indonesia, output in 2000 was still 7.5 percent lower than in 1997, and even Thailand, the IMF's best pupil, had not attained its precrisis output – let alone made up for the lost growth.

This is not the first instance of the IMF declaring victory prematurely – Mexico's crisis in 1995 was declared over as soon as the banks and international lenders started to get repaid. But five years after the crisis, workers were just getting back to where they were beforehand. The very fact that the IMF focuses on financial variables, not on real wages, unemployment, GDP or broader measures of welfare is telling.

The question of how best to manage a recovery is difficult, and the answer clearly depends on the cause of the problem. Sometimes, as in Latin America during the 1970s, crises are caused by governments spending beyond their means. And in those cases, the government will need to cut back expenditures or increase taxes – decisions that are painful, at least in the political sense. But because East Asia had neither loose monetary policies nor profligate public sectors, those were not the right measures for dealing with its crisis.

The problem with the IMF's mistakes is that the consequences are likely to be long lasting. The IMF often talked as if what the economy needed was a good purgative.

According to the IMF, then, a country concerned about its long-run prospects should swallow hard and accept a deep downturn. But the evidence does not support the IMF's theory. An economy that has had a deep recession may grow faster as it recovers, but it never makes up for the lost time.

There is an important implication: the deeper the recession today, the lower output is likely to be for years to come. In a way this is good news, since it means that the best medicine for today's economy and the best medicine for tomorrow's coincide. It implies that economic policy should be directed at minimizing the depth and duration of any economic downturn. Unfortunately, this was neither the intention nor the impact of the IMF prescriptions.

Malaysia and China

Though Prime Minister Mahathir's rhetoric and human rights policies often leave much to be desired, many of his economic policies were a success. Early on in the 1997 crisis, Michael Camdessus, then the IMF chief, announced that Malaysia's banks were in a weak position. He was wrong. While there was a high level of nonperforming loans (15 percent), Malaysia's central bank had imposed strong regulations that had resulted in banks making adequate provisions for these losses. Moreover, Malaysia' strong regulatory stance had protected banks from exposure to the exchange rate risk of borrowing in dollars and lending in ringgit, and had even limited the foreign indebtedness of the companies to which these banks lent.

Few banking systems could survive a long recession, or a depression, and Malaysia's was no exception. But Malaysia's banking system was remarkably strong. Within Malaysia, the issue of the appropriate response to the crisis was hotly debated. The finance minister, Anwar Ibrahim, proposed an IMF program without the IMF – that is, raising interest rates and cutting back on expenditures. Mahathir remained skeptical. Eventually, he dumped his finance minister and reversed his economic policies.

As the regional crisis grew into a global crisis and international capital markets went into a seizure, Mahathir acted again. In September 1998, Malaysia pegged the ringgit at 3.80 to the dollar, cut interest rates, and decreed that all offshore ringgit be repatriated by the end of the month. The government also imposed tight limits on transfers of capital abroad by residents and froze the repatriation of foreign portfolio capital for 12 months.

Some economists – those from Wall Street, joined by the IMF – expected foreign investment to plummet, the stock market to fall, and a black market to form in the ringgit, with its accompanying distortions. And, they warned, while the controls would lead to a drying up of capital inflows, they would be ineffective in stopping capital outflows. Even Treasury Secretary Robert Rubin, usually of such quiet demeanor, joined in the communal tongue-lashing.

In fact, the outcome was far different. Since rapid capital flows into or out of a country cause large disturbances, government has the right – even the obligation – to take measures to address such disturbances. In general, economists believe that market-based interventions like taxes are more effective and have fewer adverse side effects than direct controls. So we at the World Bank encouraged Malaysia to drop direct controls and impose an exit tax.

Malaysia removed the tax one year after the imposition of controls, just as it had promised. In the interim, Malaysia had restructured its banks and corporations. Indeed, it

had made far more progress in that direction than Thailand, which followed the IMF prescriptions.

In retrospect, it was clear that Malaysia's capital controls allowed it to recover more quickly, with a shallower downturn and with a far smaller legacy of national debt to burden future growth. The controls allowed it to have lower interest rates than it could otherwise have had; the lower interest rates meant that fewer firms were put into bankruptcy, and so the magnitude of publicly funded corporate and financial bailout was smaller.

The lower interest rates also meant that recovery could occur with less reliance on fiscal policy, and consequently less government borrowing and less debt. Today, Malaysia stands in a far better position than those countries that took the IMF's advice. There was little evidence that the capital controls discouraged foreign investors. Foreign investment actually increased.

It is no accident that the two large developing countries spared the ravages of the global economic crisis – India and China – both had capital controls. While developing countries with liberalized capital markets actually saw their incomes decline, India's grew at a rate in excess of 5 percent and China's at close to 8 percent. This is all the more remarkable given the overall slowdown in world growth and trade during that period.

China achieved this by following the prescriptions of economic orthodoxy: when faced with an economic downturn, respond with expansionary macroeconomic policy. China seized the opportunity to combine its short-run needs with long-run growth objectives, investing heavily in long-delayed public infrastructure, with high returns.

In making economic policy decisions, China was aware of the link between macro stability and its microeconomy. It knew that it needed to continue restructuring its corporate and financial sector. However, it also recognized that an economic slowdown would make it all the more difficult to proceed with a reform agenda.

Though the differences in individual circumstances make the reasons either for the occurrence of a crisis or for quick recovery hard to ascertain, I think it is no accident that China, the only major East Asian country to avoid the crisis, took a course directly opposite that advocated by the IMF, and that Malaysia, the country with the shortest downturn, also explicitly rejected an IMF strategy.

Korea, Thailand and Indonesia

South Korea and Thailand provide further contrasts. After a short period of vacillation, Thailand followed IMF prescriptions almost to the letter. Yet more than three years after the beginning of the crisis, it was still in recession, with a GDP 2.3 percent below the precrisis level. Little corporate restructuring had taken place, and close to 40 percent of loans were still nonperforming ones.

In contrast, South Korea did not close down banks and the Korean government took an active role in restructuring corporations. Moreover, Korea kept its exchange rate low in order to sustain exports and limit imports. And it did not follow the IMF's advice concerning physical restructuring. The IMF argued that Korea should quickly get rid of the excess capacity in computer chips. Korea ignored this advice, and as the demand for chips recovered, the economy recovered.

In evaluating the recoveries, most analysts put Indonesia aside because its economy has been dominated by political events and social turmoil. However, as we have seen, the political and social turmoil are themselves attributable in no small measure to IMF policies. No one will know whether there could have been

a more graceful transition from Suharto, but few would doubt that it could have been more tumultuous.

Effects on the Future

East Asian countries will undoubtedly develop better financial regulatory systems, and better financial institutions overall. Though its firms had already demonstrated a remarkable ability to compete in the global marketplace, South Korea is likely to emerge with a more competitive economy.

However, the manner in which the crisis was addressed – particularly the use of high interest rates – is likely to affect the region's intermediate, and possibly long-term, economic growth adversely.

While East Asia's banks were far from perfect, their achievements in allocating the enormous flows of capital in preceding decades were, in fact, quite impressive. Although the intention of those pushing for reforms in East Asia was to improve the ability of the financial system to allocate resources, in fact, the IMF's policies are likely to have impaired the overall efficiency of the market.

EXPLAINING THE MISTAKES

While the IMF now agrees it made serious mistakes in a variety of areas, it has not admitted to mistakes in its monetary policy. Nor has it even sought to explain why its models failed to predict the course of events so miserably.

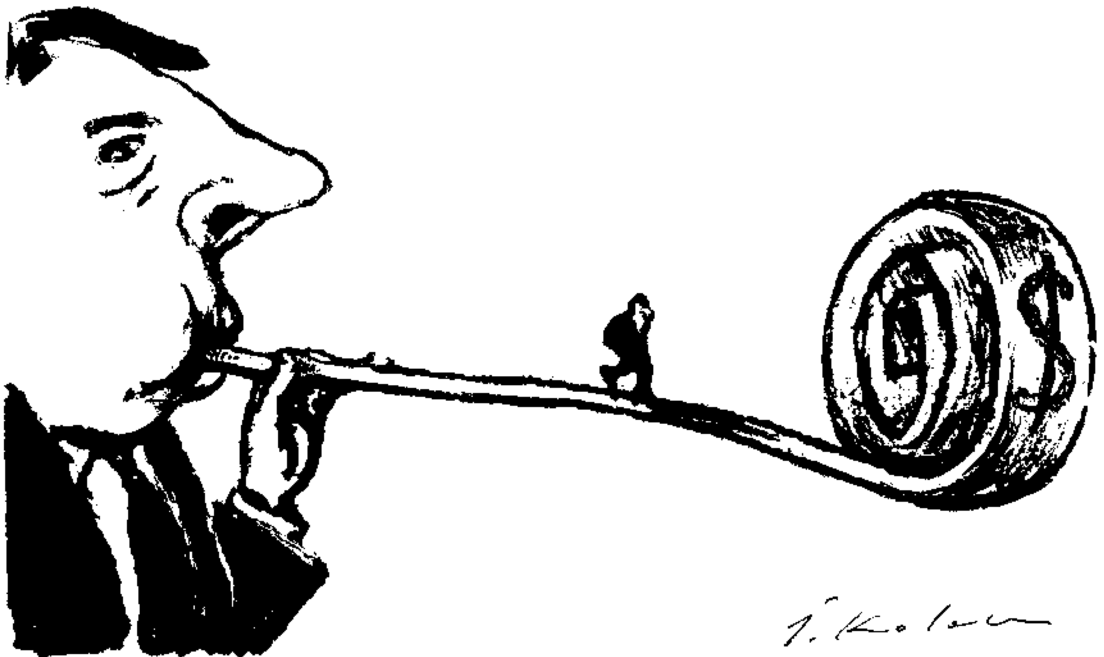
Part of the explanation of the magnitude of the failures has to do with hubris. No one likes to admit a mistake, especially a mistake of this magnitude or with these consequences. Neither Fischer nor Summers, neither Rubin nor Camdessus, wanted to think that their policies were misguided. They stuck to their positions, in spite of overwhelming evidence of their failure.

But in Asia other theories abound, including a conspiracy theory (which I do not share) that views the policies either as a deliberate attempt to weaken East Asia or at least to enhance the incomes of those on Wall Street and the other money centers. One can understand how this line of thinking developed: the IMF first told countries in Asia to open up their markets to hot short-term capital. The countries did it and money flooded in – but just as suddenly flowed out. The IMF then said interest rates should be raised and there should be a fiscal contraction, and a deep recession was induced.

As asset prices plummeted, the IMF urged affected countries to sell their assets, even at bargain basement prices. It said the companies needed solid foreign management, and that this would only happen if the companies were sold to foreigners, not just managed by them.

The sales were handled by the same foreign financial institutions that had pulled out their capital, precipitating the crisis. These banks then got large commissions from their work selling the troubled companies or splitting them up, just as they had when they originally guided the money into the countries in the first place. Some of these American and other financial companies didn't do much restructuring; they just held the assets until the economy recovered, making profits from buying at the fire sale prices and selling at more normal prices.

I don't believe the IMF was participating in a conspiracy, but it was reflecting the interests and ideology of the Western financial community. Secretive modes of operation insulated the institution and its policies from the kind of intensive scrutiny that might have forced it to adopt policies that were appropriate to East Asia.



AN ALTERNATIVE STRATEGY

My critics have rightly asked what I would have done instead. I agreed with the IMF on the importance of financial restructuring. But I would have approached it with the primary objective of maintaining the flow of finance and a standstill on existing debt repayment. A key part of corporate restructuring would entail the implementation of a special bankruptcy provision. United States bankruptcy law allows for relatively quick Chapter 11 reorganization of a firm, rather than liquidation. Bankruptcies induced by macroeconomic disturbances, as in East Asia, call for an even faster resolution – what I call super-Chapter 11.

With or without such a provision, strong intervention of government was required. But the intervention of the government would have aimed at financial restructuring – establishing clear ownership of firms, enabling them to re-enter credit markets. Such financial restructuring did not require huge bailouts. I cannot be sure that my ideas would have worked. But the chance of success with this strategy was far greater than with the IMF's plan, which failed in ways that were perfectly predictable and very costly.

The Asian crisis has brought many changes that will stand the countries in good stead in the future. Corporate governance and accounting standards have improved – in some cases bringing these countries to the top of the emerging markets. The new constitution in Thailand promises a level of transparency certainly beyond that of the international financial institutions. But the way the IMF approached the crisis has left a legacy of private and public debt. Capital markets will work less efficiently and the growth of living standards will be slowed. Indeed, the IMF policies in East Asia had exactly the consequences that have brought globalization under attack.